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LAND PLANNING AND THE PROPERTY TAX

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Land planners concern themselves with the relations among the uses to which independent private owners put their land. These private owners are largely seeking to maximize their individual net welfare after taxes. Taxes being a large fraction of all costs, their after-tax welfare is quite different from their before-tax welfare. So public land planners seeking to nudge private landowners must perforce be tax planners.

Land planners generally have been tax planners in at least a passive sense: their expectation of private response to public initiative has been based on experience, which in turn has reflected landowners' tax avoidance. Some planners have grumbled at individual tax avoidance, as though it were immoral and should go away--not a very realistic approach. Others have sweepingly condemned the entire market mechanism--a "rush to judgment" that might be tempered when we consider to what extent the sad performance of the market results from avoidance of ineptly imposed tax costs. Still others have supported tax abatement to relieve the pressure to develop suburban land--without, I believe, adequately considering that unused land lies among used parcels and disrupts their symbiotic interactions, which are the heart of public land planning and the essence of urban civilization. Yet others have foundered by expecting, private landowners to respond to, and fill in, the empty niches in grand plans much more rapidly than the Great American Land Speculator is wont to do.

To be most effective, land planners must become tax planners in a more positive sense. Collectively, they need to support national reform of the income tax as it bears on land development. Our theme today is what they can do locally through property tax laws and assessment procedures.

Land planning amends and guides the market, but it is not at war with the market. On the contrary, effective public land planning presupposes a well-oiled land market. The planner, through his influence on zoning and street layout and other public constraints, presents each landowner with a sort of environmental challenge: he hopes the landowner will respond constructively. The planner provides avenues of linkage by which landowners may relate to one another: he hopes they will use those avenues. The market motivates them. On the whole, the highest use of a site is that which most relates to and complements uses on other sites. That is what cities are all about. Planners are often preoccupied with minimizing the conflicts between neighbors, which calls for minor departures from the most lucrative use; but it must not blind us to the overriding value of symbiosis among neighbors. This is the first concern of land planning; it is also the first concern of the self-helping landowner. The worst nuisance a central landowner can commit is passive withdrawal of his land from the life of the city, right where it gets in everyone's way. The market, if he listens, tells him to participate instead.

Capital and people compactly grouped, and with good mutual access provided by quality planning, interact synergistically to produce a large surplus above cost. The whole is greater than the sum of its parts: that is "synergism." Planning and the market work together to maximize synergism.

Another function of the land market is in the development of new areas, or redevelopment when new uses succeed old, to synchronize the interdependent private investments that interact synergistically to produce a total community. Thus as a city expands, high land values at the perimeter put simultaneous pressure on all owners there to convert to urban use. Were this mechanism in good working order, planners could extend city services to compact increments of land, sizing utility lines and streets initially for the ultimate demand, secure in the knowledge that the ultimate demand would be there in short order. Private builders could orient their plans to a more certain future, minimizing the transition costs of, for example, shifting from wells and septic tanks to public water and sewers. Every private improvement could be less self-sufficient and more oriented to the prospect of a total community.

But the market is not in good working order. Taxation intercedes in the market process. Every piece of land is periodically up for grabs, where there is some "sacrament" in its life, such as demolition and construction, sale, subdivision or assembly. It is then in press among competing buyers, uses, densities, timings, parcel sizes, etc. In every such press, taxation biases the choice in favor of the lighter taxed use. The real estate tax on buildings thus always favors old over new; gas stations over apartments; tank farms over factories; parking lots over parking structures; high income residences over low (yes the high income residences are usually less intensive); billboards over offices; unused land over improved; waiting over acting. By this bias it has half-destroyed the market as an arbiter among competing land uses, and an agency promoting urban synergism. It has lowered the density, retarded the renewal, and broken up the integral linkages of the central city, fostering in their place random scattering of new buildings at the outskirts. It has so far impaired the city's function of linking small independent industrial firms as to bear large responsibility for today's onrushing merger movement in which a key word is--synergism! Firms seek through merger and vertical integration the access to services, labor and supplies which in a well-ordered city they could get from independent firms through the market.

I do not propose that we eliminate taxes. The public needs money. I do submit that it is not necessary for real estate taxes to impair the market. The trick is to modify the definition of the tax base.

In general, government can tax something; or subsidize it; or leave it alone. It is not news that we can foster a particular thing by subsidizing it; or just leaving it alone, untaxed. It is news when we can tax something and not damage it. It is even better news when we can tax something and, by taxing, actually foster and promote it as though we were subsidizing it. Impossible? Read on. That is the news--the technique is within our grasp.

The technique is simply to redefine the real estate tax base as land value alone. Value at any time is what the land if bare would sell for. It is value in the best alternative use, the economist's "opportunity cost." It is independent of present use or ownership. It changes year by year, usually gradually as demands and neighborhoods change, or as anticipated public improvements, long since foreseen and discounted into values, are completed. It is very dependent on the things that planners plan, and is in large part the product of good planning and its implementation--Alfred Marshall called it "the public value of land," in reference to its origin. A proper assessment of land changes in step with the outside determinants, ignoring the specific response that individual landowners make to the challenge that planning gives them. They are taxed not for the good they do, but for the opportunity society gives them.

Some worry that "exempting buildings" will reduce the tax base. But as much tax money may be raised from real estate this way as from the present approach. Essentially the same real estate is being taxed--just differently. Both are alternative means of asserting the public equity in its royal estate. The main difference is that one method is adroit, the other clumsy.

The real estate tax modified in this way would help planners with many of the problems that now seem so intractable, and so ominous in their implications for the future. In my limited time I will focus on one, the problem of slow urban renewal. Few would deny that the market has failed to renew our cities fast enough. For this, the real estate tax, bearing differentially as it does on new buildings, must shoulder much of the blame.

The economical time for an individual to clear and renew land is when the current cash flow from the existing or "defender" use ceases to yield a fair return on the "scrap value" of the site in the most eligible succeeding use, the "challenger." This scrap value is the present value of future income less the present value of future costs.*

The land-based tax is neutral in this decision, because it is unmoved by the act of renewal: it is the same on the defender as the challenger, whatever these might be. The building-based tax is unneutral because it skyrockets upward when the new succeeds the old. It weakens the challenger vis-à-vis the defender, by the amount of the tax increase. Not only is the new building valued higher than the old: often assessors seize this occasion to reassess the land upwards, adding to the bias against UNsubsidized renewal.

The general qualitative direction of the bias is clear, and I have said that before. Today I bring a partial progress report on some quantitative analysis.

The actual number of years by which building taxes retard site renewal depends, among other things, on how the cash flow from old buildings drops

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* For more detail on this, see my "Property Taxes and the Frequency of Urban Renewal," Proceedings of the 57th National Tax Conference, Pittsburgh, Pa., September 14-17, 1964, pp. 272-285.

off. If it plummets steeply, then renewal dates are largely preordained by non-tax factors, and the importance of tax policy is minimal. If it tails off only gradually, a substantial tax bias against new buildings retards by decades the renewal of each site regarded individually; and of neighborhoods and school districts by more than that as the non-renewal of each site robs neighboring sites of their renewability, and suppresses competition from new buildings which would pull tenants from old defenders.

On this question I have consulted a number of time series showing historical income experience of commercial buildings. The raw data were originally gathered and published by Leo Grebler, Fred Case, and Lou Winnick.* I have deflated them for price level changes. They are much affected by cycles of depression and war.

The detail and trend adjustments I will publish next spring. The general time pattern and period of drop-off is clear enough, however. Real income from old buildings dwindles away only slowly over many decades, in spite of depreciation and obsolescence. There is no sharp cut-off, no predestined date of demolition determined by technology or taste. Even when an old building has gone vacant, it may come back. After World War II real income of many buildings rose sharply.

Another source of data is the Institute of Real Estate Management "Experience Exchange" among members of the N.A.R.E.B. Their 1069 respondents in 1967 reported on operating ratios (total expenses including real estate taxes divided by total actual collections) for apartment buildings classified by age groups. For elevator apartments the ratio rose gently from 45% for 1961-66 birthdays to only 59% for all buildings over 47 years old, i.e., pre-1920.** For low rise apartments it was from 41% to 58%; for garden apartments from 40% to a mere 48%. (Op. cit., pp. 25, 39, 53.) In other words, almost half the gross collections from old apartments represent net income to the owner. A powerful factor helping hold down these operating ratios is, of course, the fact that

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* Leo Grebler, Experience in Urban Real Estate Investment (New York: Columbia University Press, 1955; Fred Case, A Study of Investment Experience. L. Grebler, Fred Case, and Louis Winnick, Rental Housing: Opportunities for Private Investment (New York: ACTION).

** Institute of Real Estate Management, Experience Exchange Committee, Apartment Building Income Expense Analysis (Chicago: I.R.E.M. of the N.A.R.E.B., 1967), p. 11.

while real operating expenses are rising, real estate tax expenses keep falling as a building ages.

A third source is a recent survey of Milwaukee County by the Wisconsin Apartment Owners' Association. These data yield consistent results.

Measured in years, therefore, the fiscal deterrent to urban renewal--that is, the threat of increased taxes on new buildings--retards the renewal of the individual urban site by decades. I could give you a precise number of years, based on, say, Milwaukee's present real tax rate of 3.3%; but it would be a false precision, since it would be based on the individual site without consideration of neighborhood and aggregate effects. So let's just say the effect on the individual taken by himself is very large; and then look qualitatively at the extended effects on neighborhoods.

The renewal of one site speeds the renewal of nearby sites in at least three ways. First, it raises the renewal or challenger value of nearby land. One new building gives heart to the potential builders of others, who naturally prefer new buildings for neighbors. Slum environs can virtually destroy the renewal value of land, a problem often noted. One or a few sound new buildings for inspiration can support supplemental and complementary renewal round about. The new GM building on 5th Avenue is reported by Fortune to have doubled floorspace rentals across the street.

This, of course, raises the negative possibility that new buildings strengthen adjacent defender values as much as challenger values. There are frequent complaints that successful urban renewal projects, for example, raise the cost of nearby land for the next project. However, these higher land "costs" are merely asking prices probably based on higher anticipated challenger values plus the knowledge that Federal funds are on tap to buy. They do not necessarily or probably in general represent higher defender cash flows.

The reason is that new buildings pull tenants from old, weakening defenders. This is especially true when the new buildings are at higher density than what they replace--something which building taxes also discourage--and so represent a clear net addition to supply. Where tenants have a choice they will naturally move to newer quarters, leaving finally at the bottom the weakest defender to be demolished. Its successor then pulls tenants from others, repeating the cycle. In the right conditions the reverberations from one new structure can resound through several rounds of induced renewal.

Milwaukee in the last eight years happens to represent the most graphic demonstration of the ramifying effects that may flow from just one new building. Through a long series of historical accidents and legal technicalities, Wisconsin had an Assessment Freeze law that proved unconstitutional after being used essentially just once--for the Marine Plaza in 1960, a high rise office and bank building. It was the first downtown building of consequence in 30 years. It pulled tenants from everyone else's building, forcing a wave of remodeling and renewal, still in progress, which has changed the face of a badly dejected downtown. By general consent, this one new competitor set off the chain reaction. There is leverage. There is power. There is a multiplier the like of which few other economic processes approach.

It is not that this one shot alone was enough. The ripples are dying out, long before the job is done. But the point is if one original cause can ramify so far, even though every induced new building was fully taxed, think what, say, twenty original causes would do, if every induced new building were to be tax free. It gives a person pause.

A third way that renewal reinforces itself is through the higher income that it brings. Renewal means capital inflow, construction payrolls, materials sales, and so on. This pushes up local income levels. Now new buildings are "superior goods." The higher the local income, the greater the premium paid for new over old floor space, and the stronger are challengers relative to defenders.

So neighborhood and aggregate effects multiply the good done by each new building; conversely, of course, they multiply the damage from the present tax policy, which defers renewal.

But neighborhood effects are not the whole of the story of multiplied effects from taxing challengers more than defenders. Consider that most building is done on borrowed money. We live in a world of credit ratings, cash flows, cash squeezes, and leverage, matters bandied about in the business school but too often underweighted in economic analysis. A tax on new buildings, coupled with low taxes on old, weakens the credit of challengers and strengthens that of defenders.

A tax on new buildings is at its maximum in the early years, the time of tightest cash squeeze. A good stiff property tax rate these days will take 20% or more of gross income from a new building. If other expenses take 30%, that is 2/7 of the net operating income. If the entrepreneur is highly leveraged--and today, who is not?--most of the rest of net operating income goes to debt service. The "nut" remaining for the entrepreneur then, especially during the early cash squeeze, is doubly leveraged, so a small rise of building taxes can wipe him out.

His credit rating in turn is leveraged by the prospects for his equity position. It is a familiar fact that a small rise of mortgage rates causes a large drop in building. Loanable funds rush out of building, not just because borrowers balk at higher rates, but lenders have to lower everyone's credit rating because of lower equity income. Real estate taxes on new buildings add to costs in the same way as interest rates--i.e., they are a fixed percent of value. A 3% of true value property tax rate hits new building with the impact of a rise of mortgage rates from 4% to 7%--except that the real estate tax is worse because the tax rate applies to the whole value while mortgage rates apply only to the debt. The tax not only defers renewal by its simple direct impact, but additionally by its leveraged effect on entrepreneur net cash flow and thence on credit ratings.

So we are talking powerful medicine when we discuss conversion of the real estate tax base to the site value basis. Next spring I will publish a study I am completing comparing challenger and defender values in Milwaukee County. The study is finding that a small rise of challenger values over defender values would cause 20% of the central city to be renewed forthwith; and that the large change resulting from a full exemption of buildings from real estate tax would cause some 50% to be renewed--<u>if</u> the labor and money could be found to do it.

Again, these results would be magnified by consideration of neighborhood effects. I will not labor that point further now. They would be magnified again by consideration of the positive effect of cash squeeze on defenders. So far I have just talked of exempting new buildings. But the land basis of real estate taxation does more than that. It raises taxes on defenders. The result is a potent cash squeeze effect. Today's real estate tax puts the squeeze on builders. The proposed land tax puts it on defenders and assorted holdouts of land. One of our Milwaukee tax assessors said to me this spring, "If anyone thinks the land tax is neutral he should just follow me around a few months and see what happens to land after we raise the assessment." He leaves a trail behind him--at first, perhaps, of wreckage, but soon of new construction. He is not untaxing new buildings: he is just uptaxing land. Nothing moves a holdout like a cash squeeze. It gets results.

So powerful is the medicine that, once it is understood, opposition may be expected, not from those who say it won't work, but from those who complain it will work too well, will destroy historical antiquities, flood the market, jeopardize collateral values, lower rents, change the character of neighborhoods, sacrifice tradition to progress, overstimulate the economy, encourage immigration, dilute the aborigines, spoil the fishing, change voting patterns, weaken old ethnic ties, and generally scare the daylights out of those who fear change and abundance. I will not try to answer all these points. Nor will I try to answer the descendants of Dr. Pangloss, who would have us do no good thing locally without first tracing its possible effects on the equilibrium of the whole wide world; but refer them to Candide and his splendid decision to cultivate his own garden well. But I do have a few words of comfort, or perhaps challenge, for planners who might be concerned that the proposal to unleash the full force of the free market is also a proposal to substitute the market for planners.

The unleashed market can solve some problems that now divert planners. It can bring urban renewal; group complementary land uses; promote low income housing; contain sprawl; attract an economic base; and weed out the worst generators of fiscal net deficits, old buildings. But on the whole, the land tax proposal implies for planners much more need and responsibility. Indeed, it gives planning so much more force than now as to frighten me a little about whether planners are prepared to exercise so much power and assume so much leadership. This is the challenge for planners. Let us enumerate the ways that land value taxation supports and presupposes good public planning.

a. It gives planners a positive tool for influencing private land use, where now they have largely powers to say "Nay." When they designate an area for development, direct routes and utilities there, and zone it for its new use--up go land taxes, cash-squeezing the landowner into early attention to his new opportunities. Further, since high-use zoning is exploited quickly, there need be no great surplus of it scattered about, as today. It remains tight, and retains its power to shape land use. So also for advantageous locations along the public roads--which incidentally cost much more to produce than zoning, and if produced in surplus because of non-development, as they are today, require the most egregious waste of public capital.

Some no doubt will even regard land taxation as a form of tyranny by planners over landowners. But note the limits to the planner's power. He does not direct a landowner to put his land to a specific use. Nor is there usually just one "highest and best" use of a given site, to which every landowner will be forced. Thriving cities are not characterized by monoculture and monotony, but by variety, constant change, and complementation. Whatever is the highest use in a neighborhood, say elevator apartments, is supplied in abundance until the need for another one is no greater than the need for some complement like a grocery store or parking structure. Thus, an equilibrium generally prevails at any time which affords each landowner several options. Within limits he may do "his own thing."

So the land tax does not turn the planner into an overcentralized administrator or petty tyrant dictating specifics where he should be delegating authority. Rather, it sets a generalized performance standard, cutting off options beyond a certain degree of slothfulness, and disregard for the public cost of giving land its latent value; but leaving wide latitude for individual discretion.

b. The land tax gives public investment great leverage over private. Today it is the reverse. Within wide limits, public roads and regulated utilities and the mailman and school bus will follow you wherever you choose to locate. The regional planning commission uses traffic counts to plan bigger roads, following the lead of private emigrés. It may not be true that Cadillacs are double-counted, but these outreaching roads do seem to have a nose for wealth and power.

The land tax lets public planners take the initiative, if they will. The city extends roads and sewers a reasonable way, and then raises taxes on the land. The cash squeeze conveys the message, "Bring me roofs to match my roadways."

We have seen that individual building in new neighborhoods needs synchronization, because of synergistic interdependence. Where the community of small independent entrepreneurs lacks synchronization it is hard put to compete with giant developers of integrated centers and whole towns, who control entire new communities centrally. To compete, the public needs a community synchronizer. This the land tax affords. The planner doesn't try to play every instrument in the orchestra, but the land tax lets him set the tempo.

But how this puts the conductor on his mettle! The man with the baton had better set the right beat, for everyone knows who he is. From our objective view of administration, of course, that is very good. From the viewpoint of a profession still a stranger to power it may present certain terrors. There's no hiding place up there. Will you be ready when the great day comes?

c. The land tax gives planners some leverage over tax assessors. Now, assessors are preoccupied assessing building values accurately--as though it made much difference. Then, they would assess site potential, the thing that planners play such a major role in determining.

d. Synchronized expansion lets planners plan for open space. Today, open space is a by-product of land speculation. It seems folly to plan public open space when private owners are supplying too much anyway. Result: in transition zones we get fenced open space that the public can pine for but not enter. This is institutionalized frustration, a staged tease that could only satisfy a generation of voyeurists. And like the tease show, it is transitory. When the landowner is ready for cash, the space is closed.

The land tax system lets transition be quick and orderly. Knowing the ultimate density the planner can provide parks in optimal measured amounts and sizes to the end that settlement be not crowded, but unsprawled. By using tax pressure to assure early compact use of residential land, he relieves the pressure to invade the measured open land.

With such power in hand, planners can even retain economists to measure the benefits and costs of open space. It is high time we introduce rational management and optimization into a topic now more freighted with blithering alarmism, hoarding neurosis, sloppy sentimentality, camouflaged race prejudice, roaring misanthropy, opinionated claptrap, opportunistic tax-dodging and prostituted nature-worship than any twelve others I can think of.

e. The land tax system shortens the period between site renewals. Every site renewal is another occasion to plan, and to plan ambitiously, excitingly, not just for rehabilitation but from the ground up. The public planner can go further. He can synchronize demolitions and replat the ground itself--something we had better get around to more often if our older city layouts are to avoid utter obsolescence.

f. The land tax system helps free planners from the constraint which I will call "French equity." I allude to the concept of equity, characteristically French, that every man's share of land should be made equal, regardless of social cost; that the object of the institution of property is not good land use but distributive equity. In city planning that means what you do for Jacque's land you must also do for Pierre's, and all their cousins, at least within the charmed circle of property; and you'd better not do anything negative to anybody's land. We have some mystical welfare economists who write abstruse theories along those lines, too, although I doubt they ever studied the effects of <u>parcellement</u> on French farming, or the <u>liberum veto</u> on the survival of Poland.

Efficiency, of course, calls for neighborhood specialization and differentiation, with high values for some and low for others. The land tax uses the fiscal and monetary mechanism to compensate the losers from the gains of the winners. Those who get the high unit values also get th high tax bills--<u>not</u> because of what they do for themselves, but for the unearned value the city planner has sent them. Thus liberated from the tyranny of pettiness, the planner can relocate things and maximize net urban welfare on a much grander scale than now.

g. Finally, the land tax system leads to demand for a greater variety of community facilities. That is because it gives people better mutual access. It reduces autarky of individual landowners. It obviates vertical integration by individual firms. It increases interdependence. It fosters more linkages of all kinds: social, commercial, industrial, political, cultural. It puts more load, therefore, on the linkage mechanism--the sector of the city that planners plan.

To be sure, it greatly shortens the linkage network, because orderly, unsprawled settlement lets people live closer, reducing the travel required for any given degree of linkage. Furthermore, it untaxes elevators and utility cores in private buildings and so lets private capital develop the third dimension of the linkage network, reducing the need for public capital. But the public capital released from the street grid, and the planning talent liberated from this single-minded preoccupation, have higher and varied uses. They can:

-- clean up air and water

-- set up mass transit

-- sewer the septic-tank suburbs, and enlarge the inadequate central lines

-- build a community house; a central mall and plaza; a Tivoli Gardens; a trade fair; an auditorium; arena; stadium; art center; zoo; gymnasium; pool; theatre; marina; museum; library--what's yours?

Reviewing those seven challenges for planners, I must plead innocent of plotting their obsolescence and disemployment. Rather, I am moved to ask, with the Joseph Schlitz Brewing Company, "How much boldness can you handle?"