



Tax Policies and Downtown

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as to whether or not there would be a market for the property, and whether the community could afford its financial share. An example is the Mission district in downtown Los Angeles, where the problem is the relocation of a transient group for which facilities are not available. Each community may have conditions which would warrant a "feasibility survey" in order to determine whether an in-depth planning procedure anticipating urban renewal is feasible; questions such as relocation, market, or financial soundness can be studied. We also have beautification programs, demolition type programs, and public improvements for basic water and sewer facilities.

A final program to which I refer and for which funds may be shortly available from Congress is the *Neighborhood Development Program*, in which, if a community has a general plan, funding from HUD may be available on a year to year basis so that improvements may begin at once and carried as far as possible annually, analyzing, each year, the requirements for the following year.

My role and that of HUD is not to convince you that you should use any of these financial programs. Our role is to show you what Congress has made available, but not necessarily to stimulate you to use it. These are tools available to local communities. The UCI-Project 21 Report suggested the economic market study and I have mentioned our Section 701 program as a vehicle. The Report mentions the need for planning and development of adequate parking in Orange County. The renewal process I have described may be employed for the accumulation of sizable amounts of land to provide parking on the 2/3 or 3/4 basis of sharing costs.

The UCI-Project 21 Report correctly cautions against piecemeal measures. I could stipulate any number of instances in which such approaches were so ineffective they were hardly worth considering: piecemeal malls for example. On the other hand, the Fresno mall, which did receive financial assistance from the government, was successful because of the complete treatment it received.

The federal government neither has nor should have the authority to initiate these programs. Local governments should, however, acquaint themselves with the various tools that are available before it becomes too late to make essential and vital improvements. I could list dozens of places in which delayed action resulted in the loss of values which could have been obtained had the opportunity been

grasped in time. Local leaders should take a hard look at their reasons for waiting. The opportunities offer great flexibility to meet the needs of most communities and we in HUD are available to assist you in such manner as you may see fit.

TAX POLICIES AND DOWNTOWN

M. Mason Gaffney

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One measure of the importance of property taxation is to add up the stream of taxes a building will pay over its life and reduce it to a present value for comparison with the cost of the building. I have done this with Milwaukee county using a 5% rate of discount and our tax rate which is now 4.1%. It results in a 68% value tax, by which I mean, if this tax were all levied in one lump sum at the time building was constructed, it would equal 68% of the cost of the construction. It is a consequential factor. It is less here because of lower tax rates, but your rates will increase as your cities get older, and you have to face up to the high infrastructure costs of your sprawl. You already depend more on state aid than any other state, and probably cannot expect additional "relief" from that source.

Results of Taxes on Improvements

Older cities throughout the United States are threatened with a kind of vicious circle related to property taxation. Older buildings tend to become fiscal "deficit generators". As they fall in value, they yield less in taxes but consume as much, and frequently more, in public services. As the city ages the higher percentage of old buildings requires the city to raise its tax rate. As the property tax rate rises the city becomes relatively less attractive to investors seeking sites to plant new capital. Whoever puts up a new building becomes a fiscal "surplus generator", which means that he is carrying all the older

properties which are "deficit generators". This is unattractive, and investors may easily find other jurisdictions where the average age of buildings is newer, or where there are other assets, such as oil wells, to carry the fiscal load.

In today's condition of credit crunch and extremely high interest rates, nation-wide competition for capital is even more severe and this factor increases in importance. If a city fails to attract new industry, and loses existing industry, it loses its employment base and is left with a higher percentage of unemployment, higher percentage of welfare cases, and older houses which yield little tax revenue. In response to this loss of tax income, cities elect to cut services and in turn lose population and industry because municipal services are essentially productive.

Advantages of the Land Base Tax

What cities need to pull themselves out of this mess is a way to raise tax revenues without imposing a tax burden. There are two ways out of this. One is for cities to get more from the state and federal governments, which effort will be aided by the recent reapportionment of state legislatures and the corresponding impact on state and federal policy benefiting cities by contrast to the rural bloc. A preferred approach is for cities and state legislatures to give major attention to the property tax, to give it the character of a tax which raises revenues without imposing burdens. This may be done in a surprisingly simple way, by converting it to the land base, and exempting or reducing the rates on buildings. Though quite unpopular for some time, interest in this approach is increasing at a remarkable rate, and the State of Hawaii and the City of Pittsburgh have experimented with it. The State of Missouri has a tax abatement law whereby, under the proper circumstances, buildings can be exempt from taxes for twenty years.

By exempting new buildings and raising property taxes from the land base, two things the city needs — a high level of services and a low tax burden — are no longer in opposition. The city can have both at once if it raises taxes from land. The reason for this is the peculiar nature of land: its immobility. You can "tax the hell" — a technical term we use in higher economics — out of land, and not one square foot will get up and walk out of town. It does not, therefore, stifle enterprise to levy a heavy tax on this base. What stifles enterprise is not how high a tax is, but rather how the tax

varies when the taxpayer acts enterprisingly; e.g., constructing a building.

Exempting buildings and levying the tax on land will not reduce the tax base. When you levy the real estate tax on the basis of land value rather than on land and building combined, you are really taxing the same real estate. You are simply taxing it a different way; on a flat rate basis where the amount of tax each year is not contingent on what the landowner does. Rather, it is contingent on what he might do as expressed by the market value of the land. This, in turn, is determined by the market's appraisal of its highest and best use.

A tax on buildings falls nominally on the person who puts up the capital. However, it is shifted because capital is migratory. The investor does not have to accept a lower rate of return, after taxes, in one jurisdiction than in another, simply because of a higher tax rate. He will want the same rate of return, after taxes, in each jurisdiction, and therefore, does not bear the part of the property tax that falls on buildings.

For a long time economists have said that this tax was shifted to tenants in the form of higher rents, through the intermediary steps of a reduced supply of buildings. However, tenants are also mobile; increasingly so in the age of auto-mobility. This leaves land as the only immobile factor, the factor which is fastened to a taxing jurisdiction, to bear the ultimate burden of any tax which is imposed locally. Conversely, to remove taxes from buildings makes more valuable that land on which those buildings, the untaxed buildings, might be placed. So to remove or abate the local tax on buildings makes the land worth more. Higher land value is the tax base to correspond to what you lose by untaxing the building. This is not only an interesting theory; we have the experience of Sydney, Australia, to prove it. Sydney is the world's second largest market for the OTIS Elevator Company. It has not taxed buildings for years. It levies its entire local real estate tax on the basis of what they call unimproved capital value, and land values are very high.

The exemption of new buildings from taxation should actually increase the tax base. For this there are a number of reasons. First, removing the tax from new buildings will encourage the replacement of old by new. New buildings generate what we economists like to call "external economies", "spill-over" or just simply "neighborhood improvement". Conversely, old buildings tend to sterilize the

neighborhood when they become slums. When the neighborhood becomes unattractive no one wishes to build there, no one wants to buy there, and property values go down. The tax base goes down and renewability of each individual site declines.

New buildings make a neighborhood more attractive. They create land values, and I use the phrase deliberately. No one creates land, of course, in the sense of area, but we do create land values. Almost every positive improvement or human action generates "spill-over" benefits which are captured in the rent and capitalized into the value of the land.

A second way in which the removal of taxes from new buildings should increase the tax base is to remove what the economists like to call the "excess burden of indirect taxation". By "excess burden" economists mean a cost to the taxpayer greater than the benefit to the tax collector. This is represented by investment which is *not* made, the marginal increment of quality which is *not* put on to a building because of the anticipation of taxes. We may think of this in terms of building heights. If, in the absence of taxes, a building would be thirty stories high, almost certainly the thirtieth story is marginal. It just barely pays its cost. It yields no surplus above cost, no rent that is, to the land. If we impose a property tax on this new building which, over the years, is the equivalent to 45% of the building cost, the thirtieth story, which is marginal without taxes, becomes submarginal and the marginal story goes down to the fifteenth or the twelfth. All that incremental height, which would be economically feasible in the absence of taxes and would yield a surplus above cost capitalized into land value, is destroyed before it is built. This is "excess burden".

Land Base Tax Encourages Urban Renewal

The same notion can be applied to the date at which buildings are built. There is a marginal date to renew a site. That is, the date when the existing use — let us call it the "defender" — is yielding an income which is just great enough to cover the interest on the capital value of the site in its alternative future use. Let us call this the "challenger". Now, the date which is optimal for renewal in the absence of taxes becomes distinctly premature if the challenger must bear a tax burden which adds almost 50% to its cost. Some calculations in Milwaukee indicate that the renewal of the average site around the downtown is postponed some thirty years by virtue of this factor. Since rent deferred is rent denied, this is a serious loss.

It also means deferred tax base which means deferred taxes. Since money doubles about every ten years at compound interest these days (at 7%), it is a significant factor.

A good way to perceive this concept of "excess burden" is that there are two equities in every piece of land. There is a private equity expressed in the income the private owner receives, and there is the public equity expressed through taxation. The interest of the private owner is to maximize the private equity. Only by accident will he maximize the public equity. He does not necessarily try to minimize that, but he certainly does not try to maximize it. A good tax is one set up in such a way that the individual, in pursuing his own self-interest and maximizing his own equity in land, also maximizes public equity. The property tax on buildings does not work that way. Public equity is held down and deferred by the private owner in seeking to maximize his own equity. The site value tax, on the other hand, lets no one reduce the public equity by underimproving.

A third benefit is to reduce public costs. This will reduce the need for a tax base. This might best be viewed as adding a third dimension to all the distribution systems of the city. That is, when private individuals improve their own sites and develop the third dimension by putting in elevators, pipes, conduits, wires, they are in effect developing a third dimension of the distribution system of the city. When you add space to a city by going up another ten feet instead of out another ten miles, you obviate a great additional load on the organism's horizontal circulatory network, at a small cost.

Another kind of public cost that is obviously reduced by faster renewal is welfare costs. Any concern that we dump welfare problems on other cities by renewing old sites is allayed by asking what might happen if everyone did it. If every city renewed itself, we would not have less housing, we would have more. We would simply upgrade the total supply, thereby providing better housing for the rich, the middle income *and* the poor.

I would like to contrast my proposal with the federally subsidized urban renewal approach. One result of the policy of urban renewal has been to add each year to our inventory of land which has been cleared but not yet renewed, a process which has generated much resentment against renewal and given some substance to charges of Negro removal and dumping of welfare clients on the rest of society. Exempting new buildings from taxation, on the other hand,

encourages the demolition of old buildings, not to sterilize the land and hold it unused, but only to salvage the land underneath the old building for *immediate* renewal. The most effective opposition to the tax suggestion I am making comes not from those who are worried about dumping welfare cases, but rather from those who are worried about flooding the market with new housing that would pull tenants away from old buildings, new offices that would pull tenants away from old offices and stores.

The Advantages of Urban Concentration

Finally, in terms of increasing the tax base there is a factor which I will call urban "synergism". I use the word because it is "in" this year. We used to call it the economies of urban "agglomeration". The individual who improves his property does not deliberately set out to enhance the welfare of his neighbors, but he does so and they do the same for him. "Synergism" is familiar, of course, in the operation of every large land developer. He improves one part of his property to enhance the productive potential of another part of it. If cities are to be effective agencies in competition with giant land owners, the city needs to use this "synergism" premise more or less consciously. The city is the agency which can coordinate the interdependent activities of the people through the wise use of city planning and tax policy to cause the development of one part of town to strengthen another part of town.

There is a logical fear that to remove taxes from new buildings would encourage the immigration of marginal capital and even marginal people who dilute a fixed tax base. Actually, the immigration of these marginal people adds to the tax base, pro rata, more than it adds to the tax burdens. That is "synergism". One thing these marginal people do is to share the common costs of those facilities that need a large market. One aspect is the process of distribution. The city may be regarded as a distributive organism. The streets and the wires and the pipes are circulatory systems. It is the nature of almost all of these parts of the circulatory system that unit cost falls with volume, but increases with distance. That is to say the more people you have within a given area the less is the cost of distributing all those services produced in central plants. By focusing more people near these we justify investments in improving them. We justify transportation firms in increasing the frequency of services which they render. A larger community can support symphonies and ball teams, sellers catering to small percentages of

the population, even minority and individual tastes. In a larger city, buildings can be used during their life span by several occupants, and not be left abandoned as orphans in an isolated location when the original owner is through with them.

Access is the key to urban value, and access is mutual. Buyers attract sellers. Sellers attract buyers. This makes an environment particularly attractive to small businesses, which are both buyers and sellers. They make fractional and intermittent use of the cities' infrastructure. The city provides them with many services that they cannot afford to provide for themselves because of their limited capital and their limited volume: a pool of trained and specialized labor, industrial supply and services, subcontracting opportunities, rental space, marketing facilities.

There is no end to "synergism". The best way to grasp it I think is to go through the Yellow Pages. You will be amazed how much you didn't know about the intricate way in which the parts of your city and your community articulate. All of this was nicely summed up by Adam Smith two hundred years ago when he noted the division of labor is limited by the extent of the market.

A new idea, such as the land base tax, generally goes through three stages. Stage one: too ridiculous to even consider. Stage two: it threatens to undermine the foundation of the Republic. Stage three: everyone has always known it. Now, the idea I have been discussing reverses the sequence. It began in stage two. Many of us had our first introduction to it when it was known as a wild idea. In the last twenty to thirty years, it has been in stage one, too ridiculous even to consider. Now, it is moving rapidly into stage three. It is not going to bring a millenium, as some enthusiastic supporters once declared, nor is it going to undermine the foundations of the Republic. It is just a good idea.