

## Our Obsolete Real Estate Taxation

A recent article provides evidence of a growing awareness that the system of real estate taxation in the United States is detrimental to the economic well-being of the Nation.†

The author notes a leveling off of the current real estate boom, during which average land prices have trebled and those in some urban areas have multiplied many times since 1935. The anomaly of the situation is that land prices have not entered the contraction phase that usually has followed earlier land price increases of similar magnitude. The reason given for this is that land prices "\*\*\*\* have lost realistic contact with the market. This has tended to create an artificial scarcity of land that is only beginning to be understood.

"Land prices are not made by people who sell their land \*\*\* but by the people who won't sell. Actual land scarcity is a myth. But there are always landowners who think they will get a higher price if they wait a while. Usually it's the highest price they've heard of in the neighborhood, plus 10 percent. It's this expectation of a future killing that produces the artificial scarcity."

The question arises, How does it happen that in a relatively competitive economy the price of anything can "lose contact with the market" and create an artificial scarcity? The answer lies in the economic characteristics of land and in the effects of prevailing social institutions governing its use and taxation.

Land is essential to all human activity. Various things can be extracted from or grown on some land, and the location or space aspect of land is essential for many purposes. Things seldom are grown or otherwise obtained from land in centers of population; nevertheless, such land is used for processing‡ things, for service activities, and for residences. Payments offered for urban sites indicate that they often are much more useful than are sites of equal area suitable for mining or agriculture. For example, several years ago a single lot on Mission Street in San Francisco sold for more than the assessed valuation of the entire northern agricultural county of California.

Sites that are most suitable for business and residential purposes are those of greatest usefulness, and therefore are those in greatest demand. Such sites are in limited supply; and, in the sense that the location of each site is unique, a particular site is in absolutely limited supply. The actual selling price of anything that is in absolutely limited supply is determined solely by the

demand for it, i.e., by the greatest amount a prospective user is willing to pay for it.

Thus if changing conditions increase the usefulness of a site, the demand for it, and therefore its price, will increase. One such change is an increase in the population of a community, which involves increased demand for things processed, services, and living space. More effective or extensive municipal services of transportation, crime and fire protection, sanitation, education, and recreation also increase the usefulness of sites in a community.

Such changes create greater opportunities for processing activities. Would-be processors and those who offer services who seek the greater return that these opportunities afford compete for the use of those sites that are most suitable for the activity they contemplate. Owners of such sites find that they can obtain higher prices for their use or sale. If a site owner believes that he can obtain an even higher price at some future time, he may choose to withhold his site from use by refusing to sell or lease at a price that permits profitable processing activity or the offering of services. When such withholding occurs, those who wish to engage in processing activities or in offering services are forced to do so on less useful sites. The result is that the aggregate of things processed or the availability of various services is less than it would be otherwise.

This, then, is the explanation of how the price of land can "lose contact with the market" and create an artificial scarcity. The problem is not a scarcity of land, but reduced availability of land that can be profitably used for processing activities or for services.

The detrimental economic effects of the situation are manifold. Processing activities and opportunities to offer services are restricted to an extent that is unknown but is believed to be considerable. The costs of processing things, and therefore their prices, are greater than they otherwise would be. In the hope of speculative gain, some owners of land on the outskirts of growing urban areas hold it off the market by asking unrealistically high prices that prohibit its profitable development for residential and other uses. Developers have no choice other than to build on less costly land farther out. The result is leapfrog development called "urban sprawl," which involves increased costs of transportation and of extended utility services. The cost of a residential site, which right after World War II averaged about one-tenth of the total cost of a home, now averages more than one-fifth of a larger total. Inasmuch as the average rate of increase of wages and salaries has been less than that of land prices, individuals

†"The Strange Leveling Off in Land," by Hubert Kay, *Fortune*, October 1963.

‡"Processing" is used here as the name for all applications of human effort involved in making, transporting, distributing, and selling things.

now pay a greater proportion of their incomes for space on which to live.

Evidently, our social institutions concerned with the use of land impede its allocation by the market to the most efficient use. Analysis of our system of real estate taxation suggests a solution to the problem. This system was evolved in an era when land was abundantly available and most Americans were farmers. The great land problem then was to encourage its settlement, and real estate tax laws were designed to provide incentive to land ownership. Today, expanding urbanization and the concomitant increase in urban land prices present a different problem. Our real estate tax system, in which sites are commonly assessed at a fraction of their market price and in which the assessed values of sites and buildings are taxed at the same rate, aggravates this problem.

People tend to accept without question and to perpetuate social institutions and customs of long standing. Yet conditions continually change, and continuous adaptation of social institutions is necessary to cope effectively with new problems that arise. One such problem is the widespread deterioration of buildings in urban areas throughout the Nation. The taxation of all structures discourages owners from improving or replacing them, because in doing so they would incur increased assessments and higher taxes. Moreover, the present tax system offers owners an inducement to permit structures to deteriorate further by granting successive reductions of assessments that result in lower taxes. This problem is discussed in greater detail in an article in another Institute publication. § The situation obviously is an unfortunate example of failure to adapt social institutions to changing conditions.

Increased taxation of buildings results in increased costs of shelter and of processing activity or services requiring their use. When a tax on buildings is increased, the return to investment in their construction is reduced, and the investment of some funds is diverted to other uses. The supply of buildings coming on the market is checked until the price of their use increases to the level at which the normal return to investment in building construction is restored. By this process, the increased cost of buildings is shifted to and borne by the users. On the other hand, an increase in the taxation of site values has quite different effects. Such a change tends to increase the supply of sites made available for use, and thereby to reduce their price, because it increases the cost of holding sites off the market in anticipation of a future gain. Moreover, increasing the tax on site values retains for community use a greater portion of the addition to the results of processing and servicing made possible by the community. ¶

The author of the article cited at the beginning of this discussion observes: "In the public interest, the U.S. has legislated exhaustively against monopolies, trusts, and other trade-restraining combinations designed to produce artificially high prices by withholding supply. But with respect to trade in the most essential of all commodities—land—our laws not only permit but actually encourage such monopolistic interference with a free market."

Action by the Federal Government is neither advocated

§ "How to Make Slums," *Economic News*, April-May 1963. Copies will be provided on request.

¶ Of course, such a tax change also reduces the portion of this addition received by site owners, but that addition is not the result of their efforts.

nor necessary. Real estate taxation is almost exclusively the province of local governments, although the extent to which they may modify such taxation may be limited by state legislation. ||

When members of local governments and the citizens they serve become aware of the advantages that will accrue to their communities by shifting real estate taxation from the value of improvements to site values, such shifts can be expected to occur with increasing frequency. The community that makes this shift will provide a more favorable condition for processing and service activities. Consequently, the competitive position of industry located in that community will be improved, and the more efficient firms and individuals will be attracted there. Such a community will be a better place in which to work and live, and it can be expected to grow and prosper.

### PENNSYLVANIA'S LEGISLATURE POINTS THE WAY IN IMPORTANT RECENT LEGISLATION

The General Assembly of Pennsylvania has taken a long step, unprecedented in the United States, toward the establishment of a land value taxation policy in the third class cities of that state. In 1951, by an act passed unanimously in the Senate and with only a single dissenting vote in the House, third class cities had been given the option of taxing land at a higher rate than buildings. Now a 1959 act, also passed unanimously in the Senate, removes the limitation on the rate at which land may be taxed, so that any of the forty-eight third class cities of the state can raise as much revenue from taxing land values only, as they could previously raise by taxing both land and buildings. The 1959 act permits tax rates indefinitely higher to be levied on land, provided that "the respective rates on lands and buildings are so fixed as not to constitute a greater levy in the aggregate" than the real estate levy now authorized for third class cities.

A third class city in Pennsylvania can, therefore, if its Council so desires, substantially reduce its taxation of buildings and make up for this reduction by increasing the tax rate on land values. *Or it can completely abolish its taxation of buildings.* And it can do this either at once or by successive steps over a number of years.

The evidence presented in the preceding sections indicates that cities which *take full advantage* of this recent Pennsylvania legislation are likely to enjoy much greater commercial and industrial development and to suffer far less from obsolescence, deterioration, slums and blight than cities which do *not*, — or than cities in *other* states, which *cannot*.

Scientific economic analysis reveals that RENT-of-land and REWARDS-of-human-effort (Wages and Interest-wages) are the only sources of public revenue. This means we can (and must) eliminate many of the massive variety of taxes now imposed on us.

Analysis also shows that human beings are best served by using RENT-of-land, not REWARDS-of-human-effort, to support government.

We are a non-profit, non-political, Federally tax-exempt institution, and we urge IMMEDIATE UNDERSTANDING OF THESE IDEAS. Correspondence is invited; financial support is urged.

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