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Property Tax – Cause of Unemployment

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Dr. Herbert Bab was born in Vienna and received his Ph.D. in Political Economy at the University of Vienna in 1936. A specialist in interest theory, he was granted a Research Fellowship to King's College, Cambridge by the famous economist, J. M. Keynes. At Cambridge began his special interest in the problems of housing. He came to the U.S. in 1938 and settled in California. He is the author of a number of papers on various aspects of housing, property taxation and interest theory.

Some time ago Soviet Premier Nikita Krushchev prophesied that Communist Russia will bury the capitalist system. Yet, it is likely that historians will come to the opposite conclusion, namely, that the cold war has saved the American economy from another Great Depression, if not from collapse.

We have lived in a defense economy for almost 20 years and most of us take it for granted that it will continue indefinitely. Yet it is becoming more and more obvious that it will not last forever. Moreover, even the tremendous defense outlays have not secured full employment and have not allowed our economy to grow fast enough. Under the impact of spectacular advances in technology the actual level of employment and production falls short of the full use of our manpower and industrial capacity.

And this gap is widening. According to Leo Keyserling it rose from \$1.5 billions in 1953 to a seasonally adjusted figure of \$76 billions in the 3rd quarter of 1963.

In view of this it would be difficult to contend that we have solved the twin problems of full employment and economic growth. The truth is that we have lived all these postwar years on borrowed time.

What have these considerations to do with property taxation? The purpose of my talk is to show that the relation of property taxation to unemployment and lack of economic growth is that of cause to effect. I shall try to explain why I believe that property taxation is one of the two chief villains in the drama we are witnessing today in these United States. The other villain is the monetary policy pursued by the government, which has increased the cost of borrowing to a point where it stifles the growth of the economy. In this context however I shall be concerned only with property taxation.

"Supported by a defense outlay of between \$45 to 50 billions the U.S. economy has been fairly prosperous in these last years. Anybody who would have advocated a public works program of that size for peaceful purposes would have been branded as fiscally irresponsible. And bankers and businessmen alike would have warned us that such a program must necessarily lead to a disastrous inflation and would undermine the stability of the dollar."

Two schools of thought have emerged as to the merits or defects of property taxation:

- one school condemns the American system of property taxation in every conceivable way.
- The other school underscores the advantages of taxing land and untaxing improvements.

Professor Harold Groves in his book *Financing Government* stated that "it has been said that the general property tax has only two faults: first it is wrong in theory and second it does not work in practice. Others have said, that the administrative defects of the tax somewhat compensate for its conceptual shortcomings."

Professor Seligman stated "that the general property taxes as actually administered are beyond doubt one of the worst taxes in the civilized world." John Maynard Keynes in a letter written to me in 1941 said "that in this country we may have to consider seriously after the war the whole question of the part played by local rates and local taxation. No one defends the existing system, but it is not easy to find an alternative."

The other school of thought emphasizes the justification for and the great advantages of taxing land.

Ricardo believed that ground rents and the value of land have a tendency to rise continuously and that this benefits solely the landowners. The progress of industrialization and urbanization in the second half of the 19th century resulted in a rapid increase in the value of urban land and the owners of such land reaped tremendous profits. This led John Stuart Mill to observe, that "Only the landowners grow richer, as it were in their sleep without working, risking and economizing". He called for the taxation of land in order to recapture the unearned increment accruing to the land owners.

The apostle of land taxation is Henry George. In his famous book *Progress and Poverty* he develops his single tax theory. He tries to show that poverty and unemployment and other evils are caused by the land monopolists. Henry George's theory is similar to that developed by John Stuart Mill. Land values are based on ground rents which are created by the community and not by the land owners. Therefore the community is justified in recapturing these rents by a single tax on land.

Land taxation has found widespread acceptance in many countries especially in France, Germany, Denmark, Australia, New Zealand and in certain parts of Canada. It has made no headway in the U.S. except in Pennsylvania, where the cities of Pittsburgh and Scranton introduced in 1913 a graded tax plan and in Hawaii where a similar tax plan was adopted in 1963.

If John Stuart Mill or Henry George would be alive today, they would be disappointed that the taxation of the unearned increment in land values has not made more progress. They would be surprised that the rise in urban land values has not been as steep as they had expected. Yet the universal use of automobiles has in an unforeseeable way multiplied the land available for residential use. It has made possible the exodus of a large part

of the middle class out of our towns into suburban areas. Thus the invention of the automobile has upset the dire predictions and expectations of the economists who advocated the taxation of land.

However, there is increasing evidence that the advantages which we have gained by the universal use of the automobile are coming to an end. Suburban areas within the range of the automobile are rapidly being built up. There is a definite limit to the distance a person is willing to travel or the time he is willing to spend to reach the place of his work. Moreover, the use of the automobile is more and more hampered by traffic congestion and parking problems. Thus the further expansion of suburban areas is likely to slow down and the upward pressure on land values in the central areas of our cities is likely to increase.

Three criteria are generally used to judge the merits of a tax.

- First, it must be satisfactory as a revenue producer,
- second it must be equitable and
- third its economic effects should not collide with the public interest.

For instance if full employment and economic growth are regarded as desirable, the question to be examined is what effects will this tax have on achieving these objectives?

The shortcomings of property taxes as revenue producers have been obvious for a long time and are widely known. The main difficulty is that revenues from property taxation do not keep pace with the ever-increasing requirements of local governments. Every county, every city official and every school administrator will testify, that there are not enough funds available to meet the requirements of local governments.

The inability of local government to raise enough revenues from property taxation has forced them to borrow at an ever-increasing rate. The debts of local governments have increased from about \$16 billions in 1947 to over \$61 billions in 1963, an increase of about 382%. During the same period private debt increased by 279% and federal debt by only 26%.

To satisfy the second criterion, a tax must be equitable. It must be either based on the ability to pay principle or on the benefit principle. The Federal income tax for instance is based on the ability to pay principle. Gasoline taxes used exclusively for the construction of roads are benefit taxes. The property tax cannot be justified by either of these principles. The ownership of property is not a yardstick of ability to pay, though this was probably true before the industrial revolution. In that age land was the main, if not the only, form of wealth and intangible forms of wealth did not exist. As to the benefit principle most of the services rendered by local governments benefit the community as a whole rather than property owners. This is especially true of schools, police protection, welfare expenses and many others.

An analysis of the social and economic effects of a particular tax system would indicate the third criterion.

When analysing property taxes we shall distinguish between that part of the tax which is assessed on improvements and that part which is assessed on land.

"A survey made by the editors of Fortune found that during the 1950's the population in metropolitan areas increased by about 400,000 persons annually. About 250,000 housing units were built yearly in these areas, but almost the same number were lost by demolition, condemnation or conversion into industrial use. Thus the housing shortage increased by about 400,000 persons each year. The editors of Fortune concluded that the battle against slums will be decided by the simple arithmetic of new buildings versus immigration to the cities."

That part of the tax that is assessed on buildings penalizes everybody who improves his land, his buildings or intends to construct residential, commercial or industrial property. The most serious incidence of property taxes is on new housing. When rental property or houses are newly constructed these taxes add 15 to 20% to the annual cost depending on assessment practices and tax rates.

"In 1962 property taxes on new F.H.A. insured houses averaged \$14.30 per month, or \$171.60 per year, excluding that part of the tax that was assessed on the land. Assuming that a family spends 20% of its income on housing, the income of a family must increase by \$858 per year in order to afford the purchase of a home. In this way many families in the lower income group are priced, or taxed, out of the market. And residential construction, a mainstay of our economy, is discouraged."

"In 1963 HOUSING STARTS reached a level of 1.6 million units, representing a value of about \$20 billions. Yet very few houses were built in the central areas of our cities and a large part of these houses were built for families in the middle or upper income group. Of these single-family homes, only 15% were sold for less than \$12,500. Another 15% sold for between \$12,500 and \$15,000. Thus 70% of these homes cost \$15,000 or more. This is so because under our income tax laws property taxes and interest charges are deductible items. A person in the 75% bracket pays only 25% of these costs and a person in the 50% bracket pays only half the property taxes and half the interest charges."

The steep increase in the level of rentals represents a true and accurate yardstick of our housing shortage. During the period 1950 to 1961

- the average rental rose from \$71.13 per month to \$186.79 or by 160%.
- During the same period median urban family income rose from \$3,497 to \$5,924 or by only 69%.
- Construction costs per square foot rose from \$8.68 in 1950 to \$11.32 in 1961 or by only 30.4%.

The ever widening gap between the level of rentals and the urban family income constitutes a rental squeeze, which has brought untold misery and hardship to families in the lower income group, especially to those belonging to minority groups. The rental squeeze has also aggravated overcrowding and slum conditions.

In the press, on the radio and on television we are often warned about the threat of inflation. Hardly ever are we told, that the increase in the cost of living is to a large extent due to the increase in housing costs brought about by the housing shortage. The inflationary effects of property taxation are reinforced by the fact that property taxes themselves are included in the cost of living index and that property tax rates have the tendency to rise.

To the extent that property taxes discourage residential construction and the improvement and modernization of homes they create unemployment. The housing construction industry employed about 2,200,000 people in 1962, that is about 1.4 persons per housing unit. Any change in the direction of home building employment is multiplied 2.57 times. Thus an increase in housing starts by 50% would give employment to 2.8 million persons. An increase by about 66.6% or by 2/3 would create about 3.6 million jobs. These figures do not take into consideration the investment in public utilities, streets, schools etc., that would be required to service these additional housing units.

Under our property tax system wealthy communities with expensive homes or with heavy concentration of industry will have a large tax basis and low tax rates. Schools will be good and public services will be adequate. Yet in a poor community the tax base will be much smaller, tax rates will be much higher and still it will be found impossible to provide for good schools and adequate public services.

In a pamphlet entitled *Paying for better schools* the Committee for Economic Development came to the conclusion that "where a child happens to live is likely to be important in determining the quality of his education. In some areas children are taught by meagerly qualified teachers in substandard schools with inadequate equipment. The school session is shorter and the school leaving age is lower than the national average."

A defect of our property tax system that is seldom mentioned is that it puts a premium on obsolescence and penalizes new housing. This is so because property taxes are ad valorem taxes. Every piece of real estate except land is subject to depreciation. Thus the owners of old and obsolete real estate will pay little in taxes, while newly constructed buildings will bear the brunt of the tax.

This characteristic of the property tax is obscured by the rising trends of land values, which in many cases offset the loss in value of the improvement. Increases in tax rates and differences in assessment procedures and practices further hide the fact that ad valorem taxes favor obsolete real property.

Let us now turn to that part of the tax that is assessed on land. Increases in population, immigration from the farms and other forces have led to a rapid increase in the population of our large cities and metropolitan areas. Population pressure is bound to increase the value of urban land. Yet an adequate system of land taxation could have prevented the steep rise in urban land values.

Economists agree that taxes on land can not be shifted but are capitalized. For instance a lot having a value of \$10,000 -- will have an imputed or expected income of \$500 -- assuming a 5% rate of capitalization. A 2-1/2% yearly "ad valorem" tax would reduce the imputed income by \$250 -- or 50%. Such a tax would naturally reduce the value of the land by the same percentage.

"Sir Winston Churchill has been most of his life an advocate of land taxation. He stated on one occasion that 'Land monopoly is not the only monopoly, but ... it is the mother of all other forms of monopoly' ".

For these reasons increases in land values can be prevented by taxing land at an appropriate rate. Yet urban land values have increased tremendously during recent years. For instance in Los Angeles county the assessed value of land increased from \$1,972 millions in 1952 to \$4,002 millions in 1962, an increase of a little over 100%. The assessed values, are supposed to represent 25% of the market value. Thus the unearned increment in land values

during this period amounted to not less than \$8 billions. Even this figure is an understatement because it is based on assessed values and land is greatly underassessed. While land values have risen by about 10% yearly, property taxes assessed on land averaged about 1.5%. Thus a person owning vacant or underimproved land would have earned about 8½% per year just by withholding land from its proper use.

A higher tax on vacant or unimproved land would make it unprofitable to hold such lands. It will tax land into better use and it will lead to a spurt in construction activity. While all other taxes are deterrents to employment and economic growth, though to a varying extent, land taxes are the only genuine incentive taxes.

Inflated land values must necessarily increase the cost of new homes, the cost of home-ownership and rentals. It discourages residential construction, prices many families out of the housing market and aggravates the housing shortage.

The average price of the site of F.H.A. insured newly built one family homes increased from \$1,035 in 1950 to \$2,715 in 1962. The site-value to building value ratio increased from 12% to 17-1/2% during the same period.

Homeowners who bought their homes some time in the past can reap large profits when selling them. Old homes should sell at a lower price, because of the depreciation of the building, but in most cases the depreciation of the building is more than offset by the increased value of the lot. This increased value forces buyers to increase their down payments or to increase their loan are higher, many families are priced out of the market.

"The tremendous rise in the expenditures of local governments confirms the excessive cost of the exodus into the suburbs. Expenditures of local governments increased from \$9.1 billions in 1946 to \$30.6 billions in 1957 or by 21.5 billions. A considerable part of this increase -- maybe one-third or more -- could have been avoided by a tax system that would insure, not only a more rational use of land, but also sound economy in our urban affairs."

We have discussed the sharp increase in the level of rents that has taken place during these last years. These increases reflect the steep rise in land values that have taken place in almost all sections of our cities. The tax assessed on the improvements has discouraged the construction of more and better housing. At the same time, the tax assessed on land has been too low to induce owners to sell, improve, or replace their rental properties.

Property taxes shape the pattern of our cities.

- If taxes on improvements are low or non-existing and taxes on land are high, the cities are bound to grow vertically and at a fast rate.
- If taxes on improvements are high and taxes on land are low, our cities will spread over larger and larger areas. They will become metropolitan areas and they will grow at a much slower rate.

Relatively low taxes on land and high taxes on improvements will discourage the owners of vacant lots or underdeveloped land, such as that used for parking lots, gas stations, hamburger stands, etc., from improving their land. It will encourage them to keep the land out of use and to sell later at a profit. This will create an artificial shortage of land, which in turn will lead to urban blight and irregular, leapfrog city growth.

This urban sprawl makes our cities look ugly, but it has many disadvantages besides:

- It gobbles up a tremendous amount of farm land;
- the farmers have to give up their land before it is really needed;
- the building developer has to go far out to find available land;
- the prospective home-owner has to travel farther;
- traffic on congested roads will increase and
- new roads and schools will have to be built.

It is generally believed that zoning laws are a very effective tool to control the growth of our cities. Zoning laws determine the best possible use of urban land. Yet nobody can be forced to improve his land and to build unless there is an incentive. This can be achieved by taxing land at a rate that will make it unprofitable to hold it without improving it.

The city planner needs land taxation just as he needs zoning laws. With both these tools the orderly growth of our cities will be assured, but -- as experience has shown -- without land taxation rational and efficient land usage becomes impossible.

Professor Galbraith and others have expressed concern about the poverty of the public sector of our economy as compared to the affluence of the private sector. The appearance of our cities, the inadequate financial support we give our schools and poor public services seem to support this view. Yet, I can not agree with Professor Galbraith's conclusion that we need more public revenues to meet these needs. It seems to me that the spreading out of our cities over wider and wider metropolitan areas has immeasurably increased the financial burden of local governments. In other words, wasteful use of land caused by our property tax system is the real reason of the poverty of the public sector.

It stands to reason that the spreading out of our cities into wider and wider metropolitan areas is a very costly venture. For instance it was found that in the New York region suburbs have to make capital outlays of \$68 per capita for new housing, while only \$44 was required for new housing in the central cities and only \$38 in the non-metropolitan area. Another survey found that it costs \$80 per household to provide water in the outlying suburbs against \$30 in the city.

The administration of the property tax leaves very much to be desired. Assessment procedures and practices are in many cases erroneous, arbitrary and widely variant. So is the ratio of assessed value to full market or cash value. In many states no public records are available indicating assessed values and the taxpayer has no of knowing what his tax bill will be.

The most serious defect in the administration of property taxation is the continuous, widespread and enormous underassessment of land. A survey made recently found that in 9 California counties, vacant lots and acreage were assessed at only 5.3% of the cash value, while residential property was assessed at 19.3% of its value. The illegal underassessment of land deprives local governments of millions of dollars of revenues. Moreover, it further aggravates the serious defects of property taxation.

We have analyzed the effects of property taxation on improvements as distinguished from those caused by the incidence of these taxes on land.

- We have found that a high and burdensome tax rate on improvements will discourage residential construction, create unemployment, penalize home-ownership, aggravate the housing shortage and force up rents.
- Yet a low tax rate on land will have similar if not identical effects: it will lead to a rise in urban land values, which in turn will discourage residential construction, create unemployment, penalize home-ownership, aggravate the housing shortage and force up rents.

The paradox of property taxation consists in the fact that lower rates on improvements produce the same results as higher rates on land and conversely higher rates on improvements produce the same results as lower rates on land.

The reform of our property tax system must be regarded as one of the most urgent and important task we face today. It cannot be any further postponed without risking grave consequences. Yet this reform will prove to be a formidable task. There is very little understanding of the problems by the public. Moreover, there exists a great number of local governments levying property taxes and it is almost impossible to coordinate and direct the policy of over 80,000 local governments towards the same goals or objectives -- except by action of State or Federal government. The States will have to find the permanent long term solution of the problems of property taxation while the Federal government will have to come forward with measures that will provide immediate relief.

There can be little doubt that the shifting of the tax burden from improvements to the land is the appropriate remedy. I shall try to outline a few ground rules for the procedure which should be followed:

- The shifting of the tax burden should be achieved gradually over a period of years.
- A predetermined yearly reduction in property tax rates on improvements should be enacted by each State and should be imposed on all local governments without exception. At the same time the tax rate on urban land should be increased to make up for the loss in revenues.
- A State agency or State Tax commission should, be set up to supervise and administer the shifting of the tax burden with the following functions:
 - To break up the property tax into its constituent parts: taxes on urban improvements, urban land, farm land and property other than real estate.
 - To enforce the yearly reduction in tax rates on urban improvements and to see to it that taxes on urban land are raised to make up for the loss in revenues.
 - To supervise assessment procedures and practices and enforce the equal assessment of all classes of property.
 - To enforce the pooling of revenue derived from school taxes and to equalize school standards on a state-wide basis.
 - To examine the merits and effects of the taxes assessed on tangible and intangible property other than real estate and to recommend the retention or discontinuation of these taxes.
 - To consider the merits of granting immediate tax relief on the first \$3,000 of all newly constructed housing in order to stimulate the improvements and modernization of homes.

This long-range program which I have outlined will have to be supplemented by a Federal program. The States will require many years to develop and enact a program of property tax reform, yet immediate relief is badly needed to encourage residential construction, create employment, lessen the housing shortage and arrest a further rise in rents. This relief can only come from the Federal Government.

As has been mentioned before, ad valorem taxes by their very nature put a premium on obsolescence. It is in the power of the Federal Government to convert the ad valorem tax into an incentive tax, a tax on obsolescence.

Instead of taxing improvements at cost when they are new and at cost less depreciation when they are old, the Federal Government could change the tax so that new buildings are not taxed and old buildings are more heavily taxed than at present. This can be done by establishing age brackets and by taxing all improvements according to their age.

- The first step would be to exempt all new residential construction from property taxation for a period of 10 years. This would represent the first bracket of the graduated tax. It could be administered in a very simple way. Our income tax laws allow property taxes as a deductible item. Property tax relief would be made effective by allowing property tax payments to be deductible from a taxpayer's tax liability and recognize them as a part of income tax payments.
- A second bracket could be established for housing when it becomes 10 years old and until it reaches 20 years by granting a tax exemption of 50% in the manner described before.
- The third tax bracket would consist of all housing over 20 years old. No property tax relief would be granted to this age group.
- Finally a fourth bracket could be established for obsolete rental property. When a building becomes older, it becomes more and more difficult to correlate age and obsolescence. Thus this tax should only be assessed on buildings declared substandard by the F.H.A. Moreover, instead of relying on assessed values, this tax should be based on rentals.

A precondition for establishing this fourth bracket is a high and increasing vacancy factor. As long as the vacancy factor is low, there is a danger that some landlords may try to increase rents and to shift the tax to the tenants. Yet, when vacancies are increasing, the landlord will have to absorb this tax. It will encourage the landlord to sell his property or to pull it down and construct a new building.

I have tried to show the relation between property taxation and residential construction, the housing shortage, the steady increase in rents, the inequality in school standards, inflated land values, urban blight and sprawl and finally the financial burden of local governments. I can not help but agree with the findings of a committee of the California State Legislature stating "that the problem of financing local government is the major domestic problem facing our country today."