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Commission on Real Property Tax Relief

Chairman Suozzi, Commission Members and Director Reid:

Separately I have presented material on how I believe our property tax relief should be accomplished, and I see no reason to repeat myself here. I have both provided several monographs to some Commission staffers and advisors and have pointed to websites where I have about fifty articles relating to the property tax.[1]

I would prefer here to address matters that may not otherwise receive much attention by others testifying. They can be labeled concerns about the environment, about economic development, and about equity as they are affected by the property tax. Normally matters such as equity and development will take care of themselves if a tax is designed with all the textbook principles of sound tax theory in mind.[2] But few taxes have been so assiduously conceived; in most cases taxes are designed not by academics; rather like sausage, they grind through the political process. I see no reason to believe the process will be different here. Still, I think it is worthwhile for a politically disinterested but irrepressible reformer to add his input to the process.[3]

Economics of the Property Tax

In any discussion of the real property tax, the starting point is to recognize that it is really two taxes from the perspective of economics: a tax on land value and a tax on improvements. Each has its own dynamic, and if this is fully understood lots of other implications become readily apparent. A tax on improvements is really quite harmful, as it penalizes the titleholder of property for maintaining and improving his site. A tax on land value fosters development of sites to the extent that rents are recaptured. The higher the tax on locations, the greater incentive to build on them. When ground rent, also called economic rent, is not recaptured, it is an invitation for speculators to seek windfall gains by riding on the productive efforts of others. Buying land and just holding it for the gain then makes economic sense, but it is destructive to the community. Morally speaking, so-called "ground rent" arises not from what a titleholder does but rather from the economic vitality of a locality or region. The property tax as it presently exists is like a train with an engine at each end -- it actually stymies action. So the first step in improving our property tax is to phase out the improvement portion on a revenue neutral schedule. Ample evidence of its success is available for those interested.[4]

Present day economics, at least the neoclassical paradigm that is taught in universities today, trivializes economic rent, and the result is to ignore and distort the treatment of land as a factor of production, as well as the property tax reliant upon it. Careful attention to rent shows that it is about a third of our GDP,[5] but textbooks usually put the figure at about 1 percent. There is a reason why most land economists are partial to the earlier classical school, which reflects the thinking of political economists from Adam Smith through Henry George.[6] But rent cannot be ignored; it either flows through parcel locations to influence their market price or is collected in the form of taxes. One way or another rent flows, and if left to pass through sites it increases their market value. As houses and other buildings get older they depreciate in value, typically from 0.5 to 1.5 percent annually,[7] so the increase in land value ultimately accounts for the price of a parcel. Assessments should reflect this proportional shift and need to be carried out frequently. Fortunately, new technology makes land assessment almost costless, something I have talked about elsewhere.[8]

A second contrast to keep in mind with regard to the two taxes on real property is the inelasticity (fixed supply) of land and the elasticity (variable supply) of improvements. This is why taxing buildings discourages development; taxing land value facilitates development. Moreover, the more land is taxed the more the high-value parcels in urban cores are encouraged to develop to the full extent that their value warrants. If not recaptured in tax collections, the rent is reflected in capitalized form in the market price of sites. Land parcels must be paid for one way or another: either in the periodic payment of rent or when they are sold to a new owner. Given the fact that improvements depreciate and land appreciates, the gain that is reflected in any sales usually constitutes a windfall to the seller. Present property taxes recapture far less than the full amount of rent flow, leaving appreciation of sites the inevitable result. Reducing or eliminating the tax recapture of rent simply enhances the windfall gain that titleholders get when property sells.

Economic Development and Property Taxes

Because the tax on land is capitalized totally in the market price, what economists call deadweight loss or excess burden is non-existent. This is significant. One study calculates that a shift to taxes solely on land value increases economic efficiency by about 10 percent.[9] This contrasts with another study concluding that the deadweight loss from the income tax is about a thirty percent, fifty percent if Social Security taxes are included.[10] It is borne out in practice when the record of cities using land value taxation is examined. In Harrisburg, PA, for example, which has been phasing in a tax solely on land value since 1982, the number of businesses on the city's tax rolls went from 1,908 to 5,900 in two decades.[11] Other statistics were just as dramatic. One study calculated that "on average, a one percentage point increase in the tax differential between land and buildings will yield an increase in the total value of construction of 17.8 percent."[12] With the number of cities worldwide employing such a method, it is a wonder that Americans have been so slow to catch on. Hong Kong provides the most impressive instance of all.

So upstate New York cities that have been in the doldrums for decades should shift to a tax that incurs no deadweight loss, which removes the penalty for development and maintenance of improvements, which removes the reward for speculative gain by holding landsites out of use, and which thereby fosters revitalization of urban cores. I will deal below with concerns about the household threatened with losing the home for inability to pay taxes – what is commonly known as the "poor widow argument."

<u>Property Tax and the Environment</u>

I have written elsewhere[13] on how tax policy affects sprawl development, and how correcting its proclivity can easily be reversed. Sprawl development is exacerbated by public policies earlier conceived without regard to their consequences. Locations have value due to the economic rent flowing through them; the higher the productivity of locations, the more the rent. This can be demonstrated by mapping land values, much like USGS topographical maps showing the isobars of elevation. Sites vary enormously by location: a one-acre site in mid-town Manhattan has just gone on sale for $1 Billion.[14] Formulas for location values were worked out by Heinrich von Thunen two centuries ago, but only about a century ago was it possible to plug in the numbers.[15] Earlier in the 20th century the Bureau of Census recorded data on land values, but it abandoned the program when assessments proved to be so inaccurate as to not make the task worthwhile.[16] As has been noted elsewhere, this is due to the failure of assessors to properly attend to the valuation of land, especially to under-assess it in downtown areas. Buildings, one must recall, depreciate in value while land appreciates, so distortions in valuations quickly result. Real estate bubbles are explained by land speculation cycles, something taxing land ameliorates. I have addressed the problem of bias in assessments elsewhere.[17]

Because land values in urban cores tend to be under-assessed and owners play the game of holding out (and often for governments to intervene), developers looking for affordable spots are often forced to settle for a second-best, suboptimal sites. They are usually further out at the edge of a city than they might wish. Although the difference is in good part picked up by transportation costs (about 90 percent of which is picked up by the society and not the driver-commuter) these are not perceived as a component of the opportunity costs.[18] The centrifugal forces of sprawl prevail. This is not an insignificant consideration: a 1993 Natural Resources Defense Council study calculated that the total costs of motor vehicle transportation to our society equal approximately a fourth of our GDP.[19] We can effectuate policy, constitutionally speaking, by either police powers or tax powers; those are the only two instruments government has. Police powers are frequently expensive, and a blunt instrument by which to address matters. Tax powers, in contrast, can be designed such that incentives foster the very policies that benefit the public. Land value taxation is a gentle means of stemming and even reversing the centrifugal forces of sprawl development.

Property Taxes and Economic Justice

The last concern worthy of address is the fairness of the property tax. In passing I will address the equity of the property tax as it exists now, even though I have noted that it can be much improved. Keep in mind that the two criteria of fairness are ability to pay and payment for use. In fact a property tax, since it is based very much on location, serves as an excellent user charge.[20] But people have come to judge it based on their income. Only two studies have been done, both years ago, concerning the incidence on homeowners of the property tax. Both concluded that it was marginally progressive.[21] Several more recent studies that make different claims are flawed; most ignore renters and non-residential properties.[22]

When one recognizes the virtues of a shift to land value taxation, the inelastic nature of land as a base means that only households who own land pay any tax at all. This relieves some 35 percent of all households, usually tenants, and more often poor. Moreover, non-residential titleholders typically pay about half of all property taxes. (Farmers' land is so remotely located that it pays little at all if it isn't already held harmless by other provisions.) The land tax recognizes the importance of location, and homeowners pay less than under the conventional property tax because their burden it assumed by high value underused parcels in urban cores. Since land values explain regional differences in housing, a land value tax makes home purchase more affordable. Reducing, and eventually eliminating, the tax on the structures more than compensates for whatever rises might obtain in the land tax for about two-thirds of homeowners. This has been borne out in many simulations as well as for localities that have adopted a phased in land value tax.[23]

In passing, I should mention that most assessors pay little attention to the land vs improvement distinction, because it makes no difference as long as parcels are taxed at the same rate. As is now clear, this can be an important consideration not only considering depreciation and as values change over time, but also if taxes on each element are at different rates. Whenever revaluations are done, residential parcels usually end up paying less. This reflects a failing in property tax administration, however, not in the design of the tax itself. A distinction needs to be made between the merits of the property tax from the standpoint of economic theory, as opposed to the quality of its administration in present circumstances. Secondly, governments have done a dismal job in explaining the property tax to the public, and this accounts for much of the animus toward it. How to improve its administration is a discussion for another day.

Options for Property Tax Relief

If households were required to pay the mortgage interest on their homes in its entirety once a year, they would likely feel burdened. Faced with a similar obligation for taxes understandably draws complaints. Yet, as explained earlier, the less the tax collected out of the economic rent of land in the course of a homeowner's lifetime use of a location, the greater the capital gain will be when that parcel is eventually sold. This is because the rent from the land component is capitalized in the market price of the parcel, even as the house depreciates as a proportion of the total value. Already, capital gains from home sales are mostly exempt from taxation at the federal (and by extension state) level. Relieving further the modest periodic taxation of home values during the period of ownership provides a windfall gain to titleholders beyond any precedent in American history. Doing so would favor the real estate industry as an investment vehicle and a venue for speculation over any other opportunity. Fairness argues against such a policy.

This is not to deny that many homeowners are unduly burdened by their property taxes. The answer to this concern is to offer to households the option of deferring their tax payments until they cash out, and then able to pay their obligation in full with any interest due. This choice becomes particularly attractive and feasible when coupled with a phased-in shift to a land value tax. There are four major mechanisms of relief employed by states in attempts to address this issue: tax caps of various sorts, differential rates on homesteads and non-homestead properties, circuit-breaker mechanisms, and deferral of tax payments. Attempts to achieve equity by credits, deductions, and exemptions may offer burden relief, but they are almost random in their distributional impact because no blanket law can equitably cover all regions and cases. Even simulating the impact is essentially impossible. I have dealt with these options in another monograph (see note supra).

As the National Conference of State Legislators has concluded, the Deferral option, now employed in 24 states to some extent, is by far the best solution. It is equitable in so far as it maintains the obligation on homeowners and generally accords with both the ability to pay and user fee criteria. It is non-distorting in both land use configurations and for intergenerational equity. It is easily administrable and understandable to both the public and to parties involved. And it is economically efficient from the standpoint of economic development. No other option among those available satisfies all the criteria of the textbook principles of sound tax theory. No other option is so politically and administratively feasible to the leaders of New York State.

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NOTES

[1] See "Property Tax Relief Measures: Answers to the 'Poor Widow' Argument" at http://www.wealthandwant.com/docs/unindexed/Batt_poor_widow_solution.htm and many others at www.wealthandwant.com, www.urbantools.com, www.schalkenbach.org, www.cooperativeindividualism.org, and www.progress.org.

[2] "Principles of Sound Tax Theory as Have Evolved over 200 and More Years," http://www.progress.org/cg/battprincip02.htm

[3] For those who might wish to know who I am, several bios are online. See http://www.friendsofthailand.org/thailandrpcvs/groups/thaiIII/updates/BillBatt.pdf http://www.schalkenbach.org/schalkbios.html#Batt A retrospective account of my ten years with the New York State Legislative Tax Study Commission, 1982-1992, as pertains to the property tax, can be found at http://wealthandwant.com/docs/Batt_WhoPaysNYST_1985.htm

[4] The most comprehensive account of Land Value Taxation's use is Robert Andelson (ed.), *Land-Value Taxation Around the World*, London: Blackwell Publishers, and *The American Journal of Economics and Sociology*, Vol.59.No 5 (2000) Supplement.

[5] See Terry Dwyer, "The Taxable Capacity of Australian Land Resources," in *Australian Tax Forum*, January, 2003. www.prosper.org.au/Documents/TaxableCapacity.pdf; and infra. See also Steven Cord, "How Much Revenue Would a Full Land Value Tax Yield? Analysis of Census and Federal Reserve Data," *American Journal of Economics and Sociology*, Vol. 44, No. 3 (July, 1985), pp. 279-293; and Mason Gaffney, "The Hidden Taxable Capacity of Land: Enough to Spare." *International Journal of Social Economics*, forthcoming July, 2008.

[6] Adam Smith observed, "Ground-rents and the ordinary rent of land are . . . the species of revenue which can best bear to have a peculiar tax imposed on them." (*Wealth of Nations*, Bk 5, Ch.2, Pt.2., Art.1) John Stuart Mill put it a bit differently: "Landlords grow richer in their sleep without working, risking or economizing. The increase in the value of land, arising as it does from the efforts of an entire community, should belong to the community and not to the individual who might hold title." (*Principles of Political Economy*, bk.5, ch.2, sec.5.)

[7] John P. Harding, et al., "Depreciation of Housing Capital, Maintenance, and House Price Inflation: Estimates from a Repeat Sales Model," *Journal of Urban Economics*, Vol. 61, No. 2 (March, 2007); and Morris A. Davis and Michael G. Palumbo, "The Price of Residential Land in Large U.S. Cities," Finance and Economics Discussion Series, Washington: DC: Federal Reserve Board, 2006.

[8] Assembly Testimony on Equity in Assessment Practices, February, 6, 2007, at http://www.wealthandwant.com/docs/Batt_Assessment.htm

[9] Nicolaus Tideman, et al., "How Much Excess Burden Can Be Avoided?" Presented at the Meeting of the National Tax Association, November 15, 2002.

[10] Martin Feldstein, "Tax Avoidance and the Deadweight Loss of Income Taxes," *Review of Economics and Statistics* (November, 1999). Abridged online at http://www.cooperativeindividualism.org/feldstein_martin_deadweight_loss.html

[11] Letter from Harrisburg Mayor Stephen R. Reed to Philadelphia City Controller, Jonathan A. Saidel, May 1, 2003, and others at www.urbantools.org.

[12] Tideman, Nicolaus and Florenz Plassman, "A Markov Chain Monte Carlo Analysis of the Effect of Two-Rate Property Taxes on Construction," *Journal of Urban Economics* 47(2)216-247.

[13] "Stemming Sprawl: The Fiscal Approach," in Matthew Lindstrom and Hugh Bartling (ed.), *Suburban Sprawl: Culture, Theory, Politics*. Lanham Md: Rowman and Littlefield, 2003. Online at http://www.cooperativeindividualism.org/batt-stemming_sprawl.html.

[14] "Roosevelt's Up For Sale at Cool $1B," *New York Post*, July 11, 2007. This is a one-acre block just north of Grand Central Terminal, bounded by 45th and 46th Streets, currently occupied by the old Roosevelt Hotel and owned by Pakistani Airlines. When speculative bubbles arise, it is explained by the increases in land prices, not structures. In fact there was a time in the 1980s when the land under the Imperial Palace in Tokyo were so high that its total values were more than the whole state of California. Soe sites were fetching US$1.5 million per square meter. See Wikipedia, Japan asset price bubble.

[15] Von Thunen was a German Economic Geographer who first calculated the value of locations relative to the cost of bringing goods to market. See Wikipedia for an account.

[16] Two early 20th century public administration texts arguing strongly for recognition of land values are Lent D. Upson, *Practice of Municipal Administration* (New York: The Century Co., 1926), pp Chapter V; and Roderick D. McKenzie, *The Metropolitan Community* (New York: Russell & Russell, 1933), Chapter XVII, "The Economic Topography of the City: Urban Land Values." Land values were taken from state and local data by the Census of Housing until 1987.

[17] http://www.cooperativeindividualism.org/batt-h-william_on-equity-in-assessment-practices.html

[18] There are many sources attesting to this, some excellent ones online. For one, see "What Does Driving Really Cost?" at www.oasisdesign.net/transport/cars/cost.htm

[19] Peter Miller and John Moffet, The Price of Mobility: Uncovering the Hidden Costs of Transportation (Washington, D.C.: Natural Resources Defense Council, 1993). This is somewhat more than the U.S. Department of Transportation's own calculation. The latter uses only direct measurable pecuniary costs and estimates that the figure was in the neighborhood of $1 trillion for 1992, about 17 percent of gross national product (converting to GDP would make it somewhat higher). Since it fails to include externalities such as pollution, accidents, and other associated costs, it seems a reasonable estimate (U.S. Department of Transportation, Transportation Statistics Annual Report, 1994 [Washington, D.C.: U.S. Department of Transportation, Bureau of Transportation Statistics, 1994], 4-5).

[20] Walter Rybeck, "The Property Tax as a Super User Charge," in C. Lowell Harriss (ed.), *The Property Tax and Local Finance, Proceedings of the Academy of Political Science*, Vol. 35, No. 1 (1983) pp. 133-147.

[21] See Peter Mieszkowski, The Property Tax: An Excise or a Profits Tax, *Journal of Public Economics* 1 (April 1972): 73-96, cited and discussed extensively by James Heilbrun, "Who Bears the Burden of the Property Tax?" in Lowell Harriss (ed.), *The Property Tax and Local Finance, Proceedings of the Academy of Political Science*, Vol 35, #1 (1983), pp. 56-71; and Henry J. Aaron, Who Pays the Property Tax: A New View, Washington: the Brookings Institution, 1975. These are reprinted and further discussed in Dick Netzer and Matthew P. Drennan (eds.), *Readings in State and Local Public Finance*. Oxford: Blackwell Publishers, 1997, Chapters 7 -- 10. See also Harvey S. Rosen, *Public Finance*, 2nd Edition (Homewood, IL: Irwin Press, 1988), pp. 483-489; Mason Gaffney, "The Property Tax is a Progressive Tax," Proceedings, National Tax Association, 64th Annual Conference, Kansas City, 1971, pp. 408-426. [Republished in The Congressional Record, March 16, 1972: E 2675-79. (Cong. Les

Aspin.) Resources for the Future, Inc., The Property Tax is a Progressive Tax, Reprint No. 104, October, 1972], online at www.schalkenbach.org/library/progressivet.pdf .

[22] Studies by Citizens for Tax Justice fail to take into account any properties other than homeowners. Some studies by Andrew Reschovsky have a similar failing.

[23] For case studies demonstrating this, simulated and actual, see www.urbantools.org.