On the Futility of a Tax Cap

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Any effort to cap taxes on real property is ultimately a fruitless and futile endeavor. To understand why, one must first see that it is really two separate taxes: one on land value and one on improvements, each with very different dynamics.

The tax component levied on improvements necessarily reduces the supply of office space, home construction, or other buildings, just as does the cost of materials, labor, and money. Taxes on improvements depress the market by what is termed deadweight loss, in opportunities forgone. Although difficult to measure, research suggests that the economic drag or productivity forgone from these taxes is about 10 percent of GDP. Secondly, any tax on improvements can be shifted, partly forward to consumers as higher prices, backwards to the suppliers of labor and capital goods.

A third consideration relates to the proportion of real estate value that improvements generally represent. Where good data exist, indications are that the combined value of improvements in most tax jurisdictions is about half, the other element of course is land value. But improvements depreciate, gradually becoming lower proportions of total price. A building might represent 2/3 of the total parcel value when new but may decline to 1/3 of the value after three decades. So the building proportion of property parcels affected by tax shifting declines over time while the land value increases. Still, taxing buildings is a disincentive to maintaining them in peak condition.

The property tax proportion on the improvement component therefore varies depending on its age and condition, to say nothing of the other negative impacts it has on the community's or region's total inventory. When all is said and done, therefore, not much good can be said for taxing improvements; it discourages the highest and best use of sites, distorts economic decisions, creates deadweight loss, reduces the inventory of office space and industrial plant, is shifted to tenants that are mainly poor people, and is administratively hard. Therefore, while one can't say that a cap on improvements is destructive by itself, the tax design itself is perverse.

A land value tax is the perfect tax: it conforms to all the textbook principles of sound tax theory: neutral to decision making, economically efficient, administratively easy, understandable and simple, progressive in distributional impact, and stable in revenue yield. And taxing land doesn't, and can't, reduce the supply of land. With all those virtues, why is a tax cap on the land component of property futile?

The value of land sites does not derive from the "quality of the earth" or anything done on particular locations alone. Rather site values come from the economic rent that flows through them. Rent is a collective product, a function of the economic health of whole neighborhoods and regions, not the result of any one site's activity. A titleholder can be idle, and even absent, and his parcel might still escalate radically in price on account of others. Because rent flows through locations reflecting enterprise activity, it cannot be halted, or reduced, or in any way eliminated except by stopping the economy of those sites. It should be considered for tax purposes as a constant. Economic regions that are in the doldrums have low site rent flowing through them. Regions that are bustling with market activity have high site rent.

Because site rent is a flow through parcel locations, and because its volume cannot in any way be altered without affecting the economy, that flow can either be recaptured in the form of taxes, diverted and skimmed by a practice known as "rent-seeking," or left there to be capitalized in a site's market value. Left in place it can actually "gum up the works." Taxing it away increases efficiency and productivity.

When the property tax is not collected, capped, limited by a circuitbreaker, partially exempted, or altered by any other device, the land rent then goes to the market value of sites, and property becomes more expensive. Relieving titleholders of their property tax burden simply alters the balance of rent flow: less is returned to society, more is capitalized in market price. One way or another rent continues to flow as long as markets flourish. One can no more stem the flow of rental value than one can stop gravity. There is, however, a solution. Stay tuned.

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