ADAM SMITH AND THE PROPERTY TAX: SOME NEGLECTED ADVICE

A New Perspective on the Inevitability of Proposition 13

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One of the appealing, and at the same time intimidating, features of the invitation I received to write this paper was the breadth (or shall I say lack of definition?) of the topic: "to retrofit Adam Smith to the property tax." What could be more fun than playing with such a topic—or more presumptuous for one whose scholarly forte could hardly be said to be the history of economic thought? Perhaps, however, that is why I, as a specialist not in the philosophic background of public finance but in its contemporary theory and practice, was asked to tackle it.

It was with real pleasure that I plunged again into that wonderfully lucid section toward the end of *The Wealth of Nations* modestly entitled "Of Taxes." As most of this learned audience is well aware, Smith launches into this massive subject with the extraordinarily efficient generalization that people ultimately derive their "private revenue" from three sources—"rent, profit, and wages"—and that these are the wellsprings from which all taxes are drawn. Then in less than 800 words he sets down his monumental "maxims" which provide the framework and point of departure for his brief but learned review of the use of these three kinds of taxes throughout history. What makes the maxims monumental is that they have continued, through the 203 years since they were published, to be the starting point from which most evaluations of tax laws and tax systems inevitably set forth. Their great relevance to the property tax in 1979 is the theme of this paper.

The fundamental importance of Smith's maxims derives from the fact that they provide the same kind of rational and moral basis for tax analysis that the other landmark work of 1776, the Declaration of Independence, did for political freedom movements or that that somewhat later masterpiece of eighteenth-century rationality, the Constitution of the United States, did for federal government. That is not to say, of course, that Smith's maxims are be-alls and end-alls, setting forth definitively every standard by which taxes should be judged for all time. But like our Constitution, which has been amended many times, these maxims give us a logical framework from which to proceed. Inherent in them is a wisdom comprehensive enough and flexible enough to assure their relevance through more than two centuries of vastly changing times and circumstances. Such universality comes less from originality than from depth of understanding of human nature and its history. Smith had a remarkable capacity to encapsulate the working principles which he believed time had shown to be the fairest and least disruptive ground rules for the administration of tax systems. What gives these rules their special strength is their combination of pragmatism and morality, both firmly rooted in a concept of enlightened self-interest—a doctrine which Smith saw as best embodied in an arm's-length relationship between the individual and his government. He perceived government as having its own interests to serve—interests by no means synonymous with those of the individual citizen.

To Smith's independent Scottish nature there seemed no doubt that human productive effort thrives best on a regimen of self-reliance, tempered with moral concern for the needs of others. In such a system, it is the job of government to create an environment within which people can pursue their activities in a just, orderly, and peaceful atmosphere. It is this view of enlightened self-interest, best served when government is kept carefully at bay, that shapes Smith's tax principles. They are first and foremost concerned with the effects of a tax system *on the individual*—not on the government. The government's rights to the individual's "private revenue" are strictly limited, as is demonstrated even by Smith's placement of his discussion of taxes in the last of the five books of *The Wealth of Nations,* and then in the second of the three chapters, followed only by "Of Public Debts." His priorities are clear. His reader has earlier been prepared for his attitude toward public spending by the discussion in Book II of "Productive and Unproductive Labour":

> The whole, or almost the whole public revenue, is in most countries employed in maintaining unproductive hands . . . [1].

> It is the highest impertinence and presumption . . . in kings and ministers, to pretend to watch over the economy of private people, and to restrain their expence. . . . They are themselves always, and without any exceptions, the greatest spendthrifts in the society.[2]

If these sentiments sound rather familiar to the reader of 1979, it is perhaps because *"Plus ça change, plus c'est la même chose."* The tax limitation debate has been around for some time, as have doubts about big government. There are interesting parallels between 1776, that year of revolution in which both *The Wealth of Nations* and the United States of America came to birth, and our own time, when public resistance to the relentless and accelerating advance of taxes in general and the property tax in particular is finding an outlet in voter rebellion. Proposition 13 was not the first of its kind, but it has had unique dramatic effect and seems to be leading the way to some basic changes in the financing of our federal system. Perhaps as a Californian I am overemphasizing the fundamental nature of this new revolution, but as a close observer of what is happening in our nation's largest state, I find some interesting movements afoot. And one of the fascinating aspects of what is emerging is the increasing relevance of Adam Smith.

The magnitude of the change which I see taking place in my state in attitudes toward the property tax and the general financing of local government can be seen best from a comparison of today's climate of opinion with that of a decade or two ago. An excellent barometric reading of that change can be taken from an essay on Adam Smith written a dozen or so years ago by the late, great scholar and dean of American public finance, Harold M. Groves. This is the lead essay in Groves' last, posthumously published book on *Tax Philosophers.* It gives a moderately appreciative view of Smith's criteria for judging taxes, but Groves' conclusion was in effect that the "A" he was awarding was for effort and that as tests of tax systems the maxims were pretty well outdated: "Suffice it to conclude that at least as to taxation the rule of historical relativity is valid. There may be some universal truths in taxation, but they are dwarfed by the constraints of a particular environment."[3]

Looked at today, only ten years after Groves' death, the long-term validity of Smith's pragmatism and sense of just dealing is far more apparent than Groves perceived. The lopsided vote which made Proposition 13 law in California was the expression of many disparate attitudes, but their common denominator was a general indictment of a tax which had run afoul of all Adam Smith's maxims and had mushroomed to a size where the pain reactions to those violations were becoming acute. Never have Smith's criteria seemed more apt. Paradoxically, however, we can learn a good deal about why they are important from studying the reasons for their seeming out of date a decade ago.

Harold Groves was a perceptive and learned student of history and of economic thought. We can fault him today only for failing to understand that he, too, was deceived by "historical relativity" and had fallen victim to the hubris of assuming that a greater measure of final truth had been revealed to his own age than to Smith's. To Groves even the great equity maxim, with its inherent ambiguity between ability to pay and benefits received as a basis for taxation, seemed somewhat confused and dated. Read today, it seems remarkably current:

> [T]he subjects of every state ought to contribute to the support of the government, as nearly as possible in proportion to their respective abilities; that is in proportion to the revenues which they respectively enjoy under the protection of the state.[4]

To Groves this seemed a rather clumsy way of saying that net income was really the best "index of tax capacity." This interpretation could possibly be attributed to wishful thinking, as Groves himself pointed out that Smith "rejected the net income tax on the score that it would confront insuperable administrative difficulties."[5]

Groves seemed clearly bothered by Smith's failure to make an unequivocal statement in favor of ability to pay as the proper standard for tax equity and by his unmistakable reference in the second phrase to the benefits-received principle. Groves had earlier done a brief survey of English tax literature, starting with the mid-seventeenth century, which he called "the heyday of the benefit theory of taxation, according to which a person should pay for what he gets."[6] While giving Smith credit for having "gestured in the direction of ability-to-pay,"[7] Groves was obviously dissatisfied with the maxim's ambiguousness and with its failure to go much beyond proportionality as a tax equity principle. Groves' concern with Smith's inclusion of the benefit principle as part of his maxim carried over into the next essay, on John Stuart Mill, whose thinking he obviously found more congenial. Even there, however, the benefits-received concept proved worrisome enough to inspire a digression of several pages, tracing a modern-day revival that Groves finally dismissed as "largely unsuccessful."[8]

The second maxim, which Smith himself believed to be of utmost importance, seemed to Groves particularly out of date:

> The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. . . . The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.[9]

Smith's reasoning was that the lack of certainty opened the door to corruption on the part of taxgatherers. Groves clearly believed that such dangers were things of the past: "[Smith's] concern for uncertainty seems to have been grounded in his observation of tyrannical administration not uncommon in British experience of his time and notoriously prevalent in France. . . . The importance of certainty as a canon of taxation may now seem remote."[10]

Smith's third maxim focuses on the importance of levying a tax at a time and in a manner "convenient for the contributor to pay it" or "when he is most likely to have wherewithal to pay."[11] Groves seems to have been little impressed by this emphasis, and he clearly believed that the fourth maxim was also superannuated: "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury." Failure to observe this rule, Smith warned, "may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes."[12]

Groves was clearly not daunted by Parkinson's law, nor did he appear to be disturbed by fears of work disincentives or the growing dimensions of the subterranean economy. He concluded his essay with an affirmation of his faith in the capacity of government to solve the administrative problems of taxation and in the "mutuality" of interest "between government and taxpayer."[13] His phrase seems chosen to show how much distance he was putting between himself and Adam Smith's skepticism about governments and their "spendthrift" officialdom.

Groves' essay shows how far we have swung in our thinking since 1969. The tidal wave of public opinion which swept Proposition 13 to victory and stirred up a host of other tax limitation measures in its wake was energized by antagonisms that had much more in common with Adam Smith's doubts about government than with Harold Groves' confidence in it. The age that is coming to birth seems more inclined to look again at Smith's advice and even to dust off the old benefits-received principle; like other antiques it appears to be attracting new respect.

The debate which preceded the passage of Proposition 13 was a far from reasoned one, but it did bring to the surface many kinds of objections to an escalating property tax. Had these objections been more logically organized and presented, they might have boiled down to a detailing of grievances not only familiar to Adam Smith but indicative of the wisdom of his maxims. The equity arguments were the most frequently and vociferously expressed. These largely took the form of tirades against the "regressiveness" of the property tax. The fact that this charge tends to be greatly exaggerated (insofar as it usually is applied to a standard of net annual income rather than lifetime average income, and fails to take account of the income tax provisions which subsidize housing) is not at issue here. There can be no doubt that whatever the degree of regressiveness, the property tax often presents serious liquidity problems for people with limited current income. Those people are hard to persuade that this levy "taxes people in proportion to their respective abilities." In his elaboration of the equity canon Smith provides even more ammunition for such property tax critics, as he warns against a lopsided distribution of the total tax burden, which should, he felt, fall equitably upon income derived from "rent, profit, and wages." (The British, of course, think of the property tax in terms of "rent," as their tax is levied on a basis of the annual income generated by property.) He says that a tax "which falls finally upon one only of the three sorts of revenue . . . is necessarily unequal" (i.e., inequitable), and he goes on to suggest that some taxes fall "unequally even upon that particular sort of private revenue which is affected by it." It is not hard to translate this into a warning of a serious equity problem for an accelerating property tax, absorbing a rapidly increasing proportion of family income. In Smith's terms, then, California's steeply climbing property tax had become a serious threat to the balance that ought to exist with respect to tax sources in an equitable revenue system. The kind of income derived from property seemed to be bearing a disproportionate share of the tax burden and was putting severe strains upon taxpaying abilities in that sector.

This disproportionate burden on property, and especially on housing, could not even be justified by appeal to the benefits-received standard of equity, for the steep rise in California's property tax burdens was not accompanied by any corresponding increase in the quality of services accruing in any very direct sense to property. The biggest increases in service costs were coming in the areas of welfare and education, and even the local educational services (which should enhance property values for families) were believed by people in many communities to be deteriorating in value as they rose in expense. Such disappointments did little to support the credibility of the property tax as a benefits levy.

Probably its worst offense against "equality," however, came in the area of "horizontal" equity (equal burdens for people with equal taxpaying ability). Serious as the "vertical" equity problems may be in the case of an *ad valorem* property tax (heavier burdens for those with more taxpaying ability), they are probably less fundamental than the horizontal inequities which seem to be inherent in the assessment process. Despite remarkable improvements in assessment techniques and despite the generally high quality of California's assessment standards, the nagging doubts about interpersonal equity were constant. These doubts and their causes grew greatly in importance as tax levels rose. Small coefficients of dispersion, relatively innocuous at low levels of taxation, became big and bothersome as tax bills doubled and tripled. It is one of the paradoxes of the Proposition 13 victory that while it relieved the pressure

by lowering tax levels, it magnified and institutionalized the horizontal inequity problem, as it adopted higher assessment bases for property that is sold or improved than for that remaining under the same ownership.

Although it created more horizontal inequities, Proposition 13 demonstrated the importance of Adam Smith's second, or certainty, canon by eliminating much of the unpredictability and severity of assessment increases. Inflation in housing prices, which began slowly and picked up force in California as the decade of the seventies advanced, created great uncertainty about what to expect as assessment notification day came around each year. As the more populous counties began to institute computerized multiple regression systems for reappraisal of residential property, reassessments (which had been on a five- or six-year cycle in most counties) became increasingly frequent. Since commercial and industrial property changes hands less frequently and thus was harder to adapt to multiple regression analysis, traditional assessment procedures continued to be applied to business properties. This use of two radically different valuation methods for the two main components of the property tax base created suspicions in the minds of many homeowners that their share of the base was being pushed up unfairly. Whether for this reason or for others, the single-family residential component of the tax base did increase sharply in the immediate pre-13 years, from 32% of total assessed value in the state in 1973-74 to 41% in 1977-78. During the same period the share of rental residential property fell from 14% to 13% and that of business property from 54% to 46%. These shifts in the composition of the property tax base not only increased uncertainties about the equity of assessment procedures but also shifted local tax burdens from liquid to illiquid forms of income.

Again, ironically, Proposition 13 has only worsened some of these problems. It has actually exacerbated the disparity between the two sectors of the real estate market. The ballot alternative to that initiative sought to keep the burdens borne by residential and business property at a constant ratio, but the formula seemed complicated and was probably never really understood by the electorate, which went overwhelmingly for the certain promise of immediate relief.

The relevance of Adam Smith's certainty maxim to all this seems clear: rapid rises in property tax levels make uncertainties about assessments increasingly bothersome. As Smith predicted, even glaring inequities prove preferable to frightening uncertainties. California's overreaction to an overheated property tax produced an earthquake; its aftershocks will be felt for years. The shaking-down process could have two distinct effects for the foreseeable future: it could guarantee a low-rise profile for the property tax, and it could tie it more and more to property-related services, making its acceptability increasingly dependent on the benefits-received standard of equity.

California taxpayers who saw their property tax bills jump 30% or more per year could have no difficulty understanding the cogency of Adam Smith's third canon on "convenience." As long as property taxes on an average-priced home were no more than $500-$600 per year, they could be paid in semiannual installments without undue pain for most householders. As these figures doubled and tripled, however, the twice-yearly payments became distinctly inconvenient for many people accustomed to income tax withholding and long easy payment terms for most of their major expenditures. To be sure, most property owners with outstanding mortgages paid their tax bills monthly as part of their payments to the mortgage holders, but for those who paid their taxes directly, the inconvenience of large, lump-sum exactions could be a vexatious problem. It was another factor that helped to build up the pressure behind Proposition 13.

Smith's fourth, or economy of administration, maxim strikes at the very heart of the property tax problem. In dismissing this canon so lightly, Groves must have been thinking almost exclusively of the income tax, though it is hard to imagine that he would today be quite so confident even about that. It seems inescapable that the complex inexactitudes of the assessment process mean that there is a fatal weak-

ness within the property tax, created by a necessary trade-off between equity and economy of administration (or maxims #1 and #4). Anyone buying or selling real estate knows how hard it is to determine value with any precision. The market is so segmented that potential buyers and sellers have difficulty finding each other, and prices placed upon property even by experienced brokers tend to be "guesstimates" of value. Such problems even in the face of actual transactions can only begin to indicate the far greater ones of appraising property that has not been on the market for many years. Intangibles such as aesthetic factors can make large differences in the prices buyers are willing to pay, and it is really the fortuitous juxtaposition of whatever buyers and sellers happen to be in the market at the same time that determines most prices. Computerized analysis of large numbers of sales can reduce these uncertainties, but it cannot eliminate them, especially for expensive homes with unique characteristics.

These difficulties are such as to make good administration of the property tax expensive; attempts to economize on it can only mean more and wider inequities. In the case of California, its generally high standard of administration, supervised at the state level by an expertly staffed Board of Equalization, was, ironically, one of the factors that unwittingly fueled the Proposition 13 explosion, as the growing trend toward annual reassessment pushed assessed valuations rapidly upward, turning computer estimates into expensive realities. Those who thought their property was overvalued found the appeals process time-consuming and demanding of both resourcefulness and self-confidence. Information about recent sales and other peoples' assessments was available, but assessors' staffs are not paid to point out weaknesses in their procedures, and appellants required both energy and ingenuity—or independent professional help—to prepare appeals. Large numbers of appeals only had the effect of pushing up the comparatively low assessments and also of adding to the expense of administration. Property owners tended to find it a no-win situation.

The trade-off between equity and administrative expense seems inescapable, although some proponents of a land-only property tax argue that many of the variables can be eliminated by excluding improvements from the tax base. This is an issue so charged with religious fervor that it can hardly be discussed dispassionately, but I should like to point out two obstacles to a land-only property tax that seem to me conclusive. The first is that in many areas there are so few vacant land parcels available for use as a basis of comparison that trying to separate the land values from the attached improvements becomes an arbitrary and theoretical exercise. There is, after all, an empirical test of the value of the entire package—i.e., sale on the open market. Abstracting the land portion of that essentially inseparable package leaves only a hypothetical value that can be proven empirically only if the property is cleared of its improvements. It seems that this methodology suggests getting rid of a complex but ultimately solvable problem by converting it into an insolvable one. It is hard to imagine that confidence in the assessment process would be enhanced by the elimination of the one absolute proof available to a skeptical taxpayer—i.e., showing what the taxed property can be sold for.

The other major deterrent to a shift to a land-only tax is the ethical one of conferring monumental windfall gains and losses by suddenly changing rules which have deeply affected property values. Expected differential property tax burdens are capitalized into the value of parcels, and changes in those burdens can drastically affect those values. Even carried out in slow transitional stages, such an arbitrary shift would produce dislocations that could be justified only by demonstrable evidence of large public advantages to be gained.

Aside from raising the problem of wasteful and unproductive administrative costs, Smith's fourth maxim suggests that the tax itself may "obstruct the industry of the people" and discourage them from engaging in productive activity. This neutrality issue really amounts to a fifth maxim. The disincentive effects of taxation are more discussed these days in connection with the income tax, although the argument has

long focused as well on the property tax, and particularly the tax on "improvements." The property tax has been blamed for the decline of central cities, the disappearance of open space and farmlands on the fringes of urban areas, and many other deleterious land-use decisions. Proponents of the land-only tax have been particularly vehement on this score, arguing that their solution would encourage the rehabilitation of older buildings and prevent "urban sprawl." This is much too complex a subject to go into here, except to say that a number of major studies of this issue have been made in recent years and have tended to produce inconclusive results. There are many factors affecting land-use decisions, and there seems to be no panacea. Experience with "graded" taxes (higher rates for land than for improvements) in Pittsburgh, Honolulu, and several other cities has produced no miracles of enlightened development, and the Hawaii State Department of Taxation has actually recommended repeal of their graded tax on the ground that it discriminates unfairly against businesses that are necessarily land-intensive. The graded tax has also been blamed for encouraging the massive high-rise development at Waikiki which has deprived the area of much of its charm.

Although in its initial effect the property tax may have a discriminatory effect on the construction industry, the shifts and changes which have followed in the wake of Proposition 13 have focused attention on some countervailing forces. As cities and counties have reappraised their budgets in the light of sharp cuts in property tax revenue, they have pinpointed many areas in which general revenue has been subsidizing construction, and especially new developments. Planning departments, engineering services, utility line extensions, new schools, and many other amenities have been heavily financed by the public purse. Many jurisdictions are now raising their license fees and service charges to developers and builders, to the extent in some places of several thousand dollars per new dwelling unit. Alan Post, chairman of a committee set up by the Governor to study the effects of Proposition 13, has predicted that this change of policy may so reverse the flight of the affluent to the suburbs that the poor will be driven out of their central cities by the turning tide. If, indeed, there is a major shift of emphasis among builders from new developments in the suburbs to restoration of urban property, some of the land tax goals may find themselves accomplished by other means. Removal of the hidden tax subsidies to new development, the increased cost of gasoline, the Proposition 13-induced move toward more complete state funding of schools, and the promise that property tax increases will be kept within predictable bounds may do the job of encouraging urban rehabilitation without simultaneously discouraging low-density living and the preservation of private open space.

It is difficult not to conclude that the passage of Proposition 13 has driven home some hard lessons about the property tax. For one thing, it has shown that Adam Smith's advice on taxation should not be lightly dismissed or assumed to be superannuated. For another, it shows that as tax levels rise the property tax becomes harder and harder to reconcile with Smith's canons. Although small inequities, uncertainties, inconveniences of payment, and administrative costs can be tolerated, large ones cannot.

These conclusions lend credence to the growing opinion among public finance specialists that the property tax not only has limits as a source of revenue for local governments but can be best accepted and justified when it is closely related to the benefits it finances. The benefits standard of equity may have had its "heyday" in the 17th century, but it seems to be staging something of a comeback. As Groves' essay demonstrated, it has been so eclipsed in recent years by the ability-to-pay standard and by the assumption that it is the duty of all taxes to redistribute income from rich to poor that most people have tended to share Groves' rather derisive attitude toward the notion that any tax should be a means of "paying for what you get." Obviously there has long been a dyed-in-the-wool conservative constituency favoring benefits

taxes, but the new group that is forming around this concept as a basis for local taxation is something else. They argue that federal and state tax systems should depend heavily on redistributive, ability-to-pay principles and should assume almost all of the responsibility for the financing of services with broadly distributed benefits. Local governments, in contrast, should concern themselves with services and facilities providing benefits largely limited to their own regions and in financing these should make generous use of the benefits standard. This arrangement rests on the assumption that severe poverty is to be eliminated by the redistributive programs financed by higher levels of government. It can be defended from charges of undue regressiveness by the reminder that its total effect could be less regressive than the system we have now, which places too much financial responsibility for too many kinds of programs on local governments and their present, markedly regressive tax systems. Providing citizens with more opportunity than they now have to pay only for those local services they need or enjoy would make for greater efficiency that would benefit the poor at least as much as the rich. It would not only eliminate much waste but subject local services to a cost-effectiveness standard that has been sorely lacking in recent years.

Conclusion

Going back to Adam Smith in reappraising the property tax in the light of Proposition 13 is like going back to basics in any discipline. He set forth ground rules which looked irrelevant a mere decade ago but which the property tax rebellion of 1978 has proven anew. Proposition 13 itself was an over-reaction, a caricature of sound tax policy. But it was brought into being by the rapid, undisciplined growth of a tax that had come to tread painfully on all the sore points which Smith's maxims had warned against. The one good principle embodied in this badly written initiative is the one which Adam Smith himself cited as of paramount importance—certainty. No matter what you pay for property, you know the limits of the tax you will be subject to. Harold Groves, while critical of Smith's emphasis on this point, seems to have overlooked the fact that certainty is perhaps the crowning virtue of his favorite levy, the income tax. For all its many faults, the income tax will not arouse the same antagonism as a too-well administered property tax because its impact is predictable and determinable by factors within the control of the taxpayer. He can stop earning income or give his income away, thus avoiding a higher tax than he wishes to pay. Similarly, he can limit his purchases and so avoid a sales tax. But only by selling his house can he escape the relentless effect of inflation on its price, and then he has to worry about his next dwelling. In the final analysis, as Adam Smith warned, a tax must stay within bounds. It must not fall disproportionately upon any specific source of income. It must be reasonably fair in its impact, convenient to pay, and not too expensive to administer. And, above all, it must be predictable, remaining sufficiently within the control of the taxpayer to keep from becoming a source of doubt and fear. Of all its faults, the property tax in California transgressed most against the canon of certainty. That was its Achilles' heel. May other states take warning.

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[1]Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations,* Book II, Chapter III (New York: Modern Library, 1937), p. 325.
[2]Ibid., p. 329.
[3]Harold M. Groves, *Tax Philosophers* (Madison: University of Wisconsin Press, 1974), p. 25.
[4]Smith, Book V, Chapter II, Pt. II, p. 777.
[5]Groves, p. 19.
[6]Ibid., p. 14.
[7]Ibid., p. 29.
[8]Ibid., p. 32.
[9]Smith, Book V, Chapter II, Part II, p. 778.
[10]Groves, p. 19.
[11]Smith, p. 778.
[12]Ibid.
[13]Groves, p. 25.