LAND USE & TAXATION

Applying the Insights of

Henry George

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Edited by H. James Brown

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This book is dedicated to David Colvill Lincoln, in appreciation for his selfless service to the Lincoln Institute of Land Policy, and through it, his generous and consistent support for the advancement of knowledge in the field of land use and taxation.

Foreword

In 1972, David Lincoln had an idea. As steward of his father's trust and sharing his abiding interest in the work of Henry George, he felt that he could best serve his father's wishes by providing a forum for the examination of Georgist ideas. After an extensive search for both the right geographic location and the best person to lead the organization, the Lincoln Institute of Land Policy was established in 1974.

This relatively long planning process for an entity that was fully funded from the beginning is in keeping with David Lincoln's thoroughness. He wanted to be very certain that the Institute had a strong foundation, and he would not be rushed into premature decisions about location and focus. Now, after guiding the Institute's activities for 22 years, David Lincoln has stepped down as chairman. Again, true to his style, he waited until he felt the organization was healthy and stable before passing on its leadership.

During the past year, his colleagues and I have looked for opportunities to acknowledge David Lincoln's contributions to the Lincoln Institute of Land Policy, but in ways that suit his quiet competence. He is not a man for accolades and applause, but rather a man of substance and thoughtful work. And so the idea for this collection of essays was conceived.

Henry George was a truly original thinker, and many of his insights are just as forward-looking today as when he wrote *Progress and Poverty* more than one hundred years ago. In fact, it is sometimes difficult to recall that George is not referring to current social and economic conditions, so familiar are the questions he addresses.

Land use and taxation issues have of course become much more complex since George's time, and there are no easy, straightforward answers. Even so, the need for practical and equitable solutions to land-related problems is even more critical today, and Henry George's ideas should clearly be considered in the ongoing search for workable policies.

It is my hope that this book will take us one step closer to a fuller understanding of important global land use and taxation issues. If it can stimulate the discovery of good answers to just one of the many land-related dilemmas we face today, there could be no better tribute to David Colvill Lincoln's years of tireless service and leadership.

—*Kathryn J. Lincoln*
Chairman of the Board
Lincoln Institute of Land Policy

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Henry George's Contributions to Contemporary Studies of Land Use and Taxation

H. James Brown

When Henry George published his most famous book, *Progress and Poverty,* in 1879, the United States had no zoning laws, no income taxes, and only two national parks. Although George could never have anticipated all the changes in real estate development, public finance, and property rights that would occur over the following century, the fundamental policy issues that he analyzed are as pressing today as they were 120 years ago. In essence, we are still asking the same question: How do you strike an equitable balance between private property rights and public interests in land?

Henry George wrote at a time when the era of nearly free land on the American frontier was coming to an end. George was concerned that diminished access to land would undermine the relative equality of economic opportunity—and therefore of political rights—that distinguished the United States from the "old" countries, some of which were responding to a wave of social conflict by retreating from representative democracy. Like the classical economists, Henry George believed that competitive markets and private property encouraged efficiency and productivity by systematically rewarding producers for meeting consumers' needs at the lowest possible cost. He also recognized that land is a very peculiar commodity. No matter how high its price rises, its supply cannot increase. Yet the demand for land inevitably grows with the human population, because every human being has to consume natural resources and needs a place to live. As a result, landowners tend to grow wealthier regardless of how well (or how badly) they use the land.

George proposed a simple but radical solution to this dilemma. While some reformers supported the outright public ownership of land, George instead suggested taxing away the value of land produced by anything other than private efforts. Such a land value tax would keep private landowners from unfairly capturing the benefits afforded by natural resources, urban locations, and public services. George also believed that this tax would force landowners either to put their land to its economically "highest and best" use themselves, or make it accessible to someone who would.

The essays collected here explain why Henry George's basic ideas about land use and taxation issues still have currency, despite how radically different the world has become as we arrive at the end of the twentieth century. The authors come to the task from a range of disciplines, providing several points of view on Henry George's contributions as an "intellectual ancestor." As Nobel laureate Robert Solow puts it, "The best way to keep Henry George's ideas alive and effective is to develop and refine them, and to extend their range of relevance to issues of land use, urban form, and taxation—including many aspects that could never have crossed George's mind."

Taking up this charge, Martim Smolka and I look at how several new land taxation policies, such as impact fees and benefit assessments, are being used to capture the portion of land values created by public actions. While the implementation of any new type of tax inevitably faces serious resistance, new land taxes are particularly vulnerable because of the political power of landowners. Even so, it is our view that these mechanisms for value capture—while more limited than what Henry George would have recommended—can still be an important revenue source for pressured local governments, particularly in developing countries.

Karl Case's essay then addresses the issue of efficiency and concludes, along with Henry George, that government intervention may be more justified in the case of land than in other kinds of markets. Case's argument is that land prices tend to undergo sharp run-ups and slow "sticky" downturns—movements that neither accurately nor quickly reflect the "use value" of land. Speculation only exacerbates this pattern, and can ultimately undermine the competitiveness of an entire regional economy.

The following chapter, contributed by Dick Netzer, describes why property taxes—which funded almost all public services in Henry George's time—now provide only a quarter of all government revenues in the United States. With the recent move to decentralize government, however, there is growing pressure to generate more revenue from the property tax. As evidence why "the ideas of Henry George are more central to the circumstances of American government than they have been for some decades," Netzer cites the threat to municipalities such as New York City, which reaped none of the rewards of soaring land values during the 1980s but must now find the resources to deliver more services locally.

William Doebele follows up with a brief history of urban property rights and land use in developing countries, where the traditional distribution of ownership long made land taxation politically impossible. Today, though, international development agencies are actively investigating ways to institute local systems of property taxation as a way to promote economic development. Doebele notes that the formerly socialist countries provide ideal laboratories for testing Georgist ideas because they are now "wrestling with both the practical and philosophical issues of the state's right to participate in the increases in land values that occur from industrialization and rapid urban expansion."

C. Lowell Harriss demonstrates that Henry George's intellectual and moral appeal extends not just to planners and policymakers, but also to environmentalists and urban advocates. Environmental and growth management regulations recognize that land is unique, and that decisions about its use have long-lasting and far-reaching effects. Harriss underscores how zoning, planning, and permitting have made it difficult to draw a precise line between privately and socially created value in land. He also warns that attempts to capture *increases* in value due to public actions may also provoke, in other cases, counterclaims on government for *decreases* in value.

Daniel Bromley offers another perspective on the fundamental Georgist challenge—balancing private property and the public interest in land.

Bromley argues that public and private rights and values are interdependent. The rights of landowners are essentially created by social rules, and those rules must evolve as society gains new knowledge and adopts new standards in both land use and politics. From that standpoint, regulations restricting what private owners may do with "their" property are simply the logical flip side of "the social gift of private land ownership." Bromley agrees with Henry George that, as an incentive system, the private ownership of land offers broad economic benefits, but he questions how land "can . . . assure liberty when not everyone has (or can obtain)" access to it.

Finally, Joan Youngman expands on several of the preceding essays by exploring the thorny issues involved in implementing a fair property tax system. She cites the many reasons for citizens' well-known animosity toward the property tax, including the difficulty of separating and measuring the public and private components of land value. Indeed, Youngman concludes that it may be impossible to disentangle these two sources of value completely as changing technology and social norms create new forms of property. Nevertheless, she notes that the recent trend toward relying on the taxation of consumption or incomes—and reducing taxes on wealth and property—raises precisely the same issues of public fairness and private productivity that Henry George identified more than a century ago.

While they offer markedly different perspectives, each of the authors who contributed to this volume would agree that Henry George's ideas have much to add to the ongoing debate over land policy and taxation issues. As we at the Lincoln Institute of Land Policy pursue our mission to inform public decisionmaking in this realm, we will continue to mine this rich intellectual legacy.

How to Treat Intellectual Ancestors

Robert M. Solow

In the life of the Lincoln Institute of Land Policy, the shadow of Henry George is always somewhere on stage or in the wings. The question of the proper relation of the Institute's day-to-day work to the ideas expressed in *Progress and Poverty* is perennially open. The Institute owes its existence to John C. Lincoln's belief in George's ideas and to his explicitly stated wish to teach and expound them. The presence of David Lincoln on the Board of Directors, along with other members of the Lincoln family, guarantees that the question will periodically arise, to be seriously discussed.

But the question would persist even without that direct stimulus, because it is right that it should persist. No one should carelessly or self-indulgently alter the seriously intended purposes of an institution, certainly not without a long evolution.

There are some—also seriously intended—qualifications built into my choice of words. Here is an illustration of their intention. Years ago, Roger Babson, financier and investment counselor, gave some money to the Massachusetts Institute of Technology for the explicit purpose—I am relying on fallible memory here—of fostering research on the relation between Newton's law of action and reaction and the business cycle. Well, there is no relation between Newton's law and the business cycle. It seems to me that a fundamentally silly purpose, even if seriously intended, is entitled to only minimal respect; MIT is justified in using every bit of flexibility that the law will allow in applying Babson's gift to sponsor intelligent research on the business cycle, even if the connection to Newton's laws is inversely proportional to the square of the distance to Jupiter. The point is that a rule of reason applies.

 The case of Henry George and the Lincoln Institute is quite different. There is nothing inherently silly—quite the contrary—about George's basic insight that the pure rental value of land usually owes little or nothing to the actions of the owner, and that therefore the rent could be taxed away without inducing any inefficiency in the allocation of resources, and perhaps with justice. (Whatever was the case in 1879, however, it is no longer true that the proceeds of such a tax would be enough to cover all the legitimate expenditures of government.) So the role of George's ideas in the work of the Institute has to be decided.

The theory of rent has a long history in economics, and George has an honored place in that tradition. This is important because it reminds us that George was an economist, and one of the major figures of nineteenth-century American economic thought. He happens also to have founded a movement, and that makes the underlying issue more difficult. There should be something to be learned from the story of other economists who intended their ideas to play an important role on a larger stage. That is the premise of this brief note.

The obvious parallel to consider is Karl Marx and *Capital*. It tells us something about the relation between a text intended as science and a political movement based on it. There was a time when Marxian economics—right or wrong, it does not matter from this point of view—was a lively enterprise. In the time of Otto Bauer and Austrian Marxism, Rosa Luxemburg and others, some Marxists were looking at the world and trying to interpret it by applying the concepts of Marxian economics. They did not seem to be inhibited by the thought that any modification or extension of Marx's ideas, any departure from the text, would be automatically an error, even a blasphemy.

But the movement took its toll, or at least that is what I think happened. The fact that the movement was or became totalitarian certainly did not help; but I am inclined to think that the course of events would have been similar anyway. Marxian economics became an act of piety instead of a research program, and *Capital* became a sort of scripture rather than a work of economic theory. I am sure there have been exceptions, but the impression is strong that Marxian economists spent their time reinterpreting the master's language into dicta about the twentieth-century world, instead of extending it and amending it to serve as a research tool for finding new generalizations about the twentieth-century world. It is a dead giveaway when a tradition spends footnote after footnote establishing legitimacy by quoting from a master text instead of going about the business of the moment. In honesty I have to say that I think that Marxian economics was a dead end anyway, so that Marxian economists would have had a hard time doing "normal science" in that framework.

By way of contrast, consider the case of Léon Walras, who wrote *Elements of Pure Economics* in 1874. Walras had no intention of founding a movement. He was the founder of what is usually called "general equilibrium economics." Here is a loose description of the idea. The state of the economy at any moment is a list of the quantities bought and sold of all the goods and services there are, and the prices at which these transactions take place. The state of the economy is determined as the solution of a large number of equations. These equations are intended to describe the behavior of families in earning and spending their incomes in the presence of given market prices, the behavior of firms in choosing production plans that maximize their profits in the presence of given market prices, and the determination of those prices by the necessity of matching supply and demand in every market simultaneously. But markets are interrelated: the price of pork depends on the demand for chicken, the supply of both depends on the price of grain. So the economy has to be regarded as a vast interlocking system.

Although it is essentially impossible to apply so complex a theory to any specific economic situation, this framework underlies a very large part of all the economic research that is done today. Clever people find shortcuts that enable them to take account of "general equilibrium effects" in the course of studying some particular applied problem; assistant professors earn tenure by exploring some gap in Walras's theory and showing how to fill it or circumvent it.

The point is that no one reads the *Elements of Pure Economics* any more except historians of economic thought. Students learn general equilibrium economics, but they learn it in its modern form from up-to-date textbooks and lectures. The theory now includes things that Walras had never thought about, asks questions that had never occurred to Walras, and uses analytical methods that were invented long after Walras's death. Walrasian economics is alive and well in the literature, but you will almost never find a reference to Walras. You will find references to Arrow, Debreu, Hahn, Hildenbrand, Mas-Colell and dozens of others, some of whom are developing the theory, some of whom are deploring its shortcomings, some of whom are rejecting the theory on the ground that its shortcomings are irreparable. But you will find no appeals to the authority of a basic text.

The case of John Maynard Keynes is more complex, and more interesting, than either of these. Published in 1936, *The General Theory of Employment, Interest and Money* was intended both to transform economic thought and to transform economic policymaking. It did both, at least for a while. It also ignited a powder-train of controversy that has lasted from that day to this, and is not over yet. In that controversy, ideas about economic theory and feelings about economic policy are all mixed up together, along with arguments about the correct interpretation of concrete data arising from today's economy. There is no doubt that Keynesian economics is alive; the controversy is about whether it is well or ill. (Again I should put my cards on the table: I am a strong, if sometimes quirky, supporter of Keynesian economics.)

The substance of Keynesian economics and the surrounding controversy is too complicated to describe here. It has to do with the question whether the sort of (general) equilibrium reached by a modern, industrial capitalist economy is likely to be well adapted to the desires—for current and future goods and leisure—of the inhabitants, or whether there is a real possibility that it will involve pathological unemployment and underproduction for serious intervals of time (and, if so, exactly why). Ideas about theory and feelings about policy intermingle because the first outcome makes a case for minimal government while the second speaks for more in the way of deliberate public action.

The interesting twist occurs within the Keynesian side of the controversy. (The reader is warned that I have opinions on all this, and they will show.) It happens that the *General Theory* is not in the form of a tight, linear argument. It contains several strands of thought which, though not obviously inconsistent or incompatible, lead in different directions. It is thus possible to argue about "what Keynes really meant." In this respect Keynes is like Marx and unlike Walras or George. So the possibility clearly exists that a piece of economic analysis can be turned into scripture. That seems to me to be the death of any progressive idea. The interesting question is not what Keynes meant to say but what is really true.

Both pursuits can be seen in the Keynesian tradition. The landscape is convoluted in ways that are of no direct interest. To simplify, there are those who insist that they are the true Keynesians, and quote chapter and verse to prove it. This tendency began in England among Keynes's younger associates and their students, but has spread far beyond that circle to other places and people. Their common enemy is what is called "American Keynesianism" (or, more picturesquely, "bastard Keynesianism"), though there is nothing specifically American (or out-ofwedlock) about it. American Keynesians have picked up on some, though no doubt not all, of the strands of thought found in the *General Theory* and gone on from there in several directions: corrections, new developments and extensions of the theory, links with other modes of thought and, above all, direct, empirically-based applications to the U.S. economy (and others) in aid of both understanding and the design of policy.

The underlying theory may be right or wrong, the applied conclusions may be valid or invalid. That is a vital issue about economics, but not for the point I am making here. Graduate students do not usually read Keynes; they study advanced textbooks and journal articles. The citations they read, and the ones they write, are to other articles and working papers. American Keynesianism, for better or worse, is an active research program. I think that is because it does not look back. "True believer" Keynesianism has been too enmeshed in textual pieties to accomplish very much. No doubt the contrast is not as stark as I have made it seem, but I would stand by the general picture.

One more example, drawn from outside of economics, may help reinforce the point. Think about Charles Darwin and *The Origin of Species*. The theory of evolution by natural selection is surely one of the great ideas of the nineteenth century, and it is alive and flourishing today. Later discoveries, from Mendelian genetics to the structure of DNA, have strengthened it. Contemporary evolutionary biologists, and by extension those who are creating an understanding of the molecular biology of the gene, are all working within the framework of the theory begun by Darwin. But no one, faced with a concrete problem in biology, asks what Darwin thought. I suppose some biologists read *The Origin of Species,* or read about it, but I also suppose they treat it as a cultural monument and not as a set of instructions about doing biology. Only a historian of ideas would ask "what Darwin really meant." That does not mean that Darwin's ideas have evaporated; on the contrary, they are living on in the only worthwhile way. A group or institution dedicated to the development and propagation of Darwin's ideas would be failing if it devoted itself to distributing excerpts from *The Origin of Species* instead of pursuing modern evolutionary biology.

It seems to me that the obvious conclusion for the Lincoln Institute and Henry George is the correct one. The best way to keep George's ideas alive and effective is to develop and refine them, and to extend their range of relevance to issues of land use, urban form, and taxation, including many aspects that could never have crossed George's mind. The range of possible activities is very broad. It includes, at the academic extreme, fostering improvements in the theory of rent and in methods for measuring the pure rent element in the market return to property. At the policy end of the spectrum, it could include such activities as studying and teaching about the control of urban sprawl, especially through financial incentives; studying and teaching about the design of land-use and land-ownership institutions in places, like Eastern Europe and developing countries, where basic institutional choices are still open; and studying and teaching about land taxation, land use and environmental amenity. The list could be very long; this random selection is intended to indicate only how diverse it could be.

This approach has the merit of treating Henry George as a serious contributor to our continually developing ideas about the use of land and natural resources, and not merely as a sort of guru with scope circumscribed by the single notion of the single tax. It seems not only more likely to lead somewhere but also more respectful.

Capturing Public Value from Public Investment

H. James Brown
and Martim O. Smolka

Without question, Henry George is best remembered for his advocacy of the single land tax. In this chapter we will investigate George's ideas on capturing public value through a tax on land, and explore the practical and political problems encountered in implementing various forms of land tax in the United States and other countries.

Our conclusion is that while there are practical and political obstacles to implementing new land taxes, there are also real opportunities. Indeed, recent land taxes that attempt to recapture value created by the public sector have been very successful. Particularly in developing or transitional economies, land taxes can be both an important source of revenue and a stimulus to economic development.

Henry George and Value Capture

Henry George proposed that a single tax on all land value would not only improve society but also generate enough revenue to cover all public expenditures. Part of his rationale was that almost all of land's value[1]—and therefore any increase in value—is the result of community rather than individual effort. In his view, it is only fair that the increase in land value resulting from community effort be taxed away from landowners and made available to the community as a whole. The logic of value capture is illustrated in the table below.

Types of Land Value Capture

	Increase in Land Value Captured by	
Increase in Land Value Generated by	**Community**	**Private Owners**
Community	(1) Preservation of beaches and other lands/parks accessible to the general public Planned cities like Brasilia or New Towns in the United Kingdom	(2) Public investments in highways or utilities Provision of high-quality urban services such as schools Changes in zoning
Private Owners	(3) Beautification of a large private garden Pollution (negative increment) Movement of a famous person into a community	(4) Well-designed community or shopping center Gated community Beautification of a large private garden

Land value increases can result from either community or private effort, and the increased value can accrue to either a private landowner or the community at large. Examples of community-based efforts include public investments to provide better access to highways or utilities, changes in other publicly defined prerogatives such as zoning ordinances, and preservation of open or public space. Land values may also rise because population and economic growth or sheer speculation increase overall demand. Private actions that boost land value include design of an attractive community or shopping center, development of a gated community, or beautification of a large private garden.

The ethical proposition that one should be rewarded only for one's own effort implies that an individual should return to the community all value that results from community action. The actions listed in the upper right-hand box (2) of the table are examples of the unambiguous situation where public policy should capture back for the community the value generated by the community.[2]

Henry George felt that this kind of tax was not only fair, but that it would also provide several social benefits. We can summarize the positive impacts George predicted from adopting a single land tax as follows:

1. *Sustainable public finance.* The land tax will generate enough revenue to cover all public expenditures.

2. *Economic growth.* The tax on land can replace other taxes that reduce productivity and efficiency. Substituting the land tax for other taxes will therefore increase economic growth. (Henry George also believed

that a full land tax would eliminate business cycles and the resulting loss of efficiency.)

3. *Reduction of poverty.* A full tax on land would increase the land available for use and decrease land speculation. Together these changes would lower land prices and reduce the cost of living and the incidence of poverty.

In addition to accomplishing all of the above, the land tax would also fairly reward both community and private effort.

Practical and Political Obstacles to Value Capture

While the idea of taxing land had many supporters before Henry George's time, George was the one who advocated the idea with the most clarity and enthusiasm. Since then, economists and others have acknowledged the advantages associated with a land-based tax. Nevertheless, land taxes have so far been implemented in only limited ways.

In the following discussion, we identify some of the fundamental obstacles to land taxes in general and to two forms in particular: the first is the pure Henry George tax that attempts to tax all land rent; the second is a narrower version that only captures increments in land value that directly result from a particular public action.

Implementing a New Land-based Tax. All tax reform programs face the problem of changing a system that has been accepted and capitalized in the market.

Economists have long noted that the only "good" tax is an "old" tax. Any effort to move to a new tax system—and land-based taxes are certainly no exception—confronts this obstacle.

Simply announcing a new land value tax is likely to have immediate impacts on land transactions and value. For instance, the recently announced plan in Brazil to sell building rights at the square-meter cost of land, the so-called "Solo Criado" program, resulted in substantial withdrawal of investment by developers. This, in turn, has led to widespread revision or retraction of the policy.

Henry George was well aware of landowners' ability to affect land policy. He noted that landowners are often politically powerful, and politicians are often major landowners. Owners of land are therefore likely to prevent any change in land taxation because new taxes might reduce land values. The political strength of landowners, combined with the threat of market disruption, make it difficult to adopt changes in land taxes.

There is also uncertainty about how much revenue a new land tax will generate. Land values would be expected to fall with higher land taxes. If land values drop substantially, the revenue from existing land taxes will be much lower than anticipated. In the case of "Solo Criado," even though the policy applied only to new development, it would affect the prices of all land. If all land prices fell enough, the total revenue from land-based taxes would decrease even with a new tax. The threat of land price declines and the uncertainty about revenue impacts thus limit the political appeal of new land taxes.

There is also a concern that in the short run when there is only a limited amount of land available for development, or when there is collusion among landowners, the tax on land could be pushed forward to housing or other land uses. If the tax were instead on the building or improvements, for example, it could raise housing prices and aggravate problems of affordability.

In sum, any new tax proposal is bound to generate major controversy. And because of the political power of landowners, it has been—and will continue to be—difficult to adopt radical changes in land taxes.

Full Capture of All Increments Henry George argued that all land value increments were the result of community or public action. He therefore advocated complete capture by the community of all increments in land value. In today's complex world, however, there is much confusion about what "community" should capture the value.

According to Henry George, fairness dictates that the individual should not reap the return from community efforts. But which of the various levels of government or community should reap the benefits from the collective effort? In some cases, it might be fair for a local nongovernmental organization—say, an association of neighborhood residents—to capture the gains. In others, the local government or special district ought to capture the value. In still other cases, a regional or national entity is responsible for the increments to land value and therefore should fairly capture the value.

Some believe that the important issue is simply to capture public value from private owners. In their view, there's no need to be concerned about which part of the community captures how much value. We believe, however, that the international trend towards decentralized government will contrive to make this issue an important political one. Furthermore, there is evidence that citizens worry about the distributional aspects of taxes, and public support may depend on whether voters believe the revenue is fairly shared. Fair distribution of benefits requires some mechanism to determine which entity is responsible and to give the captured value to the proper entity. Such a mechanism could be established, but it would have to be very complex—thus negating much of the advantage a simple land tax would appear to provide.

Another reason Henry George advocated a land tax was that he felt it would reduce poverty and result in fairer income distribution. In the late twentieth century, however, owning land provides the best hope for most low-income (and many middle-income) households to generate wealth. The typical sequencing in the informal market of developing countries (i.e., occupancy, building, serving, and titling) has provided an important avenue of economic progress for the poor. When informal land markets are regularized and title given to occupants, lower-income families receive real gains in wealth. Further increases in land values may then strengthen their economic position. A tax on all increments in land value without compensating changes in the social welfare program would therefore undermine the economic progress of low-income households.[3]

For many segments of the urban population, particularly in developing countries, land ownership is also the only means to hold any value for security. Access to land ownership has played an important role in most developing countries for middle- and lower-income families as a means of capitalization when capital markets are absent, weak, or inaccessible. In the present circumstances, then, imposing a single land tax could hurt rather than help the poor.

Henry George also argued that the land tax would improve economic efficiency. But, depending on how the tax is implemented, it could inhibit the development process as it now occurs. Developers play an important role in assembling land, designing a community, establishing the right mix of activities, and even defining new uses or ways of living. Determining how much of the value is community-generated and how much is the result of private action is difficult. Fully taking the increases in land value would virtually eliminate the developer as conceived in today's society—an agent that converts land use for profit. A developer's success or failure depends on the ability to define, manage, and sell "the right type of property, in the right location, at the right moment, for the right consumer." Without such an agent of change, valuable opportunities would be lost—a loss that can certainly be viewed as a reduction in economic efficiency.

The problem is to implement a land tax without losing the positive contributions of land developers. One solution is to capture only a percentage of the increase in value. A partial capture would leave the developer with some return, but still require a mechanism for sorting out the contributions of community and private efforts in creating value.

Targeted Collection of Land Value Increments Caused by Public Actions. While there have been many recent attempts to adopt policies to capture the value created by direct public actions, even these narrower efforts have faced implementation problems. It is often difficult to attribute changes in land value to particular public decisions and to determine the precise timing or geographical impact of the public action. It is also difficult to determine how much of observed increments should be attributed to any particular public decision rather than other decisions or sources such as urban growth.

Practical and political obstacles also arise in deciding when and how to collect a tax on increments in land value. There are three obvious candidates for the timing of tax collection: (1) when a public intervention that will increase land value is announced; (2) when the increase in land value actually occurs or is perceived by the market; and (3) when the owner realizes the increase in value at a sale or a refinancing.

In the first instance, collecting the tax in anticipation of the increase in land value provides the funds to the public most quickly, but requires that the tax be based on expected or potential value. While some betterment taxes are collected in this manner, this approach is not favored because owners have to pay before they realize a gain.

The second alternative is to tie the tax to any increment in land value. Thus, if the market raises land values, the owner pays the tax based on the new value. Henry George advocated that the tax be based on the value of the highest and best use of the land. While land-based taxes are often collected on this basis, some feel it is unfair since the owner may not value the improvement in the same way the market does. For example, better access to employment or an improved school system may increase land values, but these improvements may be of little perceived value to an elderly couple that does not work or have school-age children. Basing the land tax on market value thus requires some owners to pay even though they are not receiving benefits.

Economists typically do not see a problem with this timing because the tax is meant to be on land value rather than on personal benefits. To their minds, owners need only pay for the increased value of the land or else relocate. Others debate this issue on either political or ethical grounds, arguing that owners should not to be forced to make these changes because of factors they are unable to control. The decision in many parts of the United States to exempt the elderly from property tax increases is evidence that this view has political popularity.

The third option is to collect the tax at the time the owner realizes the increased value either by selling or refinancing the property. With this option, the owner is not required to pay until there is a transaction, and the owner has realized the gain from the increased value. The public, however, only receives payment substantially after its expenditure occurs. As a result, owners have an incentive to delay or hide the transaction and thus avoid paying the tax. Throughout the world, owners have been known to negotiate legal side contracts ("drawer's contracts") giving power of attorney without "officializing" the transaction.

The problem of when and how the tax should be collected is further complicated by cyclical variations in land prices. A tax on the incremental value must separate the cyclical component from the secular trend in prices. It is extremely difficult, however, to determine at any point in time how much of a change in land price is attributable to cyclical variation or to secular forces.

Yet another potential obstacle to the widespread adoption of value capture results from the fact that some public investments might actually lower land values. For example, public investments that reduce the spatial advantages of land with certain attributes can reduce overall land values. Value capture would seem to require that private owners be reimbursed for these declines, in much the same way that they are taxed when public investment increases land values. The logic of this symmetry clearly complicates the issue.

Recent efforts to increase private involvement in the construction and maintenance of public infrastructure adds further complexity. In today's world, we see private provision of "public" services and utilities. To be consistent with George's principles that one should be rewarded for one's own effort, private actors should be compensated when they increase the value of land owned by others (whether the others are private or public entities). Nevertheless, many people would find it unacceptable to have to pay big companies for increases in land value that result from corporate investment. Many would also find it unacceptable to have to pay their neighbors for increments in land value caused by the neighbors' efforts to maintain an attractive garden.

The capture of public investment has widespread appeal and is in fact mandated in various parts of the world. In some cases, it is possible to measure and capture the private returns that accrue from public investment. In many others, however, it is extremely difficult to assess the magnitude, timing, and spatial impact of public investment. In addition, there is no political agreement about when and how the tax should be collected. Finally, private sector involvement in providing public services raises new, complex questions about the public's responsibility to capture value generated by private investment.

Recent Use of Value Capture

Despite the conceptual and practical problems of implementation, many new fiscal and regulatory instruments have been developed to capture land value increments. These public policy actions range from the use of property taxes by local governments to the selling of building rights. In addition, local governments have been getting back some of the benefits they had given to new developments through variances or zoning changes. These modern-day exactions—which might take the form of impact fees or requirements for the developer to offer land for public use—attempt to capture back publicly given value.

There are several reasons why these narrower forms of land value capture are gaining acceptance. First of all, governments around the world are decentralizing. This trend results from both the weakening of central states and the strengthening of numerous local organizations such as NGOs and other community-based associations. As local governments find themselves with increased responsibilities and without increased revenues, they are looking for new revenue sources to tap.

At the same time, those who pay local taxes (usually in the form of some kind of a property tax) are voting to reduce or to restrict local government use of property taxes. The "local tax revolt" has been stimulated by a general desire to lower taxes, as well as by the specific complaint that property tax payments are not connected with services desired or received.

This revolt has further increased the need for local governments to develop new sources of revenue.

Linked to the widespread dislike of property taxes is the fact that current residents have the political power to impose costs on "newcomers." Many residents are of the opinion that newcomers cause all of the need for public expenditures, and that they should pay for them. Given this belief, value capture instruments on new developments have popular appeal.

Value capture is also attractive to local officials looking for new revenue sources. These instruments are usually applied on a project or site basis rather than universally, providing important flexibility when negotiating with private investors eager to make a deal. Developers are often willing to pay "exactions" as long as they can still make a profit.

In sum, the recent popularity of value capture is closely associated with the decentralization of government and the growing need of local jurisdictions to find new revenue sources. In addition, because value capture taxes are aimed at new residents or new development, they get considerable support from current residents, who have the political power to pass such measures.

Conclusion

Even though it would provide substantial advantages for society and the economy, implementing a single land tax receives little support in the complex world of the late twentieth century. Since Henry George's time, the tax system has evolved into a multitude of taxes assessed at various levels of government. Indeed, given the large number of taxes and taxing jurisdictions, it is easy to understand the difficulty of imposing a new single tax of any kind.

Nevertheless, there is growing acceptance of a narrower tax on increments in land value resulting from public investment. These taxes are taking many forms that range from a direct tax on land value increments in Colombia to impact fees for residential developments in many parts of the United States. For reasons outlined above, even broader use of these kinds of tax instruments is likely in the next century.

Although Henry George would object to these narrower land-based taxes, we believe that these new measures provide many of the same benefits that would accrue from a broader Georgist tax on all land value. First, the ethical argument for capturing publicly created value from private owners is as valid today as it was when Henry George was alive. Taxes that capture private gains resulting from public investment would also be fair.

In our view, recent adoption of narrower land-based taxes has become easier because it is consistent with the widely held view that people should pay for what they receive. Still, we are concerned about the fairness of a process where current voters in a local jurisdiction can impose taxes on those who have not yet arrived and therefore cannot vote. We must find better ways to balance local political power with a desire to capture, for the community, value that has been created by community effort.

Second, substituting a land-based tax for other taxes to pay for public investment is efficient. Taxes on other resources, such as buildings or labor, affect market incentives and tend to distort decision making. For example, a tax on houses will make houses less affordable. In contrast, a tax on land must be absorbed by the landowner and, because the resource is immobile, will not reduce efficiency.

Third, land-based taxes tend to lower land prices and reduce the incentives for land speculation. Given the surge in land prices in many locations around the world, this downward pressure on prices must be welcomed generally for its benefit to the economy, and particularly for the improvement in welfare it brings to lower-income households.

Fourth, while it is unlikely that land tax revenues could pay for all public expenditures in today's complex economies, they could cover a major part of public infrastructure investment. In this way, implementing land taxes would provide some relief for the strained budgets of local governments.

On balance, then, adoption of land-based taxes—even in a limited form—offers many benefits. A tax on land value increments in particular may eliminate some of the widespread animosity to land taxes generally. Indeed, the recent implementation of new land-based taxes could indicate one of two things: that the political power of landowners is diminishing, or that land is becoming less important and therefore not worth protecting with as much vigor. No matter which factor is at play, however, the opportunities to apply a broader tax on land may well improve in the twenty-first century.

Notes

1. Henry George and other economists speak of "economic rent" as the excess of price over the amount required to keep the resource in use. Increases in land prices directly raise land's economic rent. To simplify the language here, we use the term "changes in land value" synonymously with "changes in land's economic rent."
2. Henry George argued that all increments to land value should be taxed away, even those in the lower right-hand box (4) in the table. George reasoned that all value was the result of the existence of the community, so all value should be captured.
3. The full distributional impact of the substitution of a direct tax on land for other taxes would depend on the details of incidence of the existing tax burden and the share of land owned by each income group.

Volatility, Speculation, and the Efficiency of Land Markets

Karl E. Case

Land markets exist in all societies where land can be privately owned. These markets play a pivotal role in the allocation of scarce resources by determining the location of economic activity. Manufacturing firms bid for locations that minimize transport costs, retail activity locates along highways, households compete for locations based on accessibility and amenities, and so forth.

The general presumption of economic theory is that markets work well to allocate society's scarce resources. With respect to land, the pattern of land values that emerges from market processes is generally presumed to be efficient: competition among households and firms, free of distorting taxes or regulations, will ensure the highest and best uses of land. Tiebout further suggests that a properly functioning land market assures efficient provision of local public goods.[1]

Why, then, is the government so heavily involved in land markets? First of all, land use inevitably involves externalities that must be internalized to ensure efficient patterns of land use. For example, building a smoke-producing factory in the middle of a residential area makes little sense, and constructing a three-story house with a 3,000 square-foot foundation on a 5,000 square-foot lot clearly imposes costs on abutters. The presence of externalities may legitimately call for government application of rational zoning rules as well as taxes and impact fees.

In addition, land markets may result in an unfair distribution of wealth. Henry George's call for a "single tax" on land rests on the proposition that gains in land value result from social and demographic forces that have little to do with the efforts of landowners. Taxing the social increment, he argued, would leave the allocation of land unchanged and efficient, while also returning the gains to society. George was fully aware of the important allocative function of the land market, and he wanted to tax land without distorting that function.

Evidence of another potential source of market failure has recently emerged in the literature. Since all asset values are based on expectations of uncertain future returns, they fluctuate with changes in expectations. Where expectations are "rational," this fluctuation presents no problem for the market. But where expectations are "adaptive" or not fully rational, and/or where prices are not fully flexible, land markets can become unstable, and this may lead to misallocation of resources.

While general consensus exists on the potential solutions to the externality problem, the appropriate role for government in "speculative" markets is much less clear. Some have suggested the creation of forward or futures markets for real estate, while others have called for a variety of tax schemes. Interestingly, Georgist taxes may offer a useful approach to the problem.

Speculative Inefficiency

The argument that land speculation may result in a form of market failure has two parts: (1) land markets are particularly vulnerable to speculative swings and nonrational expectations; and (2) land prices may be inflexible or "sticky" downward.

It is well-known that changes in asset values—in all markets—are highly sensitive to changes in expectations. Indeed, the sensitivity of investment to changes in the "animal spirits of entrepreneurs" is a central theme in Keynes.[2] Land markets, however, are particularly vulnerable. To understand the argument, it is important to consider the relationship between future flows of earnings and asset values in general.

The value of any asset is what an arm's-length buyer is willing to pay for it today. This amount depends upon the buyer's expectations of the future flow of benefits, revenues, costs, and risks associated with ownership. The price paid determines the "yield" or rate of return on the investment. For example, if a no-risk bond entitling the buyer to a continuous flow of $100 per year sells for $1,000, the buyer earns a 10 percent rate of return. If, however, higher returns on assets of comparable risk are available in the marketplace, the value of the bond is lower. Assuming the availability of 20 percent returns on bonds of comparable risk, our buyer would only be willing to pay $500 for the same annual net flow of $100.

Thus, implicit in every deal involving the sale of a capital asset are an expected flow of earnings, a purchase price, and a "capitalization rate" (implied rate of return) that brings them into balance. An apartment building expected to generate annual net revenues of \$100,000 that sells for \$1,000,000 implies a return—or capitalization rate—of 10 percent. The value of any asset, then, is inversely proportional to the capitalization rate. For a flow of earnings expected to be continuous at an annual rate R, the value is simply $V = R/r$, where r is the capitalization rate or implied rate of return.

Now consider the case of a real estate asset such as a commercial building. Land is only a fraction of the building's value. Suppose that a structure containing S square feet of rentable floor space could be built on a lot containing L square feet of land. Suppose further that the full cost of constructing such a building today, excluding land costs but including development costs, is C dollars per square foot. If gross annual rents are expected to be R dollars per square foot, and annual operating costs and taxes are O dollars per square foot, the annual net positive cash flow to the owner is $(R - O)S$. If the capitalization rate is r, the total value of such a building, including the underlying land, is $(R - O)S/r$.

Presumably, then, a developer should be willing to pay approximately that amount minus the cost of construction, or $(R - O)S/r - CS$, for the parcel of land. To put this in terms of land value per square foot, V, simply divide by the number of square feet in the parcel, L. Thus,

$$V = ([R - O]/r - C)S/L$$

To see just how sensitive land value is to changes in expected rents, consider what happens if R increases by a dollar. Assuming no change in O, C or r, land value per square foot, V, goes up by S/rL. Given a hypothetical high-rise building with a ratio of building space to land area of ten to one, and a capitalization rate of 10 percent, a change in expected rent of $1 per square foot leads to an increase in land value of $100 per square foot. Using the same simple logic, a change in expected rent of $5 per square foot on a ten-story building on a two-acre lot (50 percent footprint) swings the value of the lot by $21.8 million.

A similar logic can be applied to the residential real estate market. In the single-family home market, for instance, land can account for anywhere between 15 percent and 40 percent of total value. The return to a homebuyer who pays full price (with no mortgage) for a house has two sources. First, he or she lives in the home rent-free. The market value of the housing and neighborhood services this owner enjoys is referred to as "imputed rent." Second, the home may appreciate in value.

Given that no appreciation is expected, that the full value of the housing and neighborhood services is $833 per month ($10,000 per year), and that the owner expects a return of 10 percent, the house is worth about $100,000. However, if homebuyers and sellers begin to expect annual home price inflation of just 2 percent, this adds another $2,000 to the annual yield. The full yield therefore increases to $12,000, and the house is worth $120,000 or 20 percent more.

Assuming that the replacement cost of the structure does not change, the full increase in the value of the house/land combination is actually an increase in the value of land. If land represents 20 percent of the total, its value would double from $20,000 to $40,000. Thus, a change in the expected rate of inflation in home prices of 2 percent could lead to a 100 percent increase in the value of the land that lies underneath a house.[3]

While it is clear that land values are highly sensitive to expected office rents and home prices, the question remains: What drives those expectations? Rational expectations are built on an understanding of underlying market dynamics and changing supply and demand forces. For example, in forecasting home prices, the relationship between "fundamentals" (such as household formation rates, construction costs, and housing starts) in a particular area is critical. In the same way, stock prices depend on future profits of firms, which can be modeled and projected. If expectations are not rational, however, values may over- or undershoot fundamentals. If expectations are adaptive (home price forecasts are based on past price behavior), prices may exhibit inertia and overshoot on the way up or the way down.

When actual events replace expectations, prices adjust to reality and to revised expectations. Regardless of whether expectations are formed rationally or not, if they adjust quickly to new information, markets will still be efficient. If prices are sticky or if they adjust slowly, though, efficiency may be compromised. And when adaptive expectations and downward stickiness combine, the results can lead to spatial misallocation. Consider a regional market that experiences a rise in land prices based on fundamentals. For example, suppose labor markets and office markets tighten in the region, pushing up wages, home prices, and office rents. Land prices increase by a large multiple. With adaptive expectations, inertia gets built into both markets and thus into land prices.

At this point, there is a wealth effect. The balance sheets of both households and firms reflect new assets, which may alter behavior. New housing wealth can lead to additional spending on locally produced goods and services if households substitute new equity for financial saving, or if renters become discouraged by high prices and slow their saving for a house downpayment. In addition, owners can tap their buildup in equity through home equity loans, which are pushed by banks and subsidized by the federal government through income tax deductibility.

One would expect, all else equal, that higher home prices and office rents would result in slower regional growth. In a world of rational expectations, prices and rents immediately fall to levels consistent with the new reality, keeping the economy on track. But in fact, prices overshoot and then stick. The region becomes too costly relative to other areas, and economic activity that would normally have a comparative advantage locating in the region therefore shifts to other locations.

All of this increases the severity of the regional business cycle. In a way, it is simply a version of the accelerator first discussed by Keynes. The difference is that it is the run-up in asset values, rather than a direct increase in investment spending, that accelerates the upswings and then leads to more severe downturns.

Another source of cyclical instability may be the lags implicit in the development process. The time involved in permitting, land assembly, design, contracting, and building can be as long as ten years. Such lags can lead to a classic "hog cycle."[4] The logic is simple: Developers respond to tight office markets and high rents during an economic expansion by planning new buildings. Since the response is not coordinated and since expansions are inevitably followed by contractions, the result is often overbuilding, which leads to high vacancy rates and falling rents once the buildings come on line.

Empirical Evidence of Inefficiencies

My own research, as well as work with Robert Shiller and others, has attempted to document the inefficiency of real estate markets and, by implication, of land markets.[5] Early analyses suggested that during the great housing boom of the mid-1980s in the Northeast, fundamental economic conditions did not explain the dramatic run-up in house prices. The evidence indicated that the boom was at least in part speculative in nature. That is, homebuyers' expectations of future capital gains made them willing to pay more for housing than they otherwise would have.

Building on this conjecture, we used a massive data set to construct price indexes for Atlanta, Dallas, Chicago and San Francisco for the period 1972-86. After performing weak form efficiency tests on the indexes, we concluded that indeed, past house prices seem to predict future house price changes. This is taken by most economists to indicate speculative behavior. Strong form efficiency tests subsequently provided further evidence of inertia in house prices.

Another strand of research concerns the consequences of boom/bust cycles. Looking at owners and renters in Boston by income bracket, we estimated increases and decreases in real wealth and income caused by the boom. Needless to say, the boom created much more inequality.

Finally, my study documenting the impact of the real estate cycle in the Northeast clearly reveals that the cycle had severe consequences for the functioning of the underlying economy. The recession of 1990-91 in New England was one of the most severe regional downturns in modern U.S. history, and much of this severity was the direct result of real estate markets.

Policy Options

The volatility of real estate and land prices could be reduced in at least two ways. First, one of the private futures and options markets might establish an index-based, cash-settled forward market in home values. The argument is that if potential buyers and sellers who anticipate price increases or decreases can purchase options or futures to protect themselves, they are less likely to engage in speculative behavior in cash markets.[6]

A second approach is to manage or contain land prices through taxation. But, as I have concluded elsewhere, the evidence suggests that efforts to control speculative volatility through holding taxes, short-term gains taxes, or transactions taxes have been unsuccessful. It may well be that the potential gains to holding leveraged assets during boom periods are so great that even high rates of taxation do not discourage many people from jumping in.

The problem may simply be that we do not have the political will to raise land taxes to levels high enough to really retard boom cycles. How high is high enough? No one knows, but it is probably closer to Henry George's 100 percent than to current laws around the world.

Notes

1. Charles Tiebout. 1956. "A Pure Theory of Local Expenditures." *Journal of Political Economy* 84 (December): 416–24.
2. J. M. Keynes. 1936. *The General Theory of Employment, Interest and Money*. New York: Harcourt, Brace and World.
3. This effect is even more dramatic if the home is purchased with a mortgage. An 80 percent mortgage means that the initial investment was leveraged: The buyer's investment is only 20 percent of the sales price, but he or she owns the whole house. Thus, if the house is expected to appreciate 2 percent annually (in this case, $2,000), the yield on the homeowner's investment goes up by ten full percentage points. A homebuyer who puts down only 20 percent, given an 8 percent mortgage rate, would be willing to finance a house worth over $150,000, and the land value would jump by 150 percent.
4. L. E. Browne and K. E. Case. 1992. "How Commercial Real Estate Undid the Banks." In *Real Estate and the Credit Crunch*, eds. Lynn E. Browne and Eric S. Rosengren, 57–97. Boston: Federal Reserve Bank of Boston.
5. For a full discussion of these issues, see: K. E. Case and R. J. Shiller, "The Efficiency of the Market for Single Family Homes," *American Economic Review* 79 (March 1989): 125–37; K. E. Case and Leah Cook, "The Distributional Effects of Housing Price Booms: Winners and Losers in Boston, 1980–1988," *New England Economic Review*, May/June 1989: 3–12; K. E. Case, "The Real Estate Cycle and the Economy: Consequences of the Massachusetts Boom of 1984–87," *New England Economic Review*, September/October 1991: 37–46; and K. E. Case, "Taxes and Speculative Behavior in Land and Real Estate Markets," *Review of Urban and Regional Development Studies* 9 (1992): 225–39.
6. Such a market is proposed in K. E. Case, R. J. Shiller, and A. N. Weiss, "Index-Based Futures and Options in Real Estate," *Journal of Portfolio Management*, Winter (1993): 83–92.

The Centralization and Decentralization of Government and Taxation

Dick Netzer

The America in which Henry George's ideas were formed had, for all practical purposes, one government and one tax—local government and the property tax. The Civil War aside (a big aside), the federal government in the middle decades of the nineteenth century had an extremely limited role. Its main functions were to deal with Indians on the frontier and to collect protective tariffs, the latter being a producer, rather than a consumer, of tax revenue. There were a number of major federal initiatives of great long-term importance, like subsidized construction of the transcontinental railroads, the Homestead Act, the subsidization of agricultural and mechanical arts at state universities, and the creation of a rudimentary (and unsatisfactory) national banking system. But none of these required federal taxation; whatever subsidy there was came from the grant or sale of public lands.

Civilian Public Expenditure in the U.S.

(As Percentage of Total)

	1902	1927	1966	1980	1990
By Level of Government					
Federal	18	17	43	55	52
State	14	20	27	25	25
Local	68	63	30	20	23
Total	100	100	100	100	100
By "Budget Branches"					
Explicit Redistribution	8	7	29	41	4
Elementary & Secondary Schools	18	22	21	16	14
Allocation	74	71	50	43	43
Total	100	100	100	100	100
Financing of the "Budget Branches" by Level of Government					
Explicit Redistribution					
Federal	4	14	73	85	80
State	35	41	16	12	13
Local	61	45	11	3	7
Elementary & Secondary Schools					
Federal	*	*	12	17	13
State	19	15	36	48	45
Local	81	84	52	35	42
Allocation					
Federal	24	22	35	36	38
State	10	20	29	29	28
Local	66	58	36	35	34

Notes:

Civilian public expenditure excludes all expenditure related to defense and international relations. This table is an updating of one first used in Netzer, "State-Local Finance and Intergovernmental Relations," in Blinder et al., *The Economics of Public Finance*, Brookings, 1974.

1902 is the first year for which comparable Census Bureau data on government finances are available; 1927 is the last pre-Depression year for which comparable Census Bureau data are available; and 1966 is the year when substantial spending for Great Society programs began."Composition of Public Expenditure by 'Budget Branches'" follows the conceptualization invented by Robert Musgrave, with two major modifications: first, it leaves out the "stabilization branch," a federal concern that, in expenditure terms, consists mostly of unemployment insurance expenditure; and second, elementary and secondary school expenditure is treated as a separate category that combines obvious redistributive goals with "allocation branch" goals and amounts to a large percentage of state and local expenditure.

* Less than 0.5 percent.

Little had changed by the turn of the twentieth century, when the first useful census data on government finances became available, for the year 1902. All levels of government in the U.S. spent less than $1.7 billion in that year, of which $335 million was federal expenditure for current and past defense and international relations.[1] Of the civilian public expenditure, two-thirds was financed locally. Intergovernmental fiscal relations were trivial: state aid financed about 5 percent of local expenditure

State governments had a small but significant role. They provided a variety of services that figured in the everyday functioning of civil society, but those services were not enormously expensive in those days, however costly they may have become in recent years. The major state functions were providing most components of the court system, operating the state universities (at a time when only a minor fraction of 18-year-olds completed high school), and operating a variety of correctional, health and welfare institutions like state prisons housing people serving long sentences, asylums, and tuberculosis sanatoria (toward the end of the century). By the Civil War, most states had been so burned by their experiences in financing economic development that state capital spending was minor in amount. As a result, state governments could easily live on the property tax, especially in the Northeast and Midwest where a very large percentage of the population lived.

The state share of the property tax was a minor one, because local governments were responsible for the services that did cost real money: the schools everywhere, roads in rural areas, and, in the cities, streets and street lighting, police and fire protection, and sometimes health and welfare institutions. As the century wore on, the role of municipal governments in providing utility services increased, at first in water supply and later in electric power in smaller and poorer cities that did not attract investor-owned utility firms.

In light of all this, Henry George had to be thinking of local government when he thought about government and its role in civil society, and about his place in the political arena. He also had to be thinking about the property tax. There were no other direct taxes in existence. The indirect taxes on consumption consisted mainly of federal import duties and federal and state taxes on alcoholic beverages. It is true that in Europe, then and for a long time before, most government tax revenue came from consumption taxes, so there was a plausible, if inferior, alternative to the property tax in other industrial countries. Thus, in George's world, the choices in financing government really boiled down to continued reliance on the unreformed property tax, more reliance on consumption taxes, or a shift to a radically reformed property tax—one on the rent of land.[2]

Centralization of Government in the Twentieth Century

By the beginning of the twentieth century, the major European countries were rapidly changing their fiscal systems and centralizing finances—even those where there had historically been a good deal of decentralization, notably Britain and Germany. Centralization progressed rapidly. In large part, the centralization of functions and finances was not based on any systematic opposition to local government as such, but instead reflected the costs of wars (preparation for and aftermath of) and the adoption of expensive new functions—like Bismarckian social insurance systems, heavy government investment in railroads, and the response to the Great Depression, which began early in the 1920s in many parts of Europe.

Prior to World War II in many cases and after it everywhere, most of the rich industrial countries saw the use of central government personal income taxes to finance wars (in Britain and elsewhere in Europe) and payroll taxes to finance social insurance (in Germany) as the model of modernity, as well as of the proper concern for fairness in the distribution of incomes. Few Western countries had been serious about local governments in general or about whatever form of property tax local governments had used traditionally, even in the previous century; it therefore became conventional wisdom that only central government taxes were fair and able to produce large revenues. And that was in fact true, given the quality of local tax instruments. For example, as late as the 1950s, the property values for local taxation used in "progressive" Norway were those set in 1895. Abolition of such a tax did not seem of any consequence.

In the United States, there were similar trends in the nature of fiscal federalism in the 1930s and after World War II. That had been preceded in the 1920s by a considerable, if uneven, expansion in the role of state governments. Indeed, the role of the state governments in financing civilian public expenditure increased about as much between 1902 and 1927 as it did between 1927 and 1966. (The fiscal importance of state governments in the aggregate has changed little in the past 30 years.)

The states had taken on a wholly new function: the construction and maintenance of roads. State universities and institutions were expanded. In some states, there was significant state aid for schools for the first time, usually linked to stronger compulsory education laws and the need to build high schools for all those children now required to attend them. More states were venturing into entirely new realms. North Dakota, for example, experimented with a form of state government socialism by going into the commercial banking and grain storage businesses, among other things. State governments operated marine terminals in a few places (Mobile, Alabama for one), while others financed rail passenger terminals and even a subway line (in Boston), and most had considerably more active state park programs.

By and large, what the states were doing amounted to taking on roles that, a generation earlier, would have belonged to local government—if appropriate to any level of government. This was facilitated by the adoption of highway-user taxes in all states, and the adoption of income taxes in a few states, notably New York and California. An element of this centralization of finances was reform in the property tax, along four lines. First, state government use of the property tax was reduced in most states and eliminated in some. Second, the most difficult elements of the general property tax base from an administrative standpoint, intangible property and household personal property, were removed from the base in numerous states. Third, a few states—New York, Delaware and Pennsylvania—went so far as to remove all tangible personal property (notably, business machinery, equipment and inventories) from the tax base, to be replaced explicitly by the state tax on corporate income. Fourth, most states centralized the administration of the local property tax on railroads and public utilities, and radically changed the valuation process.

The centralization process in the U.S. went much further during the Great Depression and with the maturation of the institutional changes that it provoked.[3] Those changes, which provided for large-scale income transfers to persons (along with some services to the poor) and created for the first time a true "redistribution branch" (in the Musgrave sense) in American government, were federal in inspiration and mainly federally financed. By the early 1960s, the federal government had become the number-one player in the American system of fiscal federalism. The state government role had continued to grow, institutionally because some of the federal redistributive programs required states' financial participation, and pragmatically because, after the local property tax system collapsed in the early 1930s, most states had adopted new sales taxes, primarily (at the outset) to provide income support for the unemployed.

The Great Depression began in the U.S. not with unemployment but with a liquidity crisis and a collapse of both commodity and asset prices. Then unemployment rose massively. Suddenly, a large part of property tax levies could not be collected: property owners simply could not pay. There was some voluntary walking away from property that was no longer economically viable—the "abandonment" problem that has existed in poor neighborhoods in large older cities since the 1960s—but most of the delinquency was involuntary. The property tax seemed doomed.

That prophecy appeared confirmed in the years immediately after World War II, as huge increases in school enrollments and suburbanization put great pressure on local governments, and therefore on the property tax. Assessors were not helpful. They generally treated the increase in asset values from the 1930s' low points as ephemeral, and assessments typically remained at those low levels.[4] State legislatures responded not by directing that assessments be updated, but by providing substantially increased state funding of the schools and by authorizing, in many cases, local governments to employ non-property taxes.

The financial result is apparent in the following table. The property tax provided about 66 percent of local government financing in 1932, fell to 44 percent by 1950, declined again in the late 1960s and 1970s to just over 25 percent, and has remained steady since then. Changes in federal and state government grants were the main engine of the property tax decline until 1980, but local revenue sources other than the property tax accounted for 20 of the 41 percentage-point decrease in share over the entire 58-year period.

The Property Tax in Local Government Revenues

Percent of Local Revenue Raised by:	1932	1950	1960	1970	1980	1990
Property Taxes	68	44	43	37	26	27
Federal and State Grants	13	28	28	34	40	34
Non-tax Revenue	17	22	23	22	26	30
Local Non-property Taxes	2	6	6	7	8	9

Source: U.S. Bureau of the Census.

The decline in the role of the property tax was not continuous over the entire period since the onset of the Great Depression. There have been two plateaus: from 1950 to the beginning of the Great Society era in 1965–66, and from 1980 until the present. The latter corresponds to a slight reversal in the overall role of local governments. The relative fiscal and operational roles of subnational governments in the U.S. remain larger than in any other sizable OECD country. When the comparison is confined to local governments per se (that is, excluding the intermediate layer of states, provinces and cantons), their role is larger in the U.S. than anywhere else in the world.

It is not surprising that Henry George's ideas were in eclipse during the half-century when most of the world was centralizing government functions and finances, and the U.S. replaced its single-tax, single-layer-of-government regime (in which the property tax provided as much as 75 percent of total public sector revenue) with the complex institutions and intergovernmental relations that now exist (in which the property tax provides only about 5 percent of total public sector revenue). This is not to say that George's ideas had been rendered invalid, only that they had been hidden by events, in three ways. First, while it can be argued that the centralization of government went too far, it did occur. Although land taxes have been used as central government taxes in other times and places, they have never been so used in North America and infrequently so used in other countries. Moreover, those infrequent uses generally have been so inept that the very association of central government with land taxes has unfavorable connotations.

Second, whatever the virtues of land taxes for central government, a new system of national land taxation cannot be implemented very rapidly. The huge increases in central government taxes during the century of centralization typically were responses to the exigencies of wartime, when governments needed very large increases in revenue but expected those needs to last only a few years. To be sure, it is short-sighted in the extreme never to pursue a desirable course of action because of long implementation time, when experience shows that the need for that action will recur time and again. Nonetheless, that myopia is understandable.

Third, it is not obvious that taxing the rent of land really would be sufficient to finance the enormous interpersonal income transfers that the modern welfare state makes, although some land value tax advocates believe otherwise. The level and financing of that expenditure have been the central budgetary issue in most rich countries for the past twenty years.

A New Wave of Decentralization?

Almost everywhere in the world today, devolution and decentralization of government services and finances are seen as good and important objectives to pursue.[5] There has been a great deal of devolution by privatizing state-owned enterprises in countries that previously had very limited (most developing countries) or no (the Communist countries except for China and Yugoslavia) decentralization of government, as well as in OECD countries. But the actual degree of decentralization so far varies widely. Many of the more-or-less democratic developing countries, particularly in Latin America, have achieved considerable decentralization despite a centralized political tradition (matched with preposterous constitutional rhetoric about decentralization). In others, decentralization remains a word and no more. In one important developing country—South Africa—decentralized government and substantial reliance on property taxation were essential features of the governmental structure until the last decades of apartheid.

Most countries in transition are actively pursuing decentralization, usually from need rather than conviction, with the mixed results that almost all structural changes have produced in these countries. The re-establishment of private ownership rights in land and buildings has made it natural to look toward taxing those rights as part of two processes: privatization and subnational government autonomy. It is hard to imagine a situation where the ideas of Henry George more deserve a respectful hearing, and where the implementation of those ideas has so much to offer.

The rhetoric of decentralization exists in OECD countries, too, including those that are and have been relatively decentralized for a long time, like the bigger federal countries (the U.S., Germany, Canada and Australia). In all of these countries, central government budgetary retrenchment has tended to increase the subnational governments' share of total public sector finance, but only slightly. In the OECD countries that traditionally have been quite centralized, changes have been mixed. In Spain, which has been exceedingly centralized for a very long time, there have been major shifts to regional governments and serious interest in developing revenue instruments that are suitable for use by autonomous subnational governments. In Belgium, the language issue that divides the country has led to a considerable degree of fiscal federalism in what had been historically the most centralized fiscal regime in Western Europe.

In centralized France and Italy, in contrast, there has been some decentralization of governmental machinery, but no fiscal decentralization at all. And in Britain, with a strong tradition of local autonomy and (sometimes romantically exaggerated) differentiation based on property taxation, the central government did more to destroy local autonomy in the 1980s than ever before in British history.

In the U.S., the rhetoric in favor of decentralization is as strong as anywhere, as if the American fiscal system were one of the world's most centralized, rather than the opposite. In fact, there has been a decrease in the federal role and a matching increase in the local government role since 1980, with the property tax playing a larger part in local government finance. But these reversals are quite small, and it is entirely possible that what we are observing is a new equilibrium, comparable to that which existed between 1950 and 1965, after which there was another major wave of centralization.

A number of things suggest, however, that the decentralization we have seen is a trend rather than a pause. There is the rhetoric of "less government," which clearly has less political strength at the local government level than at the federal and state levels. (There are good economic reasons why this should be so, reasons which are central to the ideas of Henry George.) There is the continuing federal budget deficit problem, which is likely to require reductions in federal civilian spending for programs and activities other than income transfers to senior citizens. There is the political appeal of personal income tax reductions at the federal and state levels. There is the reality of actions in 1995 and 1996, which radically changed the nature of major federal grant programs and which surely will slow the increase in grant levels over time.

On the other hand, it is not at all clear how long these influences will dominate American fiscal federalism. One can conceive of successful demands for major new federal initiatives that provide substantial federal funding for activities for which local governments now spend a lot. Recall that, within a short period, a massive federal police establishment has been created, and a substantial grant program as well, in a field in which federal and state expenditure had been trivial for more than 200 years.

But a sharp reversal toward renewed centralization seems unlikely very soon. The plateau or equilibrium may last for another decade, or more. This suggests that, in most of the U.S., there will be pressure to generate more revenue from the property tax for years to come. Other taxes will continue to exist and even dominate the financing of government, even if we are truly in the midst of long-term decentralization. But surely the ideas of Henry George are more central to the circumstances of American government than they have been for some decades.

An obvious example of that relevance is that most large central cities—even those that have had terrible economic problems during part or all of the last thirty years—are in reasonably good shape today, and many of them do not face serious threats of economic disaster in the foreseeable future. Even so, if fiscal responsibility for public services continues to decentralize—and reduced spending for some programs results in more local spending for everyday services to the poor[6]—those local governments will be in trouble. They do not have the revenue structures to do the financing needed.

But how can that be, given that most had booming economies in the 1980s? The answer is that local governments, like the cities of New York and Washington, were unable to share in the most important economic benefit of the booms—the huge increases in land values. The cities, and the outside governments that control them (Congress in the case of Washington)—have chosen not to impose consequential taxes on the value of land. If Henry George had been mayor of New York in 1985, he would have had no doubt about the appropriate fiscal policies, and he would have been right.

Notes

1. As the first "modern" war, the Civil War left in its wake substantial spending for services to the huge number of surviving soldiers, in 1902 about equal to current defense spending.
2. The federal personal income tax enacted during the Civil War was quickly abolished when the war ended. As in other countries in George's day, the personal income tax was viewed as a war tax, to be reduced to rather negligible levels or eliminated when peace came.
3. The Social Security Act was passed in 1935, but the first Social Security retirement benefits and unemployment insurance benefits were not paid until 1940. Coverage and benefit levels were greatly increased in 1951, when disability insurance was added. State public assistance programs were not in place in all of the states until the late 1950s.
4. In most major cities, assessed values of some types of property remain at the levels to which they were rolled back in 1934 and 1935. This is true of land values for residentially zoned land in much of New York City.
5. The exceptions are surviving repressive regimes in the Third World, not including China, which is quite decentralized.
6. A good example is the sudden rise in the incidence of tuberculosis in the 1980s, mostly among the homeless, drug-addicted and incarcerated (not mutually exclusive categories). Whatever the specific etiology among those groups, the resulting epidemic was something that city and county public health agencies had to deal with, without any external funding.