# Land tax reform: we need better battle plans!

**MASON GAFFNEY**, Professor of Economics at the University of California (Riverside), reviews the role of taxation - and especially the property tax as it is operated in the United States - in the quest for economic justice and prosperity. It is time, he says, to come out of the trenches and survey the battlefield....

BIG PLANS and Grand Visions inspire small ones. They also help orient and coordinate them. They help us divide the major from the minor, to direct our work most efficiently.

Big Plans can also scare people. That does not mean they won't prevail. They scare some because they move many others. Abstract philosophies, living only in intellectual undergrounds, build up slowly until suddenly they take command. This is how change occurs. Superficially it seems "sudden," but intellectually the way has been paved by years of Grand Visions and Big Plans.

**Safeguarding the property tax**

WE NEED TO UPHOLD and safeguard the property tax as the mainstay of state and local finance. It is partly a tax on land value. We speak of reforming the property tax, but first there must be a property tax. Because it exists, we can modify it to tap land rent for public uses in a non-catastrophic way, using traditional laws, administrative agencies and land tenures. Capping the property tax rate, as in California, ties the hands of reformers.

There has been much ado about Hawaii's phased-in shift to a graded property tax plan. However, Hawaii raises only 16% of its state and local revenues from the property tax, so the rate is very low. You can focus the Hawaiian property tax on land values 100%, and still have an 84%-messed-up tax system. Studies would then show little visible result from the reform. Critics would say "Ho-hum, we told you so."

New Hampshire is another story. It raises 64% of its state and local revenues from the property tax, double the U.S. mean of 32%. New Hampshire is called a "low-tax" state, but its property tax is highest in the nation, *per capita*, at $1344. The U.S. mean is $699 *per capita*, and it goes down to $174 in Alabama. Politicians whose priority is raising sales taxes for property tax relief might study Alabama's economy overall, and ask if that is the model to which they aspire. Its *per capita* income ranks 41st in the U.S. *May Georgists please stop looking for miracles from Fairhope, AL?* At Alabama rates, the Fairhope plan is tokenism. Meantime, New Hampshire's marshy peneplains, barren granites, icy winters, and impassable mountains are producing the 7th highest per capita income in the nation.

**In New Hampshire**, fortunately, Assemblyman Richard Noyes is hard at work upgrading the property tax. He is chair of the legislative committee overseeing assessment quality; his priority is bringing land assessments up to market, and building assessments down. He does this by pushing for more frequent reassessment. Whatever he thus achieves in The Granite State is magnified by its high dependence on the property tax.

**How about New York?** It ranks near the middle in the ratio of property taxes to all state and local taxes, at 33% (the U.S. mean is 32%). That is not because New York property taxes are low, but its other taxes are high. So New York is an OK place to sow the seed of two-rate tax-plan, but the harvest of any success will be sparser than it would be in New Hampshire.

**How about Pennsylvania?** This state stands out for its efforts to reform local property taxation but, sad to relate, it ranks below the middle in the ratio of property taxes to all state and local taxes, at 29%. It is low in property taxes per capita, at $609, less than half the New Hampshire level. Property tax reform in Pennsylvania is, therefore, heavily diluted. Add to that the problem of overlapping tax jurisdictions: when a city reforms its property tax, its county and school district carry on as before. What changes, then, is just 1/3 of 28%, or about 9% of the complex of state and local taxes. Federal taxes are totally untouched. Trench warfare in Pennsylvania cities is therefore inchmeal, and the results hard to measure.

LANDOWNERS in California are only taxed now if they use their land to hire people and produce something useful. When they do so, they meet the drag of our high business and employment and sales taxes, necessitated by the fall of property taxes. A handful of

oligopolistic landowners control most of the market; small businesses are squeezed out. This helps us segue from being at the cutting edge of industrial progress to a third-world economy - from the New Hampshire model to the Alabama model - with little relief in sight.

**Enforcing Good Laws**

IT IS IMPORTANT to assess land for tax purposes early and often, especially on a rising market. (Landowners will see to it you do so on a falling market.) Over time, land appreciates more years than not; buildings depreciate every year. Lagging assessments therefore automatically overtax buildings relative to land.

Assemblyman Noyes has published data on the effect of reassessment in New Hampshire. The land fraction of assessed value rises each time there is a reassessment. Keene, NH, is in the lead, with frequent reassessments, a high fraction of land in the mix, and a particularly strong track record attracting enterprise and jobs.

In California, where we used to have good assessment, we now have bad assessment legally mandated by Prop. 13. So long as land is unsold, and/or not newly improved, its assessment rise is capped at 2% a year, while market prices soar. Here is one example of the results. In 1995 the Metro Water District of Southern California condemned 410 acres for a new reservoir to expand the system (to accommodate land speculators in the desert boonies). A local jury hit them for $43 millions, which works out to about $1.95 a square foot.

ASSESSORS' problem today is that the strongest pressures they feel are from owners wanting to allocate as much value as possible to buildings that they may depreciate for federal income tax purposes. Here is where we must study how the parts fit together to form the big picture; here is where federal and local tax policies intersect.

Some traditional Georgists have disdained, neglected and misunderstood the income-tax treatment of land income, to their great unawareness, insularity, and weakness. Let us see how this works.

Congress and the IRS let one depreciate buildings, but not land, for income tax. This important distinction harks back to when the income tax was new, and Georgist Congressmen like Warren Worth Bailey, from Johnstown, PA, and Henry George Jr., from Brooklyn, were instrumental in shaping it.

When a building is new, the depreciable value is limited to the cost of construction. The non-depreciable land is the bare land value before construction. So far, so good. Over time, however, building owners have converted this into a tax shelter scheme. Owner A, the builder, writes off the building in a few years, much less than its economic life, and sells it to B. "A" pays a tax on the excess of sales price over "basis." The basis is reduced by all depreciation taken, so any excess depreciation is "recaptured" upon sale. It is defined by Congress as a "capital gain," and given the corresponding package of tax preferences: deferral of tax, lower rate, step-up of basis at time of death, tax-free exchanges, etc.

Thus far, any tax preference goes to A, the builder, and may be seen as a well-considered stimulus to building. Watch, however, what happens next. "A" sells to B, and B depreciates the building all over again, from his purchase price. To do so, B must allocate the new "basis" - i.e. his purchase price - between non-depreciable land and depreciable building.

How shall B allocate the new basis? Enter the local tax assessor. *Here is where local assessment intersects with Federal income tax policy.* The IRS does not try to assess land and buildings: it is not set up for that. Instead, IRS instructions tell taxpayers they may use locally assessed values to allocate basis between depreciable buildings and non-depreciable land. The IRS accepts this allocation as conclusive. As a result, influential local owners of income property press their locally elected or appointed assessors to allocate as much value as possible to buildings, and as little as possible to land. This does not affect their local taxes, but lowers their federal taxes. *It lets them depreciate land.*

Assessors don't care as much as they should: local revenues are not immediately nor obviously affected. Local assessors have little reason not to accommodate their constituents, local landowners, to help them depreciate land for federal and state income tax purposes. Thus, they have little reason to use the correct "building-residual" method of allocating value, and a compelling reason to use the incorrect alternative, the "land- residual" method. This latter method understates land value, thus converting non-depreciable land value into depreciable building value. It is the modern version of "competitive underassessment." In the process it also converts the local property tax from a land tax into a building tax.

After a while B sells to C, who in turn sells to D, so each building is depreciated many times. So is a large part of the land under it, time after time, although it should not be depreciated at all. This is carried so far that real estate pays no federal or state income taxes at all.

Within each city the property tax is progressive, but when your data meld cities like poor little Parlier and Lynwood with Beverly Hills you sometimes find poor people paying more of their income in property taxes than rich people, and getting less for it. *Switching just the local property tax to land ex buildings will do little to correct such disparities.* It will therefore make little progress toward overall distributive justice, and the wide support that would evoke. There is, in fact, a natural cap on local property tax rates imposed by local particularism. The City Council of Beverly Hills will not raise taxes in Beverly Hills for the benefit of voters in Parlier.

To avoid such regressivity we must work out some formula for power equalization. *The most straightforward formula is simply a statewide land tax.*

**What Tax to Fight First?**

WE ALSO NEED to set priorities on what tax to lower or kill. The Georgist objective is dual: to raise taxes on land, and to untax production, exchange, and capital formation. Some Georgists have gotten locked into minding just the local

property tax in a vacuum, but this was never George's main point. It certainly should not be ours today, when there are other new or augmented taxes more damaging and noxious even than the part of the property tax that falls on reproducible buildings and movable capital. These other taxes include state taxes on retail sales, payroll taxes, personal income taxes falling on wages and salaries, excise taxes, etc.

Some Georgists have supported untaxing "personal" (movable) capital, and rejoiced when it occurred. If political success be the test, this movement has won massively (although silently) in state after state, and in all Canadian provinces. The result, though, is as baleful as benign, for the exemption of capital here is only partial, and therefore discriminatory. "Real" (immovable) capital remains taxable, which biases the way investors allocate their capital. Indeed, some "real" capital is transmuted into "personal" capital merely by unbolting it from the floor, putting it on casters instead.

This result is also regressive, because "personal" capital in most industries is more concentrated in ownership than "real" (immovable) capital. In farming, for example, "personal" capital includes breeding cattle and race horses, whose ownership is highly concentrated among the very wealthy, while the working farmer's dwelling is "real" capital. Stored grain and farm machinery are also concentrated in ownership.

Other Georgists (like Larry Rathbun and George Duncan in NH, ca. 1935-50) diverted their efforts into deleting the property tax on standing timber, replacing it with a "yield" tax (at rates much too low to be revenue-neutral). Again, the result is partial and discriminatory, biasing investors to allocate more capital in the form of timber, and correspondingly less in other forms. As noted earlier, the present system works as though you exempted woodframe buildings from the property tax, and raised the rate on brick buildings.

This timber bias is highly regressive, too, because the ownership of timber is much more concentrated than the ownership of the dwellings of loggers, mill-workers, and retirees in timber counties. It would not be so bad if the reformers had seen that land taxes on timber growing-sites were raised enough to compensate for exempting the growing stock, but they failed in this: these land taxes are also held down to token levels. *The net result has been to turn timber and timberland owners into a gigantic public welfare case, a case supported by a sophisticated brainwashing machinery paid by the discretionary income and wealth of timberlandowners.*

Most Georgist activists today devote their main efforts to lowering the property tax rate applied to urban buildings. As we have seen, this effort is only effective in those few remaining states, notably NH, that still rely heavily on the property tax. Even in such states, all the gains won laboriously, trench by trench, can be lost overnight should the state legislature or the electorate be gulled into capping property tax rates, shifting taxes to sales, incomes, and productive business. This occurred in California (1978), in Michigan (1995), and has been threatened in several other states, including PA where Georgist activists make so much of the "two-rate" property tax that some localities have adopted it.

The local "two-rate" approach is potentially productive, even in states with low rates, because it sets the stage for raising property tax rates. Once buildings are exempted, a polity may raise property tax rates as high as you please without driving away any industry, capital, or talented people. Today, politicians like California Governor Pete Wilson make their careers out of starving schools and libraries and police in order to attract and retain employers by offering them lower tax rates. Given a property tax on land-ex-buildings we could support all public services without penalizing industry, or thrift, or home-building at all.

However, to achieve that end we must stifle sales and payroll and income taxes. These are the chief alternatives to property taxes. All are inherently counterproductive because all hang on some "taxable event," meaning some constructive act of production or exchange.

Henry George put it like this. A packhorse can bear a heavy load on its back, but hardly any bound to its shins. Theorists write of the "excess burden" of excise taxes, and of the "Laffer Curve Effect." Lawyers write of "taxable events." Both are describing the same thing in their own slangs. Sales and payroll and income taxes are like the load strapped to the horse's shins, dragging on every pace. Indeed, they are more like a load bonded under each hoof, for they are burdenless when the horse refuses to move at all.

What, then, makes these bad taxes so attractive to landowners? Why this constant clamour to raise them to provide "relief" from property taxes? It is because they appear to shift taxes off landowners, who are well organized and vocal, and onto workers who are not. They shift back onto landowners by repelling labour and capital, but seeing that calls for an act of insight and analysis beyond the ambition of many lazy thinkers.

**Closing Landowners' Escape Routes**

THE SOLUTION is to make the bad taxes pinch landowners in ways they cannot fail to perceive. The income tax, when new, was designed to do exactly that. First, the corporate income tax (from 1909) preceded the personal income tax (from 1913 constitutionally, and 1916 *de facto*). Then, Georgist Congressmen like Henry George, Jr. (Brooklyn) and Warren Worth Bailey (Johnstown, PA) took the lead in shaping it to focus the personal income tax on property income primarily. Over time, though, Congress has converted it, inch by inch, into the present payroll tax. State income taxes, riding piggy-back on the Federal model, followed suit. As the income tax changed it became increasingly popular with landowners, with their constant clamour for "property tax relief."

In 1942, for example, Congress excluded 50% of "capital" gains (read unearned increments) and broadened the definition of "capital" assets. As top-bracket rates on "ordinary" income rose above 50%, Congress froze the cap on capital gains at 25% (i.e., at 50% of half the gain). Meantime, wage-tax-withholding was sold as a wartime

measure - we must all do our duty, you know. College professors were mindlessly indoctrinating their students that the income tax is the perfect tax: fair, progressive, and allocationally neutral, all at once.

Then, with landowners so well protected, income tax rates on "ordinary" income went wild, rising as high as 92%. Federal and state personal income taxes became the mainstay of public finance. Owners of income property learned to avoid most income taxes by claiming short tax lives. This device lets an owner offset all taxable cash flow with overstated depreciation.

Once Owner A has thus exhausted her depreciation "basis," she sells to Owner B, who depreciates the property all over again, and so on through several rounds of depreciating the same capital. The Treasury nominally "recaptures" this fictional depreciation when A sells to B and has to report the excess of sales price over undepreciated basis as a capital gain. In effect, thus, the rent of income property shows up as a capital gain. This tax burden is capped, however, by capping rates on capital gains. This helps explain the constant drumbeat in Congress to lower tax rates on capital gains.

Many who think of themselves as "Georgists" have donned blinders on this central matter. Some simply declare a pox on all forms of income tax, as though all sources of income were the same. Others even join the hue and cry for preferentially exempting "capital" gains from taxation. These positions are, I submit, worse than foolish. So long as we have an income tax that treats land income kindlier and gentler than wage and salary and interest income, so long will we have perpetual crying for "property tax relief" via income-tax exacerbation. Landowners will shift the burden until no burden remains to shift - the condition we are approaching in half the states. Nor will they stop there. The freer they are from taxation, the greater is their motive to demand more subsidies, of which they already get many, to raise land rents and values.

However, landowners and their advocacy groups are already ahead of potential income tax reformers, and will remain so until we wake up and smell the coffee. They are already lobbying to replace or supplement income taxes with what they miscall "consumer" taxes, a generic euphemism that covers most taxes on exchange. The euphemism includes various excise taxes, retail sales taxes, revised income taxes that allow expending of all capital outlays and land purchases (e.g. the mislabelled "flat" tax), the proposed "cash flow tax," VAT, *et hoc genus omne*.

These taxes are mislabelled because they all exempt land- consumption from the base. Land-consumption is holding land without using it to earn any cash. A true, comprehensive consumer tax would include such land-consumption. At the same time it would exclude retail purchases of necessities used to form and maintain human capital. It would, thus, look less like the present retail sales tax and more like a land tax. It is only by bending the meaning of words to a class-biased goal that the apologists of private rent-taking and land-hoarding have sold sales taxes and VATs as taxes on "consumption."

Again, to turn back the ongoing drive for more consumer taxation, we need only insist that the base include land-consumption. Then either the drive would achieve a Georgist goal, or, more likely, turn tail and stampede back whence it came.

*We cannot accomplish those ends if we glue our eyes only on the next fifty feet of no-man's-land and fight only for local tax reform, trench by trench. We have to survey the whole battlefield and marshal forces where they will do the most good.*

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damage on the incentive to work and to risk one's savings through capital formation; and

- *land distribution*? No. For land would be held by those who could most efficiently use it (the market criterion), while at the same time everyone becomes the equal owner of the nation's rental income from urban and agricultural land and natural resources (the social justice criterion).

**Conclusion:** the rent-sharing policy produces

(1) *perfect equality* (distribution of asset income, which everyone shares through public spending) **without sacrificing the benefits of the competitive market**; with

(2) *perfect prospects* for investment (no-one is penalised by taxation - the fate of working people in the western market economies today - or excluded from the credit markets)

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