Take Your Choice

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Incentive Taxation discusses the practical application of land value taxation. This application is the result of a philosophy of economics that stresses two non-exclusive factors: We – and others - have the right to exist and to prosper. We also have the responsibility – as do others - to let the economic rent of land serve as a resource to fund our society's agreed-upon goals and missions.

To give a magisterial perspective on the matter is Dr. Bill Batt – a noted transportation and urban affairs expert. This is the second in an occasional series of sidebars on how land value taxation can help solve problems still with us after decades of government intervention and failure.

Take your choice: high real estate prices or more costly and reduced public services such as schools and roads. The relationship between these variables is best (and perhaps only) recognized when viewed through the framework of classical economic analysis. Henry George, the theorist and most articulate exponent of the classical economic analysis was sidelined until recent years by neoclassical economics.

There is renewed interest in George's economics today due to our ability to test its ideas with modern computers and available data, which George himself of course never had access to over a century ago.

The starting point of classical economic analysis is recognition of the three factors of production: land, labor, and capital. Each of these factors has its own distinct and identifiable price: wages pay for labor, interest pays for capital, and rent pays for land. Land means any natural resource, not just soil or spatial locations on earth but other elements as well, things that are not man made but which may be privately owned or used such as air, water, minerals, and the electromagnetic spectrum. The classical economists -- Smith, Malthus, Ricardo, and Mill – saw these as commons. George, the last defender of classical economics, lost out to a radically different view of things. Neoclassical economics largely ignores land and economic rent that leads to faulty conclusions for public policy. Economic rent is the surplus generated by common enterprise.

Today, however, there is a resurgent interest in economic rent. It reflects the net

differential productivity of locations and the resulting surplus that settles to land sites and increases their market value. Rent's return to land in urban locations is far higher than in remote regions, as markets create value by their exchanges and strategic access. Rent accounts for the changes in the prices of natural resources and locations. In fact, rent is the product value of all the creation not otherwise embodied in goods and services through labor and capital. Because rent is a product of collective enterprise and not the result of any individual's efforts, it offers a "free ride" or "free goods" available for the taking to those who have secured titles.

This is well illustrated by an example reflective of contemporary city life where rent appreciation is highest. Suppose that a new town is to be built in an empty location. If first the roads are laid out like a tic-tac-toe game, there will be nine plots. Suppose that each plot is developed by an entrepreneur, the first, perhaps, a grocery store, the second a restaurant, a third a pharmacy, a fourth a gas station, and so on. Every outside square is developed, but the owner of the center square elects to do nothing at all with his land. When everything is done, which land site excluding the structures has the highest value? The center square, of course, because it controls strategic access to all the other sites – even though its titleholder did nothing to earn the appreciation on that site value. The accretion of that land value is economic rent, and it reflects the cooperative and communal enterprise of the combined effort of all the development in that previously empty location.

Insight into the way rent accretes to the advantage of real property titleholders led political economist John Stuart Mill to observe that "Landlords grow richer in their sleep without working, risking, or economizing. The increase in the value of land, arising as it does from the efforts of an entire community, should belong to the community and not to the individual who might hold title."

As societies engage in commerce, the reality is that "rent happens." The surplus that falls upon land sites and is generated by the community, and accretes most to those sites with the greatest economic activity.

Cities therefore have land value profiles that show the highest accumulated rent at the central locations, with the market price of those locations falling quickly as one travels to the periphery. Indeed the value of locations is evident (at least in the aggregate) by looking at a city's skyline – the highest value land will have the tallest buildings. When public policy allows the surplus rent to accumulate on land sites for years on end, the market prices grow to stupendous levels. Manhattan Island, for

example, has land values (structures excluded) of roughly $500 million per acre and higher, while exurban land can be acquired for $1 thousand per acre, and remote wilderness is still available for under $100 per acre. The accumulated values of land sites are always unearned by the landholders and should not be confused with the value of improvements to the real estate, such as buildings.

Sites can sometimes have such a high market value that it leads their titleholders to overreach when they seek to sell and reap a financial gain. When that happens, potential buyers who would normally be willing to develop at those locations must settle for second-best and sub-optimal sites. The clearest illustrations of this are in the phenomena of cities with under-used urban cores surrounded by suburban and exurban sprawl. Inefficient use of sites requires a lot of expensive infrastructure built at public expense, therefore much higher taxes. The public reaction to continued tax escalation is political resistance and resentment about such burdens, and the resulting scrimping and neglect of public services. Economist John Kenneth Galbraith aptly described the results of these strains: “private affluence and public squalor.”

And yet the answer to this quandary is so simple. Henry George understood that we need only to recover the socially generated economic rent that otherwise defaults to land sites. If we collect rent in the form of taxes (or ground rent), the taxes exert a downward force on land prices, and greater market stability and affordability is typically assured. When looking at real estate values, it is easy to understand that only land increases in value by the continual accretion of rent; structures depreciate just as do computers, cars, and refrigerators. Because rent is the result of what everyone does rather than by any one titleholder, it is only just that it be the basis of taxation.

The public collection of economic rent can be done in the form of a tax shift, i.e., by gradually down-taxing structures while up-taxing land. Taxing only the value of the land sites rectifies the problems of wasted urban space and the consequent sprawl development, land speculation, tax distortion and evasion, and a whole host of other maladies that currently arise from the current conventional tax practices.

As it happens, moving to a tax only on land sites tends to have other positive effects as well: it removes the penalty imposed on those who elect to invest and improve their sites, and it encourages underused sites to be put to their highest and best purposes. Because homes are typically at the periphery of urban areas, their burdens tend to be reduced compared to their current schedules. The differences are largely assumed by underused and vacant highly valuable sites in more centralized areas. Moreover, large

buildings on small footprints of space, those sites that are used efficiently, are typically rewarded by seeing their tax burdens reduced.

Stabilizing property values through the collection of economic rent also stabilizes tax rates and burdens. It tends to provide a reliable and secure base for the support of public services without the “excess burden” imposed by current conventional taxes that encourage flight to tax havens. In the final analysis, it often happens that the increased development at the locations where activity has been induced preserves the land value of adjacent parcels in a way that the general ambiance of neighborhoods and cities overall is improved. It is no accident that some 700 localities worldwide have now discovered the virtues of land value taxation, some twenty in the state of Pennsylvania alone. The city of Harrisburg, for one, has seen the restoration of 5,000 previously boarded-up brownstones. Its Mayor Stephen Reed, who instituted the shift of taxes off of buildings and onto land values in 1982, remains in office today with his successful tenure attesting to its political acceptability.

To be sure, land speculators may not see the gains in their property values that now visit select elements of the community. On the other hand, homes are likely to be more affordable to many more people [including our children and grand children] and with the result that cities are revitalized. So, citizens should decide quite frankly and openly whether they want high real estate prices or higher costs for reduced public services. Take your choice.