Taxation of Real Estate in U.S.A.

by Lawson Purdy

THE GENERAL PROPERTY TAX

As late as 1880 the general property tax, which then amounted to $6.25 per capita for the whole United States, was almost the sole support of state and local governments. Since then, the functions of state governments have increased tremendously, and those governments now receive but a small part of their support from the general property tax and depend largely on the general sales tax, the tax on motor fuel, the income tax, and the motor-vehicle tax. In 1952 the states received 66.7 per cent of their revenue from these four sources.

Local governments, until comparatively recent years, depended on the general property tax for most of their direct support; but these, too, have turned more and more to other taxes and to grants from their state governments—which grants, of course, must be made out of state-wide taxation and out of grants which the states themselves receive from the Federal Government. The following table shows the sources from which state and local governments received their revenue in selected years.

GENERAL REVENUE OF STATE AND LOCAL GOVERNMENTS PER CAPITA FOR THE ENTIRE NATION, SELECTED YEARS

	1902		1932		1946	
	STATE	LOCAL	STATE	LOCAL	STATE	LOCAL
Gen. Prop. Tax	$ 1.04	$ 7.86	$ 2.63	$34.87	$ 1.79	$34.72
Other Taxes	.93	1.01	12.51	.92	40.78	2.69
Aid	.04	.73	1.83	7.33	5.43	15.05
Charges	.21	1.09	1.59	4.97	3.31	6.27
Total	$ 2.22	$10.69	$18.56	$48.09	$51.31	$58.73

Census Bureau State and Local Governments, Special Studies No. 25, p. 13.

Whereas in 1902 the states received almost 47 per cent of their total revenue from the general property tax and local governments received almost 70 per cent, in 1946 the general property tax accounted for less than 4 per cent of total state revenue and 59 per cent of total local revenue. This does not mean that the rate of tax has been decreased as the years have passed; it simply points out how the tax has decreased as a proportion of total state and local revenue. The following table[1] shows the increases in the per capita levies on general property from 1860 to 1941 for various sections of the nation. These divisions are those customarily used by the census.

These taxes were levied on personal property as well as on real property. In 1940 the assessment of personal property was less than 19 per cent of the total. It varies from nothing in New York to 40 per cent in some states and varies in tax rates, also, in some states.

[1]*The Commonwealth of Massachusetts, Report of the Special Commission on Real Estate Taxation and Related Matters,* March 15, 1945, p. 208.

PER CAPITA LEVIES ON GENERAL PROPERTY FOR THE SUPPORT OF STATE AND LOCAL GOVERNMENTS, 1860–1941

YEAR	ENTIRE NATION	NEW ENGLAND STATES	MIDDLE ATLANTIC STATES	NO. CENT. STATES EAST	NO. CENT. STATES WEST	PACIFIC STATES
1860	$ 3.00	$ 4.33	$ 3.43	$ 3.40	$ 3.43	$ 7.29
1870	5.87	9.94	7.31	5.87	6.08	12.68
1880	6.26	10.60	8.97	7.00	5.76	12.78
1890	7.53	11.17	9.97	8.18	8.04	14.35
1902	9.22	13.29	13.17	10.47	9.00	16.42
1912	13.91	18.53	17.71	15.38	15.06	23.28
1922	32.23	35.59	36.66	39.27	38.52	48.61
1932	40.15	48.46	54.91	47.52	38.25	50.86
1941	33.98	48.75	51.13	35.24	33.10	41.17

Comparisons for 1941 are based on data for tax collections and not on levies. The 24 states not grouped are the Southern Seaboard States from Delaware to Texas, and the 8 Mountain States including Montana and Arizona. They started with $1.84 in 1860 and went to $18.94 in 1941.

LAND VALUES AS PROPORTION OF TOTAL ASSESSED VALUE

In 1911, at the fifth conference of the National Tax Association, which is composed of delegates appointed by the governors of the several states, the members received a report recommending to assessors the practice of setting down separately the value of land and the value of improvements thereon, and the use of tax maps, land-value maps, and the standard assessment procedures. At the present time there are approximately 35 states in which the assessment is divided between land and improvements.[2]

The proportion of land values to the total assessed value of real estate was about 60 per cent prior to 1910 and has declined since to between 30 per cent and 40

[2]Letter to the publishers from the National Association of Assessing Officers, Chicago, Ill., October 25, 1951.

per cent. Exact figures are not obtainable, but we have recent figures for seven states which, together, account for over half the assessed value of real estate in the country. These states and the ratios of the assessed value of land in them to total assessed value of real estate are as follows:

ASSESSED VALUE OF LAND AS A PERCENTAGE OF TOTAL ASSESSED VALUE OF REAL ESTATE

California	41 per cent
Illinois	40 " "
Indiana	41 " "
Massachusetts	28 " "
New Jersey	29 " "
New York	38 " "
Ohio	26 " "

The figures used in computing the above percentages are from the following sources: California, *State Board of Equalization, Annual Report, 1951–52;* New Jersey, *Division of Taxation, Department of the Treasury, Annual Report, 1951;* New York, *Report of the Department of Taxation and Finance, State of New York, 1947–48;* Massachusetts, Illinois, Indiana and Ohio, through correspondence with the state tax commissioners.

INCREASED ASSESSED VALUE OF BUILDINGS

The vast increase in the assessed value of buildings is due largely to the increased cost of building materials and labor. It is proper to regard as the maximum value of a building its current cost of reproduction less depreciation, and these increased costs have influenced the assessment figures. It is the exception to find assessors who attempt to assess at full value. It is customary in many taxing jurisdictions for assessors to take some percentage lower than the law requires and endeavor to make their assessments on that percentage of full value. However, in determining a building assessment, the careful assessor is guided by the maximum that a building may be worth; that is, its cost of reproduction less depreciation. Many buildings are obsolete and therefore much less valuable than this maximum. As building costs soared during World War I, and again when the depression of the thirties was over, the assessors followed at a distance behind the increasing value of building, but all of them were influenced by it.

GROUND RENT COLLECTED IN THE UNITED STATES

The term "ground rent" is not as common in the United States as it is in England. The city of London is said to be very largely developed by persons other than the owners of the land, who pay to the owners an agreed rent, very often for a period as long as 99 years. What the lessee pays is commonly called "ground rent," a good term which can mean only one thing—the annual price paid for the use of land. In this country ground leases are often given. There are many in New York and Philadelphia, and the city of Baltimore is, to a considerable extent, developed on that basis.[8]

In considering the effects of a tax on land, the fact that the tax tends to reduce the net income, and therefore the selling value, should always be kept in mind, and the effect in dollars and cents should be considered. Land that is very valuable and stable in value tends to sell for a low income yield. The English put this in a simple form; they say that land sells for "25 years' pur-

[8]Many years ago the law permitted a ground tenant in Baltimore to buy the fee from his landlord for the amount of the ground rent capitalized at 5 per cent.

chase." By that they mean that the price of the land will be 25 times the net return. In this country we are more likely to say that land sells on a 4 per cent basis, which is the same as a 25 years' purchase. If we say that land sells on the basis of a 5 per cent yield, it will sell for 20 times the annual net rent. Sometimes land sells for as high a yield as 6, or even 7, per cent. That means that the capital value is relatively low. It was the case, and may now be, that land at Wall Street in the city of New York sold on a 4 per cent basis, while land located 10 miles or so from Wall Street was apt to sell on a 6 per cent basis. The reason is obvious. The land near Wall Street is regarded as very stable in value, while land in a suburb is much less valuable per foot and generally is regarded as less stable in its value.

How much of our land value, or ground rent, is being collected in the United States for public purposes? For the whole country a reliable answer to that question is doubtful because of the inadequacy of our statistical sources. However, for groups of cities the Citizens Research Council of Michigan (formerly the Detroit Bureau of Governmental Research) is constantly compiling material which makes computations possible. For years the council has endeavored to get from its correspondents and public officials the ratios of assessments to full market value, and to a degree it has been successful. These ratios for the cities for which they can be obtained are published in the successive January issues of the *National Municipal Review*. The table which follows is prepared from the statistics appearing in the *Review* for January 1952. It shows the approximate amount of ground rent taken through the general property tax in 256 cities, in six population groups.

PER CENT OF GROUND RENT TAKEN IN 1951 THROUGH THE GENERAL PROPERTY TAX IN 256 CITIES, IN 6 POPULATION GROUPS

GROUP	POPULATION	AVERAGE ADJUSTED RATE PER $1,000 ASSESSED VALUE	AVERAGE PER CENT OF GROUND RENT AT 5 PER CENT CAPITALIZATION
1	1,000,000 and over:		
	New York	$30.80	38.5 per cent
	Philadelphia	18.45	26.9 " "
	Los Angeles	30.92	38.6 " "
2	500,000–1,000,000	29.57	37 " "
3	250,000– 500,000	20.69	29 " "
4	100,000– 250,000	23.47	32 " "
5	50,000– 100,000	21.43	30 " "
6	30,000– 50,000	23.61	32 " "

Only three of the five cities in Group 1 supplied estimated ratios of assessed value to current market value. Of these, New York and Los Angeles have 82 per cent of the population of the three cities, and their adjusted tax rates are $30.80 and $30.92. Philadelphia has an adjusted tax rate of $18.45. An average of the three would be misleading.

Let us consider the method by which we may arrive at the amount of ground rent taken by taxation in any community for public purposes.

First we must assume that these adjusted tax rates correctly give the rate which will produce, if levied on the market value, the sum of the actual tax. We must also make an assumption as to the rate of capitalization, and in the above table that rate has been assumed to be 5 per cent.

A simple way to deduce the ground rent from the adjusted tax rate is to add the adjusted tax rate to the capitalization rate and divide the tax rate by the sum of those two. For example, if the tax rate is 2.5 per cent and the capitalization rate 5 per cent, divide 2.5 per cent by 7.5 per cent and that will give 33⅓ per cent, which, in this example, is the proportion of ground rent taken by the tax.

As the tax rate increases it rapidly takes a greater proportion for the city, and this continues until the half-way mark has been reached. After that the amount of ground rent taken by the tax becomes less and less. The table which follows illustrates this point.

THEORETICAL DIVISION BETWEEN CITY AND OWNER OF GROUND RENT AT VARIOUS TAX LEVELS, ASSUMING A GROUND RENT OF $1,000 AND A CAPITALIZATION RATE OF 5 PER CENT

TAX RATE PER CENT ASSESSED VALUE	CAPITALIZATION RATE PLUS TAX RATE	MARKET VALUE*	TAX TAKES FOR CITY	TAX LEAVES FOR OWNER
0	5 per cent	$20,000.00	0	$1,000.00
1 per cent	6 " "	16,666.66	$166.66	833.33
2 " "	7 " "	14,285.71	285.71	714.29
3 " "	8 " "	12,500.00	375.00	625.00
5 " "	10 " "	10,000.00	500.00	500.00
20 " "	25 " "	4,000.00	800.00	200.00
45 " "	50 " "	2,000.00	900.00	100.00
75 " "	80 " "	1,250.00	937.50	62.50
95 " "	100 " "	1,000.00	950.00	50.00

*Capitalized value of owner's share of ground rent.

In considering this table it must be understood that it is a purely theoretical, mathematical calculation. In practice, when men fix rents they bargain about them. Some men drive hard, sharp bargains; others do not. Some men will take advantage of a superior position and use it without mercy. On the other hand, there are those who will be considerate and who will take less than they could get by pressing their point. Therefore, in actual practice it is probable that the precise division between city and owner will occur by chance at very infrequent intervals, or never. The fact remains that the table represents a truthful statement of what would happen in theory under the circumstances described.

I am of the opinion that if any community should reach the point of taking two thirds of the ground rent, that community would do well to fix its tax rate in terms of a proportion of the annual ground rent rather than in terms of a percentage of capital value. Many persons share that opinion. However, in this country we have had the practice of fixing the tax as a percentage of capital value, and in theory there is no obstacle to continuing that practice until you have taken for public use over 90 per cent of the actual ground rent.

Most economists since John Stuart Mill are agreed that a tax on buildings tends to be shifted to the user. A tax on buildings will check building until the demand so increases as to raise rents enough to give the builder the usual return. Land, being of fixed area, is different from a building, which is like any other commodity. A tax on land does not reduce the supply of land and gives the owner no power to increase rent. A tax on land tends to remain a burden to the owner and to reduce the selling value of the land.

It is true that as taxes on land values have increased from decade to decade it has become increasingly profitable to put land to its best use rather than to put it to an inferior use or to leave it idle. Unfortunately, during the years when land-value taxes have been increased, other taxes have been increased even more. Nevertheless, when the tax takes a quarter or more of the total ground rent, as is the case in many of our American cities, the tendency is for land to pass more easily into the hands of those who will use it. This is not to say that land speculation in the United States has ceased or that "land booms" such as have plagued the country in the past never will appear again, but only to emphasize that these catastrophes must be less in number and intensity when land values are taxed as we tax them than they would be if the burden were lighter.

NEW YORK

It was stated earlier that a tax on buildings tends to check building. A dramatic example of how residential building was encouraged by removing the tax for a stated period occurred in New York in the 1920s and may be useful here to illustrate the point.

In 1920 there was a housing shortage all over the United States and an acute housing shortage in the city of New York. Almost no residence building had gone on during the war years, and when the war ended the cost of building was three times what it had been before the war started. Builders were fearful that if they erected houses the cost of building might recede again, leaving them with, for instance, a house costing $300,000 then but worth only $100,000. Under such circumstances a stimulus to building can be given by a reduction in taxes on the buildings, which will partially compensate the builder should the cost of building decline. This stimulus was supplied in New York with such good results that it seems worth while to give the story in some detail.

In September 1920 the Legislature of New York, in special session, enacted a law permitting local legislative bodies to exempt from local taxation until January 1, 1932, buildings erected for dwelling purposes, except hotels, to an amount not exceeding $1,000 for each living room, or $5,000 for each dwelling unit, provided construction was commenced after April 1, 1920, and the building completed within two years after such commencement. The exemption was further limited in 1923 to $15,000 for the total exemption for each multiple dwelling.

Pursuant to this act, the Board of Aldermen and Board of Estimate of the city of New York adopted an ordinance in February 1921 exempting new dwellings commenced before April 1, 1922, to the extent permitted.

In each of the years 1921 and 1922 the time of commencement was extended for one year—to April 1, 1923, then to April 1, 1924.

The effectiveness of the law was increased by the limit of time for commencement of a building. Its purpose was to procure new dwellings quickly, and it succeeded beyond expectation. In the Report of the Tax Department for 1927, the following dwelling units were shown to be exempted:

Dwelling units in single-family dwellings	64,994
" " " two- " "	65,004
" " " multi- " "	151,965
Total	281,963

The total exemption allowed was $916,512,915. Owing to the limitations, this amount was considerably less than the cost of the buildings.

The occupants of a dwelling unit average about one fifth more than the average family. In 1930, in the city of New York, the median family was 3.48. We may assume the average number occupying a dwelling unit to be 4. On this basis, the number of persons housed was 1,127,852, or 15 per cent of the total population of the city in 1920.

This law contained no special privilege. It was open to all alike, for the benefit of all.

The experience in New York was obtained under special circumstances. This does not, however, alter the fact that a tax on buildings tends to check building. The benefits that might accrue if a greater portion of our land values were taxed into the public treasury with a corresponding reduction or abolition of the present taxes on improvements is a subject worthy of the widest possible investigation.