

A TAX SYSTEM THAT RESTORES CONFIDENCE IN GOVERNMENT:

Balancing State and National Authority
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Since the Republicans took control of Congress in January, the potential for radical changes in both tax and budget policy has advanced dramatically. The current crop of tax proposals are all variations on the theme of eliminating the income tax as we know it by shifting the tax base to consumption. This is supposed to increase the saving rate and economic growth, but it probably will not, if the past is any guide. Instead, the Republican plans primarily amount to a massive shift of taxes onto labor and, in the case of the so-called flat tax, a gift of around \$1 trillion to the already wealthy. In addition, despite the relatively low tax burden on Americans (compared to Europeans), the Republicans are offering to cut taxes and scale back the scope of government.

The Republicans have also proposed to shift responsibility to the states for a number of social welfare programs. If the states are prepared to raise taxes to pay for their new burdens, decentralization could be a positive step. But the states are also cutting taxes, so the effects of devolution on low-income households will be ambiguous at best.

The Democrats, meanwhile, lack ideas with which to respond to these proposals. They have tied themselves to the status quo, with all of the subterfuge associated with it. Democrats have historically defended an income tax system with high marginal rates, which allows them to gain political support from those who receive tax breaks. They stand solidly behind Social Security and Medicare, even though they are financed by a highly regressive payroll tax that presumably raises the unemployment rate. The Democrats are in no position to criticize the Republicans for heaping more taxes on labor.

The problem with the approach of both political parties is their fixation on taxing cash flows instead of services and rents. (Technically speaking, the current income tax combines cash accounting and accrual accounting, but overall there is a strong bias toward cash-flow activities.) The Republicans want to tax spending; the Democrats want to tax earnings. At the same time, the wasteful use of valuable resources is subsidized. Both income and expenditure taxes interfere with the flow of transactions in the economy and act like an injection of cholesterol directly into the blood stream. Inefficient use of natural resources, which reduces the turnover of capital and further blocks economic circulation, is the social equivalent of the low-density fats that clog our arteries and destroy our health. Just as those fats line the arteries and make the heart pump harder, idle resources make the economy sclerotic by forcing labor and capital to work harder to achieve a given level of output. Then, after these absurd economic rules drive us to work harder just to stay even, we are taxed for our efforts. No wonder our economic system is sluggish, and productivity has grown so slowly.

A third way

If one gives up the idea that the siphoning of cash flows is the primary source of tax revenues, there is a third approach to taxation that neither political party is considering. Instead of penalizing either work or investment, taxes should promote initiative and discourage the wasteful use of the earth's resources. At present government policy tends to subsidize resource depletion, pollution, and urban sprawl, while it taxes away the fruits of human effort.

At Redefining Progress, we have begun to analyze the possibility of creating a tax system in California based on the principle of resource taxation. Our aim is to show that it would be feasible to phase out all existing taxes at the state and local level other than fee-for-service charges and reasonable developer exactions. Beyond user charges, state and local revenue would ultimately derive entirely from charges on the use and ownership of resources provided by nature and on infrastructure built at public expense.

The potential tax sources on which we have already done considerable research are 1) air pollution, 2) energy, 3) highway use and congestion, 4) land, 5) parking, 6) solid waste, and 7) water rights. We are hoping to add to that list forests, fisheries, mining, noise pollution, and water pollution. As we extend the analysis to the federal level, we might also add research on the electro-

magnetic spectrum, genetic resources, sea-bed mining, space debris, and other national or global resources. There may be other areas that would be appropriate objects of taxation which we have not yet considered.

Taxes on these sources would improve the economy and restore vitality to democracy. Most of what I have to say today refers to the social and political benefits of tax shifting, but I want to mention in passing three economic advantages. First, every dollar raised from one of these sources cuts taxes on labor or investment by an equal amount, enabling businesses to hire more people at higher wages, with more capital to make them productive. In addition to stripping away the taxes that reduce wages and employment levels, site value taxation will increase the turnover of capital and directly increase the amount of labor used per unit of capital. The second gain is the promotion of resource conservation. Taxing resources that are mispriced in the market will make their use more efficient. In many cases, efficiency means that social costs will be captured. In other cases, it means that hoarding will be severely limited so that resources can be shifted from low-value to high-value uses. The third benefit is a fairer and more rational tax system that rewards effort, not inherited privilege. Put simply, people should pay for what they take, not for what they make.

Economists have long proposed the use of pollution charges and some have suggested taxation of rents from land and water. But generally they have assumed this would not be sufficient as a tax base. Our calculations suggest that California could raise between \$175 and \$200 billion from resource taxes. The combined own-source revenues at the state and local level are currently around \$120 billion. Thus, without relying on any cash-flow taxes, it appears that California could increase its revenues by approximately 50% above current levels.

Taxation and federalism

By shifting taxes from cash-flow activities to resource ownership and use, the devolution of power from Washington to states and local governments could become a reality. A tragic situation has come about whereby local governments sit on huge sources of untaxed wealth while they go bankrupt and seek federal assistance. They cannot see the wealth around them because generations of public finance experts have created a fixation on cash-flow sources of taxation, which are not especially suitable for state and local government. Labor and capital are mobile. Thus, when states and local governments try to tax income or sales, they are inevitably in competition with each other. Companies force local governments to engage in bidding wars over which jurisdiction will offer the best tax abatement terms. Thus, our nation has embraced a top-heavy system of federal income taxes and tax-starved state and local governments. The result has been centralization of authority, loss of access to decision-makers by citizens, excessive federal rule-making, corruption, and a loss of faith in government.

State and local governments can reassert their fiscal power and authority by levying high taxes on immobile resources so they will not be in competition with each other. (Except in Woody Allen's movie *Love and Death*, land is not treated as a mobile asset.) Local governments can raise taxes on rents up to 100% without interfering with commerce. Appropriate pollution fees, higher parking fees, and congestion prices on highways could add to local and state revenues and to the quality of life, without stifling economic activity or leading to downward competitive pressure among neighboring jurisdictions. Indeed, the most miraculous feature of rent taxes is that high tax rates actually promote enterprise, in contrast to most other taxes. Thus, the perfect tax sources for state and local government remain largely untapped, even as they depend on the federal government for handouts.

Although levying taxes locally on immobile resources, such as site values or congestion, makes sense on efficiency grounds, this might be inequitable if the boundaries of tax jurisdictions are drawn very narrowly around the sites that generate the highest rents. Wealthy neighborhoods could form separate jurisdictions with the intention of capturing the high rents generated from their properties, thereby depriving other county residents of their tax revenues. In California this tactic has already been adopted by industrial enclaves in a couple of cities and by redevelopment districts in many more. This amounts to private hoarding, and it obstructs efforts to broadly allocate the

payments for use of socially created wealth. Thus, a state that adopted resource taxation as its primary revenue source would need to ensure that much of the revenue would be spent at a jurisdictional level large enough to be representative of society as a whole.

At the international level, the same principle applies to the taxation of resources that extend beyond national boundaries. For example, if nations tax the use of the atmosphere according to an international treaty, it would be appropriate on equity grounds for the nations that use the largest share of atmospheric resources to pay part of their revenues into an international fund to compensate other countries. Otherwise, nations such as ours that have historically used more than our share of the earth's resources will continue to reap the benefits from our excessive use.

The key point is to recognize that new issues of scale and jurisdiction will arise in a system with heavy emphasis on resource taxes. The best level at which to collect resource taxes may not necessarily be the best level at which to distribute the proceeds from the tax. This will make for interesting interjurisdictional negotiations.

Partitioning the tax base among jurisdictions

If states and local governments tapped the best sources of taxes, leaving the federal government to collect more economically destructive taxes, that might reverse the historical dominance of the former by the latter. The federal government then might have to come begging the states for money instead of vice versa. At present, the federal government collects over \$1.35 trillion from taxes on personal and corporate income and payrolls. Of that, around \$200 billion is assistance to state and local governments, and almost \$700 billion is transfer payments to individuals. State and local own-source revenues are currently around \$1 trillion dollars (not including the \$200 billion in federal grants). If our estimates for California are reasonably accurate, own-source revenues could be increased by 50%, to around \$1.5 trillion. It should be possible to eliminate all state and local assistance from the federal budget and all transfer payments except Social Security.

Even if a large part of the responsibility of providing services could be turned over to state and local governments, there are a number of national programs that could not be devolved. Defense, foreign affairs, and other purely federal activities consume over \$350 billion per year. Social Security costs another \$350 billion, and interest on the debt around \$250 billion. Thus, a bare-bones federal budget (assuming no major cutbacks in defense spending) would amount to around \$950 billion. If state and local governments raised an extra \$500 billion, the federal government would not be able to cut back by an equal amount because it has been running a persistent deficit. Also, the amount of revenue needed by the federal government will depend in large part on whether Congress is able to restrict the growth of Social Security (or perhaps even to reduce its overall size).

What taxes could the federal government rely on to raise \$950 billion? If state and local governments generated revenues solely from noncompetitive sources (land, water, parking, local pollution and congestion, and user fees), the largest remaining source of revenue that would also provide social and environmental benefits would be a charge on carbon emissions from fossil fuels and other energy charges based on non-local damage and risks. The International Panel on Climate Change estimates that a charge of \$500 per ton of carbon (around \$135 per ton of carbon dioxide) might be necessary to prevent further increases in the concentration of atmospheric carbon dioxide. A carbon tax of that amount, phased in at the national level might ultimately yield around \$500 billion (based on a guesstimated decline of 30% to 40% in the use of petroleum as a result of a 150% increase in the price of most fuels). If the tax were adopted as part of an international treaty, some of the revenue might have to be used to offset the effects of economic losses in other countries, so we might assume that only \$400 to \$425 billion would be available domestically. Charges on the use of the electromagnetic spectrum, the use of federal lands, fisheries within the 200 mile zone, and other resources might yield another \$20 to \$30 billion.

It would continue to be necessary to raise around \$500 billion from conventional taxes. The payroll tax could be eliminated, providing a large increase in demand for labor. Personal and corporate income tax rates could also be lowered by about one-third, or personal taxes reduced by

one-sixth and the corporate tax eliminated, which would make sense if their profits were no longer heavily loaded with resource rents.

All of these figures are somewhat pessimistic because they presuppose a static analysis. Since taxation of rents would encourage increased demand for labor and increased turnover of capital, the higher level of economic activity would cause incomes and tax receipts at all levels to grow rapidly. Since pollution and resource use would be tightly limited by taxation, the economic growth that occurred would be more purely beneficial and less morally ambiguous than it is under current conditions. In addition, the burden of means-tested transfer payments, which place a burden on an already sluggish economy, would become far lighter as more people were able to find work. In other words, the overall size of government could be reduced. At the same time, since the saving rate is closely tied to the rate of income growth (according to a study by Barry Bosworth of OECD nations), a higher rate of growth would partially alleviate the balance of payments problem. In all likelihood, the federal income tax rates could decline over time as the overall tax system transformed society from a condition of chronic illness to one of increasing health.

Renewing democracy

Thus far, I have spoken primarily in terms of fiscal and economic benefits that could result from a tax shift, such as full employment, economic efficiency, and fairness. There is another dimension to tax shifting that is rarely considered. It could also promote the development of a more democratic society in several ways.

The need to promote a more democratic society in the United States might not be obvious to everyone. At the formal level, we have an open electoral process, a relatively fair judicial system, and strong legal safeguards of individual rights. But democracy at its best is much more than these failsafe devices. Ideally, it is a process of harnessing the wisdom of all members of society in collective decisions. That does not necessarily mean that every citizen is directly involved in every decision. That would be unduly cumbersome. It simply means that every individual has a realistic opportunity (not just in theory) of influencing public choices.

Achieving that goal depends on at least three factors that could be changed by a tax shift. The first factor is the proximity of decision-making to citizens in both a physical and a psychological sense. The second factor is the establishment of rules that limit favoritism and corruption. The third factor is a reduction of the wealth and status differences that induce psychological dependence and deprive many citizens of the capacity to make independent judgments about public affairs.

First, a tax shift of the kind I have described would involve the transfer of many aspects of domestic policy from the federal to the state and local level. Devolution of authority would enable citizens to observe and participate directly in the affairs of government. Local government has the potential to be more transparent and more responsive to the needs of ordinary citizens than the distant federal apparatus. That very transparency has, however, given local government the reputation of being corrupt. The Progressive ideology has mistaken the appearance of professional disinterest for good government since the turn of the century. It has favored centralization of authority in the hands of federal officials. In the process, we have allowed subtler and more arcane forms of avarice to displace the more visible manifestations that citizens had some chance of controlling.

The second contribution of a tax shift to democracy is its capacity to limit corruption and thereby restore faith in the integrity of government. The public collection of economic rents would undermine the basis of many of the favors traditionally extended by local officials to friends and political contributors. For example, zoning board officials would have far less influence to sell if taxes were designed to capture most of the rents from upzoning. In addition, programs such as construction of low-income housing, water impoundments, and other projects designed to correct perceived market failures have created a context in which wholesale, institutionalized corruption has thrived. By correcting the market failure with tax policy, the rationale for financing those government programs would dissolve. Furthermore, eliminating the federal share in these

projects, which looks like free money to the recipients, would force citizens to recognize that government is wasting our money, not someone else's.

The third feature of a tax shift that would breathe new life into democracy is the redistribution of wealth and opportunity. The most important prerequisite of democracy is the existence of an independent citizenry that has the capacity to deliberate and come to judgment without undue manipulation by powerful interests. Historically, some form of property ownership was considered a necessary condition for having the leisure and the independence to make informed judgments. Those who owned only their labor power were economically and psychologically dependent on the propertied class. The political reformers of the 19th century were offended by the denial of political rights to those without property. In their efforts to broaden the base of political participation, they made a crucial choice. Instead of working to create a social system in which property ownership was within reach of everyone, they fought for universal suffrage. Given the constraints upon them, that may have been the best that could be achieved. But we should be aware that the weakness of democracy in modern nation-states can be directly traced to the continued concentration of economic power.

I am proposing that democracy will always remain thin and fragile unless wealth and economic opportunity are sufficiently dispersed to enable most adults to act as independent citizens. Above all, the average citizen needs to own enough economic assets to feel a stake in the system and to be able to withstand pressure from dominant economic interests. That would not necessarily require complete uniformity of wealth distribution, but it is clear our economy is moving in the wrong direction. Income and wealth became more concentrated in the 1980s, with the top 1% and top 10% both gaining at the expense of the rest of the population (Mishel and Frankel, 26 and 162). From 1980 to 1990, the proportion of families with some net equity in a house declined slightly, but particularly among those less than 45 years old, for whom ownership rates dropped by 5 percentage points (Statistical Abstract 1992, p. 716).

These changes might be compatible with democracy if upward and downward mobility were constantly rearranging the social rank of individuals in society, but that is not the case. Poverty and privilege are strongly transmitted from one generation to the next. American society is highly stratified. According to one analysis by two respected economists, 81% of household wealth is inherited rather than based on personal saving (Kotlikoff and Summers, 722). This high figure is based on a rather broad definition of inheritance, which includes many nonmonetary gifts and advantages supplied by relatives that do not show up in standard surveys. Other studies have estimated that in the United States today, over 40% of a person's economic status is inherited from parents (Solon, 403; Zimmerman, 427). This fits with the conclusion, reached by Christopher Jencks and his colleagues in their thorough study of mobility, that "those who do well economically typically owe almost half of their occupational advantage and 55 to 85 percent of their earnings advantage to family background" (Jencks et al., 81). Contrary to the popular image, education does not overcome the effects of inherited status. Instead, it reinforces them. Children from wealthy families do better educationally than children from poor families for a variety of reasons, but particularly because children of privilege internalize the expectation that they will succeed.

We are currently a highly stratified society in which status depends largely on the family one is born into, and the divisions are becoming deeper and more rigid. The strengthening of democracy thus depends on the development of economic mechanisms that will disperse ownership of assets more widely. A tax shift could accomplish that goal through market forces, without the economically and socially disruptive effects usually associated with redistributive measures. As the tax on natural resources rose, their market value would decline, and those whose economic power depended largely on them would lose much of their wealth. Assets that are currently held but are being used inefficiently would be sold, thereby dispersing ownership. In addition, by lowering the cost of buying a house, site value taxation would probably increase homeownership among those who are currently priced out of the market. Those who want to start their own business would also be able to do so more easily because the capital costs of entry would be lower. Finally, higher rent taxes would free up idle capital and increase its rate of turnover,

thereby expanding employment opportunities. There may be other channels as well that would lead to less concentration in wealth holdings.

The effect of these changes on democratic institutions would be profound. Many people who feel they are in the grip of forces beyond their control would gain some degree of economic stability and political self-confidence. The current trend toward a dual economy and stratified society would be halted and reversed. Moneyed interests would no longer be able to dominate the political arena as easily. If the past is any guide, an increasing number of clubs and associations would be formed by those who currently feel left out of the political process. In sum, the dispersal of economic power would reinvigorate participation in civic life.

CONCLUSION

The idea of shifting taxes from labor and capital to resources will take several years to gain general acceptance, but it is not too early to begin imagining the basis on which such a shift might take place. Rather than asking only what economic questions a tax shift will answer, we must also consider what its effects would be on public life and government authority.

First, I have suggested that a tax shift would be an appropriate response to the call by Republicans to turn authority for domestic programs over to the states. Rather than thinking of devolution merely as a way to unburden the federal government, it could be conceived as a method of strengthening the authority and economic viability of states and local governments.

Second, instead of simply dismantling the welfare state and abandoning responsibility for troubled citizens, the government could use its tax authority to create a market system that would be far more humane than the present one. Welfare for both the rich and the poor could recede in significance if we were to create an economy in which everyone had an opportunity and an obligation to be productive.

Third, by providing a source of revenue for local governments that does not require them to compete with each other in offering rebates to business, the autonomy of communities could be increased. No longer would cities have to complain constantly about the wolf at the door because they would have a reliable source of revenue.

Finally, and most important, a tax shift could restore the spirit of democratic citizenship that has been supplanted by cynicism and apathy. If a tax shift seems likely to renew the integrity of government and the self-respect of citizens, we would be remiss if we did not at least experiment with it.

References

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Appendix

The claim that a large proportion of taxes could be shifted from labor and capital to natural resources and user charges and from the federal to the state and local level hinges on the capacity of site value taxation to yield a much larger amount of revenue than the property tax currently generates. The following is an explanation of the logic we used in estimating the revenue potential of site value taxation in California.

The baseline - official state estimates of property values

Official (State Board of Equalization) statistics on property assessments in California indicate the total value of taxable land is currently around \$700 billion. The assessed value of buildings is around \$1.07 trillion. These figures offer a starting point for estimating the revenue potential. As we shall see, these assessment figures grossly underestimate the true market value of land. In order to determine the capacity of land value taxation to generate revenue, it is first necessary to develop a better estimate of the total value of land in the state.

Correcting for the effects of Proposition 13

One important factor biasing the official estimates of both land and building values downward is the process by which property is "assessed" in California under Proposition 13. Any property that has not changed hands since 1978 is assessed at the 1975 value plus an increase of 2% per year--49% over 20 years. Property that has been acquired since 1978 is valued at its purchase price plus a 2% per year increase, compounded annually. Since property values have increased by at least 200% to 300% since 1978, the assessments for property that has not changed hands since 1978 are many times lower than actual value. Since there are no statewide data showing the proportion of taxable property that has been sold each year since 1978, it is impossible to determine the precise degree of underassessment (relative to market value) as a result of Proposition 13. However, one study showed that the ratio of assessment to market value of property in metropolitan areas in 1981 ranged from 0.38 to 0.77, with a median of 0.60 (Phillips, 148). That means that a property worth \$300,000 would be valued on average at \$180,000. In other words, the value of property was 66% more than the assessed value. Since the largest metropolitan areas--Los Angeles, San Diego, San Jose, and San Francisco/Oakland all have ratios below the median, that suggests the total underassessment in the state exceeds 66 percent.

We have therefore estimated the total value of taxable property (land and buildings) in California as \$3.0 trillion instead of the \$1.77 trillion. (Land would account for around \$1.2 trillion and buildings for about \$1.8 trillion.)

Correcting for the underassessment of land

Land has traditionally been underassessed in three ways. First, property owners have benefitted most obviously when property as a whole is underassessed. The effect of generalized underassessment is to shift taxes elsewhere, onto income and sales. Second, owners have also benefitted when assessors have properly assessed the property as a whole but overvalued buildings so they can be depreciated for income tax purposes. Third, land is often assessed on the basis of its current use rather than its highest and best use, enabling speculators to hold run-down property for very little. In this case, the excess tax burden falls on other property owners who keep their buildings in good condition.

It is of course difficult to demonstrate that the practice of underassessing land is widespread in any particular jurisdiction without conducting an expensive assessment survey oneself. Several studies, however, indicate that accurate assessments would probably reveal the value of land within a city as a whole to be approximately twice as valuable as the buildings in it.

The most exhaustive study of underassessment of land in an American city was conducted in Milwaukee, Wisconsin, using 1965 data, by Mason Gaffney, an professor of resource

economics. Among other data, Gaffney and his co-workers examined the property assessments of buildings as they were about to be demolished (Gaffney, 1970). By definition, the market valued the carcass value of a building at zero. The assessor, as it turned out, assessed these buildings at around three times the value of the land they were on. Using the post-demolition value of the land on these sites as a baseline (to measure pure site values), Gaffney was able to determine for Milwaukee the average share of total assessed value of property (land and buildings) that derived from land alone. Not surprisingly, this varied considerably from one district of the city to the next. In low-rent and dense residential areas and in industrial areas, land comprised from 40% to 50% of the assessed value of land and buildings together. In the downtown area and in expensive, sprawled suburbs, the ratio of land value to land and buildings rose to between 70% and 90%. In the city as a whole, land comprised 70% of total property values. That means the total value of land was equal to more than twice the value of the buildings.

In Victoria, British Columbia, where assessments are kept up to date and where land is consistently assessed on the basis of potential use rather than current use, a similar relationship between land and building values has been found. For the city as a whole, the value of land is approximately twice as large as the value of buildings. Since Victoria is approximately as old as many California cities (unlike Milwaukee), it seems likely that this relationship probably holds in California as well.

Based on this evidence, we might reasonably conclude that the value of land in California is approximately twice as large as the value of buildings. In that case, if we start with assessed values adjusted to correct for the bias created by Proposition 13, the value of land would be \$3.6 trillion, or double the adjusted building value of \$1.5 trillion. In order to be conservative, however, we estimate that the value of land is only 33% greater than the value of buildings (which means that land and building values are split 57% to 43%). On that basis, we estimate the value of taxable land in California as at least \$2.4 trillion, which is over three times the official estimate. Note also that this figure does not include the potential land value effects of the tax changes discussed below.

Capitalization of existing taxes

Every tax on economic activity is in part an indirect tax on land values. (One reason for taxing land values directly is that the same revenue can be collected without the damage that other taxes cause to society.) The income tax reduces the amount of money that people can pay for property. The sales tax reduces the amount of money that can be spent on taxable goods and services. Since this lowers the average income of businesses, they can pay less in land rents. Every tax ultimately falls on land because land rents are derived from economic surpluses or residuals: the money that is left over after payments for labor and capital have been made. (This is not true for the individual because the landlord is the first one who must be paid. But if everyone's income suddenly goes up or down, during a boom or a bust, that affects the amount left over as surplus that landlords as a group can extract. Anyone who does not believe this should simply consider the rise of land values during the boom of the 1980s and the collapse of land values during the bust of the early 1990s.)

Since every tax on economic activity ultimately falls on land values, the removal of the taxes on personal and business income and on sales would have the effect of releasing money that would increase the money spent on rent. That, in turn, would be capitalized into higher average land values in California. We estimate that the elimination of income and sales taxes would amount to an increase in disposable income of about 5%, not counting the effects of increased employment and sales, which could amount to another 5% of state income. If disposable income in the state rose 10% or more than \$55 billion, an increase in annual land rents of \$20 billion would be likely. The capitalized value of that added rent would be around \$400 billion, assuming a 5% real interest rate.

Another large effect would be achieved by the removal of taxes on buildings. Exempting buildings from taxation would immediately increase the demand for land, thereby raising its value. In South Africa, Australia, and New Zealand, where cities have removed taxes on buildings and

taxed land alone, experience has shown that the rise in land values matches the decline in the tax base that had been provided by buildings. The assessed value of all of the taxable buildings in California is \$1.07 trillion. At a tax rate of 1% on assessed value, this yields approximately \$11 billion in revenues per year. Thus, if the tax on buildings were removed, the increase in land value would be around \$220 billion. Since the removal of the building tax would promote construction and new economies of synergy, the actual increase in land values would be higher than this estimate. For the sake of simplicity, we ignore those additions.

Finally, the existing tax on land has already lowered its market value by around 10% (assuming an effective tax on land of 0.5% and a real interest rate of 5%). Accordingly, in the absence of any tax on land, its value would be around \$240 billion higher than at present (10% of \$2.4 trillion).

Thus, the combination of removing all taxes in California would raise the value of land by around \$860 billion (\$400 plus \$220 plus \$240 billion).

Exempt land (no correction made)

An indeterminate amount of land that is owned by the state, by local governments, and nonprofit institutions could in principle be taxed but is not. Even if none of these governments or institutions is ever taxed for its use of land, it would be helpful to know the extent of the subsidy each receives so the public could make informed decisions about the merits of tax exemptions. Presumably, inclusion of this land in the tax base would disperse tax costs over a larger base, but it would not affect the total amount of tax revenues.

An estimate of revenue potential

Based on the foregoing revisions and estimates, we estimate the total value of land in California to be between \$2.5 trillion and \$3 trillion. A land tax could thus yield a maximum of \$125 billion from \$2.5 trillion or \$150 billion from \$3 trillion. (The tax yield cannot exceed the real interest rate, which we have assumed to be 5%, times the untaxed value of the land.)

The "own source" revenue (i.e., not including federal revenues) raised by all levels of government in California (excluding enterprise districts) is around \$100 billion. Thus, local governments could most likely pay for the entire cost of government--state and local--from a land value tax alone, with some left over. In combination with other incentive taxes, it would definitely be possible for California to generate a surplus that could then be distributed to all citizens of the state, just as state of Alaska does with its oil revenues.

In 1993-94, the one percent tax on \$1.77 trillion of assessed value of both buildings and land in California yielded around \$18 billion per year. We have estimated that land would have a value in California of approximately \$2.5 trillion in the absence of all state taxation. But the existing tax on land, if it remained at one percent, would lower the market value of land from \$2.5 to \$2.1 trillion and yield \$21 billion.¹ We envision that within four or five years, the tax rate would rise to 2%, the market value of land would fall to around \$1.8 trillion, and the tax yield would be about \$36 billion. Within 10 years, the tax rate could rise to around 7%, yielding around \$70 billion in revenue and lowering land values to \$1 trillion. This process could continue indefinitely, slowly increasing revenues and reducing the market value of land.

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¹ If the value is \$2.5 trillion when the tax rate is zero, and the real interest rate is 5%, then the rental value is \$125 billion. If the tax rate is 1%, then the market value is $\$125 \text{ billion} / (.05 + .01) = \2.083 trillion , which we have rounded off to \$2.1 trillion since these are fairly rough estimates anyway.)