

REFORMING TAXATION

TAXING THE FEDERAL GOVERNMENT

Steven B. Cord

A professor of history at Indiana University, Pa., suggests a new Federal-state tax-sharing plan:

“The proposal that the Federal government should share part of its revenue with the states has evinced much enthusiasm in Congress, among the states themselves, and in academic circles. But recent Senate hearings indicate that there are wide differences of opinion on who should get the Federal money and how it should be distributed.

“Walter Heller, former chairman of the Council of Economic Advisers, can be credited with starting the whole debate by proposing that the Federal government send back to the states a fixed portion of its tax revenues. . . .

“Many advantages have been claimed for Federal-state tax-sharing. First, economic growth and a powerful tax system have generated ample new Federal revenues. But at the state and local levels the situation is reversed: economic growth has increased the responsibilities of those governments—new schools, hospitals, roads, welfare, etc., are needed—and these burgeoning responsibilities have far outstripped the meager sources of local revenue. . . .

“Secondly, inevitable confusion, inefficiency, and delay result when vast amounts and types of Federal grants must be administered from Washington for a huge and varied country. . . . Because many of the Federal grants require the states to match Federal payments, the budgets of the states have been shaped, and perhaps distorted, by what the Washington administration thinks should be done. . . .

“A third advantage claimed for the tax-sharing idea is that it would preserve the independence and power of the states. It would remedy their chronic lack of funds and give them control over the various welfare programs operated within their boundaries. . . .

“On the other hand, the tax-sharing plan has not escaped criticism. It has been pointed out that if the states become accustomed to Federal handouts, a basic and dangerous dependence on the Federal government will be created. ‘He who pays the piper calls the tune,’ and perhaps in some future crisis the Federal government could threaten to reduce its subsidies to the states if the latter should refuse to follow Federal directions. . . .

“Other critics, particularly mayors, have pointed out that since the state legislatures are still rural-dominated, Supreme Court rulings to the contrary notwithstanding, they can hardly be trusted to respond to urban needs. Of course it is possible . . . to require that a large part of the Federal revenues returned to the states be spent in urban areas.

“Which brings up a third criticism: the great potential for political

squabbling. Already mayors have clashed with governors and rich states have clashed with poor states over who would get what and how. States rights advocates have argued among themselves over this plan, and of course they have argued with Federal rights advocates also. . . .

"It is at this point that I would like to add some new thoughts to this tax-sharing debate. It has not been generally recognized that for a long time *cities and states have been subsidizing the Federal government* rather than the other way around! Since the beginning of our nation, the Federal government has owned property within the various states and cities of the land, *without paying a single cent in property taxes*. I am referring to such urban property as post offices, armories, office buildings, and mints, and to such rural property as parks, natural resource reserves, and military bases.

"This Federal property benefits from the same advantages conferred on privately owned tax-paying property. Municipal police and fire protection is afforded Federal post offices even though they don't pay for such services. Roads are built, streets are lighted, garbage is collected, etc., all services from which the post office benefits without paying. In fact, by removing property from the tax rolls, Federal installations increase the local tax burdens—already distended—that private owners have to bear. Thus the state and local governments have been performing services for the Federal government for which the latter has made no payment—a subsidy if there ever was one. Before we create new counter-subsidies, why not first get rid of the old reverse subsidies?

"One simple way to do this is to *let the Federal government pay to each city and state throughout the country a tax on the full annual rental value of each parcel of land it owns*. Before delineating the advantages of this tax-sharing proposal, let us be sure we understand its details.

"In the first place, every piece of land, whether Federally-owned or otherwise, has a certain sale price. If 6 per cent is the prevailing interest return on land investment, then potential land rental of any plot is 6 per cent of the sale price plus the prevailing property tax rate in the community multiplied by the price. The sum of these two factors is equal to the annual land rent of the parcel, and it is this amount which the Federal government ought to pay to the cities and states. . . .

"Instead of this land tax, many people will ask if it wouldn't be easier for the Federal government to pay an ordinary property tax on the property it owns, just like any other property owner in the community. No, it would in fact be more difficult. With a land value tax, it would not be necessary to assess the value of Federal improvements, many of which would be hard to appraise because buildings like post offices, military bases, hospitals, etc., are not often bought and sold, thus making it difficult to ascertain their market value. It surely is simpler to assess land only rather than land and building.

"But there are many more cogent reasons why a tax on land values only rather than on land and buildings would be a better means of Federal tax-sharing. A tax on Federally-owned improvements would only increase the cost of operating such improvements and of building new ones. A tax on Federally-owned land, however, would have distinct economic advantages. It would strongly discourage the inefficient use of

land by the Federal government. The more land the government uses, the higher the cost. By keying land use to land cost, there would be less Federal sprawl. Without the goad of land value taxation, the Federal government has naturally tended to use more land or more valuable land than it had to use.

"This tax-sharing plan would have other advantages as well. Most of the rebates would go to the cities because that is where the most valuable Federally-owned land is. And it is in the cities that we find the greatest need for Federal aid. Where Federal land holdings are extensive, as in the case of air bases, national parks, natural resource reserves, etc., then the land tax payments should go directly to the state government for distribution to urban or rural areas as the legislatures see fit.

"It should be realized that this proposal, which we can call the Land Value Tax-Sharing Plan, is not another Federal subsidy but is instead a payment for benefits received. Post offices are not put out in fields somewhere. They are located where they can take advantage of the amenities afforded by crowded communities. They need access to government services and nearness to large groups of people. These locational advantages are measured by only one indicator—land values. It is only fair that the Federal government should pay for the services rendered to these facilities by the community or for the benefits received by being near their market. . . .

"In addition, under the Land Value Tax-Sharing Plan the danger of Federal domination of the cities and states is nonexistent. This is not true of the other tax-sharing plans. In fact, the Federal government is strengthening the cities and states by paying rent to them.

"But the same arguments that lead us to advocate the payment of rent to localities by the Federal government for the land it owns *applies equally as well to the states!* They, too, own land in the cities for which they are not paying taxes for benefits received. They, too, have been subsidized by the cities, and what's more, many states, recognizing the plight of their cities, have been paying them subsidies of various sorts for many years. . . .

"Nor should the indirect advantages of the Land Value Tax-Sharing Plan be overlooked. Numerous urban renewal authorities have called for heavier taxes on land values in lieu of lighter taxes on improvements, if not as yet for the Federal or state governments, then for privately owned real estate. The principle of land value taxation is clearly established, and the Federal and state governments could do much to see it implemented if they would lead the way by paying taxes on the land they own.

"A brief sampling of expert opinion is in order here. A conference sponsored by the National League of Cities and the National Council for Good Cities (ACTION), among others, voiced this opinion:

"Taxes on land (or, more correctly, site values, or perhaps still more correctly, location values) tend to encourage, speed, or sometimes even compel improvements. The bigger the land tax the bigger the pressure on land owners whose property is under-used to do something to increase its earning power—or sell it to someone who will."

"Says the well-known British economist Colin Clark: 'Any good

... and state
governments

economist can demonstrate that the land tax is perhaps the only tax that doesn't discourage enterprise.' An article in the *Architectural Forum* maintains that urban redevelopment could be more naturally and more quickly accomplished ' . . . if the profit motive were harnessed forwards instead of backwards—that is, by untaxing the improvements which are now so discouragingly overtaxed, and by shifting most of the local tax burden to the community-created location values now almost scandalously undertaxed.'

"An Urban Land Institute study declares that land value taxation 'is a golden key to urban renewal, to the automatic regeneration of the city—and not at public expense.' Limited land value taxation has been successfully attempted in Pittsburgh, Scranton, Arden, Delaware and Fairhope, Alabama. Recently the state of Hawaii has adopted this tax approach to urban renewal and land reform.

"Our Federal and state governments are presently hindering the much-needed reform of the local property tax by not bearing their fair share. It is time for them to recognize their responsibility in this area and at the same time to apportion tax revenues more equitably among the various levels of government." ("A Tax-Sharing Plan Geared to Urban Renewal," *The American Journal of Economics and Sociology*, April 1968)

WHAT ALTERNATIVES TO THE PROPERTY TAX?

A New York University economist in a report prepared for the National Commission on Urban Problems cites certain deficiencies and inequities of the traditional property tax and suggests possible alternatives.

Dick Netzer

"The property tax is by far the largest single source of funds to finance public services in urban areas. If, as seems likely, urban public expenditure continues to rise sharply, and if there are no major changes in fiscal institutions, the property tax will bear a large share of the burden; the various deficiencies of the tax will be aggravated by its use at continually increasing rates. . . .

"The property tax hits most central cities more heavily than the suburbs, burdens poor people much more heavily than the wealthy, and tends to discourage the construction of new housing and the proper maintenance of existing residences."

More specifically, there are six major deficiencies of the property tax which are apparent:

"1) The property tax on housing is analogous to taxes commonly known as consumption taxes; that is, general sales and selective excise taxes. Like the ordinary consumption taxes, the great bulk of the burden of the housing property tax appears to rest upon housing consumers, whether they are owner-occupants or tenants. There are some exceptions; the chief one is that owners of rental property cannot shift the burden of that portion of the tax which falls on the land underlying their buildings. But, for the country as a whole, probably well over 90 per cent of all property taxes on housing are borne by housing occu-

pants." This property tax, nationwide, is equivalent to a 24 per cent sales tax on housing, as compared with consumption taxes on other commodities that only rarely exceed 5 to 10 per cent.

2) The property tax is especially hard on low-income renters; it burdens families receiving less than \$2,000 a year five to six times as heavily, as a per cent of income, as it does families earning \$10,000 a year and over.

3) In a large portion of metropolitan areas, the effective property tax rates are 'substantially higher' in the central cities than in the surrounding suburban territories.

4) Many large cities, to support heavy social service costs, levy high property taxes which hasten the flight of industry and business to the outlying fringes of metropolitan areas.

5) The competition for a favorable revenue position among the multiplicity of taxing jurisdictions in metropolitan areas stimulates exclusionary zoning practices and unsound development patterns .

6) Faulty assessment practices in many areas result in inequitable treatment of property owners and contribute to public dissatisfaction with the tax system.

"The property tax does, however, show great capacity for expansion. Its nationwide yield increased by almost 30 per cent between 1962 and 1966. The property tax produces very large revenues in absolute amounts—\$23.8 billion for all local governments in 1966. The property tax remains the fiscal bulwark of local government, accounting nationwide for about two-thirds of locally raised general revenue. If state and Federal grants are taken into account, the property tax raises nearly half of total local government revenue."

The remedies
available

In view of the importance of the property tax as a source of revenue, what remedies can be suggested for its deficiencies?

"To the extent that the defects of the property tax are inherent ones, the principal remedies must take the form of some reduction in the reliance on the property tax for the financing of urban public services. The alternative financing is by higher levels of government which do not use the property tax, or by other local government revenue sources. Reduced reliance on the property tax will also diminish the importance of the other types of defects, mainly related to the fragmented local government patterns. But these latter defects can also be remedied in part by reforms within the institution of the property tax itself. The increase of state and Federal government responsibilities is an obvious route toward reduced reliance on the property tax, and one which is in keeping with developments in fiscal federalism since the 1920's."

Changes in intergovernmental fiscal arrangements can have a potent impact. Attention should be given to the extent to which the central city accommodates the surrounding suburban population with places of employment, shopping and cultural facilities and, presumably, the public services supportive of these activities. Thus there should be greater reliance on other local government revenue sources, notably direct charges for the use of public services and facilities (paid by actual users wherever they may live) and local income taxes paid by residents and commuters alike.

"The case for local income taxation does not rest on the argument that it is a good device for central city taxation of commuters. . . . The more general case for income taxation is that it does *not* have an especially adverse effect on housing, as does the property tax. It escapes the regressivity charge. Moreover, for central cities, it is superior to local sales taxes and other local business taxes, since unlike the latter, it is highly unlikely to encourage migration of economic activity away from the central cities. . . .

"An entirely different type of alternative revenue source would be a heavy tax on land values in urban areas as a partial substitute for currently collected property tax revenues. As the name implies, land value taxation is a tax on the value of land alone, irrespective of the value of buildings or the lack of buildings on a site. A step in this direction is the graded or differential tax—the application of a higher tax rate to the land portion than to the improvement portion of property valuations. . . .

"In theory, there are few if any legitimate economic arguments against site value taxation. On an operational level, there are grounds for hesitation." First of all, this would be a major institutional change and should be pressed only if it were to bring major results. There is also some question about the revenue adequacy of site value taxation. Third, administrative problems arise if both land and buildings are taxed, but at differential rates."

Another tax suggested is that of taxation of land value increments. "This kind of tax is aimed at recapturing for the government a higher proportion of what economists call the unearned increment—the rise of land value that occurs, not through efforts of an owner but through governmental action (new highways, subway lines, zoning changes, etc.) and through growth of the population and industry of the community. . . .

"Like annual land value taxation, this form of taxation would be largely neutral with respect to the use of land and would not discourage new construction. However, its economic impact and revenue potential would be somewhat less. Presumably, the land value increment tax would apply only to gains actually realized (including constructive realization at the death of the owner).

"Since some of the major defects in [present tax policy] relate to the fragmented structure of local government in urban areas, an obvious direction for reform is application of the property tax over wider geographic areas, thereby reducing tax rate disparities by evening out the differences in tax basis per capita or per pupil."

Still other tax reforms—better administration, tax hardship adjustments, housing tax incentives—are to be noted. But "the highest priority would seem to attach to de-emphasis of the property tax *per se*. It is a generally inferior tax instrument, although not the worst of all possible taxes. But an inferior tax becomes a monstrous one if applied at high enough rates. There *are* alternatives to ever-increasing property tax rates in urban areas, alternatives which require a willingness to accept real change in that most conservative of all institutions, local government." (*Impact of the Property Tax*)