

The Urban Dilemma

*Why American Cities Are Taxing Themselves Out of Existence
How They Could Tax Themselves Back In*

Why our present revenue systems stifle productivity,
eliminate jobs, empty buildings,
and destroy the tax base

How one revenue system
provides the incentives to
redevelop the cities and create an expanding tax base

by Mike Curtis

American cities are taxing themselves out of existence. They could just as easily tax themselves back in. Through the power of taxation, our cities could, as did the phoenix, fly out of the ashes of urban decay and soar to a far higher plane of community.

America's oldest and largest cities, such as Philadelphia, are in dire financial trouble. Their tax bases are shrinking, their obligations are increasing, and every time they raise taxes, it seems to alienate business owners or individuals, who stop producing and stop paying taxes altogether. Many of the political leaders of those cities believe they are approaching the point where, if they raise tax rates, so many taxpayers will leave that the cities will actually receive less revenue.

The immediate response by our city leaders is to ask for state and Federal aid and to extend the city limits and broaden the tax base. Neither option is necessary. Every city has created within its borders sufficient values to finance its municipal operations; cities need only to collect these values directly.

Almost everyone can think of two similar buildings for which the rents are very different. And we know exactly why--location. Every building and every activity takes place on land at one location or another.

When we think of the value of buildings, we think of the value of the labor and materials embodied in them. When we think of the value of land, we think of the location, or the advantages and disadvantages attached to it.

The Value of Land

As people come together in communities, they cooperate. The more dense the population, the greater the subdivisions of labor, the greater the different bodies of knowledge and skill, and the greater the economies of scale. Public expenditures--including roads, sewers and police--support this cooperation and facilitate the greater productive result.

In effect, the city is like a non-profit business that builds and maintains the infrastructure and provides services, which increases the potential to produce and satisfy our desires. It is this greater result that is expressed in the value of land and paid for by its users.

Suppose a city government dissolved--the mayor and all public employees went home, no taxes were collected, and no revenues were spent. Would it cost less to have a building constructed? No. Would it cost less to produce a loaf of bread? No. There is little doubt in anyone's mind--it is the value of land that would fall.

To a large extent, the value of land is a reflection of how much and how well public money has been spent in facilitating the subdivisions of labor and economies of scale.

When we consider residential locations, we look for proximity to jobs and stores and access to public transportation, the quality of schools, the levels of safety and beauty, and the intangible sense of community. When we consider industrial locations, we look for access to rivers, railroads, high-voltage electrical sources, and water mains. Furthermore, we look for a skilled work force. When we consider commercial locations, we look for many other things, but the most important is the number of potential customers.

Confiscatory Taxes Lower the Value of Land

In fact, the only way by which we can really measure the merits of a city government is the value it creates in its land. Yet, when a city finances the creation of this value, it usually confiscates wages, buildings, and a portion of just about everything that's produced within its borders. And this lowers the land value it created.

Consider this example. You are looking to buy a house. Suppose that only within the city limits there is a wage tax of 5 percent. Would you pay as much for a house within the city as the same house outside the city limits? No, but the house costs as much to build, no matter where it's located, so the tax on wages reduces the value of land.

Suppose you live in the suburbs. Would you consider a job in the same city at 5 percent less take-home pay? (Some cities, such as Philadelphia, levy a wage tax on all people who live and work there.) All other things being equal, you would not; therefore, the employer has to compensate with higher wages or else accept a less productive worker. Either way, the tax adds to the cost of production. However, the building and its other costs of production remain the same, so the tax diminishes the value of the location. All confiscatory taxes diminish the value of land.

In the worst areas of cities, taxes that fall on wages, buildings, and economic activity add up to even more than the value of the land. This prohibits all profitable reinvestment. We know this because properties are often abandoned by their owners, and cities have trouble finding anyone who will take those properties without charge and rebuild them.

In the profitable areas of the city, taxes are absorbed by even higher land values. This is evident because in spite of the taxes, people pay thousands, and millions of dollars to lease or purchase land.

Although owners of the best locations in the city might well afford to pay considerably more in taxes, every time tax rates increase, another marginal area of the city becomes unprofitable for reinvestment. When buildings in those areas require major repairs, their owners often abandon them and stop paying taxes altogether. It is only because of

areas where taxes exceed the annual value of land that a general increase in taxes could yield the city less revenue.

The same land that stops yielding revenue stops providing housing or jobs. This adds to the degeneration of the community and the increasing demands for police and public welfare assistance.

Empty Buildings and Vacant Lots in Valuable Areas

Throughout most areas of our cities, including the very best, there are valuable sites that are either unused or grossly underused. First, it costs as much to maintain the streets and pipes, and to have the police and fire trucks travel past vacant lots as those on which people are working or living. Secondly, because most of our taxes now come from workers, buildings, and the products they make, these unused and underused sites mean lost revenue for cities. They also mean less jobs and housing.

When the owners of empty buildings and vacant lots are offered thousands or millions of dollars, why don't they sell? They receive no income from their ownership at all. If they sold their properties and put the money in the bank, they would receive interest. Any income is better than none. However, many people find the annual increase in the selling value of their land, after the property taxes are paid, is greater than the interest they would receive by selling the land and putting the money in the bank. During a recession, for example, while land prices are falling, many people believe that in the long run, the selling price of their land is their best financial asset. As a result, they hold the land out of use, and this creates lost revenue and a shortage of housing and jobs.

In the world of competitive enterprise, as business ebbs and flows--a steel mill closes down, a truck manufacture expands, a clothing producer goes abroad, and another computer factory is established--there is little pressure on those who do not use the land to sell to those who will. What begins as small pockets of inactivity, waiting to see what market demands are in their future, both for their products and for their land, often manifests in the degeneration of a whole region of the city.

The Solution

Eliminate all confiscatory taxes and collect revenues based on the rental value of land. By taxing the rental value of land, each city would be charging for the opportunities created by the community.

In the best areas of the city, the land tax would take the profit out of holding land that was unused or grossly underused. In marginal areas, removing taxes from economic activity would take the penalty out of producing housing and jobs. Because the land tax would have to be paid whether the land was used or not, owners of valuable land could not afford to hold it idly. They would either have to use it themselves or sell it to someone who would. The land tax would expand the revenue base and provide the incentives for redevelopment--more housing, jobs and economic activity. As the redevelopment of the city continued, construction would radiate back into the worst neighborhoods and create additional housing and jobs. As the worst areas of the city became wholesome communities, the land within them would attain a value and provide revenue.

To implement this concept, an assessment must be made. Confiscatory taxes--like those on buildings and wages--lower the value of land. Consequently, it is necessary to determine what the rental value of each parcel of land would be in the absence of all taxes now levied by the city.

In most cities, the "real estate tax," often called the "property tax," is the largest or second largest tax levied. This tax is levied on the value of buildings and land at the same rate. However, in many cities, the value of the building and other improvements is assessed separately from the value of the land on which they are built. In those cities, only a minor change in the law is required to significantly reduce the level of confiscation and increase the revenues based on benefits received--reducing land speculation and increasing redevelopment.

Example of The Property Tax vs. The Land Value Tax

The following is a hypothetical consideration of the property tax--as it is and as it could be. The following exercise shows how the present property tax permits speculators, who hold many of the most valuable

building sites empty in a city, to make a profit while making construction costs prohibitive in the worst areas of the city.

This example contrasts the present property tax with the predictable effects of a tax that generates the same total revenue from the value of land only. You will see how assessments on land only reduce the taxes of homeowners, discourage non-use and underuse of valuable land and, in the worst areas of the city, create a natural enterprise zone with no real estate taxes at all.

Let's imagine it's the mid-1980s and you bought a \$150,000 house on the edge of Center City, Philadelphia. In the first year, the market value increased by 4.8 percent, or \$7,200--a modest increase for housing during the 1980s. If you received \$12,000 in annual rent, that would be a total gain of \$19,200.

If the building is worth \$120,000 ^{+ land 30M} and we allow 4 percent of that for maintenance and management, that's \$4,800 in expenses.

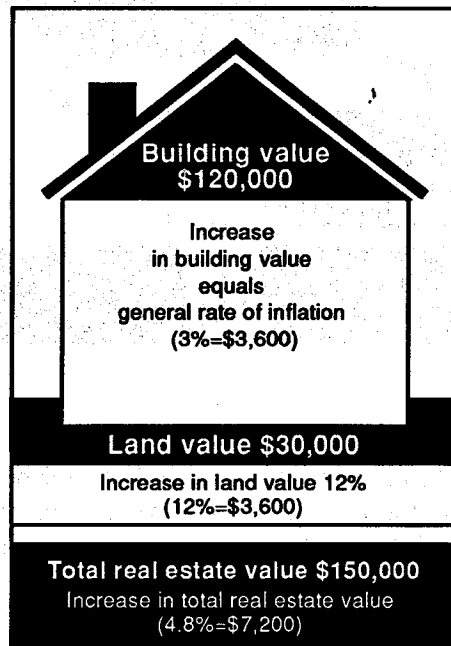
In Philadelphia, the property tax rate is about 2.5 percent of market value for land and buildings. Your \$150,000 asset would pay \$3,750. That would bring your total expenses to \$8,550. Subtract that from a total gain of \$19,200 and you have a net gain of \$10,650. If you divide \$10,650 by your investment of \$150,000, you would have received a 7.1 percent return.

The figure of 7.1 percent seems rather low for the mid-1980s, but every year the rent and the selling price of your land has been expected to rise more than inflation, and increase your rate of return.

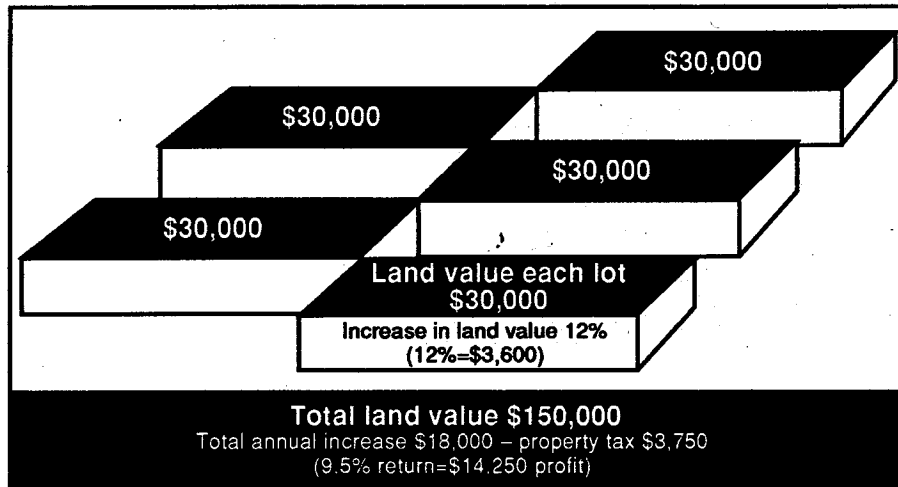
By contrast, a closer examination of your investment presents an alternative. The 4.8 percent annual increase in the value of your property can be broken down. If the building is in good condition and consistent with the development of the neighborhood, it might be worth four times as much as the land--\$120,000 for the value of the building and \$30,000 for the value of the land.

The building, which is a product of labor, increases in value at approximately the rate of inflation: 3 percent of \$120,000 = \$3,600. One half of the \$7,200 increase in the value of your property would be the value of the land: \$3,600 divided by \$30,000 gives your land a 12 percent annual increase in value. For the same \$150,000--at \$30,000 each--you could buy five lots without a house. You receive no income, but the land has increased at 12 percent per year: \$150,000 x 12 percent = \$18,000. Your only expense is the property tax of \$3,750, which leaves you with a net gain of \$14,250, or 9.5 percent. Is it any wonder that people hold on to land from which they experience no actual income?

VALUABLE LAND OPTION



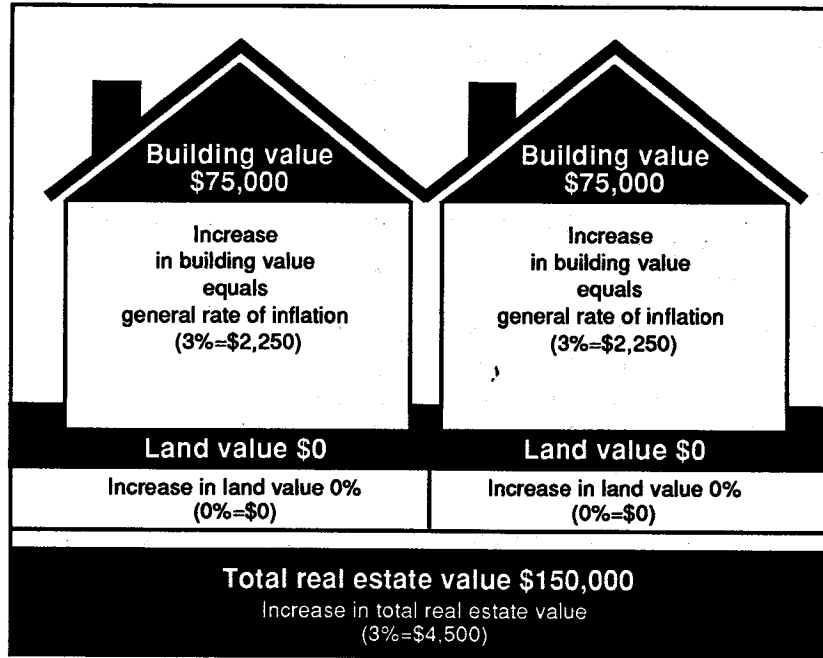
FIVE VACANT LOTS OPTION



To reiterate, land prices fall during recessionary periods, therefore constituting a net loss to landowners, many of whom still do not sell. They believe their most profitable asset will be in the long-term increase in the selling price of their land.

Now imagine the very best place you can that has no land value. Many cities offer these vacant lots and broken-down houses for free. All you have to do is rebuild. In spite of this, many of these properties have no takers. Since the land is free, you could spend the full \$150,000 on buildings. You could build two \$75,000 houses. The question is: Could you rent the houses for enough money to make a profit?

FREE LAND OPTION



In the mid-1980s, in an area where rents were not increasing, such as the worst slum, no one would have accepted 7.1 percent return. For the purpose of comparison, the same 7.1 percent return used in the first example will be used here. We need a net profit of \$10,650 to yield 7.1 percent return on a \$150,000 investment.

You would gain 3 percent in the appreciation of your \$150,000 buildings: \$4,500, but you also need 4 percent of the \$150,000 building value for maintenance and management, or \$6,000. This requires \$12,150 to be collected in rent. Divide the rent by two houses and 12 months, and you must be able to charge \$506.25 per house each month.

However, the property tax, which in Philadelphia is about 2.5 percent of your total \$150,000 property value, will add \$3,750 to the rent someone must be willing to pay in order for you to make a profit. In other words, the property tax adds over \$150 to the minimum profitable rent of each \$75,000 house per month.

Land Value Tax Providing The Same Revenue

With a tax on the value of land only, the owners of land that has no value, like that in the last example, would pay no tax. It would lower the minimum profitable rent for each \$75,000 house by over \$150 per month. Although it might not be enough to make reinvestment in housing profitable in the very worst areas, certainly it would make reinvestment profitable in others.

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 $B=3L$

In the city of Philadelphia, the total land and building value is approximately four times the total land value. In order to generate the same revenue from land as is currently being collected from land and buildings, the tax rate must be multiplied by four: 2.5 percent on land and buildings = 10 percent on land only.

Reflect on the first example of Center City. The land and buildings were worth $\$150,000 \times 2.5 \text{ percent} = \$3,750$. The land was worth $\$30,000 \times 10 \text{ percent} = \$3,000$. The result is a \$750 reduction in the homeowner's taxes.

Now consider the speculators. Under the present system, they would have paid the same 2.5 percent, or \$3,750, and enjoyed a 9.5 percent return. If they paid only a land tax of 10 percent, they would have paid \$15,000 in taxes and experienced a mere 2 percent return.

Shifting taxation from production to the value of land within a city does not diminish the selling price of the land as long as it does not increase total revenues, because it does not diminish the potential profits. It does, however, increase the cost of holding idle land so that landowners will have to develop it themselves or sell to someone who will. And that means housing and jobs.

This change in the property tax can be implemented gradually over many years. Through a scheduled reduction in the tax rate on buildings and a synchronized increase in the rate on land, cities can convert their property tax into a tax on the value of land.

In Pennsylvania, this gradual shift has begun in fifteen cities. Predictably, results have been favorable--more jobs and housing.

Summary

At present, urban revenues are primarily based on confiscatory taxes. These taxes reward non-development in valuable areas and prohibit redevelopment in the worst areas of our cities. By reducing the taxes of owners who withhold their land from production, our present system increases the cost of government and ultimately destroys the tax base and the cities.

By taxing the rental value of land, the revenue is based on the value of opportunities and services rendered--each landowner pays only for the value of the benefits received. Because it makes each parcel of land profitable only when put to productive use, the land tax delivers a compelling incentive for the redevelopment of cities.