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A Tax Tool for Meeting Urban Fiscal Crisis*

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Most of our central cities, as is now well known, are threatened by a vicious circle which is related to property taxation.

As buildings become older, they tend to become fiscal deficits requiring more in cost than they return in taxes. As the central cities age, the buildings become old and fiscal-deficit generators. This requires the central city to increase its tax rate.

The higher tax rate in cities drives investors elsewhere, both home builders and industry, because whoever puts up a new building under this state of affairs tends to become a fiscal surplus generator, and no one really wants to be that: it means you pay more in taxes than you get back in services.

Since there are many competing jurisdictions, investors do not have to be fiscal surplus generators. They can find a warm welcome in outer communities at lower tax rates.

So, as the central cities move into the downspin of this unfortunate circle, they tend to lose industry and, as a result, lose employment opportunities. At the same time they tend to gain old dwellings which attract people with low incomes who increase welfare costs. They are left with a high percentage of old buildings, which generate fiscal deficits, and fewer and fewer surplus generators with which to meet them.

Now if, to solve this problem, cities slash services in order to lower tax rates, they find cutting services and reducing the quality of schools also drive away population and income and industry.

What the cities need are more revenues without increasing the burden of taxation.

One way to go about this is to reapportion the state legislatures and get back more [tax money] from the state, which cities richly deserve. I am sure we all applaud the recent tendencies in that direction, weak and halting though they may be. Reduced Federal farm and military and "moondoggle" programs would also help.

The second way is for cities to get more of their taxes from the land base rather than the building base.

* Excerpts from testimony at a hearing of the President's Commission on Urban Problems, Pittsburgh, Pa., June 11, 1967, former Senator Paul H. Douglas presiding.

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In that manner it is possible for a city to get as much tax revenue as it wants without driving away the capital it must attract and hold. If land becomes the tax base rather than buildings, the conflict which we think we see today between the low taxes necessary to attract capital and public services themselves is no longer a conflict. It is possible to raise services and still make a tax environment attractive to capital.

Some people fear that by exempting buildings from taxation a city would reduce its tax base. I do not believe that is so.

The tax on buildings ultimately is borne by the landowner in the form of lower land values. Nominally the tax appears to fall on capital. However, since capital is migratory, investors don't have to accept a lower rate of return in the jurisdiction that taxes them. Therefore they can and do shift the tax.

Now, as I used to see it, they shift it to the tenants; and, indeed, some of that occurs. Anything that reduces the supply of a commodity increases the price. If you reduce the supply of buildings, you can raise the rent. However, tenants are also migratory—less than investors who move through well-paved ways in search of higher returns—but in the long run they also are migratory, and increasingly so in this age of automobility.

If taxes are not shifted forward to tenants in higher rents, that leaves the non-migratory element, the land, to absorb the tax.

So the effect of the tax on buildings is to lower the value of land on which those buildings might be placed. Conversely, to remove the tax on buildings is to create a benefit to the landowner which should be capitalized into higher land values.

Therefore, when you remove the tax from buildings and shift it to land, you do not reduce the tax base. You are basically taxing the same real estate, just differently. The tax is no longer contingent on the owner putting up a structure. The tax is determined by potential value—if the assessor does his job well—and not on actual use.

I go further and say as a result of removing the tax from buildings and levying the property tax on site value alone, the tax base actually should increase.

One reason is what economists like to call the "excess burden of indirect taxation."

Suppose I own a piece of land and erect a 30-story building on it. The fact that my tax bill rises when I put up the building makes the upper stories submarginal. Land is space, and space has a third dimension. Think of urban space as being subdivided into strata. On every site, however high its value, there is a marginal stratum. The top story of a high-rise building occupies the marginal stratum of space.

The top story which would be just marginal without taxes becomes submarginal in the presence of a tax on buildings. Several layers below, a story which would be better than marginal in the absence of taxes becomes just marginal. Those stories in between, which are better than marginal in the absence of taxes, are destroyed before they are built, *i.e.*, not built at all, because of the threat of taxes. These would have yielded a surplus above cost, adding to ground rent and land value.

To remove taxes on buildings therefore is to permit each site to be developed more intensively and generate additional rents over and above what it does under the threat of taxes on buildings.

A good way to look at this is to think of there being two equities in land, a public one asserted by taxes and a private one taking what remains. The best use of land, from a social viewpoint, is the use that maximizes the sum of the public and private equities.

But the decision-maker is the private owner, whose motive, of course, is to maximize the private equity alone. A good tax is one so structured that the private decision-maker, in maximizing his own equity, also maximizes the sum of the private and public equity.

The building tax is a bad one because the private income taxes is maximized at a much lesser intensity than would maximize the sum of private and public income. Thus it creates an artificial conflict between private interest and public interest. The site-value tax, in contrast, is free of this fault.

A second aspect of "excess burden" has to do with the timing of urban renewal. You can think of the margin of land use in terms of time, as well as space: *i.e.*, in the fourth dimension as well as the third. Advancing the date of site renewal toward the present by ten years is moving into a reach of time that is made submarginal by imposition of a tax on new buildings.

Of course, when you put up a new building, your property tax bill goes up by a very large factor. That tends to retard the optimum date of site renewal from the viewpoint of the landowner who, of course, is interested in maximizing his equity after taxes.

Untaxing buildings will also make it possible to lower certain public costs, making the tax base go further. As one example of this, consider vertical transportation. Vertical transportation is a substitute for horizontal transportation—not that it gets you to the same place, any more than lateral streets get you to the same places as longitudinal ones, but it taps new strata of space that can be linked into the urban nexus with much less increase of load on streets in the first two dimensions than if more horizontal space were tapped. That is self-evident geometry.

We hear a lot these days about "intermodal bias," referring to the public subsidy in auto transport. We should also be thinking about interdimensional bias. We subsidize horizontal transport, but we tax vertical transport by the building tax. Vertical transport is almost always supplied privately. Something like one-third of the cost of a high-rise building consists of the elevators, utility core, stairways, and other elements that come under "vertical transportation." Private builders supply this at their own expense and then we tax it besides. If there were more of it, we should need less public outlay on streets and utilities.

Untaxing buildings should also reduce welfare cost. A tax system which accelerates renewal causes old buildings to be replaced by new ones. The inhabitants of new buildings throw less of a load on the welfare rolls than the inhabitants of the old. From a purely local point of view the benefit is obvious and the argument overwhelming.

From a national viewpoint the argument requires more thought but is equally compelling.

You frequently run into opposition to urban renewal from those who don't want to displace the people in the area being renewed. It sometimes seems the city is dumping welfare problems on the rest of the world.

I don't believe that is a correct analysis. There is no solution to the housing problem for poor people without building more buildings. The ultimate thing that will improve the housing conditions of the poor, and everyone else, is to increase the supply of quality buildings, which in the main means new buildings, the idolaters and collectors of antiquity notwithstanding. In the process you frequently tear down old ones and replace them with new, better and at higher density. The net result is increased supply. This lowers the price, making better housing available for poor and rich and middling alike, and creating new employment opportunities in building, and operating buildings once built, to pull people off welfare.

It is a fair criticism of the present Federal Urban Renewal Program that it chronically clears and sterilizes more land than it renews, adding something to its bombed-out inventory each year. That really does dump welfare problems and reduces net housing supply. The criticism and resentment generated by that problem should not, however, be directed against a proposal to untax new buildings. For this, the present proposal, stimulates demolition only by increasing the positive incentive of builders to salvage derelict lands for immediate renewal.

Another general reason why the land tax base would be greater than the present property tax base is really a set of reasons, which may be summed up in such expressions as "the economics of urban agglomeration," or urban "linkages," or Adam Smith's dictum that "The division of labor is limited by the extent of the market."

My conclusion follows in four steps: 1) Cities exist to bring people together—for cooperation, mutual aid, sociability, cost-sharing, specialization, diversification and stability, exchange, etc.; 2) These collective benefits are captured in the rent of urban land and capitalized into land values; 3) Each new building not only develops the potential rent of its own site, but on balance adds to the potential rent of neighboring sites, whose development in turn feeds back an added potential rent on the first site; 4) Taxing buildings inhibits new buildings and quality building and intensive building and so prevents full realization of an enormous urban potentiality above and beyond the simpler "excess burden" I described earlier.

For example, in a large market most facilities enjoy high "load factors," the ratio of mean load to peak load capacity. Facilities get used around the clock and the calendar, so capital need not be dead most of the time as it is in small towns and remote suburbs. For the other, almost everyone observes it is usually better to have a new building as your neighbor than an old one. New buildings not only generate fiscal surpluses themselves but radiate external economies which bolster the value of nearby property.

For those general reasons, then, I don't believe there is any danger of losing the tax base by exempting buildings. And if I should be wrong, an additional advantage is that you can go right ahead and increase the tax rate as much as needed without doing any damage whatever to the profit motive.

You can go all out in taxing a piece of land and it will never get up and walk out of town; whereas, if you do the same thing to buildings placed on the land, they won't walk out of town today, but as they get old the sinking funds to replace them will be reinvested elsewhere, leaving your city with the fiscal deficits while the surplus generators are off taking the sun in California or overseas.

The site value tax automatically solves certain perplexing problems of distributive equity. When you grant the favor of intensive zoning to one land owner and deny it to another, you are redistributing wealth in a very heavy-handed manner. Under the site value system, favorable zoning would also be favored with the equipoise of heavier taxation because the right to develop land more intensively makes land more valuable.

The rent surpluses of the central cities, which are capitalized into the highest land values per square foot in the world, would also be tapped and spread around, and in a manner compatible with economic efficiency.

Please don't tell me this is unjust to vested interests, because we already do a good deal of this sort of thing today through our utility pricing practice which charges everybody the same rate no matter where he is located, even though by this means the rich central territory is carrying the lean, low-density peripheral areas of urban sprawl. The site-value tax achieves the same distributive goal as our utility pricing practices, that is, it taps central rents to benefit everyone, spreading the rent thin. But it does the job in a way that is compatible with economic efficiency, while our uneconomical utility pricing practices destroy half the pie in the process of sharing it.

Another advantage of the site value system at the national level, and also at the local level, would be to increase employment opportunity: in the construction business first, and through reverberating effects in all businessses. By removing taxes from buildings you would encourage more frequent renewal. The effect is somewhat the same as lowering the interest rate paid by builders when they borrow. Thereby you would increase employment opportunities, and that lowers welfare costs.

Yet another advantage of the site value system is the advantage it offers to small business. This may best be understood through the phenomenon of credit rationing. Under the present system, when we put up a new building, we are immediately hit with our heaviest taxes which add greatly to the risk and credit requirement. This helps to ration out those firms which have a particularly hard time raising money. These tend to be the small firms, the competitive cutting edge of our economy which makes the free market work the way we like to preach that it does.

A tax on site values, by contrast, begins at a low level and does not go up at the moment of greatest capital need. It remains at the same level it was before. It might be construed as a loan from the city treasury to the builder—a loan which he pays back in the later years of the building. Thus it favors the credit-weak over the giant corporations which have had such a big piece of the little action in urban renewal we have had thus far.

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