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INCREMENT TAXES AND THE PARTIAL EXEMPTION OF BUILDINGS

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My subject raises this question: How can the land owner be made to contribute to the support of the government a larger proportion of his income than at the present? Caption of this paper was suggested by two circumstances:

First, The energetic campaign waged in behalf of the proposal that the rate of taxation upon real-estate improvements shall be gradually reduced until it equals only one-half the rate upon land.

Second, That recent adoption of a tax upon the unearned increment on land values in Germany and England and the recommendation of a similar tax for the city of New York by a commission on new sources of revenue, appointed by Mayor Gaynor in 1910.

In this paper I shall briefly review the arguments for and against both these innovations in our system of taxation. But first I wish to emphasize the self-evident truth that the primary purpose of taxation is public revenue, and not social reform. Nevertheless, if it can be shown that the present system of taxation is hostile to the interests of any class of citizens, bearing most heavily upon those least able to carry the burden, and so fettering certain classes in their efforts to rise from poverty into affluence, we must admit that the system should be changed. I wish also to call your attention to another fundamental and obvious fact, namely that the introduction of an ideal tax system—if all authorities should agree upon one—might cause such a violent readjustment of various business and financial interests that the damage suffered by citizens would be greater than the gain to the state.

Finally, let us not forget that taxes should be paid out of income, and not be so levied that their payment will necessarily involve a reduction of the taxpayer's capital or wealth.

Having these elementary propositions in mind let us examine the proposal looking to the gradual reduction of the tax upon real-estate improvements. This has been known in New York as the Sullivan-Short Bill, or the Sullivan-Schapp Bill. It provides that within a five-year period at the rate of ten per cent per annum, the tax rate upon buildings shall be reduced until it is only one-half the tax rate upon land.

The most active supporters of this measure are well-known advocates of the single-tax theory of Henry George, and this fact has been the basis for the most common, if not the weightiest objection to it; its opponents stigmatizing it as the entering wedge of the single tax. This particular objection, of course, I need not discuss. Whether or not the measure savors of the single tax is of small consequence.

Many remarkable claims are made for this measure. In New York City and other large cities special emphasis is laid on the contention that it will lessen the congestion of population because of the stimulus it will give to construction, and the consequent reduction of rent. It is contended further that it will release large sums of capital for use in building and for general purposes: that it will reduce speculation in land; that it will cause vacant lots quite generally to be improved; that it will bring more and cheaper land into market for business uses, so that cities adopting it will be specially attractive to manufacturers; and finally, that the fact of its gradual introduction will give small holders time in which to make improvements and thus take advantage of the new law.

Beyond question, the reduction of the tax rate upon real estate improvements would tend towards a reduction of building rents, for the land owner would be called upon to bear a larger share of the tax burden, thus lessening the contribution which is forced from the tenants in the disguise of rent. But there is no reason believing that there would be less congestion of population in our large cities. The argument seems to lie all the other way, for a land owner

would obviously be under inducement to erect the highest possible structure in order that he might secure a return from his building sufficient to make compensation for the increased tax upon the land. Ground rents would certainly not be reduced by the change. On the contrary, there is a *possibility* that ground rents would be increased. And this certainly would be the case if the stimulus to building were sufficient to bring into demand much land that is now vacant. But the lessees of land, whether they pay the present or higher ground rent, will be driven by competition to exploit the land to the full limit allowed by law. It seems inevitable, therefore, that the proposed reduction in the building tax would have the effect of making our large cities more compact and condensed than at present, with the poorer classes herded more closely than now in tenement houses in no respect better than those which they at present occupy. It is true, however, that the rent per square foot of all buildings would probably be somewhat less than under the present system, and that the rich, as well as the poor, would share in the benefit.

The contention that most of the vacant lots in our cities would be improved will not bear analysis. There will, of course, be no increase in population as a result of the change, and no increase in the amount of capital available for building construction. Builders may, indeed, at first be tempted to offer higher rates of interest, and thus they may draw capital away from other industries. But this will increase their costs and so lessen their ability to attract tenants by the offer of lower rents. Many of our large cities, notably New York City, are already overbuilt. This condition is almost a chronic one, so keen and unceasing is the competition among builders and land owners.

They are always discounting the growth of a city, and are erecting buildings this year in the hope that developments will furnish them with tenants next year, or with confidence that certain little changes in style, or conveniences will attract tenants from older buildings. This is speculative building, to be sure, but it is always under way and would be neither lessened nor increased by a shifting of a portion of the tax from the building to the land.

Vacant lots in the most desirable locations, such as those nearest the residential or business centers, would doubtless be improved earlier than under the present system of taxation. But the lots less advantageously situated, especially the land on the outskirts of a city, where now houses with dooryards and gardens are possible, would be less attractive to a building company than at present, especially if it were planning homes for the poorer classes, for it would be necessary to crowd the houses and condense the dooryards and gardens, so that the homes would be less salable.

The advocates of the measure argue that the small holder of land during the five year period of the introduction of the new tax system, would have an opportunity to make improvements and at the end be in a position to reap all the advantages of a building owner. This argument, you will observe, assumes that there exists an unlimited demand for building space provided only that a certain reduction of rent can be secured. It also assumes that the small owner will be able to get the necessary capital. There is no warrant for either of these assumptions, since we know that many small owners of unimproved land are at present barely able to pay taxes and interest charges, it is morally certain that a change in the law such as is proposed, would bring foreclosure of many small mortgages, and financial distress to many comparatively poor people.

Concerning the greatest and most important effect of such a change in our tax system, and the only one of which we can be positively certain, its advocates have practically nothing to say. I refer to the fact that the increase of the tax upon land will inevitably cause a decline in the market value of all land. It will not cause a reduction of ground rents, but it will reduce the net return to the land owner, of which the market value is the capitalization.

Hence, the friends of the measure who figure the probable changes in the respective rates on land and buildings on the basis of present land values, make a serious miscalculation. If, for instance, a piece of land is now yielding a rental of \$8,000, and is taxed \$2,000, its market value in a 6% community is \$100,000.. Now let the rate be raised to 3% in the

hope that the tax yield will be \$3,000. Immediately the taxable shrinks in value from \$100,000 to \$88,888 and the tax at the rate of 3% yields only \$2,666. The land owner has lost nearly \$12,000 in capital value in order that the state or city may add \$666, to its revenue from taxation. If it desired to double the land owner's tax contribution, and increase it in this case from \$2,000 to \$4,000, the tax rate would have to be raised to 6%, which would cause a decline in the capital value of the land to \$66,666.

But no such great changes will result, I am told, for it will not be necessary to double the land owner's contribution to the revenue in order to compensate for the loss of revenue from improvements. Let us grant that, and assume that this piece of land must be made to pay to the tax collector \$3,000 instead of \$2,000. In that case the market value of the land will decline from \$100,000 to \$83,333 and the tax rate on land would be 3.6 per cent. This on the average would be the probable effect in American cities of a reduction of the tax on buildings to one-half the rate on land.

But, I am told, this is all theoretical, and would not actually take place, since the new system would be introduced gradually, it is held that the decline of land values each year would be slight, and would, on the average, be counterbalanced by the increment of value due to the growth of population. This reply is unconvincing, for it assumes as a certainty something which at best can be only a probability, namely, that land values are to increase, whereas experience teaches us that many pieces of land in our cities decline in value while others are advancing. To such an extent is this statement true in the City of New York that an impartial student cannot escape the conviction that a change in our tax system such as is proposed, would almost immediately produce a real estate panic of mortgage foreclosures.

The notion that a heavier tax on land would lessen speculation in land, is without basis.

A speculator in land is one who buys expecting after a period to sell at a higher price. The rate of taxation is merely one of several circumstances which he takes into account. If it is low he will bid more than if it is high, and

so will all his competitors in the bidding; and if the tax rate is high his bid, and all others, will be correspondingly lower. The tax rate, whether high or low, does not have the slightest effect on speculative buying; it merely fixes the level at which a speculative purchase shall be made; (it does not lessen in the slightest the incentive to speculation or minimize its reward if the speculator has made a lucky guess or shrewd forecast as to the future demand for a piece of land).

Nor is there any reason for believing that better buildings and tenement houses would result. Builders would be in competition with one another just as now, and each would be under the same pressure as now to give the tenant only just what is necessary to secure his tenancy. Those builders who without scruple construct a shell that looks like the real thing, would continue the practice of their criminal art.

Let us now briefly examine the other plan for making land bear a larger share of the tax burden namely, the tax on the unearned increment in land values. As economically all recognize, the value of land apart from its improvements is wholly due to the social demand for its use and any increase in its value is due to an increase in the social demand arising from the growth of population. It is also recognized that a tax upon land cannot be shifted, for the rent of land depends on social demand and not on the will or desire of the land owner.

The problem is: How can part of this rent, which is the product of social needs, be made to contribute more generously to the support of government? We have seen that any attempt to increase the amount which the state appropriates from the present rent in the form of a tax, will result in grave injustice to individuals; for it deprives them both of property and income. The unearned increment tax is not open to this objection, for it is aimed, not at existing values and incomes, but at the increased values and incomes which shall be created by social demand in the future. It is in no sense, therefore, confiscatory.

In Europe, where this increment tax has been recently introduced, it is levied, as a rule, only upon the death of the owner or upon the sale of the land, and the rate of the tax

varies with the percent of increase in the values of the land and with the number of years that have elapsed since the last transfer.

In this country, since it is the American practice to assess land with an eye to its market value, rather than to its actual rental value, the levy of an increment tax can be made here in a much simpler form than in Europe. For this reason Mayor Gaynor's commission promptly dismissed the idea of copying the European method, and instead recommended a tax of 1% per annum on all future increases in land values that did not result from the efforts of the owners, the increase to be determined by comparison of assessed valuations in the future with the assessed valuations of a basic year—say 1912.

This method of levying the tax has three distinct advantages over the European method. First, the probable income each year can be more easily estimated. Second, it amounts to a perpetual surtax on all unearned increments of land values. Third, it promises an increasing revenue to the city or state, thus making possible a steady reduction of the general tax rate to the advantage of the owners of land which has depreciated or remained stationary in value. Experts employed by Mayor Gaynor's commission estimated that the revenue from this tax would increase at the rate of \$1,500,000 per annum, so that in ten years it would amount to \$15,000,000, and in thirty years to \$45,000,000.

Real estate men have not looked with favor on this proposed tax. They express the fear that it will cause a shrinkage of land values. This fear, however, is not justified. Since the tax will not apply to property now stationary or depressed in value, it cannot adversely affect the market value of such property. On the contrary land of this character will be benefited by the reduction of the general tax rate which the revenue from the increment tax will make possible.

As to land favored by the changing conditions of city life and therefore increasing in value, this increment tax will be tantamount to a small special assessment in return for advantages flowing from improvements made either by the city or by private enterprise; and it would be much more just and searching than any system of special assessments can

be, for it would reach all pieces of property benefited and would tax them only in proportion to their benefit.

The only objection to this tax worth considering is that it will increase the problems, perplexities and temptations, of which the assessor is the victim. It must be admitted that the unearned increment tax would work injustice under a system of corrupt or unscientific assessment. But so does our present tax system. And I see no reason for objecting to a change which will make property owners more alert in the protection of their interests and more willing to co-operate with reformers in efforts to perfect our methods of assessment.