A Lesson in Real Estate

by MITCHELL S. LURIO

WITHOUT preliminaries, a numerical example of certain effects of the application of Henry George's remedy is presented here, using averages of figures compiled by apartment house managing concerns and the assumptions implicit in the logic of remedy. The effects considered here are static rather than dynamic, the stable condition before and the stable condition after the transition from the present real estate tax system to the George system. In other words, we shall ignore transient effects and assume that "other things remain equal."

The principal assumptions are that an increase in the tax on buildings can be passed on to the tenants and its corollary that a decrease in the tax compels owners to lower the price per apartment. This is because supply of new and remodelled buildings responds to profitability and change in supply is anticipated. The second assumption is that an increase in the tax on land values cannot be passed on to the tenants because owners cannot increase the supply of land and its corollary that a decrease in the tax on land values is a saving that is pocketed by owners.

Consider a low rise apartment building with an annual operating income of $100,000. By rule of thumb its market value is six times annual income or $600,000. If similar empty sites are worth $100,000 then this particular building is assumed to have a market value of $500,000. Studies show that on average real estate taxes are about 15 percent and all other operating expenses are about 30 percent of annual revenue or $15,000 and $30,000 respectively, leaving $55,000.

The owner then earns $55,000 on an investment of $600,000 or 9.167 percent which on average is not an unreasonable figure for this type of investment over business cycles. It is to be noted that depreciation has been ignored. Those who seek the ownership of real estate as a "tax shelter" derive a temporary tax saving by reason of the fact that depreciation is not a cash outlay but is considered a deductible expense, reducing the owner's earnings for income tax purposes and therefore the tax thereon.

If, overnight, the Georgist remedy were applied, and we ignore transient effects and assume immediate change to the final static condition, there must be a removal of the $12,500 tax on the building, or 5/6ths of the original total tax of $15,000. Simultaneously, our assumption is that the tenants get the benefit of this reduction, which is a 12.5 percent saving. Annual income is reduced from $100,00 to $87,500; expenses remain the same at $30,000 leaving $57,500. This is not all. The tax on the site must be increased so as to reduce the site value to zero. Since the assumed rate of return is 9.167 percent, an increase of $9,167 in the land value tax takes all the benefits of the remaining land rent away from the owner. This increase in the land value tax is paid by the owner, reducing the $57,500 balance above to $45,833.

Since the land has lost its market value because the tax on it was increased from $2,500 to $11,567, the market value of the real estate is no longer $600,000. It becomes $500,000, just the value of the building. And $45,833 left over for the owner is exactly 9.167 percent of $500,000.

Let us compare the figures before and after. Before, the city in which the property is located collected $15,000 in real estate taxes. After, the amount due the city was $11,667, a loss to the city of $3,333. After, the

tenants paid 12.5 percent less than before. This example shows what seems to be an undesirable change in city revenues. But an empty lot originally worth $100,000 on which the annual tax was $2,500 will after the change be subject to a tax of $11,667, a very substantial gain in city revenue.

The ratio of 5 to 1, market value of building to market value of the site before the change, is a very high ratio and is exceeded only for a short time by brand new buildings that make full use of a site. Our cities are full of older buildings, of dilapidated property, of vacant land and though the ratio of assessed value of all buildings to assessed value of all land in all towns and cities, runs between 2 and 3 to 1, it is more likely, because land is usually assessed for a smaller part of its market value than buildings, that the real ratio is below 2 to 1. It was not many years ago that in New York and in Boston, the ratio was 1 to 1.

If the example chosen had been that of a site worth $200,000 and a building on it worth $400,000, a ratio of 2 to 1, the figures would be very different. Try it as an exercise. The land tax or rent would be $24,334, an improvement in city revenue of 62 percent more than the previous total tax of $15,000. Thus overall city revenues will be two-thirds larger than they are now.

The train of reasoning here, though ignoring side effects, shows the essential character of what is known as the "single tax." It is true that the change would create other forces, some tending to lower rent and others to raise rent in various degrees and in various places. The effects of these forces would require further changes in the "tax" on land until they dampen down to the steady state; and then only the regular flux of things would require annual reassessments to insure that the city was collecting practically all of the rent. But the example is given to show in a concrete manner how the initial forces would operate.

If the change took place over a period of a generation, there would be little hardship even in the most extreme situations—none at all in most cases for people would have time to adjust. The effects of this gradual change, however, would be immediately anticipated and taken into account in the marketplace, as has been demonstrated in Southfield, Michigan. There the policy of maximizing land assessments and minimizing building assessments brought a most amazing growth in the quantity and quality of its buildings, its revenues, its employment and its prosperity.

And if, in addition, no land were tax-exempt, there would be a total increase in city revenue of 100 percent over present revenue, and taxes on personal property would quickly be abolished. And I can even believe that instead of subsidies that went from the federal government and the states to the cities, it could be the other way round—cities could give a certain percentage of their rent revenue to the states and federal government and begin the process, possible only where there is an informed and moral electorate, of removing all taxes.

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LOCATION VALUE EXPLODES

The Hawaiian economy was explosive enough to bring Amfac (formerly American Factors) $2,480,000 for 4 acres on Maui (original cost $40,000). The community services, sunshine, large investments by airlines and by the Rockefellers in hotels, could have benefited the whole economy if they had location value taxation. L.M.G.