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# Alternative Methods of Taxing Property

ARLO WOOLERY

The accelerating inflation of the past twenty years made it difficult for tax assessors to estimate current market values for their assessment rolls. Then, in the past year, the inflation rate and property values declined. Shortages of mortgage funds and resulting high interest rates have led to a large amount of sales data with price information seriously distorted by "creative financing." Unless the assessor was able to adjust nominal selling prices for effects of "creative financing," there was a chance that his entire assessment roll would be distorted. Even if sales involving "creative financing" had become the norm, the production of accurate assessment rolls required a great deal of statistical skill and technical capability. Unless data were analyzed by price-strata and geographic location, there was great danger of producing an assessment roll that was severely biased.

In recent years, assessors who were able to keep up with the accelerating real-estate prices were vulnerable to political reaction. California assessors who were able to stay on top of the burgeoning real-estate prices in that volatile market found that the voters took matters into their own hands. They approved Proposition 13, limiting real-estate taxes to 1 percent of market value as defined in the initiative. Two years later, Massachusetts voters approved Proposition 2½, and several other states made similar attempts to limit the growth of property taxes.

In some eastern states, effective property-tax rates reached levels close to 10 percent. When property-tax burdens of this magnitude were added to mortgage payments with interest rates of 12 to 15 percent, it was obvious that something had to give. The give was generally in the direction of shifting taxes from residential property to business property through various classification and exemption mechanisms or of delaying the implementation of court-ordered changes.

Mineral-rich western states were able to reduce pressure on the property tax by placing greater emphasis on severance taxes. This led to the exporting of part

of one state's tax burden to consumers in other states. The United States Supreme Court ruled that this matter was to be handled by state and local governments.

The only major involvement of the federal government in local property-tax matters came in the area of interstate transportation property regulated by the Interstate Commerce Commission. Under the provisions of Public Law 94-210, local taxing jurisdictions were prohibited from using higher assessment ratios or tax rates on property of interstate common carriers than for other commercial and industrial property. This legislation has slowed the spread of classified property-tax systems and brought a modification of tax structures in states with classification.

"Market value" has been redefined to mean something other than the most likely selling price in a transaction between a willing buyer and a willing seller under terms that are typical for the type of transaction and the locality involved. Under Proposition 13 in California an adjusted base-year value or actual price of sold property is the base for property taxes.

The growing use of mini- and microcomputers is making it possible for assessors even in small jurisdictions to maintain current market-value tax rolls that are updated annually. The same computer capability makes it possible to conduct continuing sales-ratio studies that should result in better intrajurisdictional and interjurisdictional equalization.

Modern technology and the growth of the information sector of the United States economy pose special problems for already beleaguered assessors. New kinds of property and new rights in property have given rise to new problems in valuation and tax theory that have yet to be addressed. Allocation of the tax base for properties that cross taxing-jurisdiction boundaries compounds the problem of handling these new property types.

Even though there are many examples of well-functioning property-tax systems that differ greatly from the capital-value system employed in the United States, there is little likelihood that these systems will be copied by property-tax policymakers in the United States. The system and the mechanism now in place is the one likely to be in place at the turn of the century.

### *New Kinds of Property*

There are new kinds of property coming into existence that defy traditional assessment approaches. For instance, communication satellites that have no fixed situs on the earth's surface but still represent substantial amounts of tangible personal property. Fitting this property into the property-tax base involves two major problems. First, there is the problem of the annual valuation at market value. Second, there is the problem of situs. What jurisdiction can properly claim authority to tax the value represented by a satellite in synchronous orbit 25,000 miles above the earth's surface?

The United States is rapidly becoming an information society with well over

half of its workers involved in information handling. One of the major information-handling tools is the computer. Virtually all major businesses use computers to process and store data for thousands of different purposes. Micro- and minicomputers have proliferated to the point that individual family members now have their own personal computers. The computer is rapidly becoming as commonplace as the portable transistor radio of thirty years ago.

At first blush the computer hardware appears to be the most valuable property involved in this part of the information explosion, and it is already being widely taxed as tangible property. However, an even more valuable portion of this information-processing package is the computer software – that is, all of the programs and procedures that make the hardware useful. The principal, if not entire, value of software is in its intangible elements. When computer programs are stored on computer tape, that intangible value is embodied in the tangible tape. When the tape is sold, the price is made up in small part by the value of the physical tape and in great part by the information stored on it. The assessor is faced with the problem of deciding whether the tangible personal property represented by the computer tape as enhanced by the program it contains is an item that can be valued and taxed as part of the property-tax base.

The explosive growth of the cable-television industry represents another facet of the information era. Nearly one-third of the homes in the United States either are currently connected to cable or are in areas easily serviced by existing cable installations. Few local assessors have mastered the valuation techniques required to establish fair market value for the tangible cable plant, let alone the valuable programming that is now part of the daily fare offered on nationwide cable-network operations and delivered to them by microwave and satellite transmissions.

Procedures have been established for the valuation of traditional communication property of telephone and telegraph companies that in the past transmitted messages over wires and cables. Now many of these companies operate microwave- and satellite-communications equipment that involves major investment in installations at specific points but involves little tangible property between those sending and receiving points. This poses a new problem for assessors. Should they, and how do they, allocate taxable value to taxing jurisdictions containing a majority of the users of telecommunications equipment installed outside of the jurisdiction in which those users live? The whole question of allocation of these values is becoming increasingly important and complex. It may be appropriate for the user of property located in several different taxing jurisdictions to become part of the formula for allocating taxable value.

### *New Rights in Property*

In addition to the problem of valuing and taxing new types of property, the assessor is faced with determining the value and tax status of new rights in existing property. A very definite change in ownership of property rights is

brought about by rent control. Tenants living in property under rent control pay less than the going market rent. Once rents are established at something less than current market rates, the value of the affected property will be something less than the market value of the same property without rent control. There is market evidence indicating that apartment buildings under rent control sell at two and one-half to three times their gross annual rent. Similar apartment buildings not under rent control sell at six to eight times their annual rent. If an apartment building not under rent control would sell for \$200,000 but only for \$100,000 if under rent control, there has been a transfer of \$100,000 of market value. The transfer in this case is from the landlord to his tenants. The tenants have in effect received a property right created by the rent-control laws that is worth \$100,000. Generally, the landlord will pay property taxes on the current \$100,000 market value, but the tenants are not taxed on the other \$100,000 in value. So the taxing jurisdiction in effect is forgoing one-half of the property tax that would normally be due on the apartment building. The question for legislators and assessors is this: Can you develop a property-tax program that would properly assess and tax the value represented by the newly created property rights of nonowners, such as tenants in rent-controlled properties?

Neighborhood groups represent another set of claimants to rights in property. The holder of the fee title in property is frequently prevented from using his property at its legally permitted highest and best use because of pressures brought upon him and the permitting authorities by his neighbors or a loose federation of citizens organized to police and to monitor changes in the use of property in their neighborhood. Here again the holder of the fee title will see the value of his property diminished to something less than its value under the highest and best use simply by the action of a group of citizens who with no legal claim to that property are able to influence its use and thereby its value. Generally, the owner of the property would pay property taxes based on the current use and not on the higher and better use if he were not subjected to the pressures of a neighborhood association or citizens group. Since that group has effectively taken over part of the property value through its ability to inhibit change, the property-tax base suffers, and these questions arise: How does that particular transferred value get into the tax base? Will the community recoup the revenues lost in the process by inducing increased values in other parcels, or will lost tax revenues remain lost?

Another area involving new and apparently untaxable rights in property is created by the activity of environmentalists. Environmental groups can have a significant impact on the use of property even though they have no legal claims to it. There is a long and growing list of major industrial projects that have been altered or abandoned in response to the opposition of environmental groups. Abandoned development results in lower property values for the fee owner, losses to the developers who put up front-end money, and often substantial legal costs. Here again the shift in values from the fee owner to the nonfee claimant represents untaxed property that would normally be in the property-tax

base. However, the general public is more likely to benefit from the environmental activity than from rent control or locally focused activities of neighborhood groups.

There are many other areas in which specific rights in property have not become a well-measured part of the value of the property. Water rights often represent the most valuable component of the ownership of a piece of land. The value of the surface rights may be much less than the value of the water rights attached to them. The same is true in the case of mineral or petroleum rights. Mineral or oil rights may represent a much greater value than any potential use of the surface of the land. These mineral rights can be leased or sold separately from the surface rights to land. These severed rights are valuable property that is often omitted from the tax roll and when included is seldom valued and assessed at market value.

### *Some Alternatives to the Existing Property Tax*

Present property-tax laws generally require that all land and improvements be assessed and taxed at actual market value or some well-defined fraction of market value. In only a few places, notably Pennsylvania, is the land element of the property-tax base allowed to be taxed at a substantially higher rate than buildings. Pittsburgh currently taxes land at something like five times the rate on buildings. While there may be good economic arguments for taxing land more heavily than improvements, there are questionable political arguments for omitting improvements from the property-tax base and allowing the entire tax burden to fall on the land. Hawaii went through this exercise a few years ago and found that a pure land-value tax just would not work in its environment of increasing "no-growth" sentiment.

Many of the arguments against the property tax revolve about the valuation process. Opponents claim that it is difficult, if not impossible, to obtain annual estimates of a fair market value for all property on the tax roll. This argument could lead to the use of a physical measure of the defined tax base. It would be possible to tax land on a square-foot or acreage basis simply by putting a different rate per square foot on defined areas or defined uses.

With the current moves toward limiting the revenues that can be raised by the property tax by a pure percentage limitation, government is faced with broadening the property-tax base or looking for alternative revenue sources to fund local-government expenditures. Given the difficulty of finding alternative sources for the over \$82 billion raised by the property tax annually, government may be better off looking for methods of broadening the property-tax base. Certainly, valuing and assessing all land at its current market value would be a positive step in this direction. If all privately held rights in property were valued and taxed at the figure indicated by the market, the result would be a substantial broadening of the tax base.

The assessor must also be alerted to the true market value of the new kinds of

property that are coming into existence in response to technological change. Satellites, computers, cable television, commercial electronic games, and a new kind of property brought about by the marvel of the silicon chip represent a real challenge to property-tax administrators at all levels of government.

### *Lessons From Other Countries*

*The Netherlands.* About ten years ago, the Netherlands returned to the local property tax as a way of increasing revenues to the municipalities. Nearly 100 percent of municipal income had been derived from the national government. With the adoption of the local property tax, municipalities were allowed to raise up to 15 percent of their total income through real-property taxation. This newly adopted property tax had two separate levies; one against the owner of the property and the other against the user. Obviously, in owner-occupied homes the owner would pay both levies since he was also the user. The general division was about two-thirds of the total levy on the owner and one-third on the user.

The Netherlands also left some alternatives for the base of the local property tax. Municipalities could decide to levy on either: (a) the real economic value of the real property, computed as if the property were for sale, empty; or (b) the total surface of all floors in the property with the number of square meters of floor space multiplied by certain coefficients determined by the nature, the use, the location, and the quality of the improvement to achieve some approximation of the real economic value of the property. The coefficients ran from 0.1 to 3.0. Thus, the most heavily taxed property would pay thirty times as much tax per square meter as the most lightly taxed type of property, which was vacant land. Choosing the surface base got around the arguments involving valuation. However, the coefficients adopted for location, use, and quality could engender much the same type of argument as that of valuation.

*Sweden.* At the local level, the Swedish property tax can become highly progressive, since the imputed rent of an owner-occupied property would be added to the owner's income and taxed at the marginal income-tax rates. Also, the imputed rent ranges from 2 to 8 percent of value with the higher rates applied to more valuable homes. In Sweden, income subject to taxation consists of wages and salaries, interest and dividends, profits from the sale of assets, and imputed rent on owner-occupied property. Since Swedish income taxes are steeply progressive, homeowners residing in identical houses but having different incomes could pay different amounts of property taxes.

*The United Kingdom.* Property taxation in the United Kingdom goes back nearly 450 years to the Statute of Sewers, which involved some aspects of the property tax. However, it was in 1601 with the advent of the Poor Relief Act that the standardized local property tax to finance the relief of the poor came into existence and was identified with a specific locality. This has now become primarily a tax on the occupation of real property with the extent of the liability being based on the estimated rental value of that property. Actual liability to

rates is established by evaluating the occupancy of the property. The occupation must be actual, beneficial, exclusive, and, to some degree, permanent.

The rental value of property that determines the amount of the property tax is based on the reasonably expected rent from year to year, given a hypothetical landlord, a hypothetical tenant, and the actual property as it stands. The use of rental value as the tax base presupposes adequate independent evidence of market rents that can be used to produce assessments that fairly reflect annual values as between different classes of property and in different areas of the country. The advantages often cited for the annual rental-value base are as follows:

1. Rates are especially suitable as a local tax since the subjects of taxation are directly related to the local jurisdiction within which they are situated.
2. Expenditures on property form as valid a subject for taxation as income, sales, or capital; it is not unreasonable that a higher contribution is paid on the larger and more expensive accommodation while a lower charge is made on cheaper properties.
3. Since rates are independent of central government and perceptible, they promote local autonomy and the accountability of local councillors to their electorates.
4. Rates enable the community to recoup, to some degree, part of the value that it creates.
5. They are productive in yield, efficient in operation, easy to recover, and cheap to assess and collect.
6. They are difficult to avoid or evade, especially when compared with some other taxes that have led to the development of the "black economy" and the "avoidance industry."
7. By virtue of their open character, they enable the rate payer to be aware of his liability in advance, to secure information on local expenditures, and to appeal readily against his assessment through proper machinery.
8. They are flexible in nature, so that relief and exemption can be granted in case of need and other circumstances.
9. Rates have become broadly proportional in effect since the regressive element for lower incomes has been largely mitigated by rebates and other reliefs.

*Taiwan.* The Republic of China has opted for a graduated land-value tax with the rate of taxation rising with increases in value over those established in a base year. Annual tax rates run from 1.5 to 7 percent of total land value. If there is no increase in value, the tax rate is 1.5 percent. On any increase up to 500 percent, the rate is 2 percent. On increases over 2,500 percent, the rate of taxation becomes 7 percent. Land-value taxation in the Republic of China has been designed to accomplish the following goals:

1. To promote public enjoyment of benefits derived from the ownership of land.
2. To encourage the proper utilization of land.
3. To curb monopoly ownership and speculation in land.

4. To eliminate unfairness in the distribution and enjoyment of the benefits from increases in land values.

In addition to the annual land-value tax, the Republic of China has adopted a land-value-increment tax that also encompasses some highly progressive rates. This tax is similar to a realized-capital-gains tax, with the tax liability imposed at the time of sale. Originally, the rates ran from 20 to 80 percent of the actual gain, depending on the amount of the value increase. These rates have recently been modified so that there is a 40 percent tax imposed on the portion of the gain representing less than 100 percent of the original capital value; 50 percent on the portion of the gain between 100 and 200 percent of the original capital value; and 60 percent on all of the gain in excess of 200 percent of the original capital value.

There was an early proposal under which the land-value-increment tax would be imposed after ten years, even though ownership had not been transferred. This tax would amount to an unrealized-capital-gains tax that would certainly have discouraged the holding of land out of productive use if that land were increasing rapidly in value. However, this proposal was never adopted into law.

### *Conclusion*

A cube with political, economic, and technical dimensions would provide a rough model of the property tax in the United States. Let the volume of the cube represent total property-tax collections scaled as a percent of total market value of taxable property or as a percent of personal income. This percentage has been fairly constant at 1.5 to 2.0 percent of market value and just over 4 percent of personal income. When technical innovation or progress allowed a level of administrative efficiency that caused an economic squeeze on the taxpayer, the political dimension changed to keep property-tax burdens in line with the wishes of the voting public. If elected officials failed to respond to the voting public's perception of being overburdened by property-tax payments, that voting public took things into its own hands and through the initiative process amended laws and constitutions in a manner that gave some measure of protection against unlimited growth in property-tax collections.

The political dimension also changed with continuing attempts to limit the burden on homeowners by adopting classification schemes that put residential property in a favored position or by homestead exemptions that accomplished much the same thing but in the process put owners of lower-valued housing in a more favorable position. Also, the political and economic dimensions were often altered by granting property-tax relief based on age or income.

The prevailing political perception is that business has the cash flows to meet property-tax payments and also the mechanism for including the property tax within its pricing structure. Therefore, there is little political danger in using business as a property-tax collector even though the people who are the customers of business would in the long run pay a major portion of the tax.

The major shaper of the technical dimension of the property-tax cube is the new generation of mini- and microcomputers. The low-cost computer hardware has put this technology within the financial reach of virtually all taxing jurisdictions. Now the possibility of a true ad valorem property tax levied annually on current market value has become technically feasible. This technical breakthrough holds the promise of greater equity and economy in the administration of the property tax if there is sufficient political support for its use.

When asked why they do something the way they do it, people are most likely to respond: "Why, that's the way we have always done it." It will be the same with the property tax. The United Kingdom will most likely follow more than 400 years of tradition and continue a tax system based on annual rental values. The United States with a shorter period of tradition will be just as hidebound in maintaining the present capital-value system even though it is rapidly losing its identity as a true ad valorem tax. There is little prospect for major structural change in the property tax as it is employed in the United States. The system now in effect will likely be in effect at the turn of the century.