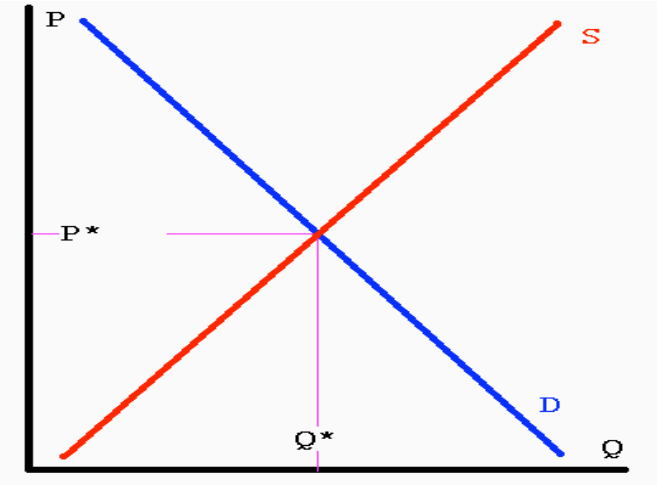
Explaining the Virtues of a Land Value Tax for Those Who Never Had Economics 101

H. William Batt, Ph.D., Center for the Study of Economics, Philadelphia March, 2008

Tweaking the current property tax to be only on the value of land sites is the perfect tax. It is easy to understand by everyone. It is easily administered. It is totally fair, inasmuch as those who own no land -- mainly poor people -- pay nothing at all. It is completely neutral because it doesn't affect decisions made in the absence of a tax. It is totally efficient because it incurs no deadweight loss (economic terms for reduced productivity or economic drag) on entrepreneurial activity. It is also a very stable source of revenue. This paper is an attempt to explain all this for people who never took Economics 101. We ought not to confuse its often-poor administration with the virtues of the design itself.

The current property tax is really two taxes, a tax on the assessed value of land, and another on the assessed value of improvements, or buildings. The tax on buildings should be done away with; why should we penalize titleholders who maintain and improve their property parcels by hitting them with a higher tax when their values go up? We've known for over a century that taxing improvements was dumb, but some people argued that it was difficult to know how to separate those values from the land on which they sit. These days we have computer programs and data that allow us to solve that problem. This makes a land value tax easy to administer and easy to understand.

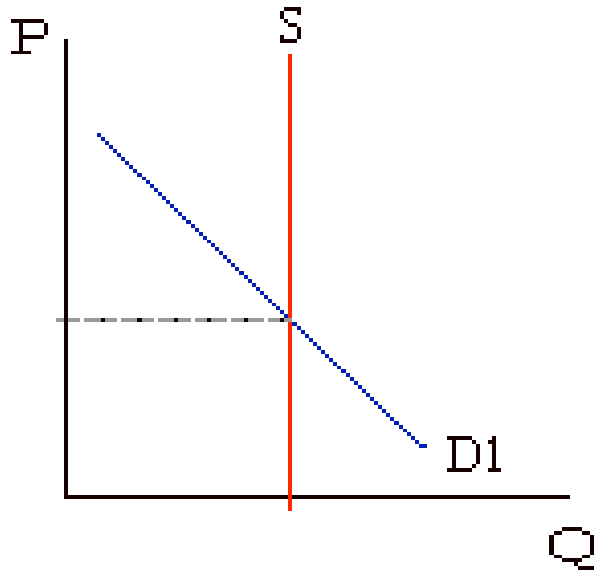
Figure 1



So we're faced with the question of explaining why and how a land tax works and why it is the perfect tax. The first thing is to understand the meaning of supply and demand curves. Using normal X-Y axes, as shown in Figure 1, we typically assign the quantity to the X, or horizontal, axis, and price to the vertical, or Y-axis. Having done that, it is easy to impose typical slopes for supply and demand. To track supply, the amount of a product on the market increases as the rise goes up. That's why the supply curve normally goes from southwest to northeast. The demand curve is just the opposite: it slopes from northwest to southeast. This is because when a price is very high, very little product will be on the market, but more and more will be available as the price falls. The supply of houses and other buildings is responsive to supply and demand, and therefore we say that it is "elastic."

But how about the land itself? Land is "inelastic." The supply curve for land is totally vertical, parallel to the Y-axis, no matter how much the price. That's why Will Rogers said, “Buy Land; they ain’t making it any more!” Whatever responses arise from the market in land are the result of adjustments in the demand price. The price of land therefore varies far more than prices for other items on the market, because there can be no adjustment in supply, one way or the other.

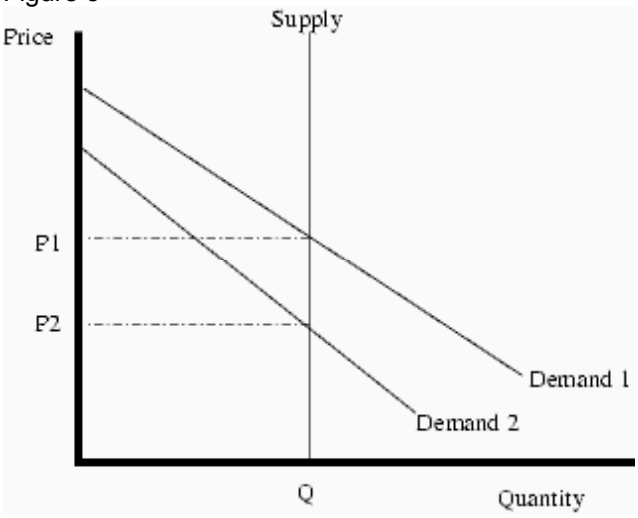
Figure 2



The price of the land comprises not just the purchase price but also any and all other costs associated with its ownership. If, for example, a sewer and water service charge is associated with a site, it must be included in the total cost. Even non-monetary costs should be recognized, like the obligation to keep a sidewalk shoveled or to abide by all building and zoning ordinances. If the obligation of holding title includes a mortgage, it too needs to be included in the total cost of ownership. Most significantly here are the burdens of taxation, which comprise a significant component of title obligations. Land taxes are borne totally by owners, whereas building taxes can be shifted to others.

Since the total price of a land parcel is determined by the market and is fixed by the supply and demand curves, the various components, i.e., the obligations of title vary internally according to the shifts in those costs. If, for example, the mortgage rate (and hence the monthly payment) goes up, that means there will be downward pressure on a site's market value. If the tax on the land goes up, the market price must also adjust. So too when mortgage rates or taxes go down — the value of the land component of a site will rise or fall in response. Economists say that taxes and all other elements are "capitalized" in the market value of the sites. They can't be passed forward or backward; they are borne totally by the titleholder. So those who don't own land pay no taxes at all.

Figure 3



When I explain the dynamics of a land tax to officials, using Figure 3, I sometimes ask them to put their finger on the intersection of the supply and demand curve, and then ask them what happens to the market value when a tax is added. If they don't understand economics well, their usual tendency is to move their finger up the vertical (inelastic) supply curve. I then have to point out that they can't do that, because the price is set not by the cost inputs but by the open market. This is why a tax on land value is totally neutral and efficient with respect to markets. Adding or reducing a tax on land may change the intersect from P1 to P2 or not, but the total payment is the same. This is a very important point. And the feedback effect on the price of market sites makes it very stable compared to taxes on sales and income.

The upshot is that land sites are paid for, one way or another, either through an up-front purchase price (often with a mortgage), or in taxes over the years. The greater the amount of property tax relief, the less affordable homes become. Together all the duties of site ownership add up to the same amount. The value of a site is a function not of what the titleholder does but is due rather to the total entrepreneurial activity of a neighborhood and region. If we don't tax the land, the market alone will absorb that extra value, often raising real estate locations so much that people can't afford to settle where they would like, and forcing them to move to second-best suboptimal locations. The more land sites are taxed, the more they perfect markets and foster the potential economic health of their localities. This is why a land value tax makes sense, and why governments are looking at it with renewed interest.

A phased-in tax shift off building values onto land values can a be revenue neutral, and has a sound moral as well as economic logic. Building values relate more closely to a titleholder's own efforts in contrast to community created value reflective of locations. Arguably that which we earn we should be allowed to keep; that which the community created, what classical economists called rent, should be returned to the community. This insight was understood very well by Adam Smith who observed that "Ground-rents and the ordinary rent of land are . . . the species of revenue which can best bear to have a peculiar tax imposed on them." Of course "land" then meant natural resources of every sort, and rents from land were the windfall gains that fell to titleholders, even though they arose through common effort. John Stuart Mill put it a bit differently: "Landlords grow richer in their sleep without working, risking or economizing. The increase in the value of land, arising as it does from the efforts of an entire community, should belong to the community and not to the individual who might hold title." We can learn a lot from the classical economists.

Use of locations is ultimately paid for, either through taxes or through purchase. Tax relief can be provided both by eliminating the tax on improvements and by deferral of payments. In most localities where assessments are sound, most homeowners pay less. The best means of accommodating households who are cash poor but asset rich is to allow deferral of taxes until a sale is eventually consummated. This way the community gets what it is rightfully due and households can live on without fear of eviction for non tax payment.