Incentive Property Taxation Can Enhance Housing Affordability

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The Mayor's Housing Action Agenda (1998) took a traditional view of Seattle's current housing crisis by focusing on the supply and demand imbalance. The assumption is that by adding a large volume of market rate housing units, prices and rents will be brought down through the filtering process. Critics argued that the current rate of new construction can never keep pace with population growth and in-migration of the highly paid technology work force. Housing advocates argued for more subsidies at the low end of the housing supply. Others dismissed the action agenda as too modest to affect anything but the margins of affordability.

The supply-demand view may be a valid way of looking at short term spikes in housing prices, but it is not a particularly useful way of addressing the housing affordability problem. The lack of affordability has been a long term trend since the late 1970's, and it is best described as the growing gap between rapidly rising housing costs and moderately rising household incomes. Subsidies are a stop gap solution because taxpayers will eventually grow weary of forever paying for other's basic shelter needs. The housing affordability gap especially for renters is widening at a faster rate than would ever be possible to close by applying public subsidies.

Why is the housing market system not working for households at all income levels? Formerly, up to the mid 1970's it was working, as median income families could easily afford median priced owner and rental units. To understand how housing costs have gotten out of hand it is necessary to look at not only houses and apartment buildings but also the land beneath them. Over three decades the price of building materials and construction labor have increased at about the level of the consumer price index, that is, the rate of general inflation. On the other hand, residential land prices have soared far above general inflation.

In regional housing markets across North America, there is strong evidence that rising residential land prices are largely responsible for driving the increase in housing costs. At the national level, residential land prices rose by 2,000 percent since 1950, compared to about 400% for building components and incomes. As land prices rise, builders find that in order to make new homes marketable they must erect larger houses to increase the building-to-lot value ratio. Higher developed site costs induce the use of highly leveraged long-term mortgages, increasing profits to lenders and increasing costs to consumers.

The rapid rise in land prices since the 1970's is to a large degree a function of the "commodification" of housing—the inclination to not only acquire property as a hedge against inflation, but to maximize the accumulation of equity by trading up homes and seeking new locations which increase the most in value. This upward pressure is further exacerbated by land speculation—the holding of underutilized sites in central locations or suburbanizing areas, creating an artificial scarcity of land. These withheld lots can yield lucrative returns, or "windfalls" for owners who later resell to developers who in turn pass on the higher land costs to housing consumers. In essence, the housing market brings supply and demand into equilibrium for the house itself but not for the land on which it is built. When land prices get out of hand, the supply cannot be increased because ultimately there is no more than what nature created, less what is withheld from the market by speculative holding.

Many environmentalists are now coming around to the view that mispricing or misusing of the "gifts of nature"—including land and non-renewable resources—leads to environmental degradation and economic inequality; and furthermore, the present tax system encourages this regressive behavior. Property taxes are a good example of perverse incentives. Under the present tax system where buildings and land are taxed at the same rate, owners have no incentive to invest in property improvements because doing so will result in higher taxes. Conversely, holding onto underutilized lots or letting buildings deteriorate results in low taxes.

Thus, inherent in the equal rate method of property taxation is a built-in disincentive to utilize land wisely or to place it on the market at reasonable prices. "Taxing labor and capital tell businesses and households to scrimp on workers and tools--to practice underemployment and under-investment," says Alan Durning, author of *This Place on Earth* and *Tax Shift*. "A reasonable tax policy would tax the gifts of nature first and tax labor and capital only as a last resort. Shifting taxes from buildings to land aids compact development while suppressing land speculation, promoting productive investment and tempering housing costs."

An alternative method of property taxation proposed by a growing number of environmentalists is based upon a foundation laid by a 19th Century reformer. In his seminal book, *Progress and Poverty*, political economist Henry George lays out his fundamental reform premise: the abolition of involuntary poverty by opening the earth's resources on equal terms. Greater access to land could be accomplished, he argued, by reducing taxes on wages and capital, and by placing a higher levy on land holdings. Owners of unused sites would be induced to sell their sites at reasonable prices, thus bringing idle land into productive use and allowing more workers to engage in productive work.

In contrast to the conventional equal rate system which applies the same tax rate to land and improvements, a revised 2-rate property tax structure taxes the assessed land value of each parcel at a higher rate than the building assessment. In principle, this heavier tax on land taxes mainly the site value (or speculative value) created by the community at large through the presence of infrastructure, transportation improvements, and nearby private building activity. Suppose a lot in a prime location appreciates in value at the rate of 10% per year. A 1.5% conventional tax takes only a fraction of the annual gain, leaving the owner with a net "windfall" of 8.5% per year.

Indeed, why wouldn't the owner hold out for the maximum resale price when surrounding new development enhances the value even more and land prices are at a premium? This is what Seattle's preeminent land speculator Sam Israel did while amassing a fortune from deteriorating downtown properties by doing nothing with them but sit and watch the site values grow. The Douglas hotel was bought for $16,000 and resold for $1 million. The present property tax system accomplished no less than to assist Israel by keeping his tax bills low due to the deteriorated condition of the buildings. Had a land-based tax system been in place, the incentives would have been reversed. A high percentage of the speculative gain would have been captured in taxes, inducing him to sell to a new owner who could reduce comparative tax liability by making building improvements. Lower cost land (driven down by a heavy land tax) and lower taxed buildings are passed on to subsequent owners and occupants in the form of more affordable rents.

Proponents of 2-rate incentive taxation anticipate several significant benefits to the public interest. The following points elaborate:

1. As a result of placing proportionately higher taxes on land, it would become more costly to hold onto vacant and underutilized centrally located sites. A trend would emerge towards *infill development* and a gradual re-centralization of urban development. Simultaneously, there would be a corresponding diminishing demand for sites at the urban fringe where urban sprawl is rampant.

2. A reduction in tax burden on improvements would facilitate *revitalization* and the replacement of obsolete buildings in older central cities. Property owners, responding to the financial inducement to reduce the land-to-building assessment ratio, would build more intensively on underutilized sites.

3. The 2-rate tax would *discourage land speculation*, or the holding of unimproved or under--improved property for the purpose of reselling without substantial capital investment. A differential tax rate which is high compared to land price inflation would diminish the accumulating windfall for the holdout owner.

4. Because the property tax is broad-based, all sites would experience a *downward pressure on land prices*. High value residential properties would lead the trend. The high tax on land becomes a liability which is capitalized into lower resale prices. Over time, successive waves of high value locations would diminish in value, exerting a price-dampening effect on other properties. On lower value sites builders could then erect more modest dwellings and still make a profit.

A land value property tax appears reasonable in theory; can it actually work to bring down housing prices? Pittsburgh, which pioneered the alternative tax system, is regularly near the top of the list of larger cities with the most affordable housing. By taxing land at a rate six times higher than buildings, this city has a higher rate of owner-occupancy than most major U.S. cities. Given the political will to change the property tax system, long term housing affordability is possible.