

TO REDUCE HOUSING COSTS WE MUST REFORM THE PROPERTY TAX

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In Colonial United States, taxation was based on capital accumulations, primarily land, which was considered the best judge of wealth. From our country's foundations, therefore, state and local governments have relied heavily on a general tax on property—both real property (land and buildings) and personal property. Four states no longer tax personal property, and in most states, the tax is principally on real property, business equipment and inventories. (Netzer, 1966, ch. IV)

At the turn of the century property taxes accounted for over 80 percent of total state and local revenues. Since the 1920's, there has been a steady decline in the

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dominance of the property tax, and since the 1950's the property tax as a percentage of revenues has stabilized at about 45 percent of all state and local tax revenues. (Netzer, 1966, p.4) The property tax, however, remains the backbone of local governments, accounting for 37 billion dollars or 60 percent of current tax revenues. (U.S. Bureau of Census, 1970.)

This article will examine the economic effects of the property tax in relation to urban housing. Specifically it will consider two 1973-74 proposals for reforming the property tax. The first was advanced by Phillips Finkelstein in a study conducted by the New York City Office of Administration, *Real Property Taxation, Alternative Approaches: New York*. Finkelstein advocated a shift in current property tax assessment and rate structures to impose a more severe tax on land and a reduction of the property tax on improvement. (Finkelstein, 1974.) The second proposal was advanced by Assemblyman Andrew Stein, Chairman of the New York Temporary State Commission on Living Costs and the Economy, in a report entitled "Tax Equality Act." (New York Temporary State Commission on Living Costs and the Economy, 1974.)

There is perhaps no more serious urban problem than the current housing crisis. Both the President's Commission on Civil Disorder (Kerner Report) and the National

Commission on Urban Problems (Douglas Report) saw the lack of adequate housing as a fundamental element of urban unrest and decay. They recommended heavy federal subsidization of housing, running into the billions of dollars. This, of course, is one answer, and may indeed be necessary. Jane Benedict, Chairwoman of the New York City Metropolitan Council on Housing, a militant tenant organization, has suggested that housing can no longer be built by private enterprise and should become a government service. (New York Temporary State Commission on Living Costs and the Economy, 1973.)

Without getting into the pros and cons of massive governmental action, we should consider why private enterprise can no longer produce housing that many people can afford. Actual construction cost (and the developer's profit), when capitalized, seldom run in excess of 50 percent of the rent of an apartment. Of the total costs to a tenant, 40 to 50 percent are a direct result of the capitalized cost of the land and the property taxes assessed against the rental property.

A major obstacle to low cost private housing is the property tax. Real property taxes generally represent from 20 percent to 30 percent of the rent paid by apartment dweller. This is equivalent to a 25 percent to 43 percent sales tax on housing rent.

Nationwide there has been growing unease over the rise in property taxes. In New York City, for example, it has risen from 5.519 percent of assessed value (1969-70) to 7.35 percent (1974-75), an increase of 33 percent in five years. Most states now offer some relief from the property tax. These forms of relief, provided by the state or local governments, generally ease the tax burden on certain groups such as homeowners, the aged, or those below certain incomes. Two methods of relief are often used: homestead exemptions that remove a portion of property value from taxation—available only to homeowners; and "Circuit breaker" programs that provide tax cuts or refunds when property taxes go above specified percentages of income.

Only six states—California, Michigan, Minnesota, Oregon, Vermont, and Wisconsin—apply the "circuit breaker" approach to renters. Specific proportions of rent count as taxes to determine whether the taxes go above the specified percentages income. Nine other states—Colorado, Connecticut, Illinois, Indiana, Maine, Missouri, Nevada, New York, and West Virginia—provide some relief to elderly renters. New York relief is limited to those elderly who live in rent controlled structures. (U.S. News and World Report, 1973.)

The principal additional method of tax relief, used

primarily to spur housing development or renovation, is tax abatement. A certain percentage of tax liability is abated, usually for a term of years, in return for an agreement by the landlord to make certain repairs or improvement, or to provide housing for certain groups of people, the elderly or moderate income, at rents below these available on fully taxed properties.

The problem with tax abatement is that it cause an increase in taxes on non-qualifying properties in order for the city to maintain the same tax yield. Thus, short-term gains in development may be offset by disinvestment in non-qualifying properties. Another objection is the discriminating nature of the tax abatement. Since all poor or moderate income tenants do not live in tax abated buildings, an inequality exists in the tax treatment.

The Finkelstein study of new York City documents uneven property tax assessment practices that characterize the nation. He found an underassessment of land as compared to improvement, and a lower assessment for single family homes as compared to multiple dwellings. The resulting tax inequity means that low and moderate income families, who predominantly rent, pay a larger proportion of their income in property taxes (as a component of rent). In addition, the heavier assessment on improvements provides a reward for underutilization of urban land which may increase urban land speculation and lead to higher land prices.

Given the lower income of renters and the tendency of assess apartment structures at close to full value it is not surprising that the property tax has been condemned as a regressive tax. Analysis by economist Dick Netzer and others support that belief. (Netzer, 1966) Particularly with regard to low and moderate income families, the property tax is held sharply regressive.

Besides the vertical inequity indicated by the regressive nature of the property tax, the federal income tax code creates a horizontal inequity through its failure to treat homeowners and tenants of equal income as equals. A homeowner has two specific tax advantages: first, he does not have to include as income the "imputed net income" the homeowner could obtain by renting his home to another family, and he therefore lives "rent free," secondly, he is allowed a personal deduction for interest paid on his mortgage interest payments and for property taxes paid on his home. The combined savings are considerable. Table I considers two individuals with assets of \$25,000 yearly earnings of \$10,000; however, one owns his home, having an equity of \$10,000, the other rents. The residual income for each taxpayer, after expenditures for housing and rent, are

equal. The federal income tax liability, however, is not equal, strongly favoring the homeowner.

TABLE I. Unequal income tax treatment of two taxpayers, one a homeowner, the second a renter.

	Homeowner	Renter
Earnings	\$10,000	\$10,000
Income from Assets 6% return		
—assets of \$25,000		1,500
—assets of \$15,000	900	
—imputed income on equity on house (10,000)	600	
TOTAL MONEY INCOME (less)	10,900	11,500
Rental Payments		2,100
Housing Expenditures	1,500	
Residual Money Income	9,400	9,400
TAXABLE INCOME	8,600	9,775
FEDERAL INCOME TAX LIABILITY	1,512	1,770.50

Federal Taxable Income based on money income of 10,900 for the homeowner, less deductions of \$650 for mortgage interest, \$450 for property taxes, and \$1,200 for deductions. Average deductions from U.S. Master Tax Guide. (Commerce Clearing House, 1973.) The renter is assumed to take the standard deduction of 15% of Adjusted Gross Income (\$11,500). Exemptions are not considered in this analysis.

In addition, the property tax offers little incentive for a landlord to improve his property. Improvements are capital expenditures that are not treated favorably by the federal income tax laws, yet add to the value of the landlord's property. (See Slitor, 1974.) This leads to an increased assessment and higher taxes. The increase in assessment would not be limited to the value of the improvement but typically would reflect any appreciation of the property since the last assessment—something which the landlord naturally prefers to hide.

The quality of rental housing is a function of the quality and amount of current expenditures (maintenance and operating expenses) and capital expenses. Economically, we must assume that the landlord chooses whatever mix of expenditures will maximize his profits. This would depend on the price of the current and capital inputs and the expected return to the landlord in rent roll for a given quality of housing. The property tax is an expense which does not add to the quality of the housing and cannot, therefore, create a larger rent roll for the landlord. A rise in property taxes requires the landlord to make a choice.

He can reduce his return on investment, reduce other current expenditures (maintenance), delay schedule capital improvements, or increase rents.

Quality at any given rent level will decline. In an uncompetitive market the tenant will be forced to pay more rent, if the landlord can pass the extra tax on to the tenants, or suffer deteriorating housing if rent control prevents a pass-through. The property tax is certainly not a neutral tax, as it has important deleterious economic effects in urban areas. Specifically, with regard to housing, its application leads to higher land costs and rents and acts as a disincentive to housing improvement.

The Finkelstein study follows the proponents of the Henry George School of land taxation, reversing the trend to tax land more lightly than improvements. Finkelstein's proposal of heavier taxation or assessments on land, relative to improvements, would shift the impact of the property tax and result in higher taxes on vacant land and low intensive land uses (such as single family homes) and lower taxes on denser land uses (multiple dwellings). Costs would be lower for landlords of rental properties and rents lower for tenants, predominantly the low and moderate income populations in urban areas.

A subsidiary benefit would be to encourage more intensive land use and thus discourage urban sprawl. With our current high tax on improvements and our low tax on land, we tax vertical growth and subsidize horizontal growth. Rather than making it more costly to live further from cities, we build roads, sewers, and water mains to encourage sprawl. With our rising concern over energy use, the encouragement of density use must be given renewed consideration.

The most recent proposal of property tax relief which would create tax equality between renter and homeowner was advanced by the New York Temporary State Commission on Livings Cost. (1974) The Commission proposed that localities be given the op-

tion of creating a leasehold tax. The leasehold tax would be charged against all residential leaseholds in the locality in an amount proportional to the real property taxes presently charged to the owner of the fee interest. Individual tenant liability would depend upon the percent his usable space represents as a part of the total residential usable space.

The landlord would collect the leasehold tax as a trustee and would pay the monies to the local governmental body which imposes the real property tax. The leasehold tax would be a credit against the real property tax charged to the owner.

The benefits of the system stem from the income tax deductions permitted to the tenant. At present the landlord collects the real property tax as a component of rent and pays it to the local taxing body. The landlord's gross income includes the real property taxes, therefore, his taxable income (assuming no other deductions) is gross income minus real property taxes.

The leasehold tax would be charged against the tenant; the landlord's gross income would be reduced by an amount equal to collected leasehold taxes because

the landlord would be a mere trustee for the leasehold taxes. The landlord's taxable income would remain his gross income less deductions, but the gross income would be reduced by an amount equal to the total collected leasehold taxes. Thus the landlord loses revenue income equal to the leasehold taxes he would collect as trustee.

The tenant would pay a tax which he can deduct from his gross income. This deduction would result in a federal tax benefit to each tenant in the State of New York in an amount approximately proportional to his income (See Table II). A smaller state and local (where applicable) income tax benefit would also accrue.

The proposed leasehold tax would not cost either the landlord or the tenant any money because the tenant already indirectly pays the real property taxes. This proposal merely reduces the inequities between the homeowner, who can deduct his real property taxes, and the tenant who now cannot.

It is argued that the proposed leasehold tax would provide some tax relief to most tenants. In addition, since the landlord would act as a trustee in the collection

TABLE II. Estimated yearly rent, property tax and tax savings under proposed leasehold tax, by income for New York Residents

Gross Income	\$4,500	\$8,500	12,500	20,000	30,000
Estimated					
Yearly Rent	\$1,260	1,530	2,000	3,400	4,200
Estimated					
Property Tax	\$315.00	382.50	500.00	850.00	1,050.00
Federal					
Tax Savings	\$53.55	72.68	110.00	182.00	378.00
State Tax					
Savings	\$12.60	22.95	35.00	93.50	157.50
NYC Tax					
Savings	\$4.41	6.89	10.50	21.25	33.60
TOTAL TAX					
Savings	\$70.56	102.52	155.50	296.75	569.10
Savings as					
percent of income	1.57%	1.21%	1.24%	1.48%	1.90%

1. Estimated yearly rent derived from distributions of rent as a percent of income, by income class, 1970 Census Data, Census of Housing, New York State. (U.S. Census,
2. Estimated property tax per renter derived by multiplying estimated yearly rent by .25, the estimate of the ratio of property tax to rent.
3. Tax saving estimates derived by multiplying estimated property tax per renter by the marginal rate of taxation, the tax imposed on the last taxable dollar after allowable deductions. Average deductions by income class were derived from 1973 U.S. Master Tax Guide (Commerce Clearing Housing, 1973.)

of the tax, his non-payment could result in criminal penalties. Too often, localities must resort to *in rem* (against property rather than a person) legal proceedings to take over a building for non-payment of property taxes. Such actions typically occur after the landlord has abandoned the buildings, which has deteriorated beyond use to the locality or its tenants.

Both reform proposals will reduce the burden of the property tax and lower rental costs to urban tenants. Any major reduction in property tax cost, however, will require a massive shifting of responsibility for the financing of certain civilian programs from localities, which must rely on the property tax for revenue, to the state or federal governments. Welfare and education costs would be prime targets for such a transfer.

Government can do little to curb rising construction and maintenance costs. The property tax, which does represent 20 to 30 percent of housing cost, can be reduced by effective government policies. Without major property tax reform or relief, decent housing will more and more be priced out of reach of most Americans.

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