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There has been an increasing awareness in the United States that taxation may play an important role in influencing land use. This awareness includes a recognition of certain undesirable consequences of past Federal, State, or local tax policies and practices. Although there is no single overall Federal policy on the use of public or private land, the Federal Government has a special interest in the effect of taxes on land use. Findings/Conclusions: One of the most important sources of State and local revenues are property taxes which generally consist of a dual tax levied on the land and its improvements. The present system of property taxation tends to overtax improvements and undertax land. This provides a disincentive to maintain or improve urban property or develop urban land to its highest use. Property taxes on agricultural land, if assessed on the basis of potential market value, can be a heavy burden on the owner. A 1973 study showed, in several cities, a systematic overassessment of properties in blighted and declining neighborhoods and an underassessment of properties in stable and improving neighborhoods. The study concluded that the most urgent property tax reform is to equalize effective tax rates across neighborhoods within the same city to share the costs of public services more evenly and not penalize deteriorating neighborhoods. Major issues that need to be dealt with include: a need for coordinated action by all concerned Federal agencies to harmonize tax policies with national policy objectives, identification of inconsistencies between tax provisions and specific national goals and programs, and development of alternative strategies to achieve national objectives. (RRS)

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STUDY BY THE STAFF OF THE U.S.

General Accounting Office

Effects Of Tax Policies On Land Use

This document presents an overview of public and private studies that have considered the potential effects of local, State, and Federal taxes on land use.

There has been increasing recognition that tax policies and practices can have a negative or positive effect on desired land use objectives and can become important tools in land use planning. The Federal Government has a special interest in such effects because it sponsors many programs and policies with land use implications, especially in housing and urban development.



PREFACE

This study presents an overview of the effects of local, State, and Federal tax policies and practices on land use as they have been discussed in the literature of the last several years by economists, lawyers, assessors, and other experts and considered by interested public and private organizations. A selected bibliography of some of the more authoritative and/or informative publications used in the study is presented in the appendix.

The property tax, the most important non-Federal tax affecting land use, is discussed in three chapters; one chapter provides general information on this tax and proposals to reform it, while the two following chapters focus on its impact (1) on agricultural and other rural land uses and (2) on urban land use. Another chapter discusses local and State sales and income taxes, which appear to have had a lesser impact on land use. The effect of Federal income and estate taxes is treated in a subsequent chapter. A final chapter summarizes major tax policy issues which have been considered in the past but merit further consideration by the Federal, State, and local governments and public or private researchers.



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D I G E S T

With growing concern over better land use planning in the United States, there has been increasing recognition that tax policies may have an important influence on land use. Such influence may come from Federal, State, or local taxes which, in addition to raising needed revenues, can have a negative or a positive effect on desired land use objectives. The Federal Government, as sponsor of a great many programs and policies with land use implications (such as urban rehabilitation or preservation of agricultural land) has a special interest in the effect of tax policies.

GAO has made a survey of public and private studies in this area and found that considerable attention has been directed to the effect of tax policies and various reform proposals. The literature contains much discussion of the possible adverse effects of State and local property taxes that allegedly retard urban redevelopment, promote metropolitan sprawl, or contribute to the loss of prime agricultural land to urban development. In recent years, increasing interest also has been focused on Federal tax policies that provide investment incentives not necessarily in harmony with national policies, especially those intended to promote housing and urban development.

Effect of property taxes

One of the most important sources of State and local revenues are property taxes. They generally consist of a dual tax levied on the land and the improvements thereon. This feature has been criticized by many researchers as leading to various undesirable land use consequences. Proposals have been made to change to a system of taxing the land only and not the improvements. (See ch. 2.)

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It has been argued that the present system of property taxation tends to overtax improvements and undertax land. This provides a disincentive to

--maintain or improve urban property, thus contributing to urban blight;

--develop urban land to its highest use, thus encouraging land speculation and metropolitan sprawl.

The proponents of a land value tax claim that taxing land heavily according to its economic value and taxing improvements lightly or not at all would promote more orderly development and stimulate urban renewal. However, other views caution against too optimistic expectations from the proposed tax and question the feasibility of such a significant departure from the present system of raising needed local revenues. There has been general agreement on the need for improving State and local tax administration to achieve more uniform and equitable assessments and provide effective State supervision over local jurisdictions.

Effect on farm land

Property taxes on agricultural land, if assessed on the basis of its potential market value, can be a heavy burden on the owner. (See ch. 2.)

In a period of rapidly rising land values, especially at the fringe of urban areas, such taxation can lead to the conversion of the land to nonagricultural use. To arrest the loss of valuable farm, forest, or open space land, a majority of the States have enacted so-called differential assessment legislation providing preferred treatment in taxing such land at its current use value.

The various laws, their effectiveness, and recommended improvements are discussed in a 1976 study prepared for the Council of Environmental Quality. Those laws, which not only impose lower taxes on farmers but also provide for penalties if the use of the land is later changed, are considered most effective. However, their administration complicates the work of the assessor, who must maintain duplicate assessment rolls.

Effect on urban blight

The effect of the property tax on urban blight has been the subject of a 1973 study sponsored by the Department of Housing and Urban Development. The study showed that in several cities a systematic overassessment of properties in blighted and declining neighborhoods and an underassessment of properties in stable and improving neighborhoods. This assessment bias adversely affects the properties of landlords who must absorb the high tax burden, and therefore tends to reduce their expenditures for maintenance and repair. (See ch. 4.)

The study did not support the allegation frequently made that the possibility of higher assessment because of improvements discourages adequate maintenance; generally, city assessors have reassessed rehabilitated properties only lightly, if at all.

Based on its findings, the study concluded that the most urgent property tax reform is to equalize effective tax rates across neighborhoods within the same city to share the costs of public services more evenly and not penalize deteriorating neighborhoods. Other reform proposals advocate equalization of tax bases either among all taxing jurisdictions of a metropolitan area or among all jurisdictions in a State. These proposals seek to help central cities with a declining tax base, but increasing demands for public services, by making available the superior tax base of more prosperous areas.

State and local sales and income taxes

Sales and income taxes are also important revenue sources for State and local governments. The taxes can have a direct or indirect effect on land use by influencing a taxpayer's decisions on acquisition, operation, and disposition of real property. The effect of such taxes apparently has not been studied to any appreciable extent and therefore is not well known. (See ch. 5.)

Some studies, however, have cited the combined burden of all State and local taxes in certain areas as a factor contributing to the shift of economic activity to other areas having a more favorable tax climate.

Intergovernmental competition to attract industry has been keen in some areas, and various proposals have been made for a more active Federal role in promoting intergovernmental cooperation.

Effect of Federal taxes

The Internal Revenue Code includes a variety of tax benefits which have provided certain investment incentives for land use that may or may not be in harmony with certain other national policy objectives. (See ch. 6.)

Questions have been raised about whether existing tax incentives are at cross purposes with certain important national goals such as housing for low-income families, and urban renewal; whether there is a need to make the code neutral in influencing taxpayers' land use decisions; or whether the code should provide for specific incentives to strengthen ongoing Federal programs.

It has been argued that Federal tax provisions favoring home ownership--such as deductions from taxable income for mortgage interest and property taxes--tend to favor the affluent, stimulate growth of the suburbs, and cause owners to neglect maintenance of existing urban housing. Tax benefits from depreciation deductions and other tax shelters were found to have promoted new commercial or residential construction, including an upsurge in vacation homes, which has significantly affected urban and nonurban land use patterns that may be contrary to national housing policies.

Various reforms in Federal tax policies have been proposed, many of which, however, are controversial; and their effect on individual taxpayers, affected industries, and the national economy as a whole are difficult to predict. The desirability of adopting such tax reforms, particularly in connection with any stronger program to revitalize the cities, is now under consideration by the Administration and the Congress.

The Federal role

As property taxation is a State and local government responsibility, the Federal role is limited essentially to an evaluative and advisory function. Federal agencies having program responsibilities

affected by property tax policies have found it useful to arrange for studies evaluating such effects--some of these studies are cited in this report. Recently, proposals have been made to increase Federal efforts in seeking improvements in State tax legislation and administration, and promoting intergovernmental cooperation, possibly by Federal financial incentives.

Sales and income taxes levied by State and local governments, though probably of less consequence to land planning and use, may also merit Federal attention to the extent that they affect important national programs (e.g., local taxation contributing to outmigration from cities receiving Federal subsidies).

The role of Federal income tax policies in relation to direct Federal housing and urban development programs is at present under intensive public study, to seek more consistent and effective attainment of national goals. Both the executive and the legislative branches of the Government are considering reforms of tax provisions as part of a new Federal urban policy. Besides the several proposals pending before the Federal Government, additional proposals may be expected from the work now underway by other important study groups that are looking into desirable urban strategies.

While much useful analytical work has already been performed in the studies mentioned here, the Congress and the Administration have to deal with difficult and complex policy issues that may require further study and additional analyses of alternative strategies. Certain major issues that should be dealt with are:

- A need for coordinated action by all concerned Federal agencies to harmonize tax policies with important national policy objectives (such as housing), and among congressional committees that are responsible for tax legislation and for direct assistance programs.
- Identification of inconsistencies between tax provisions and specific national goals and direct expenditure programs; determination of desirable and appropriate changes in tax provisions; and evaluation of the potential effect of such changes.

--Development of alternative strategies to achieve national objectives, using direct subsidies, tax incentives, or a combination of the two, and selection of the most suitable option.

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ABBREVIATIONS

CBO	Congressional Budget Office
CEQ	Council on Environmental Quality
HUD	Department of Housing and Urban Development
USDA	United States Department of Agriculture

Chapter I

INTRODUCTION

With the increasing concern in the United States over the need for orderly planning of land use to conserve valuable resources, protect the environment, and limit uncontrolled growth, there has been an increasing awareness that taxation may play an important role in influencing land use. This awareness includes a recognition of certain undesirable consequences of past federal, State, or local tax policies and practices; it also means the consideration of new approaches in tax policy that will promote desired land use objectives in addition to raising needed revenues and thus assigning taxation a positive role in the land use planning process.

The Federal Government has a special interest in the effect of taxes on land use. Although there is no single overall Federal policy on the use of public or private land in the national interest, the Congress has enacted numerous laws establishing Federal programs or policies that seek to accomplish a multitude of national objectives with land use implications. Some of these programs are in such important areas as housing (for example: subsidized housing, rehabilitation, or urban renewal), transportation (for example: highway or airport construction), water resources development, environmental protection, and recreation. Other programs--to name additional examples--affect the use of agricultural land, forest resources, minerals, and coastal zone resources.

These and other Federal programs with land use implications may be carried out by direct Federal action (such as major water resource projects) or by assisting State, regional or local agencies or eligible individuals through grants, loans, or other financial subsidies (such as most programs in housing, transportation, or environmental protection).

While these Federal programs or policies pursue specific objectives considered desirable in the national interest (for example, production of housing for low-income families) their success will depend, to some extent, on the availability and proper use of land resources, and the Federal Government must be concerned with interrelated State and local activities, including tax policies of State and local jurisdictions.

States and their political subdivisions have enacted a variety of taxes, principally property and income taxes, but also inheritance, transfer, and sales taxes, that may affect the decisions of property owners to buy, hold, or

sell real property; where to own such property; and what use to make of it. Therefore, such taxes may affect the timing, intensity, and nature of land use.

For example, high property taxes levied on the basis of highest and best use rather than actual use, may induce landowners to sell farm, forestry, or open space land for development, thus contributing to the loss of prime agricultural or other economically or environmentally valuable land. As a result, many States have enacted preferential property tax laws to lower taxes on agricultural and other rural land, and some provide penalties for converting it to other uses.

On the other hand, high property taxes on urban property, adding to the financial burden of inner city property owners, may contribute to the neglect and deterioration of such property and discourage its rehabilitation. A further effect may be to discourage new investment in inner city property and encourage investment in suburban property, thus contributing to stagnation in the inner city and to suburban sprawl in outlying areas.

While much public discussion and treatment in literature have taken place on the pros and cons of State and local property taxation and its effects on land use, less attention has been given until recently to the effect of Federal income taxes. The Government generally has not used the Internal Revenue Code as an instrument to accomplish specific land use objectives, but some provisions (often referred to as tax expenditures) have provided certain investment incentives, to land use which may or may not be in harmony with the land use objectives of some of the Federal spending programs. A question has arisen about whether existing income tax incentives are at cross-purposes with certain important national program objectives, especially in the area of housing development, and whether there is a need to make the Internal Revenue Code neutral with respect to influencing taxpayers' land use decisions or to provide for specific tax incentives that would strengthen ongoing Federal programs and facilitate their accomplishment.

Increasingly, the role of Federal taxation as a determining factor in land use decisions and its relationship to specific national policy objectives is being recognized, and both the legislative and the executive branches have considered this factor in connection with proposals for tax reform as well as with the need to develop a more workable strategy of revitalizing the Nation's hard-pressed cities. While the Tax Reform Act of 1976 (Public Law 94-455) has made little change in existing income tax provisions affecting

investment in real estate, considerable interest is being focused on what may become major revisions as part of future tax reform legislation.

It should be noted, however, that the effect of Federal estate taxation on the use of agricultural land was recognized by the framers of the Tax Reform Act of 1976, which includes revisions intended to facilitate the preservation of family farm lands.

CHAPTER 2

GENERAL EFFECT OF PROPERTY TAXES

SIGNIFICANCE OF PROPERTY TAXES

The property tax is probably the most significant tax affecting land use and, at the same time, one of the most important sources of revenues raised by State and local governments.

According to 1975 statistics ^{1/} the property tax produced about \$51 billion of State and local revenues, representing 36 percent of total taxes and 28 percent of revenues from all sources collected by State and local governments. There is great diversity among the States as to the extent that State and local revenues rely on the property tax, ranging from 9 percent in Alabama to 48 percent in New Hampshire. The burden imposed by the tax also varies greatly among the States--from \$12.69 per \$1,000 of personal income in Alabama to \$75.14 in Massachusetts.

The potential effect of property taxes on land use depends, of course, on how heavy the burden falls on the property owner in assessment value and tax rate; but the fact that there are about 66,000 governmental units having property-taxing power (1971 statistics) shows how widespread the use of the tax is and its great potential for affecting land use.

TAXING LAND AND IMPROVEMENTS

A special feature of property tax in the United States is that it is a dual tax levied on the land and the improvements thereon. Generally, the portion assessed against buildings and other improvements has constituted 60 percent or more of the total tax raised. This predominant reliance on taxing improvements rather than the land has been criticized as leading to various undesirable land use consequences. In particular, it has been suggested that heavy taxes on improvements may discourage maintenance, improvements, and modernization of residential or commercial property, and thus contribute to the problem of urban blight. On the other hand, it has also been suggested that light taxes on urban and suburban land may be a disincentive to developing land to its highest use, may encourage holding land idle for speculation, and may contribute to urban sprawl.

^{1/}"Facts and figures on Government Finance," 19th Biennial Edition, 1977, Tax Foundation, Inc., New York, N.Y.

The present system of property taxation has been called a combination of overtaxation (on improvements) and undertaxation (on land) that combines and confuses two opposite and conflicting taxes and reverses the profit motive instead of aiding it toward urban renewal and urban development. The disincentive nature of the tax on improvements has been pointed out by showing that the tax, although levied at a seemingly low rate per \$100 valuation, represents a very great burden to the owner in relation to the net income an owner might earn from improvements, or to the carrying costs an owner must meet.

It has been pointed out that a low property tax on land fails to charge property owners for often sizeable community investments which provide many valuable services to their properties. This failure to recover community costs may substantially increase land values and give property owners a hidden subsidy.

PROS AND CONS OF A LAND VALUE TAX

Current literature discussing recommended reforms of the real property tax has given much emphasis to the desirability of changing over to a land value or site value tax--i.e., taxing land heavily according to its economic value and taxing improvements lightly, if at all. Many advantages are claimed for such a restructuring, including advantages in economics, equity, and other desirable social, environmental, and fiscal consequences. In particular, more favorable land use patterns are expected, such as

- more orderly development from rural to urban land,
- valuable vacant land less likely to be held idle, and
- a rise in the level of land use and acceleration of the redevelopment of urban land.

The proponents of land value taxation believe that much heavier taxation of urban and suburban land would help pay more adequately for the cost of local government, slow down the pace of land price inflation, and exert pressure on the owners of underused or misused land to put it to better use instead of waiting for further subsidies and inflation of land prices. From these advantages further favorable consequences are expected; such as more orderly land development in the cities, and a reduction of the incentive for builders to "leapfrog" into the countryside, and for industry to seek plant sites away from urban centers. Shifting the

property tax to land alone, it is claimed, would provide a strong incentive for urban renewal, as it would stimulate owners to develop their properties to their highest and best use.

Literature on property tax reform cites not only favorable factors for the site value tax but also negative considerations. A major obstacle to instituting such a tax would be the politically difficult shift from a firmly established system of raising revenue to a new, untried system that might penalize present owners for past unearned increments in land value, give intensive land users possible windfall gains and necessitate finding other nonproperty tax sources of revenue unless partial taxation of improvements is continued.

The practical experience in several taxing jurisdictions that have used some forms of land value tax has been considered inconclusive. This includes tax policies in Australia and New Zealand and experiments with graded taxation (i.e., taxing land at higher rates than the improvements thereon) in Southfield, Michigan; and Pittsburgh, Pennsylvania. Also, the State of Hawaii instituted a graded property tax, but shortly after its enactment exempted residential properties from the higher land taxes envisioned by the law. Because of this exemption and certain special local conditions, such as the high cost of development in Hawaii, the tax may not have a great effect on land use and provide the desired incentives to redevelop blighted areas.

PROPOSALS FOR REFORM OF PROPERTY TAX ADMINISTRATION

Whereas some critics have considered the present property tax as inferior and unfair, particularly in light of the claimed superiority of a tax on land alone, other writers have pointed out the merits of property taxation, though conceding the need for better tax administration to achieve more uniform and equitable assessments.

Following are some measures considered necessary to reform the property tax assessment machinery:

- Enlargement of assessment districts away from small, inefficient taxing units with competing or conflicting assessment procedures.
- Elimination of overlapping assessment districts.
- Placing direction of assessment agencies under a single administrator instead of a board, not only at the State but also at the local level.

- More regular assessments on a timely basis.
- Upgrading assessment appeals agencies to assure independent and equitable consideration of taxpayers' protests.
- Upgrading the qualifications of the assessors and their aides.
- Measurement and equalization of assessment levels by State agencies.

Reforms relating to changes in the property tax base have gone in two directions: to make tax assessments more uniform as required by the legislation in most States, or to make exceptions to the uniformity principle for the benefit of certain classes of taxpayers. In the second category are homestead exemptions mostly restricted to veterans, the elderly or otherwise needy persons, so-called circuit-breaker laws that give homeowners and home renters refunds or tax credits in amounts that vary inversely with the recipient's household income, and preferential assessment of farmland. Farmland taxation is further discussed in the chapter dealing with tax effects on agricultural uses of land.

AN EXPERIMENT IN LAND GAINS TAXATION

A special tax with an intended effect on land use--to discourage short-term speculation in land--is Vermont's land gains tax enacted in 1970. This tax is a real estate transfer tax collected by withholding at the time of sale; it is measured by the seller's gain and holding period. It applies to property held for less than 6 years and is levied at a progressive rate, starting at 5 percent on a profit of less than 100 percent if the sale occurs within 5 years of acquisition, up to 60 percent on a 200-percent or greater profit if the sale occurs within less than 1 year after acquisition.

The tax applies only to incremental land values and excludes gain allocable to buildings or other structures. It also exempts part of the land used for the principal residence of the seller or to be used for this purpose by the purchaser. Further exemptions apply to transfers where no gain is recognized for Federal income tax purposes.

The Vermont tax has been limited in its results as a revenue source because of its exempting various categories of sellers, but it is generally considered in the literature a promising new land planning tool. It intervenes in the

land market and affects both land demand and supply, and its exemption structure directs the effect most heavily on the speculator and the subdivider, while improving chances for profit and planning for land users and builders.

Other variations of real estate gain taxes are in effect in several countries of the British Commonwealth, including Canada and New Zealand. These taxes were specifically intended to curb land speculation and price escalation.

Most recently, in April 1978, the Mayor and City Council of Washington, D.C., approved a somewhat weakened version of a new house transfer tax designed to discourage real estate speculation in city neighborhoods. The proposed tax would be aimed at reducing the profitability of speculative purchases that have driven up city house prices and led to the eviction of low-income tenants. The tax is keyed to the period during which an investor holds the house and his profit from the sale. There would be, however, a rather important exemption for houses that comply with the city housing code and which the seller guarantees for one year.

CHAPTER 3

PROPERTY TAX EFFECTS ON AGRICULTURAL AND OTHER RURAL LAND USES

ADVERSE EFFECTS OF PROPERTY TAXATION

Farmers, forest operators, and others holding lands in lower intensity uses have long complained that taxing property on the basis of its market value is unfair and sometimes ruinous to them. They claim that they cannot be expected, in a period of rapidly rising land values, especially in areas adjacent to metropolitan centers, to refrain from developing their land for more intensive uses unless they receive some form of tax relief.

Agricultural interest groups have been joined by environmentalists to argue that high property taxes force the conversion of agricultural and open space land to suburban uses for residential, commercial, or industrial development, contributing to suburban sprawl and resulting in the loss of prime agricultural land or otherwise valuable open space at the fringe of urban areas.

In the absence of a scientific measure of whether a tax is equitable or not, it is difficult to judge the fairness of real estate taxes on farms and other less-developed land. However, statistics show that real estate taxes on farms have taken a somewhat larger proportion of the owner's income than have taxes on other property. Furthermore, State and local governments have increasingly become aware of the alarming degree that expanding urban areas have increased pressure for the development of surrounding rural areas, driving up rural land values and property tax assessments. Recognizing the tax burden placed on these landowners--based on the much higher potential value of the land rather than its current agricultural use--and the public interest in preserving land in farming or other open space uses, many States have enacted legislation providing special preferred treatment in taxing such land.

SPECIAL LEGISLATION

Such special legislation, generally referred to as differential assessment of farm and open space land, was first enacted by the State of Maryland in 1956 and, as of April 1976, was in effect in 42 States. Some of the remaining States have so-called classification laws that allow for

more modest preferential treatment, others are considering the enactment of preferential tax legislation. Although the great variety of differential assessment laws makes it difficult to classify them properly, they can be generally grouped into three types:

- preferential assessment,
- deferred taxation, and
- restrictive agreements.

Some State laws, however, include elements of more than one of these types.

Preferential assessment laws

Under this approach, land devoted to agricultural or related uses is assessed by its value in that use. These laws, in effect, abate the taxes that would have been imposed on the difference between assessed value based on fair market value at highest and most intensive land use and assessed value based on farm use. In contrast with the other two types of differential laws, preferential assessment laws impose no penalty on the owner who decides to put her/his property into nonagricultural use.

Eligibility requirements by individual State laws vary considerably. Some apply not only to agricultural use but also to open space, timber or forest, or recreational use. Some require a minimum farm income, a history of eligible use, or a minimum length of tenure by the family. In some States coverage is voluntary and subject to application by the taxpayer, in other States it is automatic for eligible lands.

Deferred taxation laws

These laws also provide for assessments based on current use value but impose a sanction on owners who convert land to non-eligible uses. Such owners must pay some or all of the taxes which they were excused from paying for a number of years before conversion. The number of years for which the rollback of taxes is required varies considerably among the States having such laws, ranging from a minimum of 2 or 3 years to the full period for which a tax saving had been granted. Some States charge interest on the rollback while others do not.

Here again, as with preferential assessment laws, eligibility requirements vary among States, except that these laws generally are not automatic and landowners must apply to be covered. Local governments, however, generally have no choice and must grant tax deferral to eligible applicants.

Restrictive agreement laws

Some State laws permit local governments to make agreements with landowners under which the owners agree to restrict the use of their land for a period of years in return for certain tax concessions. Generally, the restriction on the use of the land is in effect for 10 years, and penalties are provided for changing use of the land contrary to the agreement.

Generally, the State or local government has the option of granting the restrictive agreements only in areas where open space is to be preserved. The provisions of the laws and the terms of agreements vary considerably, and in some cases there is no clear distinction between restrictive agreements and the provisions of deferred taxation.

EVALUATION OF DIFFERENTIAL ASSESSMENT

The three approaches discussed above serve one common objective--to impose lower taxes on farmers or other owners of open space land--but there are important differences in terms of equity and land use effects. Preferential assessment makes no distinction between the bonafide farmer and the speculator. A deferred tax or a restrictive agreement, on the other hand, seeks to limit the tax concession to hold the land in agricultural use and deny it to those who change it to other uses.

The effectiveness of the penalty which is imposed on owners who convert the land to other uses depends on the amount of the penalty, mainly the number of years for which the rollback is required and certain other terms such as payment of interest on the rollback. Generally, the restrictive agreement, being for a term of 10 years and tied to a local government's land use planning procedures, may be expected to be more effective than a deferred taxation provision for 3 years. In many situations, however, various factors other than the burden of property taxes will affect the decision of landowners on whether to continue farming or convert to other uses. The prospects of much larger financial gain from selling or developing the land will often override any other considerations. Therefore,

differential assessment is not necessarily an effective tool for preserving agricultural or open space land.

There are other disadvantages to differential assessment. It may increase the burden of other property owners or necessitate the imposition of other taxes. It complicates the work of the assessor, who must maintain duplicate assessment rolls, especially in the case of deferred taxation.

It is noteworthy that in recent years States have been moving away from preferential assessment laws and have enacted deferred taxation or restrictive agreement laws. An April 1976 study sponsored by the Council on Environmental Quality (CEQ), (entitled "Untaxing Open Space") evaluated the effectiveness of differential assessment of farms and open space and recommended:

- A. If differential assessment is to be a useful land use device, state legislation should
 - provide for deferred taxation to achieve greater equity among all taxpayers, and for a rollback period of at least 10 years;
 - provide for at least partial compensation of the local jurisdiction for its resulting tax expenditure, possibly by State subvention or a State income tax credit, and uniform assessment procedures throughout the State;
 - establish a statewide data system that will allow officials to assess the tax expenditure involved in the program and determine its effect on rates of sale and conversion.
- B. Differential assessment, being a useful component of a broader approach but not an adequate tool by itself, should have the following characteristics:
 - Eligible land should be designated only after determining its suitability, and the need for farm and open space use in relation to the demand for urban, commercial, or other development purposes. The designation should facilitate large-scale land use patterns and be made on the State, regional, or possibly county level, rather than the local level.

--Strict controls should be placed on the development of the designated land. Such controls may necessitate compensation payment to the owners by such techniques as public purchase of development rights or transfer of development rights.

The CEQ-sponsored study concluded that the recommended measures should be sufficient to keep specified land out of development, but not necessarily in agriculture. To assure this objective, additional policies such as special incentives or subsidies would have to be enacted.

CHAPTER 4

PROPERTY TAX EFFECTS ON URBAN LAND USE

As Senator Muskie, in his foreword to a 1973 study on "Property Taxes, Housing and the Cities" ¹/pointed out, the property tax has come to be regarded as a potentially important factor in the area of land use planning, especially for urban communities. Senator Muskie stated that the property tax has variously been cited as a cause of urban blight, an obstacle to urban redevelopment, and a possible lever in the rebuilding of decaying urban centers.

However, the facts to support these charges have until recently been inconclusive. Therefore, of special importance are the results of the Arthur D. Little study that under contract with the Department of Housing and Urban Development (HUD) analyzed the effect of property tax policies on urban blight in 10 American cities. A.D. Little reported on its study to HUD in January 1973, and the study was published in April 1973 as a Committee Print in the 93d Congress, 1st Session, by the Subcommittee on Intergovernmental Relations of the Senate Committee on Government Operations.

FINDINGS OF LITTLE STUDY

The Little study was conducted through interviews with property owners and local officials on the operation of 420 housing projects in 10 cities. The selection of projects sought to deal with a variety of housing market conditions and considered for each city three classifying characteristics--property type, owner size (i.e., number of units owned), and neighborhood type.

The study showed several cities a systematic over-assessment of properties in blighted and downward transitional neighborhoods and an underassessment of properties in stable and upward transitional areas. The apparent assessment bias against low-income properties contributed heavily to the regressiveness of the property tax. Variations in effective property tax rates by neighborhoods were shown to be much larger than intracity variations by age or size of structures or owners' characteristics.

¹/Analysis by George Peterson and others of a HUD-commissioned study by Arthur D. Little, Inc., "Property Taxes and Urban Blight", D.C. Heath and Co., Lexington, Mass., 1973.

When these tax differentials are passed on to tenants, the assessment bias is distinctly prejudicial to the poor and often the minority population. To the extent that landlords must absorb part of the tax burden--and high vacancy rates in blighted areas often necessitate this--these charges will substantially diminish a property's cash flow and contribute to reduced expenditures for maintenance, repairs, and upgrading.

On the other hand, in examining the contention that increased assessment of improvements discourages owners from adequate maintenance of their houses, the study found that the selected cities' assessment practices did not support this allegation. In most cases, housing rehabilitation costing less than \$3,000 per unit was not reassessed at all and those properties that were reassessed had their valuation increased by much less than the cost of rehabilitation. From the evidence gathered by the study, it appears that the actual disincentive effect of property taxation on maintenance and upgrading of urban housing may have been exaggerated.

Regarding the market for low-income properties, the study concluded that administration of the property tax can adversely influence such markets and contribute to their collapse into "crisis ghettos." Through overassessment or failure to reduce assessments it discourages transfers of property to new purchasers who might be more willing to improve and adequately maintain properties acquired at low prices than would older absentee landlords who acquired the properties many years ago and are saddled with capital losses that discourage fresh investments. For downward transitional neighborhoods--which usually end up as blighted areas--the study similarly found that property tax administration can either accelerate or retard this downward trend.

Regarding the publicly subsidized market for low and moderate-income housing, the study found that many investors cited the uncertainty of future property tax obligations as one primary risk involved in the operation of such housing. No Federal guidelines exist on how subsidized properties should be taxed. Assessment methods vary widely among different cities (assessment may be based on construction costs, on estimated market value, or a percentage of rent receipts) and depend on administrative decisions that a city can reverse at any time. Considering the frequent incidence of defaults on subsidized housing, the study points out the undesirability of burdening property managers with the additional risk in connection with the uncertainty of their property tax liability.

Inasmuch as a high percentage of current investment in housing for low-and moderate-income families, both new and rehabilitation projects, is federally subsidized, the study found a real need for a Federal policy on how to assess such projects--a need expressed by assessors as well as investors. An equitable method of determining the value of such projects for assessment is considered especially important, because it affects the volume of federally assisted projects undertaken in a city and the success of any program to reduce rents for low-income families.

As a matter of special interest, the study found among investors and assessors little dissatisfaction with the principle of property-value taxation and not much enthusiasm for proposed modifications of the present tax system. Investors and assessors were strongly opposed to either land taxation or differential rates for land and structures. These opinions are noteworthy in view of the often-voiced criticism of the present system of taxing improvements, in addition to taxing the land, and the contention that this contributes to urban blight and suburban sprawl by discouraging intensive land use and encouraging horizontal spreading out and increased lot coverage.

Apparently, the importance of the property tax on improvements in causing sprawl in metropolitan areas is debatable. Possibly, owners and tenants often prefer low density type developments and are willing to accept commuting and other costs connected with housing located in outlying areas.

PROPOSED REFORMS

On the basis of the findings in the Little study, the authors concluded that one of the most urgent tax reforms is to implement what is already legally prescribed, namely, uniformly assessing all residential properties regardless of neighborhood location, and thereby equalizing effective tax rates across neighborhoods within the same city. They reason that neighborhood equalization would make the tax burden more equitable and contribute to the upgrading of blighted areas.

Another property tax reform proposal is for the equalization of tax bases, either among the jurisdictions of a metropolitan area or among all tax jurisdictions in a State. Under this proposal local jurisdictions would share their assessed property values on a regional or statewide basis and apply their tax rates to the average level of property wealth in the larger area rather than to their local wealth alone. This taxing method would help central cities with a declining tax

base, but increasing demands for public services, by making available the superior tax base of other areas.

However, considering the varying conditions found by the Little study in different metropolitan areas, George Peterson et al. question whether such tax equalization would in all cases aid fiscally distressed central cities in relation to their more prosperous surrounding suburbs. While tax base equalization would help the competitiveness of some cities (like Baltimore) having a deteriorating property tax base, for others (like Detroit) it would destroy the one advantage the central city now enjoys--a concentration of taxable commercial and industrial property that makes it possible for the cities to raise tax revenue at a lower rate than other jurisdictions.

A unique method of tax base sharing was introduced in 1971 for the Twin Cities metropolitan area by the Minnesota Metropolitan Fiscal Disparities Act. This law provides for a plan under which all communities in the Twin Cities area--including nearly 250 independent cities, towns, townships and school districts--will share 40 percent of the commercial-industrial growth that occurs anywhere in the area and will receive a proportionate benefit from such growth in their tax base. The plan will help relieve some of the fiscal pressure on rural communities in the early stages of urbanization as well as the considerable redevelopment needs of the two central cities.

Another major objective of the Twin Cities plan is to stimulate a more efficient and rational pattern of metropolitan area development. Reducing fiscal disparities may reduce the competition among local governments to attract commercial-industrial growth regardless of possible adverse effects on other communities or the region as a whole. Reducing the variation among communities in taxing commercial-industrial property is expected to lead to more efficient development patterns within the metropolitan area.

A study of the plan's effects, after two complete years of operations (1974 and 1975), concluded that a modest degree of reducing fiscal disparities had been achieved, and further reductions were to be expected in the future. However, the formula for distributing the areawide tax base was found to need adjustment to adequately consider disparities in the costs of public services for certain population groups. Also, a greater effect on reducing inequities among communities would probably require a redistribution of the tax base for residential property in addition to commercial-industrial property.

The further role of tax base sharing as a development tool was--tentatively--found to be of little effectiveness, because local governments continue to make development decisions on narrow fiscal grounds even when these decisions conflict with regional development goals. There appears to be a need for additional policy tools available to a regional planning agency to be used together with tax base sharing to influence the self-interest of local governments.

In any proposed reform, the States have to play an important role to monitor local assessment performance and encourage efficient assessment techniques or to initiate appropriate changes in tax legislation. The Little study disclosed that local assessment procedures were more effective and equitable in cities (like San Francisco and Portland) where the State government exercises considerable control over local assessment practices. California, for example, has a State Board of Equalization which makes periodic evaluations of local assessors' policies and procedures and encourages new appraisal techniques. In Oregon, the State can order an independent appraisal of local properties and can pay the costs of such a reappraisal. In any event, the States can help local jurisdictions overcome the most serious defect in present assessment systems, which is the failure to keep abreast with changes in neighborhood-wide market values.

It is noteworthy that the Committee for Economic Development (CED), in a recent statement released December 20, 1977, entitled "An Approach to Federal Urban Policy", pointed out, among possible approaches to revitalization of the cities, the desirability of State or Federal incentives to encourage the sharing of tax revenues throughout an entire metropolitan area, particularly where political reorganization, such as annexation of adjacent territory, is not possible. The statement therefore suggested for further consideration in an on-going study by the CED Subcommittee on Revitalizing America's Cities the role States should play in encouraging local government in redistributing income through tax sharing.

George Peterson et al. believe that the Federal Government has a role in reinforcing the reform efforts of the States. This can be done through technical assistance, development of model statutes, or Federal incentive grants.

SPECIAL DEVICES TO STIMULATE URBAN INVESTMENT

Several States, as part of their property tax policies, have used a number of special devices to stimulate certain socially desirable patterns of urban private capital investment, such as rehabilitation of dilapidated housing, re-development of blighted areas, and preservation of historically

or architecturally significant structures. These devices, briefly discussed in this section, are tax abatement, tax increment financing, and transfer of development rights.

Tax abatement

An abatement is an exemption from property taxation given to a property in whole or in part for a limited period of time. Abatements can be granted in different ways, for more or less limited geographical areas, and for more or less limited periods of time. By lowering a property owner's fixed costs, abatements are generally intended to encourage increased expenses for maintenance and rehabilitation and, in case of rental properties, maximizing rental revenues.

Abatement programs for only very limited urban areas have been considered more likely to encourage simultaneous renovation of a majority of the structures in a neighborhood and to minimize resistance to cost-recouping rent increases. Possible disadvantages associated with such programs are adverse pressures on adjoining neighborhoods, especially through the relocation of displaced tenants, and increased public service costs resulting from the rehabilitation. These claimed detriments, however, would seem to be inherent to any concentrated urban rehabilitation program and not directly associated with tax abatement.

Abatements offered for limited periods of time also have been considered more apt to encourage redevelopment of an entire neighborhood but these programs raise questions of equity for the affected property owners that may not all be ready or able to equally participate in the program and may derive varying benefits, if any at all. A special incentive type abatement was granted by the City of Wilmington, Delaware, which abated 150 percent of the improvement value for a 5-year period.

The effectiveness of abatement programs as a device for stimulating urban rehabilitation apparently has not been firmly established in the literature and has been questioned in light of the Arthur D. Little study, which showed property owners planning to renovate their properties to be only negligibly motivated by preferential tax policies. However, a recent study on urban housing rehabilitation sponsored by the United States League of Savings Associations ^{1/} favorably mentioned a 25-year tax abatement program of the City

^{1/}"Urban Housing Rehabilitation in the United States", by Nathaniel H. Rogg, Nov. 1977.

of St. Louis, Missouri, as a means to encourage rehabilitation in the inner city. Any housing rehabilitation in certain city areas will be assessed at the same value as assessed before rehabilitation and will retain that assessment for 10 years. For the next 15 years the improvements will be assessed at only half the usual value.

Also, it has been recently reported that the Governor of the State of California is proposing the enactment of a 5-year property tax exemption for housing and commercial rehabilitation to spur rebuilding in urban centers of that State. The exemption is hoped to provide an incentive to restore old buildings and reverse the trend under which investments have gone to new suburban shopping centers while the business and industrial centers of most large cities in California have been neglected. However, this exemption will require a constitutional amendment because the state constitution requires all property to be taxed at the same rate.

Tax increment financing

This concept originated in the 1950s in California and was adopted in a dozen other States (as of 1975). It provides for channeling tax revenues over and above those from a frozen assessment base to a specially created public development authority to help it finance the acquisition and redevelopment of properties in a limited, blighted area. The assessments in the area are generally frozen as of a certain date, with the taxes on the frozen base going to the municipality and/or other governmental unit usually entitled thereto, whereas tax revenues attributable to any increases in the tax base go to the development authority.

The authority uses incremental tax revenues to repay tax anticipation bonds that it issues to finance the purchase and clearance of lands to be redeveloped in the blighted area and to make necessary offsite improvements. The properties are resold to private developers who will pay property taxes on the full value of their properties. These tax payments are divided between the authority and other tax claimants until all outstanding bonds are retired, at which point the municipality will again receive all tax revenues levied against the entire property tax base.

Originally, tax increment financing was conceived to circumvent the California legal requirement that cities obtain voter approval before issuing bonds. The device has since been used for various development schemes, not only for removing blight, but also for large projects that otherwise could not be readily financed. There are a number of

unanswered questions about its effectiveness as a non-Federal nonsubsidized technique to rejuvenate urban areas, as well as its cost effectiveness in comparison with other financing devices such as general revenue bonds. Apparently, there have been successful applications in the States using the technique, but this would seem to depend on local legal, economic, and political conditions.

Transferable development rights

This device is more in the nature of a land use planning tool than a part of tax policy. It involves separating the development potential of a particular property from the general ownership rights and transferring the development rights to a public body or another property owner.

This can be accomplished by government acquisition of development rights in an area where development is not considered desirable and resale of these rights to developers in areas where more intensive development is possible. Another technique is to authorize the private transferability of development rights within the framework of appropriate governmental regulation. In both cases, the benefits to the seller of the rights would be the lower property tax on the lessened value of the now-restricted property and the proceeds from the sale of the rights.

Some experience has been gained in the use of this device in New York City and Chicago. In New York, it involves the transfer of authorized but unbuilt floor area between contiguous sites. Chicago, which has since abandoned the plan, permitted transfer between noncontiguous sites. It has been pointed out that the experience to date is inconclusive, and many uncertainties must be resolved before this device can be more widely adopted.

CHAPTER 5

EFFECT OF OTHER STATE AND LOCAL TAXES

Besides the property tax, there are other forms of State and local taxation that can--although less than property taxation--affect land use, principally sales and income taxes.

SALES TAXES

Sales taxation is an important revenue source for State and local governments. Almost all States and many cities levy sales or gross receipts taxes, and in 1975 raised approximately \$50 billion from this source. The land use effect of such taxes, however, has not been studied to any appreciable extent and therefore is not well known.

Possibly, sales taxes could influence land use by changing the income available to the property owner and creating a set of interjurisdictional price incentives that will influence business activity levels and land use decisions. However, lacking appropriate studies, this land use effect is open to speculation.

With respect to residential land use, a sales tax would have little effect on timing, location, or style of residential development because it represents only a small percent of a family's housing expenses. If the tax were eliminated, a family would not be able to purchase very different housing. It has been pointed out, however, that replacing sales taxes by higher property taxes as a source of local revenue would have a greater effect in view of the sizeable increase in property taxes that may be needed. It has been argued that the use of sales taxes most likely maintains property values at a higher level because sales taxes are less likely to be capitalized into lower property values than property taxes, and this may affect the demand for residential land.

Applying this argument to land used for agricultural or open space purposes, it has been further reasoned that the imposition of sales taxes instead of increases in property taxes may prevent increased tax costs to such land uses and thereby slow down somewhat the conversion of this land to other uses.

With respect to commercial and industrial land uses, the effect of sales taxation would be small if a shifting of such taxes to other parties takes place. The part of the tax burden not shifted, or a possible decline in business activity because of the shifting, would probably not decrease income enough to alter land use demands. There may be, however, an effect on land use as a result of interjurisdictional price differences. Differences between a tax-imposing jurisdiction and one that does not have a sales tax may produce incentives to seek one business location over another and thus alter land use demands.

It also has been argued that the use of a sales tax may affect land use if the tax is used for the provision of services that are capitalized into property values. This result may be expected in the same way as benefits (such as streets, sewers, and other public improvements) financed with property taxes are capitalized into property values.

STATE AND LOCAL INCOME TAXES

Almost all States levy an income tax, and several have given their local governments the power to levy such a tax. Total State and local revenues from this source amounted to about \$28 billion in 1975 and represented about 20 percent of total tax collections in that year.

Income taxation, having an income-reducing effect, alters the taxpayer's purchasing power and can affect land use. Expenditures of a community's tax revenues, if they benefit property owners, may be capitalized into higher property values. This may create a greater demand for housing and, in turn, force some consumers to switch to less expensive, or more intensive, land uses.

As in the case of sales taxes, interjurisdictional differences can produce incentives to prefer one location over another. However, studies investigating the migration incentive have to deal with many complex factors and have been largely inconclusive so far.

Agricultural and open space land can also be influenced by income taxation. It has been argued that such land users would be better off when income taxes were substituted for property taxes. Statistics show that agriculture has contributed a disproportionately larger share of property taxes, whereas imposition of a flat rate income tax would make agricultural land users pay a smaller portion of tax bills. This may also happen under a progressive rate income tax, depending on the profitability of individual landowners' operations.

Some studies of the effect of taxes on business activities have shown that income taxation has been found the least acceptable form of taxation by businessmen. They have preferred property taxes as well as sales taxes over income taxes. However, it seems reasonable to assume that businesses will prefer those taxes that burden them least, and this depends on the type of business activity being conducted; i.e., firms with large labor forces will prefer property taxes, while capital intensive firms will prefer other types of taxation. In specific situations, business concerns may make land use decisions because of tax considerations, but generally the effect of taxes has been minimized by three offsetting factors: the ability to shift the tax burden to the customer, the availability of public services that the tax levy will provide, and the deductibility of State and local taxes for Federal income tax purposes.

A recent study published in June 1977 by the Rand Corporation 1/found little evidence of a significant relationship between local taxes and economic development. The study cites several previous researchers who were unable to uncover significant effects of taxes on industrial growth and location of industries. It also found that taxes ranked relatively low in surveys of factors considered important for locating industry, while transportation, labor supply, and public services were ranked substantially higher.

Various studies, however, have cited the relatively high State/local burden as a factor contributing to the out-migration from New York City and other parts of the Northeast and the shift of economic activity to the so-called "sunbelt", with obvious land use implications. Statistics of the comparable State/local tax burden for 1975 show a high of 16.7 percent of personal income in New York compared with a national average of 12.3 percent. Measured on a per-capita basis, State/local tax payments varied from a low of \$405 in Arkansas to a high of \$1,025 in New York. All southern States were below the national average. 2/

Several States, including Connecticut and New Hampshire in the Northeast and Florida and Texas in the South, have no personal income tax. Particularly striking is the difference

1/"The Urban Impacts of Federal Policies," Vol. 2, Economic Development, by Roger J. Vaughan. Three other volumes are not yet published.

2/Advisory Commission on Intergovernmental Relations, "Significant Features of Fiscal Federalism", 1976-77 edition, Vol. II - Revenues and Debt.

between the New England States, New Hampshire and Vermont. Whereas the former has no State income, no sales, and virtually no inheritance taxes, the latter levies income taxes at 25 percent of Federal plus a 9-percent surcharge, has a 3-percent tax, and computes estate taxes at 30 percent of Federal.

Intergovernmental competition in the State/local tax sector has been keen in some areas to attract economic activity. Some States and localities have assumed a more active role than others. The increased use of industrial development bonds (further discussed in chapter 6) has been evidence of such an activist role. Intergovernmental competition is especially keen in some metropolitan areas where a multitude of local governments 1/may seek, through a combination of taxes, zoning, and possibly other devices, to retain urban resources but keep out urban problems.

The Federal Government, for constitutional and political reasons, has been limited in taking specific actions to reduce or mitigate the effects of interstate tax or economic competition. There has been some Federal leadership, however, through Office of Management and Budget Circular A-95, in promoting intergovernmental cooperation on the regional level, and the growth in the number of Councils of Government is attributable largely to Federal efforts. Various proposals have been made as a result of recent public and private studies for a more active Federal role in promoting intergovernmental cooperation. Some of these proposals, including Federal financial incentives, apparently are receiving further consideration, especially in connection with the development of new strategies to help revitalize the cities.

1/In 1972, the "typical" SMSA (Standard Metropolitan Statistical Area) had 84 local governments consisting of 2 counties, 13 townships, 21 municipalities, 18 school districts, and 30 special districts. Advisory Commission on Intergovernmental Relations, "Improving Urban America: A Challenge to Federalism", Sept. 1976.

CHAPTER 6

EFFECT OF FEDERAL TAX POLICY

There has been increasing recognition that Federal tax policy over the last 30 years may have had an important affect on land use patterns, especially in urban areas, but also to some extent in rural areas.

In its provisions for individual income taxes, the Internal Revenue Code has provided strong incentives toward home ownership by excluding from taxable income certain costs of home ownership. The Code also has provided significant incentives toward construction of new rental housing through its allowance of depreciation deductions from business or investment income and of so-called real estate tax shelters that permit offsetting losses from real estate investments against other unrelated taxable income. Some other Code provisions that are deemed to have an effect on ownership and use of real property are

- allowance of accelerated depreciation for certain types of properties;
- special income tax treatment of capital gains applicable to real estate transactions;
- tax exemption for interest on State and municipal bonds issued to finance public facilities, industrial development, or pollution control; and
- preferential treatment of expenses related to environmental protection, energy production, and preservation of historic structures.

In addition, the imposition of Federal estate taxes was found to have an effect on the survival of small family farms and thereby influence patterns of agricultural land use. Heavy estate taxes may force the heirs to sell the farm property and lead to its conversion to commercial or other non-farm uses.

EFFECT OF INCOME TAXES ON HOUSING

It has been suggested that many of the aforementioned provisions of the Internal Revenue Code have brought about certain undesirable, though evidently unintended, results for urban and suburban development. Thus, over the last

several years the National League of Cities has argued that current and past tax law has encouraged both undesirable growth and costly decline and points out that this position has gained increased support.1/

A study of the effects of Federal tax policy on urban development sponsored by the Urban Institute 2/has concluded that Federal tax provisions historically have favored

- low-density urban sprawl over compact development;
- construction of single-family, owner-occupied housing over multifamily rental apartments;
- development of new commercial-industrial, residential, and public buildings over the maintenance and repair of older structures.

A critical review of the Federal tax provisions in question has led to the recognition that they may bring about taxpayer investment decisions having as much of an impact as direct Federal expenditure or subsidy programs. The results may be consistent, but also often contradictory. The implications of tax laws with respect to urban development probably have not received the same scrutiny as direct expenditure programs and overall national policies. In the legislative process, tax expenditures come under the jurisdiction of the tax law writing committees rather than the committees responsible for the direct programs, and there has been little, if any, integration of their respective objectives.

As the National League of Cities pointed out in its recent testimony before the House Subcommittee on the City, there is a need to more carefully consider the impacts of Federal tax laws in the best interest of the cities, but the task is difficult, and hasty reform is not likely to produce results superior to the current situation. The League recommends that, when considering changes in the tax law, the

1/Testimony of National League of Cities before Subcommittee on the City, House Committee on Banking, Finance and Urban Affairs, June 16, 1977.

2/George E. Peterson, "Federal Tax Policy and Urban Development," forthcoming in 1978, The Urban Institute, Washington, D.C. Also, see his testimony at the hearing cited in note 1.

first step should be to discover what the results of the tax provisions are; the second, to assess any inconsistency with policy goals and direct expenditure programs; and the third, to determine where it is desirable, possible, and appropriate to make them consistent.

Similarly, the Urban Institute's study cautions against underestimating the considerable complexity in the relationship between urban growth and Federal tax policy and against ignoring other factors influencing metropolitan development. Tax policies should not be the primary determinant of urban growth and it would be irrational to redesign the Federal tax structure for the sole purpose of improving the quality of metropolitan development. Rather, tax changes should be considered which restore the tax system's neutrality in the urban land and other markets while eliminating tax advantages that many regard as undesirable on equity grounds and because of their dollar costs to the Treasury.

In addition to those by the National League of Cities and the Urban Institute, Federal tax reform proposals recently have been made by the President's Urban and Regional Policy Group, 1/and certain alternatives to present real estate tax shelters were discussed in a nonpartisan analysis by the Congressional Budget Office.^{2/} Also, the House Subcommittee on the City, as a result of its hearing held in June 1977, submitted proposals for consideration by the Administration and the House Ways and Means Committee for certain changes in tax policies in connection with new approaches to solve housing and urban development issues. The Subcommittee's report, however, includes minority views that strongly object to the proposed changes.^{3/} Most recently, the President's January 20, 1978, message to the Congress on proposed tax reform includes revisions that would affect urban land use.

The following sections present a discussion of several tax provisions considered to have significant impact on the ownership and use of land.

^{1/}"Cities and People in Distress," National Urban Policy Discussion Draft, Nov. 1977.

^{2/}"Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives." Background Paper by Congressional Budget Office, May 1977.

^{3/}Report by the Subcommittee on the City, House Committee on Banking, Finance and Urban Affairs, 95th Cong. 1st Sess. Sept. 1977.

Income tax incentives to homeownership

The oldest and most widely recognized provisions of the Federal income tax affecting land use are those allowing the deduction of mortgage interest and property tax payments from a taxpayer's adjusted gross income (Internal Revenue Code sections 163 and 164). They were relatively insignificant as an incentive for homeownership until World War II. At that time less than half the nation's population owned their own homes. During World War II the average income tax rates jumped from 4 percent to 25 percent, thus increasing the value of the homeowner deductions and creating an after-tax gap between homeownership and rental costs.

An additional incentive to homeownership, it is claimed, has been that Federal tax policy in the case of owner-occupied housing does not require the owner to declare the rental value of his home as income; this treatment is said to favor the homeowner over a taxpayer who invests the same funds in income-producing assets and uses the money so earned for rental housing.

Pointing to the great surge in homeownership in the period from 1948 to 1960, when owner-occupied housing rose to over 60 percent of total housing, some studies contend that favorable tax treatment of housing investment has partly contributed to this result. However, there are certain direct Federal programs that have also greatly contributed to this result, especially FHA and VA mortgage insurance, federally subsidized highways, and water and sewer grants and loans.

The same provisions that have aided carrying out the national goal of encouraging individual homeownership are accused of playing a major role in the decline of the central city, the overdevelopment of the suburbs, the promotion of land speculation, and the introduction of tax biases against renting by low-income households. The argument is that the tax advantages for homeowners have encouraged homeownership rather than rental housing and have stimulated the construction of new single-family, detached housing. Taxpayers are drawn from existing urban residences needing maintenance or rehabilitation to land at or beyond the urban fringes where conditions facilitate this new construction. Thus, it is argued, tax provisions have contributed unintentionally to both the decline of older urban areas and to the overdevelopment of the suburbs.

Recent tax law changes have substantially diminished the tax incentive for owner-occupancy by making it more attractive for many taxpayers to claim the standard deduction. In 1969 the proportion of taxpayers itemizing deductions on their returns, and thus gaining the full benefit of the tax advantages for homeownership, was estimated to be about 58 percent. After the latest increase of the amount of the standard deduction in the tax revisions of 1977, it is estimated that only 20 to 25 percent of taxpayers will find it beneficial to itemize deductions on their returns. High-income individuals, however, will be unaffected by these changes in the tax law because they will still find it worthwhile to itemize deductions. Investments that receive favorable tax treatment will continue to be undertaken by investors in high marginal tax brackets at the expense of competing investments that receive less-favorable tax treatment.

Depreciation deductions

Other major income tax provisions affecting land use are the depreciation allowances contained in section 167 of the Internal Revenue Code. These provisions allow a deduction in computing adjusted gross income for a reasonable amount of wear, tear, and obsolescence on certain types of income-producing property owned by the taxpayer. They were originally intended to permit the taxpayer to recover higher capital investment in an asset through equal, annual depreciation charges over the asset's useful life. Later, various methods of accelerated depreciation were incorporated into the Code whereby proportionally more of the taxpayer's cost of an asset can be written off in the earlier years, with decreasing allowances in later years. The amount of accelerated depreciation allowable varies, depending upon the types of property involved. For new residential rental housing the 200-percent declining balance or the sum-of-the-years-digits methods are allowed; for new commercial-industrial property the allowance is 150 percent; for used residential rental housing it is 125 percent; and for most other property only straight-line depreciation is allowed.

It has been suggested that this unequal tax treatment tends to encourage investment in new property rather than old. The more rapid depreciation accorded new construction enhances the after-tax profitability of such investment, as compared to an investment of the same amount in older property.

Until recently the profitability gap between new and old nonresidential property had been even larger than for residential. The Internal Revenue Code allowed 200-percent declining balance depreciation for new commercial-industrial property,

but only straight-line depreciation for older properties. This differential tax treatment provided an important spur to the construction of suburban shopping centers and industrial parks during the 1950s and 1960s. However, more recent changes in the income tax law have reduced the depreciation permitted for new commercial-industrial property from 200 to 150 percent.

The depreciation provisions tend to attract investment toward new construction at the expense of the rehabilitation and maintenance of existing structures. Also, the owner of old rental housing in deteriorating neighborhoods may attempt to increase the rate of return on his/her investment by cutting back on maintenance costs as higher accelerated depreciation deductions run low. In addition, the fact that the relative benefits provided by the accelerated depreciation deductions are used up in comparatively few years tends to encourage quick turnover of investment property and discourage more stable ownership.

An important tax sheltering aspect of the depreciation provisions is the allowability of such deductions as offsets against unrelated taxable income. Also, a taxpayer can calculate his/her depreciation deduction based on the total cost of the property regardless of any debt incurred to obtain the property and not limited to the taxpayer's equity in the property. For example, a taxpayer making a 10-percent down payment and borrowing the remaining 90 percent needed to finance a \$1 million building can claim depreciation on the full \$1 million building cost.

Real estate tax shelters are of particular benefit when the taxpayer can claim (1) accelerated depreciation that in the building's early years exceeds economic depreciation and (2) immediate deduction of interest and property taxes during the construction period, rather than amortizing these costs over the life of the building. Because of special tax rules governing limited partnerships, a favored form of organization for ventures in real estate development, the value of these deductions is substantially enhanced when a large share of total development cost is financed with borrowed money. However, successive changes in the tax law have gradually limited some of these benefits from depreciation and from interest and taxes during construction.

Real estate tax shelters permitting sizeable deductions against taxable income, whether from building operations or any other sources, enable the taxpayer to derive a favorable cash flow and to recoup his/her initial investment in a relatively short time. The higher the taxpayer's income tax bracket, the greater would be the cash flow benefit. Moreover,

developer/builders, who cannot fully use these tax benefits because of insufficient income for offsetting, can sell their rights to the benefits to outside investors and thus obtain the capital needed for their building projects.

The tax shelter provisions of the Internal Revenue have provided special incentives for certain housing investments, not only for commercial developers of residential housing but also for homeowners acquiring a second home for vacation use. During the last 15 years, there has been a great upsurge in the construction of vacation homes and condominiums that has significantly transformed the American landscape and greatly affected land use patterns. Statistics show, as of 1974, the subdivision of between 10 and 20 million recreation lots, the construction of about 3.5 million second homes, and an annual rate of about 150,000 newly constructed vacation units.

Recent studies of the vacation home market have shown the importance of tax policy for the development of this market, evidenced by findings that a major percentage of purchasers were motivated primarily by the benefit from tax deductions. In recognition of this trend, the Internal Revenue Service, in a ruling published in 1973, reduced the tax benefits from renting vacation homes (which enabled taxpayers to offset "paper losses" on renting a vacation home against regular income) by limiting the amount of expenses that can be deducted. The Tax Reform Act of 1976 further reduced this tax shelter by limiting the period for which the taxpayer can personally use the vacation home and also claim it as an income-producing business venture.

The Internal Revenue Code contains several special depreciation provisions enacted in recent years to positively influence investment decisions in the direction of certain desirable national goals. Of particular importance for urban housing is the allowance of 5-year accelerated depreciation for rehabilitation of rental housing for low-income families--section 167(k). The tax incentives generated by this section under the 1969 Tax Reform Act were designed to work in conjunction with the subsidy program under section 236 of the 1968 Housing Act. Although these incentives helped to increase the number of rehabilitated units, they apparently have not been as effective in stimulating the desired investment in rehabilitation as had been anticipated.

Studies of the effectiveness of section 167(k) have pointed out several questionable features of this program. ^{1/} Questions have been raised about whether investment decisions influenced by such tax inducements will result in improving the right kind of facilities by the right kind of investors and whether this is the most efficient way of doing it. In particular, the program may attract mostly high-income investors who can obtain the greatest tax benefit from accelerated depreciation but as absentee owners are not directly involved in the management and continuing maintenance of the property. Effective operation of central city housing, however, is a management-intensive activity requiring onsite supervision of and a long-term interest in the property.

Capital gains treatment

Another group of tax sheltering provisions favoring real estate investment are those providing for special treatment of capital gains and losses. This treatment generally applies to all properties held by a taxpayer, except inventory or property used in his/her trade or business. The sale of such assets will generally result in capital gains or losses, although losses may not be recognized for the sale of personal assets not used for the production of income.

Section 1202 of the Code provides that only 50 percent of a net, long-term capital gain will be taxed when the property is sold. Several other specific capital gains provisions may affect land use. Section 1034 provides for the deferral of gain from the sale of a principal residence when applied to a new residence. Section 121 allows taxpayers over the age of 65 to exclude from gross income up to \$35,000 of any gain derived from the sale of their principal residence. Section 1039 provides for the deferral of gain from the sale of a low-income housing project when applied to another such project. Section 857 provides for special tax treatment of real estate investment trusts and their beneficiaries. Also, under section 1231, gains from the sale of coal, iron ore, certain unharvested crops, or other property used in a trade or business are taxed as capital gains.

It has been pointed out that the preferential taxation of capital gains tends to steer capital investment into durable assets such as land and housing whose value is likely to appreciate over time. This may influence investors toward housing or

^{1/}Arthur A. Little, Inc., "Project Rehab Monitoring Report" (May 1971) and Touche, Ross and Co., "The Impact of Section 167(k) on the Rehabilitation of Multi-family Housing" (1974)-- both studies were prepared for HUD.

commercial development--especially in those areas that have a high rate of real estate appreciation.

Tax exemption for State and municipal borrowing

The Internal Revenue Code (section 103) exempts from taxation interest earned on bonds issued by States and municipalities for public facilities, industrial development, or pollution control purposes. This tax exemption, depending on whether it stimulates investment in urban or nonurban areas and whether it promotes modernization of existing facilities or construction of new facilities, will affect the pattern of urban development and/or suburban growth.

The use of tax-exempt bonds for financing public facilities or the installation of pollution control equipment in the central cities generally will have a favorable effect in promoting urban rehabilitation. However, such bonds issued on behalf of private industrial firms to help them finance new plants may be used to attract new industry to a nonurban area and hasten the migration from the central cities. Although the 1968 Revenue Act limited the size of most industrial development bond issues, it provided for a number of significant exceptions for specific quasi-public purpose and the use of such bonds was expected to remain popular.

Another use of tax-exempt bond financing involves the formation of municipal utility districts that are empowered to finance the installation of public facilities outside the existing public service network required for the private development of new land. Such capital costs are partially shifted to the Federal taxpayers, reducing the cost of new subdivisions to the developers and the resident and, possibly, further contributing to the expansion of metropolitan areas.

PROPOSED REFORMS OF INCOME TAXATION

A variety of changes in the Federal tax code have been discussed in literature, by public interest groups, and by officials in the executive and legislative branches of the Government, to try to mitigate what are considered to be undesirable effects on urban development and to bring Federal income tax provisions into better harmony with national housing policies. Following are some of the proposed changes and their expected effect:

- To reduce the incentive toward homeownership for high-income taxpayers.

1. A tax credit in lieu of the present itemized deductions for mortgage interest and property taxes or a ceiling on the amount of the tax savings a homeowner could claim.

--To stimulate certain types of housing construction.

1. A refundable or a nonrefundable tax credit for builder/developers.
2. A tax credit to builder/developers combined with the HUD current section 8 program.

--To stimulate maintenance of existing housing.

1. A current deduction for, or allowance of rapid writeoff of, maintenance expenses.
2. A tax incentive for maintenance tied to the builder's long-term property ownership.
3. Equal treatment of investment in new housing construction and in rehabilitation of existing housing by equalization of depreciation allowances.

--To reduce tax sheltering benefits presently favoring high-income taxpayers and commercial or speculative construction.

1. Limit deductions for accelerated depreciation to the amount of the owner's equity rather than total indebtedness, or disallow all excess depreciation.
2. Limit the deduction for business losses from accelerated depreciation to the amount of related business income.
3. Eliminate the preferential tax treatment for capital gains.

--To reduce incentives for investment in areas outside and away from the central cities.

1. Remove tax-exempt status of municipal bonds issued for certain quasi-public purposes that subsidize private industrial or residential development not clearly in the national interest.

Most of the suggested reforms are controversial, and their possible favorable or unfavorable effects on affected parties and national objectives are not well known at this time. Although there appears to be a consensus on the desirability of some changes in present tax provisions, to make them neutral toward taxpayers' investment choices, there is considerable debate over the introduction of new tax incentives specifically aimed at urban redevelopment or other national housing goals. Some critics do not advocate such incentives and believe that Federal assistance should be provided instead through direct grant or loan programs. The HUD position in this matter was expressed in the June 1977 hearings before the House Subcommittee on the City, when the Department's representative concluded:

"Tax policy cannot do everything; nor should there be an overreliance on it when there are other more direct tools available. This is not to say that tax policy, and particularly policy with respect to single-family housing, has had a neutral impact on our urban development experience. This policy has undoubtedly had a profound impact on our cities-- and I believe this study 1/will be a very useful contribution to our knowledge in this area. In this connection, we are especially appreciative of the efforts of this Subcommittee, and the CEQ, in pointing out the role of Federal tax policy in the problems of our cities."

EFFECT OF ESTATE TAX ON FARM LAND

It has been alleged for a number of years that the Federal estate tax has had an important effect on the conversion of land used for farming to its development for housing or business use. This was particularly true for farm land on the fringe of a metropolitan area, where the pressure for development increased the fair market value of the land far beyond that of its use for farming.

The effect of the Federal estate tax was felt when the owner of the property died. The farm land would be included in his estate and taxed at its highest and best use. It was claimed that the resulting estate tax would be so high that the heirs would be forced to sell the property to developers to pay the estate tax.

1/Study by Urban Institute. (See p. 27)

Until 1976, section 6166A of the Internal Revenue Code allowed the heirs to pay the estate tax over 10 years if a major part of the estate consisted of a closely held business (including farms). The interest rate on the unpaid balance was approximately at the market rate, so that the deferment of the tax provided only moderate relief for the heirs.

The Tax Reform Act of 1976 made extensive changes in the estate and gift tax law that were expected to remedy this situation. Two provisions were aimed primarily at this problem and two others will have an indirect but important effect on it. Section 2032A of the Code, as amended, provides that, if certain conditions are met, an estate can elect to value real property used for farming or in a closely held business at its actual value in such use rather than its value in its highest and best use. A major limitation is that the special use valuation may not reduce the value of the property more than \$500,000. This would, of course, reduce its usefulness for high-value intermediate or large farms.

The second provision aimed specifically at giving relief to farms and closely held businesses is section 6166. It provides that, if more than 65 percent of a decedent's adjusted gross estate consists of an interest in a farm or other closely held business, the estate may elect to defer paying the part of its tax liability that is attributable to the interest in the farm or business for 5 years (paying only interest on the liability in the meantime) and thereafter pay the tax in equal installments over 10 years. A special low interest rate of 4 percent per annum is charged on the outstanding tax liability that is attributable to the first one million dollars of the decedent's interest in the farm or business. Interest on the balance of the liability is charged at a rate that is currently 7-percent per annum.

The other two provisions that indirectly aid in preventing forced liquidation of farms are the new unified credit and the increased marital deduction. The former law provided for a \$30,000 lifetime exemption for the gift tax and a \$60,000 exemption for the estate tax. Under the new law, the gift tax and estate taxes have been integrated into a Unified Transfer Tax that includes a unified credit which is the equivalent of an exemption for gifts and estates of \$120,666 in 1977, rising annually thereafter to \$175,625 in 1981 and succeeding years.

Before the Tax Reform Act of 1976, the marital deduction (the tax-exempt amount a decedent leaves to his or her spouse) was limited to one-half of the adjusted gross estate. The new law allows a deduction up to one-half the gross estate or \$250,000, whichever is greater.

Prior exemptions were established many years ago and, because of inflation, had become somewhat unrealistic. Both the unified credit and the increased marital deduction effectively exempt or reduce the tax on relatively modest estates and facilitate retention of farms and other closely held businesses in the decedent's family. This may slow the conversion of such farm land to other uses.

CHAPTER 7

MAJOR TAX POLICY ISSUES AND THE FEDERAL ROLE

STATE AND LOCAL TAXES

Among the various taxes that may affect the ownership and management of real estate, State and local property taxes generally have been considered to have the greatest effect on land use. Much attention has been devoted in the literature to the adverse effects of property taxes and the need for reforms. One of the most strongly advocated reforms is the change to a land value tax, in lieu of the present system that predominantly taxes the improvements on the land. Many beneficial results are expected from such a reform in terms of better and more rational land use that would benefit urban redevelopment and help arrest metropolitan sprawl.

There have been opposing views, however, that caution against too optimistic expectations from the proposed land value tax and question the feasibility of making such a drastic change in what is today one of the most important sources of local tax revenues. Practical experience seems to be inconclusive about the benefits actually obtained in the few jurisdictions that introduced land value taxation in some form. More research and experimentation apparently are needed to demonstrate the claimed advantage of this proposed system of taxation, which would be a major departure from the present system.

Since most property taxation is governed by State law, the States have to play an important role to encourage efficient and equitable local assessment and enforcement procedures. The manner and strength of such supervision varies widely among individual States, and it has been suggested that the Federal Government should have a role in reinforcing the reform efforts of the States.

One particular contribution the Federal Government could make to improved property tax administration relates to the taxation of federally subsidized low- and moderate-income housing. Since no Federal guidelines exist about how subsidized properties should be valued for property tax purposes, and the uncertainty of the property tax obligation adds another risk to those borne by the investor in such properties, it would be desirable for HUD to provide some Federal guidance and help to alleviate this uncertainty. A recent GAO report to the Congress on real estate tax problems concerning HUD-assisted multifamily housing recommended that the Secretary of HUD, among other actions, establish procedures to assure

that real estate taxes assessed on both HUD--owned and insured multifamily projects are fair and equitable (CED-77-125, Sept. 27, 1977).

The problem of how to protect valuable agricultural and open space land against the encroachment of unlimited economic development and metropolitan sprawl has received increased attention by State legislatures. A majority of the States have enacted laws permitting some form of differential property taxation for farm and open space land, taxing such land based on its current agricultural use rather than its higher potential value. The various types of laws, their effectiveness, and recommended improvements in such legislation have been fully discussed in the 1976 CEQ-sponsored study "Untaxing Open Space" which presents a good up-to-date overview of this particular aspect of property taxation and land use.

As property taxation is primarily a State and local government responsibility, the Federal role in this area appears to be limited essentially to an evaluative and advisory function by assisting in research studies, evaluating effects in terms of desirable national land use policies, and stimulating improvements in legislation and administration. One appropriate way to carry out Federal activities of this nature is through sponsoring the work of private and public organizations with expertise in the area. Principal Federal agencies having special interests in the effect of property taxes on their program responsibilities are HUD (for urban land uses) and USDA (for agricultural land uses). These two agencies have, in fact, sponsored important contract studies, as has CEQ with respect to differential tax legislation for agricultural land. 1/

A more active Federal role to influence State and local property tax policies and develop a desirable national urban policy was advocated in the November 1977 discussion draft "Cities and People in Distress," submitted by the President's Urban and Regional Policy Group. The draft recommended, in order to reduce fiscal and social service disparities in urban areas, Federal efforts to ease or compensate for local property tax burdens through such methods as income tax credits or revenue sharing. The draft also proposed that the Federal Government encourage tax base sharing--similar to the system in Minneapolis-St. Paul--that could be done by requiring some regional revenue sharing as a condition of Federal grant assistance.

1/Several of these studies are cited in this study.

Another recent policy statement that pointed to the need for reexamining the role of local property taxes in the context of a Federal urban policy was issued in December 1977 by the Committee for Economic Development. The Committee raised the following questions for further consideration by its Subcommittee on Revitalizing America's Cities:

--How effective would be proposed changes in local property tax practices, such as uniform statewide assessments and differential assessments on land and improvements?

--What should be the role of the States in redistributing income through tax sharing by local governments?

Aside from property taxes, sales and income taxes are important revenue sources of State and local governments that can have a direct or indirect effect on land use by influencing a property owner's decisions on acquisition, operation, or disposition of real property. The effect of such taxes apparently has not been studied to any appreciable extent and therefore is not well known. Although this effect is probably of less consequence than property taxation, there may be effects that merit further consideration; for example, the possible effect of sales or income taxes on migration of businesses from central city areas.

The intergovernmental competition among State and local jurisdictions to attract economic activity through tax incentives has obvious land use implications and may affect Federal objectives in housing, transportation, or other fields of economic activity. Therefore, the Federal Government, although limited in what it can do by direct action, has an interest in encouraging intergovernmental cooperation, especially in metropolitan areas, and in mitigating fiscal disparities where they might affect adversely national economic objectives. Various proposals have been made as a result of recent public and private studies, which call for a more active Federal role in the form of Federal financial incentives. These proposals merit, and apparently are receiving, further consideration in the executive branch.

FEDERAL TAXES

Increasing interest has been directed by private and public researchers and policymakers to the impact of Federal taxation on land use, in particular as it affects urban housing. Both the executive and the legislative branches

of the Federal Government are currently considering reforms of Federal income taxes that might be instituted as a part of new strategies to revitalize deteriorating cities.

The President's Urban and Regional Policy Group, in its discussion draft of November 1977, has recommended a series of tax reform measures to eliminate what the Group considers "bias against financing growth in core cities."

The Group recommends that the tax code be made consistent with the Nation's urban priorities by revising those provisions that have influenced real estate investment to the detriment of older urban areas and cities in distress. Specifically, the Group favors

- special incentives to industry to locate in center cities,
- giving the owners of older properties the same benefits as those provided for constructing new properties,
- limiting interest and property tax deductions and capital gains treatment presently favoring single homeownership, and
- extending the investment credit to new construction of industrial structures and substantial rehabilitation of existing structures.

The Group does not recommend changes in the status of tax-exempt municipal bonds until a further review has been made in connection with overall tax reform. The Group cautions that any proposal to make changes in the tax code may have potential drawbacks, given the code's complex nature and as it cannot be easily targeted for specific purposes.

The President's tax proposals, transmitted to the Congress in January 1978, include several reforms that would affect land use in urban areas. One proposal would reduce real estate tax shelters by limiting depreciation allowances to the straight-line method, except for continuing the declining balance method for new multifamily housing until 1983 and for new low-rent housing on a scaled down basis after 1983. Another proposal, eliminating the alternative capital gains tax, would affect real estate transactions by high-income taxpayers. Also, the proposals would limit the use of tax exempt bonds and introduce an option to issue fully taxable bonds in conjunction with receiving a direct

Federal interest subsidy. These latter changes may restrict future economic development away from the central cities and favor economically distressed areas.

In addition, the President's proposals provide for extending the existing 10 percent investment tax credit for machinery and equipment to cover new construction and rehabilitation of industrial and utility structures and increasing the investment credit for pollution control equipment installed in existing plants. Because the proposed credit for industrial structures may give older firms an additional incentive to move out of the central city, the Congressional Budget Office, at the request of a task force of the House Committee on the Budget, analyzed the effect of the President's proposals on central cities and presented possible alternatives. 1/

Further, the President's message of March 28, 1978, to the Congress for a proposed comprehensive national urban policy proposes a differential investment tax credit of 5 percent to induce firms to locate or expand facilities in economically distressed areas. This credit would be in addition to the 10 percent investment credit proposed in the President's tax message for both structures and equipment, providing a total credit of 15 percent.

In the Congress, the Subcommittee on the City, House Committee on Banking, Finance and Urban Affairs, in its report of September 29, 1977, made several proposals intended to achieve greater neutrality of the tax code regarding (1) incentives for investment in housing versus other economic goals, and (2) incentives for new construction versus rehabilitation of existing housing. The Subcommittee proposes

- replacing homeowners' deductions by tax credits,
- providing tax benefits to renters as well as homeowners,
- phasing out certain tax shelters,

1/"Analysis of the Impact on Cities of the President's Investment Tax Credit Proposals and some Possible Alternatives," Feb. 15, 1978.

--limiting depreciation allowances to the straight-line method for both new construction and rehabilitation, and

--restricting the use of tax-exempt industrial development bonds.

The Subcommittee does not recommend new tax incentives specifically aimed at urban and regional development and expresses a preference for direct grant and loan programs. Also, the Committee believes that investment credits for plant and equipment should not be extended unless their possible adverse effect on housing investment has been carefully considered.

Minority views on the Subcommittee's proposals voice strong objections, because tax policy is not a reliable tool in seeking national homeownership objectives and proposals of this magnitude do not seem justified based on the narrow scope of the testimony received.

The effect of Federal income tax policies on housing is also treated in the May 1977 background paper on Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives which the Congressional Budget Office prepared at the joint request of the two legislative committees for Urban Affairs and the House Committee on the Budget. This study was intended to assist the Congress and the executive branch in considering alternative methods of subsidizing low- and moderate-income rental housing, in lieu of present tax shelters which at the urging of HUD the Tax Reform Act of 1976 had left unchanged for a 5-year period until 1982. The CBO study discusses alternative subsidies that could be substituted for existing tax shelter subsidies but, according to the CBO's mandate to provide nonpartisan analyses of issues before the Congress, presents no recommendations.

Besides the several proposals pending before the two branches of Government, additional proposals may be expected to be forthcoming as a result of the work now under way by the following study groups:

--The Committee for Economic Development's Subcommittee on Revitalizing American Cities.

--The National Commission on Neighborhoods, created by Public Law 95-24.

--The Rand Corporation study, "The Urban Impact of Federal Policies."

Most of the proposals to change the tax code are controversial, and it is difficult to foresee all their ramifications, not only for future trends in housing investment but also for economic effects beyond the housing area. While much useful analytical work has already been performed in the studies mentioned here and possibly others not considered in this survey, the Congress and the Administration have to deal with difficult policy issues, some of which may require further study and additional comparative analyses of alternative strategies. The following major issues are involved.

- Coordinated Federal action The formulation of tax policies that will harmonize with important national policy objectives--such as adequate housing--requires coordinated action among all Federal agencies concerned with meeting the particular objective as well as among the Congressional Committees responsible for writing tax laws and those authorizing direct Federal programs.
- Inconsistencies between tax policies and national program objectives Much research has been performed to identify provisions of the tax code that are not consistent with specific national objectives in housing and urban development. In the cases so identified, it is necessary to determine what changes in tax provisions would have to be made to make them more nearly consistent with national program objectives and to evaluate the potential effect of such changes on taxpayers' investment decisions, affected industries, and the national economy as a whole.
- Alternative strategies to achieve national objectives National policies to promote housing development, especially for low- and moderate-income families, can be accomplished through a variety of incentives made available by the Federal Government using direct subsidies, tax benefits, or a combination of the two. A consideration and evaluation of alternative strategies that may be used by the Government is a difficult, complex task. The May 1977

background paper by CBO on real estate tax shelters and alternative subsidies demonstrates the complexity of the issues involved and could serve as a model for similar analyses of other tax provisions that have been challenged (such as the use of tax-exempt industrial development bonds by municipalities).

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