Tax Structure Analysis Report
Office of the City Controller
City of Philadelphia
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Excerpts from the Report:
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Philadelphia's Real Estate Tax Distorts Incentives To Develop
Most local jurisdictions levy some form of tax on real estate. In fact, in most local jurisdictions including counties, cities, and school districts, the tax on real estate comprises — by far — the largest share of locally generated revenues. Only a handful of states levy a Real Estate Tax. The Commonwealth of Pennsylvania does not. Despite the fact that the tax may be widely levied, the effect of an indiscriminate tax on real estate may discourage development.

Because it increases the cost of owning or improving a building, a tax on buildings discourages individuals from constructing or improving their structures. Alternatively, a tax on land discourages speculation by raising the cost of holding land unused and increasing the likelihood that the owners would do something with the land to generate revenue. Economic theory would therefore suggest that removing a tax from buildings would encourage people to build more valuable buildings, just as placing a tax on land would drive land into production and encourage people to make that land more productive.

The traditional property tax is levied on both the land and the structures on it at the same rate. To encourage development and discourage speculation, many jurisdictions have altered their tax structure to place a higher tax on land than property. Pennsylvania law allows localities to introduce land-value taxation or to implement a split-rate tax that levies one tax on land and another tax on the structures and buildings upon that land. Many Pennsylvania cities including Allentown and Harrisburg employ such a split-rate tax. Under such a system, owners of vacant lots and blighted buildings pay substantially higher taxes because the system places a premium on the value of the location. Essentially, any property owner whose land is worth much more than the structure upon it would pay more under a split-rate system than under a single-rate system. By shifting the tax burden from buildings to land by taxing land assessments at a higher percentage rate than building assessments, jurisdictions like Allentown and Harrisburg have changed incentives for property usage.

Because a conventional property tax penalizes property owners who improve their properties (if the value of the property increases, the amount of taxes owed increases), speculators have an incentive to allow buildings to deteriorate and then ask for a lower property assessment. A two-rate property tax system that taxes land at a high rate and buildings/improvements at a lower rate encourages property owners to develop their properties more fully since the actual value of the improvements to the properties are taxed at a lower rate than the land upon which they sit. Because the value of the land, not the deteriorated condition of the property, would determine tax liability, owners of vacant properties would have an incentive to do something productive with that property — or sell it to someone else who will.

Theoretically, land-value taxation is more efficient than traditional property taxation. Land-value taxation does not impact production since land is already produced. If properly administered and implemented, land values are transparent to all involved parties. They can be monitored regularly so that market values can easily be reassessed. The value of land is assessed by consideration of three factors: the land's natural setting and landscape, the public infrastructure and policies (including zoning considerations) of the land's larger political jurisdiction, and the private investments and activity that surround the land.

This underscores the maxim that the three most important factors when considering purchasing property are "location, location, location." For example, a piece of land located close to a good school, public transportation, and business opportunities, would be worth more than a similar land parcel next to a vacant, garbage-strewn lot in a depressed area of the city. Similarly, because of the value of land, two otherwise identical houses will have dramatically different values depending upon where they are located. In Center City, the house may sell for hundreds of thousands of dollars while the same house located in a distressed neighborhood may command only a few thousand dollars.

The success of the city's program of Real Estate Tax abatements provides additional evidence that a shift away from high taxes on improved buildings can encourage development. Since the tax abatement for conversion of commercial and industrial buildings into residential properties freezes the tax developers pay, the developers are able to increase the value of the property without incurring a greater Real Estate Tax burden. By taxing land more heavily than improvements, the city would similarly reduce the tax increase for any improvement and move projects forward which may currently be unfeasible.

While evaluations of land-value taxation in the United States are limited, empirical evidence exists to support its theoretical attractiveness. Studying the effect of two-rate property taxes on construction in Pennsylvania in 1997, Virginia Polytechnic Institute and State University Economics Professors Florenz Plassmann and T. Nicolaus Tideman show that cities that have adopted a two-rate property tax actually enjoy significantly higher levels of construction activity than they would with single-rate taxes. Also in 1997, University of Maryland economists Wallace Oates and Robert Schwab took on the subject in The Impact of Urban Land Taxation: The Pittsburgh Experience. While pointing out that it is generally difficult to separate the effects of a tax reform from other economic events, Oates and Schwab concluded that "the reliance on increased land taxation played an important supporting role by enabling the city to avoid rate increases in other taxes that could have impeded development."

These findings were echoed in the testimony given before Pittsburgh's city council nearly two decades earlier by Carnegie Mellon University Professor and Nobel Prize Laureate Herbert Simon. When the legislative body was investigating the possible benefits of an increase in land tax rates, Simon said: "Assuming that a tax increase is necessary, it is clearly preferable to impose the additional cost on land by increasing the Land Tax, rather than to increase the Wage Tax — the two alternatives open to the city. It is the use and occupancy of property that creates the need for the municipal services that appear as the largest item in the budget — fire and police protection, waste removal, and public works. The average increase in tax bills of city residents will be about twice as great with a Wage Tax increase than with a Land Tax increase."

The Controller's Office investigated two cities with land-value taxation, Allentown and Harrisburg, to determine the development response to the shift in property taxation. Harrisburg has employed a higher tax rate on land than on buildings since 1974. Figure 4.6 shows that when the city increased the ratio of its tax on land to its tax on buildings (Harrisburg has almost doubled the ratio of the tax on land to the tax on buildings over the last 14 years) an increased number of building permits were issued and the total value of permits filed increased. According to Harrisburg Mayor Stephen Reed, the city has managed to reduce its vacant building stock from more than 4,000 to fewer than 500 during the past two decades — a drop of approximately 90 percent.

Allentown shows similar positive trends. In 1996, Allentown adopted a land-value tax system by popular vote. The enabling legislation embedded in the new Home Rule Charter prohibits city council from levying any other tax than a tax on land values to generate new tax revenue. Figure 4.7 shows that both the value for new commercial construction and the value for new residential construction are up significantly.

Such empirical evidence supports the strong theoretical basis for land-value taxation. By altering the way property is taxed, jurisdictions can alter the way property owners maintain their real estate holdings. By taxing land, local jurisdictions can encourage property owners to best utilize their properties, discourage speculators from holding land vacant and allowing buildings to decay, and — where market demand exists — encourage development. Of course, such a shift in taxation should be complemented with efforts to enforce the city's licensing laws and building regulations to further encourage owners of rundown properties to maintain their properties or sell them to someone who would. But even if taxing land would fail to change market conditions enough to drive land into production, at the very least such a move would alter the incentives presented by the tax on property to make those who own vacant and underutilized land pay more to support the city expenditures necessary to serve their properties and deal with the often-dangerous externalities associated with vacant buildings and land.

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Recommendation: Institute a Land Tax, changing the way property is taxed in Philadelphia from the current system (where the tax from structures and improvements generates approximately 77.5 percent of Real Estate Tax revenues) to a system where the tax on land and the tax on structures/improvements each generate an equal amount of revenue beginning fiscal year 2003 (July 1, 2002).

This shift would capitalize on the real estate maxim that location is the most important factor in determining the worth of a property and create a system where land is taxed at 3.44 times the rate of structures/improvements. (Such a ratio would generate half of Real Estate Tax revenue from land and half from buildings.) Modeling by the Controller's Office using data from the Board of Revision of Taxes shows that approximately 78 percent of residential taxpayers would see their Real Estate Taxes reduced with this shift, while approximately two-thirds of those whose taxes might increase would see increases of less than $100 per year. Such a shift could aid blight-removal and neighborhood-transformation efforts. By taxing the value of land more than the value of the structures/improvements that exist on it, this split-rate taxation discourages speculation and encourages development and neighborhood revitalization. Owners of vacant and underutilized land and properties would find it more costly to continue to maintain their holdings in an underdeveloped state. Those who want to construct or improve homes and buildings would pay less in the short and long run instead of being punished with significantly higher taxes on their investments. (An 18-month moratorium on reassessment of recently sold land and property could be established to give developers an opportunity to assemble land for new construction.) This shift would be budget neutral[6] in the first year — with the potential to generate additional future revenues as additional development takes place in Philadelphia — as the increased taxes on land will generate enough revenue to offset the reduction of the taxes on real property. While this shift could be accomplished in a budget-neutral manner, implementing a system to properly value land, and then support and defend those values for assessment purposes, could generate one-time and ongoing costs for the city's Board of Revision of Taxes.[7] Ongoing reassessments will then be crucial to maintaining fairness in the system and making the incentives of land-value taxation work.

6 By budget neutral, the Controller's Office means that, in this case, revenues generated by the higher tax on land and lower tax on structures will be sufficient to meet the current budgeted revenue projections for the Real Estate Tax.

7 An estimate by the Board of Revision of Taxes suggests that the cost to establish fair, defendable, and supportable land values could be between $6.2-6.7 million per year. The Controller's Office notes that this estimate would nearly double the budget of the Board of Revision of Taxes and, therefore, may be seen as somewhat liberal.