// Incentive Taxation

CENTER FOR THE STUDY OF ECONOMICS

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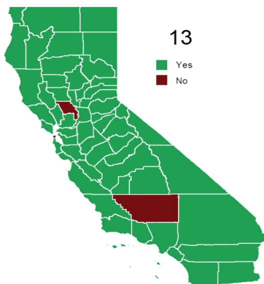
PROP 13: HOW TO HAMSTRING PARADISE

Intense debate over Prop 13 continues as **California**'s economic woes intensify. Lefties continue their claim that high income and cap gains taxes have nothing to do with dropping receipts in a recession, while Righties claim that Prop 13 has nothing to do with the state's eroded school system.



A state that once had high property taxes, wealth, and opportunity for all is now 38th in property tax incidence. Since the proposition's passage, the *Sunshine State* has been harnessed with a witches' brew of sales taxes, in-state capital gains taxes, and high marginal income tax rates. The squishiness of taxation is clear in California: tamp down one tax, hike another, and the subject of taxation moseys on down the road.

No sober observer now denies that there is an outflow of high and middle income earners from California to **Utah**, **New Mexico**, **Texas** or **Colorado**, and the inflow is poorer or immigrant families. The result, broadly, is *tax receipts* emigrating and new property owners paying property taxes many times higher than a similar house in a similar location. Large commercial properties manage this scenario by keeping the title to their property in a shell, while selling or merging elsewhere on the company's books. Small businesses cannot use this luxurious opt out of Prop 13. The center cannot hold.

When California instituted a cap and replaced it with statewide taxes, it made those taxes become more volatile. Success for Prop 13 depended on the mobility of Californians: a constant churn of properties, since a sale brought about a reassessment to keep all the balls in the air.

There is one fair level-the-playing-field solution to Prop 13's inequity and the disappearance of capital from the taxman's hand and that is to raise revenue from a very stable, solid tax - land value tax (LVT). The numbers in practice elsewhere indicate LVT will make it possible to fund government, not hurt new homeowners, families and immigrants, and will permit the reestablishment of an economy based on initiative and effort rather than rent-seeking and gaming the system.

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D.C. WALTZES AGAIN WITH LVT

WALTER RYBECK and JOSHUA VINCENT

The lead to the recent Washington Times story[1] gives LVT backers hope.

The DC government doubled the annual property tax rate from 5 percent to 10 percent for unoccupied residential buildings and vacant lots known as "Class 3" properties. The new tax rate will be reflected on the bills, which cover the period from October 2008 through March 2009.

Once again, the tale of two cities plays out. LVT has been on and off in the U.S. capitol since the mid-1970's. Movement to LVT, led by committed advocates and dozens of neighborhood and policy groups, always was tantalizingly close.

Back in 1990, there were four classes of DC real estate:
Class 1: Owner-occupied residential (rate = less than 1% of assessed value)
Class 2: Non- owner occupied residential (rate = 1.5% of assessed value)

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D.C. Waltzes again with LVT

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Washington, D.C.

THE D.C. GOVERNMENT DOUBLED THE ANNUAL PROPERTY TAX RATE FROM 5 PERCENT TO 10 PERCENT FOR UNOCCUPIED RESIDENTIAL BUILDINGS AND VACANT LOTS KNOWN AS "CLASS 3" PROPERTIES. THE NEW TAX RATE WILL BE REFLECTED ON THE BILLS, WHICH COVER THE PERIOD FROM OCTOBER 2008 THROUGH MARCH 2009. *BERT V. GOULAIT/THE WASHINGTON TIMES.*

Class 3: Hotel/Motel (rate = 1.8% of assessed value)
Class 4: All Other -- commercial / industrial / vacant land (rate = 2.13% of assessed value)

DC assessments are assumed to reflect 100% of market value. Assessments are based on data that is generally about 2 years old. In rising markets, properties appear to be under assessed. In falling markets, properties appear to be over assessed. Owner-occupied residential also benefits from a homestead deduction - an amount (which changes from time-to-time) that is deducted from the assessed value before the tax rate is applied.

In 1990, a push was made for a split-rate tax. Real estate interests were very opposed, but some of the Council members understood the popular resentment against vacant properties. So, they enacted "feel good" legislation that created a penalty tax of 5% on vacant land and unoccupied buildings. This became "Class 5" property. According to the legislation, parking lots were considered "improved" because the owners insisted that flimsy shacks and paving, often crumbled, constituted improvements, although any purchaser of the lots would consider them detriments. So, they were taxed as Class 4 property.

The Pro-Housing Coalition was formed when homelessness became a hot issue, nationally and locally. A study found that DC had about 7,000 vacant dwelling units and about 10,000 vacant but usable private parcels. This incongruity of people living on the streets while building lots remained idle and while housing was boarded up created great anger and concern.

The Coalition attracted an impressive list of clergy and housing activists who agreed that a tax shift off buildings and onto land would create pressure to put the unused sites and dwellings back to use. The DC council was under pressure to act. It was in this climate that the powerful Board of Trade, and especially the powerful parking lot owners within the Board, were determined not to let any LVT version succeed. Instead, John Wilson, chair of the Finance and Revenue Committee of the council, proposed the setting up of a new vacant class.

The League and Pro-Housing Coalition strongly opposed that as administratively unsound, and without the self-policing features of a split-rate tax.

This was "feel good" legislation because it gave the appearance of bold action while doing relatively little. The loopholes were so broad, that out of more than 10,000 vacant properties, only about 2,000 were liable for the tax. For example, "for sale" properties were exempt. How hard is it to plop a "For Sale" sign on a vacant property? Another exemption was for properties damaged by fire. Not surprisingly, arson cases more than doubled after enactment.

"Class 3" property in Washington, D.C.

Folks who supported the split-rate opposed the "Class 5" legislation because it would not discourage speculation and reduce the penalty for property maintenance or improvement. It would encourage arson, be administratively burdensome and arbitrary. (How long is too long for a property to be vacant?) Some arbitrary time must be chosen. It's not easy for the tax department to determine whether property is vacant or how long it has been vacant. Then, as soon as the department has its list of properties that have been vacant too long, the list is obsolete. Over the years, the exemptions were tinkered with and the "for sale" exemption was dropped.)

In the late 1990s, the Council decided to simplify the property tax system. The classification system was paired down to three classes (Residential, Non-Residential, Vacant).

Then, the vacant tax was dropped. About two years ago, as the article indicates, the vacant property tax was reinstated for revenue-raising purposes. Revenue from land underused or vacant is becoming a greater source for the DC government. Is this a move forward? We can hope, yes. But, if that revenue is structured to encourage arson, to make it more difficult to repair or improve vacant property, or if it scares away people who would do so, then this is not a productive direction.

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D.C. Waltzes again with LVT

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The new rates per $100 of assessed value:

1. $0.85 Residential real property, including multifamily
2. $1.65 Commercial and industrial real property, including hotels and motels, for the first $3 million of assessed value.
   $1.85 Commercial and industrial real property, including hotels and motels, for assessed value more than $3 million
2. $10.00 Vacant real property

[1]http://www.washingtontimes.com/news/2009/mar/02/dc-rehabbers-decry-10-tax-rate/

"Revenue from land underused or vacant is becoming a greater source for the DC government. "

Commentary

Robert DeNigris

As Foreclosures Surge

The current administration sat by in April as 12 Senate Democrats joined 39 Senate Republicans to block a vote on an amendment that would have allowed bankruptcy judges to modify troubled mortgages.

Then-Senator Obama campaigned on the provision. And President Obama made its passage part of his anti-foreclosure plan. It would have been a very useful prod to get lenders to rework bad loans rather than leaving the modification to a judge.

But when the time came to stand up to the banking lobbies and cajole yes votes from reluctant senators — the White House didn't.

"But when the time came to stand up to the banking lobbies and cajole yes votes from reluctant senators — the White House didn't."

Mr. Obama's plan to keep struggling Americans in their homes now relies on lenders to voluntarily rework bad loans. The plan provides ample incentives, including payments to servicers who successfully modify loans and, in some cases, payments to mortgage investors who agree to modifications. Whether that will be enough remains to be seen.

The administration estimates that its plan will prevent three million to four million foreclosures, but it will take several months before there is enough data to evaluate. In the past, however, voluntary modifications have failed to curb the rise in foreclosures. The number of foreclosure filings in March was very high, with estimates between 290,000 and 341,000.

Even if lenders do agree to modify loans, many Americans will still be in trouble. That's because nearly 14 million homeowners are "under water" — they owe more on their mortgages than their homes are worth.

In a bankruptcy, such homeowners would likely have their loan principal reduced, lowering their payments and helping them to rebuild equity. In a typical voluntary loan modification, however, the monthly payment is reduced, but not the principal. That puts under-water borrowers at high risk of re-default, because there is no equity to fall back on if a financial setback leaves them unable to make mortgage payments.

The negative feedback loop — foreclosures begetting falling home prices, which beget foreclosures, further weakening the banks — is well under way. We hope the president's plan can break the
loop, but without bankruptcy reform it is going to be a lot harder.

The Senate balks at allowing bankruptcy judges to modify troubled mortgages: but what about those 14 million homeowners?

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Commentary

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Yet the Obama administration now wants to provide incentives to loan servicers and mortgage investors to voluntarily modify mortgages. Why can't we try to help out these people directly?

We have already given too much away. The government should assess the value of the buildings on these mortgaged properties (insurance replacement costs) and lower these mortgages to that amount. Since the rest of the mortgage covers the cost of land, the government should buy that land outright, and pay the banks for it. This will reduce the mortgages of those in trouble, and get money into the hands of bankers. The land the government will now hold should be leased back to its former owners, at an affordable cost, and will generate revenue to the government for eons to come. This is called a land value tax.

"Mr. Obama's plan to keep struggling Americans in their homes now relies on lenders to voluntarily rework bad loans."

Robert DeNigris Trustee of Ardentown, DE (a land value tax community)

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