A Tax Reform Plan for Local Government

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A proclamation that the era of Big Government is over, by a Democratic President no less, is a wake-up call to tax reformers to contrive how to finance a power shift from Washington to the grass roots. Without a tax structure suited for Little Government, decentralization will be difficult to achieve, and impossible to sustain.

Block Grants No Answer. Many mistakenly hope to restore local power via massive no-strings-attached federal block grants, but federal money will have to be restricted if the budget is to stay balanced.

Experience, moreover, warns that the dispensing of federal grants is almost invariably followed by revelations of dubious use of funds in some communities. Public rejections of Congress and federal agencies to re-attach strings. Red tape and supervision by distant bureaucrats, which now cry out for reduction or elimination, surely will be revived if Uncle Sam’s money is involved.

Some mayors and governors are already bickering over who will get Uncle’s money and under what terms. Genuine empowerment requires that they collect and control their own income and stop going hat in hand to Washington for funding. “Who pays the piper calls the tune.”

Perils of Local Taxes. Raising nonfederal taxes also is replete with pitfalls. Cities and states are under pressure to keep taxes low. Businesses and individuals rightfully insist, “Give us low taxes or we’ll take our marbles elsewhere.”

Beyond that, most local taxes are horrors. They undermine the interests of communities, producers, and homeowners. They are grudgingly accepted as necessary evils. Raising them substantially would magnify their negative impacts, making them intolerable.

The urgent need is to identify a tax that does not drive jobs and businesses away or put jurisdictions at a competitive disadvantage.

Waiting in the Wings. Such a tax exists. It is the two-rate tax, tailor-made for these times and circumstances. Also called a two-tier tax or modified land value tax, it promotes growth while generating adequate revenues. Yet its successful applications here and abroad are a well-kept secret, perhaps because the device is embedded in a tax people love to kick, the property tax.

The conventional property tax deserves kicking. Its incentives are upside-down. It penalizes with higher taxes what communities acutely need — construction and repair of homes and commercial structures, and the job creation associated with these activities. It rewards with lower taxes those who hold land idle or let buildings deteriorate.

These destructive features of taxes on buildings obscure the constructive part of the property tax — the tax on land values — which recycles community values created by population growth and public works.

Some cities have turned the property tax right-side-up, using the two-rate system to greatly reduce taxes on privately-created improvements and to increase tax rates on socially-created land values.

Pittsburgh pioneered this approach. A study by University of Maryland economists Wallace Oates and Robert Schwab shows Pittsburgh dramatically out-performed comparable Rust Belt cities and that its growth was concentrated in the center, not the suburbs. Over a dozen Pennsylvania cities followed suit with consistently good results: more private downtown renewal and affordable housing plus tax relief for most homeowners.

A Pro-Enterprise Strategy. The two-rate tax attracts new business and expedites expansion of existing ones. A land tax, as Adam Smith noted, uniquely imposes no deterrent to production.

A majority of New Zealand and Australian localities took taxes off buildings altogether, taxing land values only. Because the two-rate tax can be introduced gradually, American cities typically start with a small differential (land tax rate twice the rate on buildings), then increase the ratio later. Pittsburgh, for example, now taxes land values at a rate six times higher than on buildings.

Untapped Riches. Are large doses of federal aid still needed by central cities and poor states? Less than one might suppose. Despite the blight and outmigration plaguing many cities, most have a rich lode of land values. Urban ills are often blamed on high land prices. Given a proper tax structure, this “problem” can be part of the solution to heal central cities.

Many low-income states such as those in Appalachia are land rich. Failure to tax natural resources adequately forces them to over-tax production, wages and commerce. Tapping the land value of their coal and minerals would go a long way toward freeing their citizens from grinding chronic poverty.

Conspiracy vs. Desperation. Big Government was not foisted on America by some dark conspiracy. It arose when cities and states were seen as failing to cope with basic human services during the Great Depression. People in desperation followed national leaders who promised to address their needs. But as a result, government grew at all levels.

This should be recalled because, unless states and local governments put their houses in order and successfully operate close-to-home government, present moves toward decentralization almost certainly will be derailed by another call for the feds to come to the rescue.

This can be averted if tax reformers, who have focused almost exclusively on federal revenues, pay attention to requirements for a new tax climate on the home front. They can make a good start by spreading the good news that the two-rate tax would give cities, counties and states a means to thrive under their own steam.