Professors and the Land Tax

BY FRED HARRISON

A HIGH-POWERED Californian professor flew into London to study the British land market under Mrs. Margaret Thatcher's tenure of 10 Downing Street.

George Lefcoe, Professor of Law at the University of Southern California, held top-level ministerial talks in Westminster and probed the operations of such innovations as the enterprise zones.

And he gave his conclusions in an interview: "When one thinks of all the issues – local finance, declining inner cities, public housing – these are big questions to which very small answers are being given."

The British government, he said, had adopted an incremental approach which was risk-averse.

"These are very cautious public policies. Reagan has upset a good deal of American political practice by making very large changes. The Thatcher programme is incremental, a modest one that builds on the past."

He then talked about fiscal policies, and gave support for a limited form of land value taxation. "It is legitimate to tax sites to offset the cost of new infrastructure which benefits those sites. I don't understand why the concept of special benefit assessment isn't the logical late-20th century revival of Henry George.

"Once a certain number of owners lay claim to an infrastructural improvement, it is perfectly proper that they should be asked to pay for it out of the increased value of their sites. We do this with developers in California."

He opposed, however, the full capture of the annual economic rent of land as a general property tax. As an influential authority on land law, then, his views are worth scrutinising in some detail.

THE PROFESSOR believes that there is a role to be played by land speculators – and, therefore, that a serious shortcoming of the policy of taxing the economic rent of land is that it undermines the speculative function.

As Lefcoe declared: "There *is* a justification for land speculation; speculators hold land out of use which ought not to be put to immediate use.

The argument rests on the claim that speculation maximises the allocation of resources to their best use. The reasoning goes like this. There may be a short-term use to which a site would be put if the owner were obliged to pay a tax on economic rent. But the yield would be less than the alternative use to which the land could be put in the *future*.

By compelling the owner to use his site now, the tax enforces a waste of resources. For either

- the current investment is prematurely written off when the high-yield activity becomes viable; or
- because of the initial investment, the high-yield activity is unduly postponed, thereby reducing both long-term entrepreneurial profits and consumer satisfaction.

THE PLAUSIBILITY of this objection can be readily undermined.

One could use this argument to defer indefinitely *all* changes in land use (if we assume a dynamic, growing society). For there is nearly always a better use to which land could be put at a later date.

● **George Lefcoe**

> **In other words, if you do not undertake investment in Time A, because you can get more for your money in Time B, then in Time B it follows that there will be an even higher return to be gained by deferring development until Time C – and so on.**

And that, of course, is the reasoning of the speculator. Where the fiscal carrying-costs of land are low (as in the US) or zero (as in Britain) it pays the owner to defer using his land until it suits his financial arrangements to sell up and make a capital coup.

Lefcoe's defence of speculation is known as the doctrine of ripening costs, which can be traced back to Richard T. Ely in the 1920s. He opposed Henry George, the American economist who popularised the concept of land value taxation.

In recent years, however, this doctrine has been systematically demolished by one of Lefcoe's colleagues at the University of California, Prof. Mason Gaffney, chairman at the Department of Economics at Riverside.

THE DOCTRINE of ripening costs is classified by Gaffney as a debating ploy. He itemises some of the weaknesses of the argument:

- It looks only at one side – the benefits of deferring use – and not at the costs.
- It overlooks the interdependent nature of urban land uses, by presuming that the owner's advantage is everyone's advantage; in fact, the withholder increases his certainty by imposing uncertainty on others.
- It sidesteps the question of why, if idle land is not ripe for a new use, it has been removed from its previous use.

Most important of all, the doctrine fails to supply any criterion of ripeness. Gaffney argues that, once such a criterion is developed, the weakness of the argument is exposed.

Lefcoe claims that we cannot know objectively when the correct time has arrived for a change in the use of land:

> **"At time zero it is the way of the world that one seldom knows in advance when it will have turned out to be the best time."**

Therefore, because of this lack of omniscience, it is better not to compel people (through the fiscal system), to undertake developments which – presumably through the exercise of their intuition – they would rather not finance. Far better to allow the individual to carry the risk of making a mistake – at his expense, and

Can the land tax produce a net loss for society?

PROF. George Lefcoe's objection to the *ad valorem* t x economic rent of land is a two-pronged attack.

For he also claims that the tax could cause a net lo s community. His proposition goes like this:

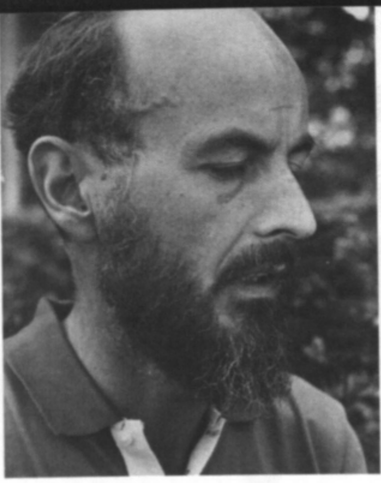
> **Land value taxation cannot cope with a situation by compelling an improvement in the use of lan location, it reduces the value of land in another lo produce a net loss.**

The hypothetical situation is illustrated with Cases 'A' In the first, the introduction of land value taxation values in Location II by –5, but there is room to comp for there is a net gain of +5, as a result of the increas values in Location I.

But what about Case 'B'? Here, there is a net loss o tax has reduced values by 10 in Location II, but economic regime has pushed up values in Location I b 7. Was the change worthwhile? Isn't the community the overall?

THIS ARGUMENT against an annual tax on land va unconvincing.

- **Planners who establish new land use restrictions r upset the existing selling prices of land, but they ar required to show a net financial gain. So why should reformer be confronted with such an obligation?**
- **Is the assertion true? Values can come down in o while rising in another. For example, late in the 19th the invention of refrigerated ships enabled the Au farmers to break into European markets with beef and This forced down British farmland values, and raised Au land values. Was there a net gain? The data would not**



● **Donald Shoup**

● **Mason Gaffney**

not society's – by allowing him to freely decide when to put the land to a new use.

MASON GAFFNEY has developed a criterion for judging when a tract has ripened and is ready for an alternative and better use.

Ripeness, he says, arrives "when the value imputed to the site by each succeeding year's hypothetical optimal building stops rising faster than the interest rate."[1]

By using this criterion, a rational judgment can be made about when to improve the use of land.

Entrepreneurs exercise such a judgement every day. Those who misjudge their decisions – or have a vested interest in avoiding investment altogether – like to shift the blame. As Gaffney put it:

> **"There is a tendency for people to attribute their actions to taxes in order to divert responsibility (without authority) to the broad shoulders of city hall. This may be why we hear so often that land is being developed prematurely 'because of taxes'."**

He does not deny that there is a rationale for reserving land for a higher use in the future, however. But on the whole, "this rationale is a rationalisation, a less-than-half-truth blown into a whole truth. It overlooks the fact that most of the costs of waiting are borne by the public while most of the benefits go to the owners."[2]

ULTIMATELY, the speculator can be asked to put his money where his mouth is. Gaffney puts the argument in more scholarly terms:

"In those rare cases where it is economical to withhold land for ripening, the taxing of land values will not interfere with his doing so.

"The holder will simply invest a few years' taxes economically in reserving the site for the alledged future higher use. If it is not economical for him to do so, why, that is the evidence that the higher future use is not that much higher to justify the cost of wasting the present rents to achieve it.

"A simple way to perceive it is that the holder invests foregone current rents in order to secure higher future rents. A common way of expressing this is that he maximises the discounted cash flow over time."

Sound – in terms of economics and ethics – though this final argument is, it may not encourage people to support land value taxation. For it invites this well-worn challenge: why should people with a low income – say, the proverbial widow living on a high-value site – be compelled to pay a market-determined land tax out of a meagre income?

An answer to such an objection can be developed from the work of another Californian professor, Donald Shoup, of the School of Architecture and Urban Planning in Los Angeles.[3]

Shoup proposes that greater use should be made of the right to defer property tax payments. Liability would not be eliminated, for owners would finally end up by paying precisely the same amount. But the tax liability would be met out of future cash receipts – either when the owner's income rises, through career advancement, or out of the proceeds from the sale of the property.

If the owner died, the tax authorities would have first claim on the estate. And since the deferred taxes would be subject to interest payments, the community would not have lost a penny on the deal.

Thus, the owner may argue that he would make more money in the future if he did not put the land to immediate use. The authorities could then agree to defer current taxes, which they would recover out of the future high-yield use. There would be no difficulty in establishing legal safeguards to ensure that the community did not lose out.

This modified approach would neutralise the argument that land value taxation imposed the risk of wasting resources, through investment in low-yield capital projects or through a distortion in the pattern of land use.

And by giving the option to the landowner, it would enhance the political acceptability of the land tax in the eyes of the public.

REFERENCES
1. M. Gaffney, 'Replacement of Individual by Mass System', *Proceedings of American Real Estate and Urban Economics Association*, Vol. 4 (1969), pp. 21-68.
2. M. Gaffney, 'The Synergistic City: Its Potentials, Hindrances, and Fulfillment', *Real Estate Issues*, Winter 1978, p. 55.
3. 'Financing Neighborhood Public Investment by Deferred Special Assessment', *National Tax Journal*, Dec. 1980.

us to answer that question, but this did not count as a reason for holding up scientific, technological and economic progress.

● **Private sector decisions can destroy land values in one area and raise them in others. If Walt Disney Productions decided to move their Magic Kingdom from Orlando to Key West, the land values in central Florida would drop dramatically. Such decisions are taken regularly by individuals and firms: are *they* ever required to justify themselves on the basis that they will injure neighbouring land values?**

● **The objection assumes that there ought to be a net gain, to compensate the injured parties. This is an equity argument that depends upon one's viewpoint. Land values are socially created, so can there be a moral justification for compensating the owners of affected land? Hardly! Capital owners may suffer, however (where their investments were "lumpy" and could not be reallocated to alternative uses without a loss); and employees would incur the cost of relocating themselves in a new area of employment. These costs could be legitimately met out of public funds, and would not be conditional on a net gain in shift of values as between two specific locations. Such compensation, however, would be an innovation today; for the tax authorities are regularly imposing new forms of taxation which injure the earning capacities of capital and labour – and this is done without offering compensation.**

● **A net financial loss, if it actually occurred, need not represent a worsening in welfare, if the non-cash benefits (e.g., conservation of natural resources) are taken into account. Lefcoe's argument leaves these considerations aside. But a net loss to the central exchequer – which would indeed be serious for a government which relied on the Single Tax (raising revenue exclusively from the economic rent of land) – is inconceivable. The normal trend is to higher productivity, growing populations, increasing consumer demands – the ingredients which force up land values. Can it be maintained that, under a regime of land value taxation, economic activity would regress to a lower level than has already been attained?**

● **Even if the argument were true as between two identifiable locations, the nation-wide benefits would override the local loss. For under the present fiscal system, society loses more by *not* having land value taxation. Given the enormous waste of natural resources arising from conscience-less speculation, the extra costs imposed on household budgets due to urban sprawl, the aesthetic impoverishment of the social environment – the list is a long one – little force can be attributed to this particular argument advanced by Prof. Lefcoe.**

CASE 'A'

	Location I	Location II
Time a	35	35
Time b	45	30
	+10	– 5

CASE 'B'

	Location I	Location II
Time a	35	35
Time b	42	25
	+ 7	–10