Is a land value tax the solution to our housing affordability problem?

By Catherine Cashmore
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There's been a lot of debate around property taxation in Australia - significantly negative gearing, which allows an investor to use the short fall between interest repayments and other relevant expenditure, to lower their income tax.

The policy promotes speculative gain meaning the strategy is only profitable if the acquisition rise in value rather than holding or falling - therefore, in Australia, investor preference is slanted toward the established sector – the sector that attracts robust demand from all demographics and as such, in premium locations, has historically gained the greatest windfall from capital gains.

Aside from the impact this creates in terms of affordability (pushing up the price of second-hand stock, burdening new buyers with the need to raise a higher and higher deposit just to enter ownership), it also negatively affects the the new home market, which traditionally struggles to attract consistent activity outside of targeted first home buyer incentive; albeit, the headwinds resulting from planning constraints and supply side policy should also not be dismissed.

Additionally, capital gains tax and stamp duty have also received much debate. Both are transaction taxes, and therefore have a tendency to stagnate activity, acting as a deterrent to either buying and selling.

Stamp duty, as modelled by economist Andrew Leigh, is shown to produce a meaningful impact on housing turnover, leading to a potential mismatch between property size and household type – a deterrent to downsizing and therefore selling.

Additionally, it burdens first time buyers by increasing the amount they need to save in order to enter the market and frequent changes of employment concurrent with a modern day lifestyle, are hampered as owners, unwilling to move any meaningful distance outside their local neighbourhood, search for work in local areas alone.

But, outside of academia and intermittent articles, there is scant debate in Australian mainstream media regarding land value tax and it's practical impact.

The theory is taken to its extreme and best advocated by American political economist and author, Henry George, who wrote his publication *Progress and Poverty* - an enlightened and impassioned read - and subsequently inspired the economic philosophy that came to be known as 'Georgism.'

The ideals of Henry George reside in the concept that land is in fixed supply, therefore we can't all benefit from economic advantage gained from 'ownership' of the 'best' sites available without effective taxation of the resource.

George advocated a single tax on the unimproved value of land to replace all other taxes – something that would be unlikely to hold water in current political circles. However, his ideals won favour amongst many, including the great economist and author of *Capitalism and Freedom,* Milton Friedman, and other influential capitalists such as Winston Churchill, who gave a powerful speech on land monopoly stressing:

"Unearned increments in land are not the only form of unearned or undeserved profit, but they are the principal form of unearned increment, and they are derived from processes which are not merely not beneficial, but positively detrimental to the general public."

In essence, raising the percentage of tax that falls on the unimproved value of land has few distortionary or adverse affects. It creates a steady source of revenue whilst the landowner can make their own assessment regarding the timing and type of property they wish to construct in order to make profit without being penalised for doing so.

However, when the larger percentage of tax payable is assessed against the value of buildings and their improvements – through renovation, extension or higher density development for example –

not only can those costs be transferred to a tenant, there is less motivation to make effective use of the site. This has a flow on effect which can not only exacerbate urban ‘sprawl’, but also increase the propensity to ‘land bank.’

The Henry tax review commissioned by the government under Kevin Rudd in 2008 concluded that “economic growth would be higher if governments raised more revenue from land and less revenue from other tax bases,” proposing that stamp duty (which is an inconsistent and unequitable source of revenue) be replaced by a broad based land tax, levied on a per square metre and per land holding basis, rather than retaining present land tax arrangements.

The Australian Housing and Urban Research Group attempted to mimic the proposed changes using their AHURI-3M micro-simulation model in a report entitled *The spatial and distributional impacts of the Henry Review recommendations on stamp duty and land tax* .

And whilst it’s difficult to qualify how purchasers may factor an abolition of stamp duty into their price analysis, perhaps adding the additional saving into their borrowing capacity, and therefore not lowering prices enough to initially assist first homebuyers. It does demonstrate how over the longer-term falls in house prices have the potential to exceed the value of land tax payments, assisting both owner-occupier and rental tenant as the effects flow through.

Additionally, increasing the tax base would provide developers with an incentive to speed up the process and utilise their holding for more effective purposes.

And importantly for Australia, it can provide a reliable provision of revenue to channel into the development of much-needed infrastructure.

The rational for this is coined in the old real estate term ‘location, location, location.’ Everyone understands that in areas where amenities are plentiful – containing good schools, roads, public transport, bustling shopping strips, parks, theatres, bars, street cafes and so forth – increases demand and therefore land values, invoking a vibrant sense of community which attracts business and benefits the economy.

The idea behind spruiking a 'hotspot', such a common industry obsession, is based on purchasing in an area of limited supply, on the cusp of an infrastructure boom such as the provision of a new road or train line for example, enabling existing landowners to reap a windfall from capital gains and rental demand for little more effort than the advantage of getting in early and holding tight whilst tax payer dollars across the spectrum fund the work.

Should a higher LVT be implemented, the cost and maintenance of community facilities could in part, be captured from the wealth effect advantaging current owners, compensating over time for the initial outlay. Imagine the advantage this would offer residents in fringe locations who sit and wait for the failed 'promises' offered, when they migrated to the outer suburbs initially.

Take New York for example – between the years 1921 and 1931 under Governor Al Smith, New York financed what is arguably the world's best mass transit system, colleges, parks, libraries, schools and social services shifting taxes off buildings and onto land values and channelling those dollars effectively.

The policy influenced by Henry George ended soon after Al Smith's administration, and eventually lead to todays landscape - a city built on a series of islands, with limited room to 'build out' facing a chronic affordable housing shortage with the population projected to reach 9.1 million by 2030.

More than a third of New Yorkers spend half their pay cheque on rent alone yet like London, there is little motivation for developers to build housing to accommodate low-wage workers concentrating instead on the luxury end of market, broadening the gap between rich and poor as land values rise and those priced out, find little option but to re-locate.

New York's Central Park is the highest generator of real estate wealth. The most expensive homes in the world surround the park with apartments selling in excess of $20 million, and newer developments marketed in excess of $100+ million.

Like London it's a pure speculators paradise – in the 10 year period to 2007, values increased by 73% - owners sit on a pot of growing gold and there's little to indicate America's richest are about to bail out of their New York 'addiction' with an expansive list of A-list celebrities, high net worth individuals, and foreign magnates, owning apartments in the locality.

New mayor-elect, Bill de Blasio, who won his seat, based on a promise to narrow the widening inequality gap - preserve 200,000 low and middle income units, and ensure 50,000 affordable homes are constructed over the next decade, will struggle to subsidize plans whist facing a deficit reputed to be as much as $2 billion in the next fiscal year.

Yet economist Michael Hudson has recently assessed land values in New York City alone to exceed that of all of the plant and equipment in the entire country, combined.

Currently more than 30 countries around the world have implemented land value taxation - including Australia - with varying degrees of success not only based on the percentage split between land and property, but how those funds are channelled back into the community and the quality of land assessments in regularly updating and estimating value.

Pennsylvania is one such state in the USA to use a system which taxes land at a greater rate than improvements on property – I think I'm correct in saying 19 cities in Pennsylvania use land value tax with Altoona being the first municipality in the country to rely on land value tax alone.

Reportedly, 85% of home owners pay less with the policy than they do with the traditional flat-rate approach. When mayor of Washington county, Anthony Spossey, who also served as treasurer from 2002 to 2006 and under his watch enacted an LVT, was interviewed on the changes in 2007, he commented:

"LVT ..helps reduce taxes for our most vulnerable citizens. We have an aging demographic, like the county, region and the state. Taxpayers everywhere are less able to keep up with taxes, and that hurts revenue. LVT helps us mitigate the impact both to them and the city. It's a win/win."

Until fairly recent times, another good example to cite is Pittsburgh. Early in the 1900s the state changed its tax system to fall greater on the unimproved value of land than its construction and improvements.

Pittsburgh's economic history is a study in itself, and has not been without challenges. For those wanting to research further, I strongly advocate some of the writings of Dan Sullivan - (former chair of the Libertarian Party of Allegheny County, (Pittsburgh) Pennsylvania) - who is an expert on the economic benefits of LVT and has written extensively on the subject.

Sullivan demonstrates that Pittsburgh not only enjoyed a construction boom whilst avoiding a real estate boom under a broad based LVT system, but also effectively weathered the great depression whilst maintaining affordable and steady land values along the way.

In comparing it to other states struggling to recover from the recent sub-prime crisis he points out:

"In 2008, just after the housing bubble broke, Cleveland led the nation in mortgage foreclosures per capita while Pittsburgh's foreclosure rate remained exceptionally low. Since then, the foreclosure rates in Las Vegas and many Californian cities, none of which collect significant real estate taxes, have passed Cleveland's foreclosure rate. However, on September 15, 2010, The Pittsburgh Post-Gazette *reported that while at the end of the second quarter of 2010, 21.5% of America's single-family homes had underwater mortgages (the American term for negative equity), only 5.6% did in Pittsburgh. As a result Pittsburgh was top of a list of the 10 marketswith the lowest underwater mortgage figures."*

When land value tax is implemented - with the burden taken of buildings and their improvements, ensuring good quality assessments and sensible zoning laws – it not only assists affordability keeping land values stable, but also benefits local business through infrastructure funding, discourages urban sprawl, incites smart effective development of sites, reduces land banking, and as examples in the USA have demonstrated – assists in weathering the unwanted impacts of real estate booms and busts.

Despite the numerous examples across the world where a broad based land value tax has been deployed successfully, changing policy and bringing about reform is never easy and rarely without complication.

Additionally, the implications of a yearly tax on fixed low-income retirees must be handled with care and understanding, as there are ways to buffer unwanted effects whilst changes are implemented.

Therefore, the process adopted in the ACT which is abolishing stamp duties over a slow transitional 20 year period to phase in higher taxation of land is not altogether unwise.

With any change to the tax system, the headwinds come convincing the public that it’s a good idea. In this respect balanced debate and conversation is necessary, as questions and concerns are brought to the fore.

The increased tax burden also falls on those who have significant influence across the political spectrum; therefore strong leadership to avoid lobbying from wealthy owners with vested interests is essential.

Albeit, as I said last week, we have a new and growing generation of enlightened voters who are well and truly fed up with battling high real estate prices, inflated rents, and care not whether it’s labelled as a ‘bubble’ – but certainly care about their future and that of their children.

Therefore – I do see a time when all the chatter around affordability, will finally evolve into real action – and a broad based LVT should form an important part of that debate.