

## LAND TAXATION AS AN INSTRUMENT OF LAND POLICY

BY

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Currently there are a number of programs being actively utilized, largely in urban fringe areas that combine the public revenue potential of the land tax and improvement of the degree to which land use fosters greater liveability. The programs selected for brief consideration vary considerably in the degree to which revenue and the degree to which land use is emphasized.

An aspect of programs of the type considered here, that is not evaluated, is the perception the community has of the fairness of the approach. Certain industries, for example, agriculture, timber and recreation, feel that somehow they are being asked to bear too large a portion of the environmental preservation and local revenue contribution goals. Two businesses making the same level of profits may be asked to contribute very differently under a program of improved land use and the capture of land rents for social use.

### UK Development Land Tax

Real estate put to a higher use in the UK after May 1, 1977 is subject to the Development Land Tax (DLT). This tax is payable at an 80% rate on the difference at the date of disposal between the value on April 6, 1965, or the date of acquisition, whichever is later.

The DLT is paid by the person making the disposal. Also DLT becomes payable and due when a material development takes place without change of ownership. Improvement of the land beyond that authorized in original planning document is a material development. A building improvement to be a material development must increase its dimensions. The value of the development must be more than £5000 to become a material development and subject to DLT. The theory of this approach is that property enjoying material development has been sold at the market price and re-acquired at that same price.<sup>1</sup>

The aim of the British in their DLT legislation is to help bring about a higher level of accomplishment in meeting the goals of town and country

planning. It is believed that DLT will eliminate most of the problems of compensation and betterment because the payment, directly or indirectly, of compensation to prevent the development of land will not increase, but government will be able to benefit up to 80% in betterment arising from public expenditures and planning controls.

The writers of the DLT legislation have attempted to establish a tax and benefit system that does not destroy the efficiency of the market in determining the selection of sites for business development. On the other hand the DLT legislation accepts the proposition that the free market is not efficient in taking externalities of land use choices into account. The market is seen to be unable to give proper weight to the desertion of the central business district (CBD) and to the breakdown of old established communities.<sup>2</sup>

The DLT, or betterment approach to the capture for social use the increase in the value given to land in the market due to inflation, population growth, cheap energy and urbanization, is quite different from that of land value taxation (LVT). The use of DLT does not provide a steady source of government revenues for local governments covering relatively small geographical areas, as is possible under LVT. Also DLT does not provide an annual pressure for efficiency as does the annual LVT payment. The role of government in decision making under DLT is concentrated during the period when a change in land use is being considered, i.e., material development. Under LVT the possibility of making large errors is reduced because the LVT tax is constantly pressing the owners and managers of land to move toward full use within zoning restrictions.

The DLT advantage rests in its apparent greater public acceptance than LVT and in the fact that DLT substantially reduces the pressure of landowners to change zoning restrictions. Although LVT is not as effective in reducing market pressures to change zoning, it does, of course, make preservation of zoning boundaries somewhat easier. However, the market pressures to change zoning decisions are not always entirely undesirable. The market pressures may exist because a basically bad decision was made at the original zoning decision. If this is the case, the DLT approach makes correction nearly impossible while under LVT a persistent market pressure for change will be experienced. The market price appreciation while a land use correction is underway, benefits the social organization through the added tax payments arising under LVT. The DLT approach does not provide for additional society benefits in the form of tax payments until a change in use has been consummated.

#### Developmental Rights of Farm Land

In several states legislative proposals and legislation has actually been adopted (Hawaii, Massachusetts and New Jersey) that follow the betterment and the UK land development philosophy. The proposals and the legislation<sup>3</sup> provide for the setting aside of land for particular uses, say agriculture.

The owners of the land are free to use the land for agricultural purposes and to sell it to others for use as agricultural land. The value of the land in the market and on the property tax rolls is determined on the basis of agricultural use.

When the designated government level decides a better or different use of the land is appropriate the land is purchased from the owner at its market value. The governmental unit then changes the use to which the land can be put, say to industrial park, and sells the land at auction to the highest bidder for the land in this new use. The difference between the market purchase of land for agricultural use and the price received when the land was auctioned off is revenue for use by the government in meeting public sector needs.

### Sweden's Preemptive Purchase of Real Estate

The concept of preemptive purchase has been discussed along with the right of eminent domain and other procedures for the government to acquire ownership of land. Under eminent domain the land ownership has to be a necessary aspect of carrying out a determined government program. The unique characteristic of preemptive purchase as it has been developed in Sweden is that the government makes an investment that will provide revenues for the financing of public services. The preemptive purchase is a procedure for governments to acquire control over the economic rent being earned by lands and to direct the use to which the land is to be put.<sup>4</sup> Both the control over use and the revenue base acquired are important aspects of the preemptive purchase approach to taxation and land policy.

The Swedish legislation gives the municipalities the power to purchase and property that comes on the market at the price agreed upon between prospective buyers and sellers of real estate. The sale of any piece of real estate is not final for a three month period while the municipality makes up its mind as to whether it is going to use its preemptive purchase right and acquire the property. After three months the deed of sale becomes effective and the municipality's power of preemptive purchase has expired.

The municipalities cannot forecast what properties will be sold. They really only have the power to take the "pick of the litter" as it were. As a result the procedure does not permit the full initiation of a land use plan but it does through the acquisition of certain key properties affect the basic character of development. Even this opportunity to direct land use while acquiring control over land rents is dependent on municipalities having assets to make the actual purchases. A number of financial procedures could be legislated depending on how active a program is considered appropriate.

The Swedish procedure of giving the power of preemptive purchase to local governments has stimulated local interest in ownership and use of the land within the municipality's borders. The residents of a number of urban areas have acquired considerable stock of land ripe for more intensive use or for a shift in use to meet new needs.

While providing a growing municipal revenue base, and setting in a general way the direction of development, the preemptive purchase of real estate develops a public understanding of the social qualities of income from land ownership and of land use decisions. Another desirable quality of the preemptive purchase is its local control and its contribution to a community attitude of being able to solve problems through community action. The preemptive purchase avoids nearly all national control and the making of decisions by the faceless and heartless bureaucracy.

### Korea's Land Readjustment

The rapid development of Korea during the past twenty years has caused them to expand the use of the "land readjustment" approach as developed in Germany under the name Lex Adickes and adopted for use in Japan and Taiwan.<sup>5</sup> The procedure which provides for the financing of relatively large new housing developments out of increased land value arising when agriculture use is no longer required, was formalized in law by Frankfurt-am-Main, Germany in 1902, and in Japan in 1919. The British improvement trusts used in the 'colonies' and still active in India operate along similar lines.

The Korean land readjustment functions under detailed legislation. In Japan they had been largely voluntary associations developed to make urbanization possible. Currently land prices have risen so rapidly that the voluntary associations are not needed to realize urban values on suburban land in Japan.

In Korea the title to the land of an area to be developed for urban use is transferred to a government agency. All the expenditures for streets, sewers, schools, etc., are paid for through sale by the government of some of the lots in the developed area. When these improvements necessary for urban use are completed, each of the former landowners receives title to developed lots that now have a market value considerably greater than when the land was only available for agriculture, but the number of square feet of saleable land is considerably less. The government through its earnings from sale of withheld lots can frequently increase its income above total development costs. These funds can be used to subsidize housing for the poor.<sup>7</sup>

## Conclusion

The definition of land taxation can be usefully broadened to include a variety of types of government fiscal policies aimed at making the economic rent of land available to society through use of procedures other than the application of traditional taxes. The UK, Korea, Sweden and some state activity in the U.S. are developing techniques to reach this goal. The aim is basically to supplement the decisions of the market in a manner that takes account of many of the externalities of land use choices.

## To Encourage a Widely Dispersed Land Ownership

A state land tax and the federal income tax can be combined to provide a capitalization rate which encourages ownership by relatively small capitalists and by active users of the land. If tax adjustments of the type described below are not provided for, the capitalization rate encourages land ownership by large capital accumulations and ownership by non-operators. In other words, the current situation in the United States left unadjusted acts to eliminate small owners of land and owner-operated farms.<sup>8</sup> This same tax relationship can be expected to develop, and to a degree apparently already exists in many nations with similar land ownership dispersion trends.

The U.S. Department of Agriculture economic studies in their calculation of profits from farm ownership, take an economic position based on two assumptions that require some examination. These are:

- 1) that agriculture, despite the relative importance of the no-cost or production inelastic supply situation of land, can be compared with other industries; and
- 2) that income from operations which does not include unrealized capital gains, is the correct base to use in measuring economic well being of the agricultural industry.

## Variable Capitalization Rate

The only procedure readily available to develop a variable capitalization rate would work like this. The average marginal federal income tax rate for the past five years of all owners of rural land would be taken off their federal income tax returns. This average marginal rate would be used to calculate three different capitalization rates. For example, if the average marginal federal income tax rate is 55% or above,

the interest rate used in capitalizing net income is 3%, if between 42 and 55% the rate is 4% and between 30 and 42% the rate is 5% , and if below 30% the rate is 6%.

The above approach to working toward a solution of the problem arising from sales at much higher prices than assessed values encounters a number of "no-no's." The difficulties in adapting the variable capitalization based on a 5 year moving average marginal income tax rate are of a number of varieties. For example the typical constitution's use of "equal rate of assessment" could be interpreted either way when applied to an assessment based on a variable capitalization rate as affected by a five year moving average marginal income tax rate. The procedure would violate a basic idea of value that sees it being determined by what is produced rather than by the income capitalization rate of the owner.<sup>9</sup> Finally, there are the changes in tax returns arising from auditing and attitudes towards secrecy of income data.

The variation in capitalization rate depending on marginal income tax rates points to the need to coordinate the property tax with the income tax. This has been realized at the lower end of the income distribution and the "circuit breaker" concept has swept the country since its introduction in Wisconsin in 1964.<sup>10</sup> However, the interrelationships of expensing improvements on working as well as semi-hobby ranches, the importance of the lower capital gains tax on realized gains arising from the sale of land by high income receivers and the special treatment real estate receives under court interpretation of state inheritance tax legislation, plus the loopholes in the federal estate and gift taxes, have not been sufficiently integrated into the administration of the property tax.<sup>11</sup> In addition, the unique characteristics of land, i.e., basically indestructible, largely inelastic supply, little cost of production, large number of uses, make it particularly attractive as the receptacle of basically inactive capital resources.

All of these income and death tax advantages given to realized and unrealized income become visible in land sales prices. On the other hand, it is very difficult to develop procedures for reconstructing sources of income of land owners in order to arrive at a value based on a reasonable rate of capitalization. Many of the difficulties encountered in attempting to reconstruct value from income information arise from the federal income tax's failure to include unrealized capital gain in the taxable income base. The situation points to a need to integrate the federal income, capital gains and estate tax liabilities in estimating earnings to be capitalized.<sup>12</sup>

The reconstruction of income efforts of the U.S. Department of Agriculture's Economic Research Service and the revenue departments and commissions of the various states have been notably unsuccessful in reaching a figure that can support the high real estate prices existing in the market. The values constructed from capitalizing income are much lower than market prices, yet even these low prices are seen by the average rancher and farmer to be too high a base for use in applying a land tax. The failure of "use" value to support the high market price, causes people to believe the market price is unrealistic. They come to favor laborously developed capital value of ranch and farm land constructed from operational expense and income data. It is then argued that it is this base to which land tax rate is correctly applied.

### Equality of Treatment

Land tax equality of treatment under modern conditions requires different rates of capitalization based on the provisions of the federal income and estate taxes. This has not been recognized in legislation except in the "circuit breaker" development. The equality envisaged by the writers of state constitutions in the levy of the property tax on rural property cannot be enjoyed today without relating the property tax quite closely with the federal income and estate tax.

Equality of treatment under modern conditions is not being achieved by constructing what is called "use" value.<sup>13</sup> The wealthy and high income owner of rural property pays a tax based on a valuation considerably below the economic value of the property to him. At the same time, the low income person and the owner of property with a modest estate finds even this low value to be "too" high.

The economic and administrative problem poised by these conditions requires a new type of uniformity. The uniformity provided by market price does not afford the degree of fairness demanded of the public sector. An adjustment toward the concept of ability to pay would seem to be a necessity. This can be reached by developing a procedure for sharply reducing the property taxes of the low income and non-wealthy owner of rural land. This would be an expansion of the "circuit breaker" concept to rural land ownership. On the other hand, as pointed out above, a different rate of capitalization could be utilized for owners based on their marginal income tax rates. Under this procedure all owners of rural land would continue to be subject to land taxes at the current rate as a minimum, and to additional taxes as the capitalization rate went above that possessed by the farmer or rancher without significant additional economic resources.<sup>14</sup>

### Conservation and Use of Mineral Resources

The land tax as used in the taxation of natural resource property is a compromise between a government's claim over all resources below the surface and allowing resources to be freely exploited by whomever gains control. The capital value of subsurface land like the surface value is determined by prices set in the market. In the case of subsurface value, however, the sales are sometimes insufficient to set a price. A number of elements are involved in creating this situation. The substantial investment needed to exploit the resource and longterm price and cost estimates required are certainly among the more important factors.<sup>15</sup> There is great uncertainty with respect to cost and revenues and therefore simple buy and sell decisions are difficult to make.

The use of a land tax at a uniform rate over all types of land with subsurface resources as well as surface value in its base, possesses a

deceptive simplicity. The horrendous problem of setting value on subsurface resources with a cost and demand related to rapidly changing technologies, new discoveries, and political decisions that are so much a part of this approach to resource taxation, must be included in any consideration of this approach to mineral taxation. These problems need to be weighed against the benefits of a substantial tax on subsurface wealth.

A land tax including mineral and petroleum products in its base is perhaps the best assurance that tax policy can provide that these resources will not be withheld to push up price and exploit the economic power the control of supply over basic resources provides. The levy and collection annually of a substantial tax on the best estimates of the market value of known subsurface resources increases the cost of withholding. Sometimes this pressure provided by a land tax to utilize known resources is considered to be bad conservation and wasteful resource management. The optimal level of operation of a mine is increased when a land tax is assessed, very much as the optimal operation level is speeded up when interest rates are high, i.e., the current value of production is increased relative to the present value of future production.<sup>16</sup>

On the other hand, all of the other tax alternatives tilt production decisions somewhat toward reduced current production and toward delayed marketing of the resource. This is the relationship basically because production creates a tax liability and non-production does not.<sup>17</sup> Only the land tax approach develops a tax liability when the resource is not being mined and sold. Production year by year decreases the tax base and if future scarcity due to production did not increase the value of the resources above current per unit real value, taxes would decline as exploitation increased.

NOTES

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2. Land (Green Paper). Cmnd 5730 (London: HMSO, 1975).
3. Phillip Alampi, "A New Approach to Saving Farm Land," State Government 66, Autumn, 1973, No. 4; 211-12. & D.R. Denman, "Public Appropriation of Unearned Land Values," (Vancouver, B.C.; B.C.U., 1969): 8-13; Land Use Planning Report, Dec. 12, 1977: 397.
4. Swedish preemptive purchase law, Law No. 868, 1967.
5. Nashahiko Honjo, "City Planning Administration," in Trends in Japanese Development Planning (1970): 86, 89.
6. Leo Jacobson and Ved Prakash, (ed.) Urbanization and National Development (Beverly Hills: Sage, 1970): 4.
7. William A. Doebele, "Land Readjustment as an Alternative to Taxation for the Recovery of Betterment: The Case of Korea" (unpublished) TRED Conference, October 22-24, 1976.
8. Death taxes work to encourage corporate ownership of land.
9. Sherman J. Maisel, Appendix to the Report on Housing in California (Sacramento: Governor's Advisory Commission on Housing Problems, 1963: 269.
10. Advisory Commission on Intergovernmental Relations, Property Tax Circuit-Breakers: Current Status and Policy Issues, M-87, February, 1975.
11. For example, under Oregon law an estate consisting of out-of-state land would be exempted from the Oregon inheritance tax. Richard W. Lindholm "Death and Gift Taxes" (Area 6), A Description and Analysis of Oregon's Fiscal System (Salem, Oregon: Department of Revenue 1971).
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13. Joseph H. Genley, "Assessing Farm Land under Maryland's Use Value Assessment Law," Assessor's News Letter, 33, January, 1967, 4-6.
14. Dallas Holmes, "Assessment of Farmland Under the California Land Conservation Act and the 'Breathing Space' Amendment," California Law Review, 55, (April, 1967): 273-82.
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17. Allyn O. Lockner, "Economic Effect of a Progressive Net Profits Tax on Decision Making by the Mining Firm," Land Economics 38 (November, 1962): 341-50.