

# A Ground Duty Reform

By Professor Dr. Dirk Loehr, chairman of Sozialwissenschaftliche Gesellschaft 1950 e.V., delivered 2012 to the Ministries of Finance in Bremen, Thüringen and Hessen, Germany.

Translated by George Morton.

Gentlemen,

as you know, the existing property tax is currently regarded as unconstitutional; reforming it is on the political agenda again. Your institutions have also taken part in the reform efforts and have put forward your proposals.

- a "simplified tax", with only the land area, plus floor space calculated in an across-the-board way, as the basis (the "South" model). "Asset" values are not considered at all.

- a model based on market values; the tax would be calculated using certain empirical values and statistical assessments, based on the examination of selected real cases (the "Bremen" model).

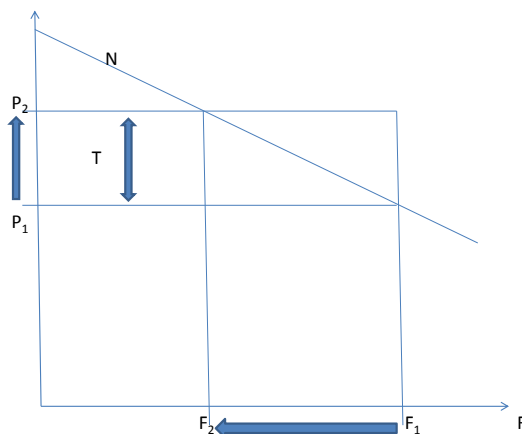
- a "combination model" which combines the known, regularly updated guideline values for land and would make these the basis for the tax (the "Thüringen" model).

All three models envisage, as now, the taxation of both land and any structures on it (the "combined basis of assessment").

As the president of an independent organisation with a link to the science, I would ask you to consider the following:

A combined basis of assessment contributes firstly to discouraging the efficient use of scarce sites. However, investments in our largely too old stock of buildings, an ongoing task, should be made more attractive for owners. Taxing buildings would penalise energy-saving measures, modernisations, extensions etc., which normally lead to an increase in the property value or to an increase in the usable space. And that continually, year on year.

The problem is illustrated by the diagram below, which concerns in a simplified way the taxation of buildings. Proceeding from a fictional start, the area available as far as  $F_1$  is used for a building. The building's costs, which in market equilibrium correspond to the reduced net yield, are at  $P_1$ . For the sake of simplicity, a uniform building price per unit of area was assumed. Now, a combined tax can be passed on. Due to the tax  $T$ , the costs rise to  $P_2$ . With unchanging demand  $N$  (more exactly the marginal revenue product) this leads to a fall in the proportion of economically undertaken construction from  $F_1$  to  $F_2$  (to the left of that the construction is covered by the higher demand). Efficient use of the available space is discouraged.



As said, this is a simplified model. It makes clear, however, that from a personal standpoint the tax can be passed on by the owners to the users of the land. If the owners are not the users, the tenants bear

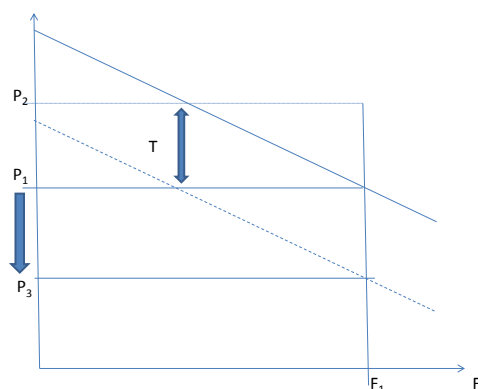
most of the tax (independently of the question of tax liability). The landowners on the other hand bear the tax only slightly. Functionally, the burden is mainly on the users and not the owners. The social consequences of passing on the tax to tenants are worth considering. The "social" reservations emanating from different quarters regarding a change to a purely land basis for assessments are thus very hard to understand - the aim would appear to be the preservation of the ownership status quo.

The landowners are however the very people who profit from the largely publicly financed infrastructure, since this raises land rents and values (and NOT the values of the buildings). The result is that the landowners are the beneficiaries of investments in infrastructure. The costs are borne to a large extent by the tenants (a combined tax can be passed on), and by other public sources of revenue (the business tax, transfers due to the equalisation among Germany's states etc.). There is a decoupling of the beneficiaries and payers of the financial burdens. This really has nothing to do with equivalence (to that extent the justifications of the proposals of the "Thüringen" and especially the "South" model are not comprehensible). On the contrary, rent-seeking is institutionally encouraged by the decoupling of the benefit (to the owners) and the costs (to the public). The "South" model in particular offers land rent and values to well organised groups, passing the costs on to the public. One should therefore not be surprised at the applause of the homeowners' association. Yet at the overall economic level, external effects are produced, the failure of the land market is stimulated and a foundation for bad government is laid.

As a member of an expert committee and a tax advisor, I am sceptical about the "Bremen" model's statistically based calculation of the market value. This mass-approach to developed sites can in my opinion not be adopted without a standardisation of types which potentially infringes the principle of equity. The very demand by the courts for an area calculation which is "dependent on the residential quality" cannot be satisfied by a typifying mass-approach. How can rooms inaccessible from a corridor, offset storeys etc. be measured? Exactly because of the ongoing task of energy-saving renovation, a splitting of the property market into well and badly renovated buildings can be expected. How can this divergence be calculated statistically? What can be done about faultily carried out energy-saving renovation (which is nothing unusual)? In general, how can maintenance residues, construction defects etc. be calculated using a mass-approach?

In recent years a lot of effort has been put into discussing an ecologically oriented reform of the communal property tax. The results have in part differed greatly. However, disregarding differences of detail those involved have largely been in agreement on one point; a non-combined tax makes sense. In addition there has been great unanimity that land values should play a large role. For me it is frankly amazing that this discussion is now simply being disregarded by the finance ministers of Germany's states.

To illustrate, here is a second diagram showing the effect of a land-value tax (as an imputed tax), a premise being the existence of strict regional and building planning. The total available area can be assumed to be  $F_1$ . The demand (marginal revenue product) and the area are not changed by the tax (the land supply is with strict planning totally inelastic).



Passing on the tax to the land users or tenants is impossible under these circumstances. On the contrary, the landowner has to bear the tax as the beneficiary of public infrastructure investments. As a part of the value-forming land rent is recovered by the tax, the land value falls from  $P_1$  to  $P_3$  (instead of rising to  $P_2$  as with the combined basis of assessment). This is significant, not least for start-up businesses, businesses in conurbations and for property formation by, among others, young families. At the same time:

- the tax has to be earned. It encourages more efficient land use. The upkeep of buildings and energy-saving measures are encouraged, in contrast to a combined basis of assessment, and that allows the construction industry turnover without consuming more land.
- the tax leads to a mobile land market with high turnover, which is among other things of great significance for firms and private households looking for suitable locations.
- the tax is very simple and cheap to administer, due to recourse to land guideline-values. However, it must be required that the system of expert committees be unified at the federal level and strengthened.
- the tax leads to a high, stable revenue.
- the tax represents a link between the private benefit (land rent and values) to the owners with the corresponding expenditure (infrastructure, planning), which otherwise would have to be borne solely by the public (equivalence !)

Regarding the discussion about the ecological restructuring of the communal land tax, the land-value components could be supplemented by further land-related features (e.g. the adoption of an area component in the basis of assessment).

I believe the arguments for an uncombined basis are too good to be simply ignored. I have by no means put them forward completely here, although there are enough further arguments. If what I have written at least raises doubts among you, my aim will be achieved. As I, despite all these differences, have the impression that you are working seriously and hard at the reform project, I am not exactly pessimistic.

To conclude, something else to think about. Should agreement among the states on reform not be possible, framework legislation with corresponding let-out clauses could be considered. In this way the legislative competence could effectively be transferred to the state level, which in my opinion would be quite justifiable.

Should you wish to discuss this, I am very willing to talk about it in your working groups or if desired, to provide information.

For the sake of transparency I will take the liberty of copying this circular to selected representatives of the specialist public.

Yours sincerely

Dirk Loehr