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Theoretical Basis of Land Value Taxation

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Introduction

Tax is a compulsory payment, usually of monetary form, made by the general body of subjects or citizens to a sovereign or government authority. It has the following special characteristics:

- it is paid without quid pro quo;
- it is enforceable in law;
- it may be levied against persons (natural or corporate); and
- it may also be levied against property.

Our primary concern here focuses on the last aspect i.e. taxes levied against property and in particular landed property. Indeed, we are not concerned with landed property per se. The scope here is limited to tax operations that are meant to capture land value. But taxes that are levied against property are not the only taxes that would capture land value. Even taxes levied against persons would at times capture land value as will be discussed later in this chapter.

Some requirements for a good tax structure

Adam Smith (1776) and Musgrave (1989) have identified some prerequisites for a good tax system. The following broad requirements are generally associated with a good tax:

- the distribution of the tax should be equitable, in other words every taxpayer should be expected to pay a fair share of the tax (i.e. the Canon of Equity);
- the tax structure should endeavour for fair and non-arbitrary administration. It should also be understandable to the taxpayer (i.e. the Canon of Fairness);
- when compared to the revenue collected, the administration and compliance cost of a tax should be as low as possible - in other words it must be economical to collect (i.e. the Canon of Economy);

- tax obligations should be based on benefits receivable from the enjoyment of public services (i.e. the Benefit Principle);

- tax should be levied at the time, or in the manner which is most likely to be convenient for the taxpayer (i.e. the Canon of Convenience);

- taxation should as much as possible avoid creating 'excess burdens' that would interfere with the efficient functioning of the host market.

The above conditions for a good tax system were meant to apply to taxes in general and therefore also with regard to property and land taxes.

Although taxes could also be used as instruments of socioeconomic leverage, or for achieving various other non-fiscal goals, due care should be taken not to deviate from the above-stated principles for a good tax. In this context it is noteworthy that land taxes are quite often suggested as useful instruments to assist with land redistribution and/or land reform programmes.

The historical concept of land value taxation

Put at its simplest the concept of land value taxation rests upon the premise that only land should be taxed. As Youngman (1993) puts it, even this simple idea can create major difficulties in political acceptability and administrative limitations. In any society, there are three classical factors of production, land, labour and capital. The latter two have their costs and therefore their prices in terms of wages and interest. On the other hand, land has no cost of production, and if land was in unlimited supply people would pay little or indeed nothing for its use. However, land is not unlimited in supply, it is quite the opposite being fixed in supply. This fact creates demand for land in particular locations and therefore a value of land. Whilst land is generally accepted to be fixed in supply, the concept of alternative uses can create a supply shift, in that, supply for one kind of use rather than other kinds follows its own supply versus rent curve to the point where supply and demand equalise. The rent for land is said to constitute two components, firstly, its transfer or opportunity cost, which is the rent of the land in its next best use. Secondly, an amount attributable to scarcity or inelasticity of supply for a use in a particular location. It has been recognised that land was a free good as opposed to labour and capital that are never free. Therefore the market price of the products of land is determined by the cost of labour used in their production and capital equipment. On this basis the amount remaining for distribution as land rent is an excess (Lindholm, 1965; Douglas, 1961)

The history and economic foundations of land taxation are firmly rooted in the

early 18th and 19th centuries. The Physiocrats argued that a particularly unique way to raise revenue was through the taxing of land (Quesnay, 1963 (1756)). Their belief in the sterility doctrine gave rise to the theory of 'impost unique'. Taxation of land was justified because of the productivity of land. From a social standpoint, therefore, the taxation of land had positive benefits. This group of economists tended to the view that since all taxes had to be paid out of rent, it would be sensible to replace all other taxes by a single tax on rent. In many respects the work of the Physiocrats laid the theoretical foundations that subsequent economists would construct their theories of land taxation. Smith (1776) famous for his canons of taxation made a number of important contributions to the land tax debate differentiating the land tax between a tax on agricultural land and a tax on ground rent to cover developed land. He found land to be suitable for taxation, since the tax would fall on the economic surplus and as such could not be passed onto consumers in the price of goods.

Ricardo (1817) suggested that the rent for land be the residual after paying for the costs of variable factors of production. His theory was largely based on the premise that a tax on land rents would not have harmful effects of the economy as such a tax would not inhibit production. Ricardo's theory was taken further by Mill (1824) who explained that a tax on the rent of land would not affect the industry of a country. In this regard he contended that as the cultivation of land was dependent upon the investment of capital, the capitalist was to some extent indifferent as to whether he paid the surplus, in the form of rent to an individual, or a tax to the government. Following on from his father's work Mill (J.S.) (1848) suggested that if the rent of land increases as a result of society, the owners of the land should have no claim to this 'windfall' increase in land value. The difficulty with this approach is based on the issue of clearly linking the increase in value to some identifiable societal improvement.

Henry George (1879) set out his views on the taxing of land (the 'single tax') in some detail in his book, *Progress and Poverty.* George was influenced by the state of the economy of the time and in particular, how development and progress in society was accompanied by high levels of poverty. His explanation of this phenomenon centred around the scarcity of land which was as a result of land speculation. The solution proffered by George was to replace all taxes with a single tax on land. This would have the desired result of making land more accessible to a greater number of people, raise wages, lower prices and in consequence raise the living standards of workers. In this regard, an increase in land values would be due to increased productivity which was closely related to increases in population and wealth. This rental income gave land its value and as such could be collected in taxes without decreasing the incentives for efficient production (Lindholm, 1965).

Proponents of land value taxation have cited a number of appealing properties, one of the main ones being its neutrality with respect to land use (Bentick, 1979; Tideman, 1982; Wildasin, 1982, Tideman, 1999). As Netzer (1966) argues, location rents constitute a surplus, and taxing these rents will not reduce the supply of sites offered, provided that landowners have been optimally using the land prior to the imposition of the tax. Economic theory also shows that under the assumption of perfect markets, a tax on any good with perfectly inelastic supply and non-zero elasticity of demand will be borne entirely by the supplier of the good; it cannot be shifted to its user because any increase in the price would lead to an excess supply of the good (in a competitive market the demand for units that are offered at a price above market price will drop to zero). Therefore, a tax on land has to be paid by the owner of the land (Skaburskis, 1995). Given that the supply of land is fixed, the tax does not have any substitution effect and therefore no deadweight loss, which makes it an ideal tax from an efficiency point of view. It is also argued that the real property tax (a tax on both land and improvements) has a number of negative economic effects on investment decisions (Mathis and Zech, 1982). It is alleged to discourage improvements to a site by reducing the economic return from such improvements. This reduction, in turn, results in a disincentive to maintain and improve buildings, the substitution of land for capital, causing urban sprawl, the utilization of buildings beyond the point at which they should be replaced and the speculation in land by holding it off the market. Advocates of land taxation argue that removing the tax on improvements and taxing only the value of the land would result in a restoration of the incentive to develop land to its fullest potential.

Ever since the publication of George's *Progress and Poverty* in 1879, the possibility of using land value taxation as a source of government revenue has intrigued economists and other tax specialists. The impact of George's ideas, whilst not widespread in a geographical context did effect the politicians of the day in New Zealand, Australia, South Africa, Jamaica and Kenya to introduce such a tax. Indeed, graded property tax systems, where land is taxed at a higher rate than improvements have been used in several Canadian provinces as well as several cities in the United States (Oates and Schwab, 1995; Brueckner, 1986; Wuensch et al, 2000).

The concept of land value

Classical economists have identified land, labour and capital as the three factors of production (Vickrey, 1999). Under 'capital' was implied all means of production that have been created through human effort while 'land' was primarily used to describe natural resources that were not created through human effort.

Land value in turn refers to the earnings accruing to land in the process of production. Where land is not put into productive use, the value will be based on the opportunity cost of not putting land in the production process. 'Opportunity cost' here refers to the next best alternative use that land could be put to. These earnings may be realized in loose form and expressed as rental income/value, for example annual, quarterly, monthly, weekly or daily rent. The earnings may also be realized in compact or discounted form and expressed as capital value. The capital value is the basis upon which the exchange price of the land will be considered. Land value therefore refers to a stream of income from land as a factor of production considered under a certain or definite period of time. Value in this case is tied to the income generating advantage of land. However, even land that is not put in the income generating process will still have its value derived on this basis by relying on the concept of opportunity cost. Opportunity cost would be subject to the prevailing land market conditions.
As a factor of production, land like any other commodity, is traded in the market. This means that the price (value) of land will be subject to the economics of demand and supply. In this respect, land becomes a unique commodity since it has unique demand and supply descriptions. Indeed, as a discipline, land economics is based on two basic concepts, namely:

- that the supply curve of land - as a commodity - is perfectly inelastic, and

- that the demand for land is derived demand.

Land is fixed in terms of geographical location. For that matter, all economic advantages provided by land must be utilized on site. Location is therefore crucial in determining land values because shortage in supply at one place cannot be made up for by surplus at another place. The value of land will be influenced by those economic factors pertaining to the area in which it is situated.

The immobility of land in turn influences its economic characteristics. Just as the land is Fixed in geographical location, its supply too is generally considered as Fixed. Because the supply of land is fixed, in theory, its supply curve is perfectly inelastic. This means that increases in the price of land from P1-P2 (as shown in Figure 1.1) arising from a shift in the demand curve from D1-D2 will not stimulate an increase in supply. The supply will remain the same no matter what the price increase is. This particular fact applies for land as a gift of nature that cannot be created by efforts of man. It also applies for land that has undergone capital investment by man. Some lands are uniquely developed to the extent that their supply is inelastic. For example, no matter what prices are offered for Fort Jesus in Mombasa, Kenya or the Pyramids in Giza, Egypt, there would be no increase in the physical supply of such lands. In theory, at least, this applies to all

lands with only limited variation.

The supply characteristics of land, as discussed above, have a significant impact on the levying of land value taxes. These taxes are levied on the assumption that they would not interfere with the supply of land and hence cause no disruption of the economic equilibrium. In practice, however, the supply of land for a particular use in a given area may change in the long run as more land is brought into that use. Even in the short run, land can be transferred within limits from one use to another, for example, through rezoning (e.g. converting a residential house to office space).

The demand for land, as such, is purely derived demand. Land is not demanded for its own sake, but virtually as a factor that is used for the production of goods and services. The demand for land will therefore depend on the demand for goods and services. For example, increases in the demand for housing will occasion an increased demand for residential land. Therefore, the demand of goods and services is what will determine the demand for land of a particular use. Since use is interchangeable, this will affect supply for that use and hence price. Demand for other goods and services and revenue from them will therefore determine the income accruing to the land for a particular use and hence its value.

Bases of land value taxation

There has been considerable debate as to whether the imposition of a land tax would have side effects or not. On the one hand there are those who hold the view that land taxation would not have any effects on the productive nature of land. On the other, there are those who hold the view that land taxation will indeed have an impact on the productive nature of the land. The introduction of a land tax may have foreseen and possible unforeseen consequences. It is therefore necessary to provide a brief theoretical basis for land taxation as such.

The view that taxation of land would not have any effect on the production characteristics of land is supported by two well-developed theories, respectively the theory of economic rent and the tax capitalisation theory.

Theory of economic rent

In micro-economic theory, economic rent simply refers to any payment accruing to a factor of production over and above payment that is necessary to keep it in

production. The payment that is needed to keep the factor in production is known as 'transfer earnings' (Foldvary, 1999). Transfer earnings are payments that would remunerate all the factors involved in the production process at market rates. However, due to increase in demand a factor may earn more than transfer earnings. Depending on the nature of supply for that particular factor, payments over and above transfer earnings may be realised in the short run or in the long run.

If the supply curve of the factor is relatively elastic (i.e. the supply is responsive to increased demand), more factors will be attracted into the market to meet the increased demand and the surplus payment over and above transfer earnings would be eliminated in the long run. In this case the surplus earnings would be referred to as quasi-rent. Machinery and equipment, for example, would earn quasi-rent in the event of increased demand because they cannot be manufactured, assembled and delivered immediately to meet the increased demand.
On the other hand, if the supply curve of the factor is relatively inelastic (i.e, the supply would not relatively respond to increased demand), more factors would not be attracted into the market to meet the increased demand and the surplus payment over and above transfer earnings would persist in the long run. This is economic rent.

Land, being a gift of nature cannot be reproduced in greater quantities to meet increased demand (Foldvary, 1999). It is therefore, scarce by nature and fixed in supply. Any payment to land over and above the transfer earnings, is thus a surplus. As indicated above, transfer earnings essentially refer to payments made to maintain the current use of a factor (i.e. to ensure that its productive advantage would not be transferred to another use). Given that payment to land is in the form of a surplus, it is better to tax land - as such a tax will not affect the transfer earnings and thus will not cause distortions in the economy. By taxing only the surplus earnings (in respect of the land) that can be taxed without causing any interference in the market, a land tax conforms with at least one of the requirements of a good tax system: It minimises interference in economic decisions in otherwise efficient markets.

Tax capitalisation theory

The tax capitalisation theory is based on the assumption that whenever a tax is imposed on land as an asset, the capital value of the land is diminished by an amount equivalent to the capitalised value of the tax at the prevailing rate of interest. In essence it is assumed that subsequent land owners/buyers would first capitalise the annual tax then deduct it from the sale price. Hence the subsequent land owner/buyer would only pay a diminished price for the value of the land. The

returns from such land would also be discounted net of tax; for example, capital value of land would be derived from rent less tax as an expense. In this way it is assumed that only the original landowner would bear the tax burden and that the tax cannot be shifted otherwise the burden would fall where it is not intended and cause disruption in the economy.

According to this theory the purchaser, or an investor in land would not be discouraged by mere imposition of tax. In this way, investors would not shift their capital to other sectors by way of tax consideration. However, the capitalisation theory presupposes the existence of the following conditions:

- an active land market so that values will reflect market forces rather than non-economic influences;

- the supply of land is inelastic with respect to changes in the returns on land, otherwise at least part of the tax would be shifted rather than capitalised;

- the pattern of future tax liabilities is foreseeable and fully anticipated;

- the government does not spend the tax revenue in a way that affects the value of services to the land

- the tax does not affect the rate at which returns to land are capitalised.

Tax as instrument of economic leverage

Various arguments have been put forward to discredit the proposition that a tax on land will not cause disruption of the economy as suggested by both the economic rent theory and the tax capitalisation theory. It has been argued that although the supply of land is generally fixed or completely inelastic to changes in price, supply for a particular use in a given area may change in the long run as more land is brought into use. Even in the short run land can be transferred - within limits - from one use to another (for example, converting residential use to office space or agricultural to residential) in a process known as occupational mobility of land. Although fixed in supply, land is capable of assuming alternative uses and although the physical limitation of land supply tends to have no or negligible economic significance, changes in its use may indeed be economically significant.

Many of the arguments against land taxation focus only on the negative aspects of the effects of a tax on land use as a fiscal tool. However, there is a further aspect to look at that could benefit the discourse on land taxation theory. Instead of limiting discussions to the merit of a land tax as a means of raising revenue, the

scope of discussion on land taxation could generally be broadened to also include the non-fiscal aspects of land tax, i.e. its possible use as an instrument of economic leverage. There should be increased realisation that land as a primary factor of production and a land tax may therefore have potential as a strategic policy instrument for overall economic management. This would be especially so in developing countries where land constitutes a large proportion of factor input. Land therefore maintains a significant influence in economic production hence by mere fiscal control of land use (factor input) the policy maker can directly influence the trend of economic performance for better results. However, the principles to which a good tax should adhere - as stated above - should not be forgotten in the process of attempting to attain non-fiscal goals.

Classification of property and land taxes

Taxes on property (including land) can be classified in three main categories depending on the choice of tax base. These categories are the following:

- taxes based on the income derived from property;
- taxes based on area (i.e. property size); and
- taxes based on rental or capital value (i.e. ad valorem).

According to this classification, there are taxes that are specifically levied in relation to land (e.g. annual land tax or a real property transfer tax). There are taxes that are generally levied on wealth/property and fall on land where land forms part of the property/wealth base of the taxable person (e.g. estate taxes or death duties). Furthermore, there are those taxes that are generally levied on income or expenditure and capture land (value) only indirectly in so far as land forms more or less important part of the income base1 of the taxable person (e.g. income tax on rental income or value-added tax (VAT) on the acquisition of a house from a property developer).

In some jurisdictions, mainly in developing countries, property taxes (be they on land only, or on land and improvements) are levied in relation to the size of the property. In some instances location and use will also be used to determine the tax payable.

For purposes of the discussion that follows, the focus will only be on those taxes levied with reference to the value of immovable property, and more specifically ad valorem property taxes.

Taxes based on rental or capital value

These are also known as ad valorem taxes. An ad valorem tax can be levied on an annual basis with reference to the rental or capital value of the property (e.g. a property tax), or it can be levied every time the taxable object (e.g. real property) is transferred by way of a transaction or otherwise (e.g. transfer tax). Capital value taxes could be based on a variety of bases, namely: capital improved value, unimproved land or 'site' value, improvement value only, improvement value plus site value, incremental value, etc. From these bases the following taxes can be generated:

Rental value

Rental value taxes are usually based on the net annual rent. In this case, a yearly rent that the property would most probably generate is determined. This we may call the gross annual rental value. From this statutory deductions or out-goings for maintenance, insurance, management costs etc. are made, resulting in a net annual value that is subject to tax.

It is important to note that the rental value tax is applicable whether the rent is realised or not in any one particular year. Even if the property remains unlet for a whole year, the tax is still levied because it is based on a hypothetical other than actual rent. This is its main difference from income-based taxes. The latter would consider the actual rent paid as the basis of taxation.

This tax has two main advantages. As it is levied on a broader tax base that includes land and buildings, it could, given the same or even a lower tax rate, yield more revenue than a tax on the value of land only. Secondly, it involves ease of assessment, as rents in one locality are comparable in a market situation. Its disadvantage on the other hand is that it has allocational defects. It may discourage investment in real property with investors preferring to invest in untaxed land uses or in the capital market.

Capital improved value

Most jurisdictions presently levying a property tax uses the capital value (i.e. market value) of the property for assessing tax liability. If the property consists of land and improvements, it is the single, combined value which has to be determined.

Unimproved land value

Unimproved land value tax or unimproved site value tax (USV) is levied on the

capital value of the land assuming it is vacant. Any improvement on site is generally disregarded in the assessment of capital value. USV tax has several advantages:

- it encourages physical development in urban centres;

- it discourages ownership of land for speculative purposes;

- it is a simple tax to levy without many technical and administrative challenges; and

- the amounts to be raised can be determined in advance and therefore used for purposes of certainty in budgeting.

USV has been subject to certain criticisms especially regarding its regressive nature:

- it is difficult to determine how much of the land value is derived from the site or location value and how much from the reproducible assets and entrepreneurial expertise;

- related to the question of value is the contention that for the tax to be equitable it should be applied when land is first acquired; otherwise unearned increment is diffused through the purchase and sale of the property;

- it is regressive in terms of residential development because taxpayers with a lower income spend a higher percentage of their income on housing than do those on higher incomes. Subjecting them both to ad valorem tax therefore does not conform to the principle of equity;

- it is also regressive in terms of methods of assessment that tend to favour the rich against the poor; lower priced properties are many and change hands more frequently; assessors therefore may be inclined to assess high-priced properties more conservatively than low-priced properties because sales comparables are scarce for high-priced properties that are owned by high-income earners;

- it favours large-scale development against small-scale development (such as owner-occupier home developers), who receive no income from the subject properties that they can in turn use to pay the tax; and

- it may involve allocational defects through a ‘substitution effect’; the tax burden can be considered as ‘qualitative’ i.e. involving the choice of different types of uses, or ‘quantitative’ i.e. involving intensity of use. A qualitative choice

is likely to deny other uses, which are equally important in the urban economy, their due share of land (e.g. when commercial use pushes out residential use); whereas quantitative choices on the other hand involve, as one example, cases where single-storey buildings are pulled down to facilitate the development of high-rise buildings under the same land-use category, a process that requires large capital outlay and may lead to unnecessary commitment of capital to real estate vis-a-vis development in other productive sectors lsuch as industry or agriculture.

Improvement value only

Taxes based on improvements, in contrast to USV, leaves out the site value and apply to the value of improvements only. This is appropriate in the case of the benefit principle. For example, if local taxes were being levied to finance and sustain services like waste collection, street lighting, road maintenance and so forth it would not be equitable to charge a site value tax. In this case, a vacant site adjacent to a site with a high-rise improvement on it would be paying the same amount of tax (assuming that both sites are similar in all other respects) yet the landowner of the vacant site would not have equal enjoyment of all these services. The level of development is an important consideration. A property with low-level development generally generates a lower demand for services than a property with high-level development.

Including the value of improvements in the tax base to finance provision of related services, may however discourage development. Secondly, valuing improvements on a regular basis for property tax purposes implies a more complex and costly process of valuation in comparison to USV. As improvements keep on changing every year due to new construction, extension or demolition, maintaining a capital improved system is administratively more cumbersome.

Site value plus improvement value

In some cases property taxes may be levied on both site and improvement values, as separate taxable objects. Although such a tax broadens the tax base, it necessitates assessed values for both the land and the improvements. Although some of the benefits of both a land only tax system as well a capital improved tax system can be gained, it is administratively costly and cumbersome to have separate values.

Other property-related taxes

Capital gains taxes

Taxes can also be based upon capital gains. In this case, if land forms part of the

subject capital, land value will form the basis of the tax. Capital gains taxes include taxation of inheritance. This is a softer form of wealth tax because it is to be paid, not by the person who has worked to generate the wealth, but instead, by a person who simply stands to benefit from it. What is more, the payer does not have to find money to pay as it can be paid using part of the wealth.

Capital transfer taxes

There are taxes that fall upon capital (included) when it is being transferred. The transfer value would be the basis of the tax. Such taxes include stamp duty, real property transfer taxes and so forth. As far as these taxes may pertain to land as a possible or the only taxable object, they are unique in that they are only levied upon transfer of the land; unlike most of the land based taxes that are levied on regular basis, usually annually. The tax will not be levied as long as land does not change hands, irrespective how long it may take. On the other hand, it would apply as many times as land changes hands - even if these changes take place in less than a year.

Incremental land value taxes

Land tax can also be levied on the basis of incremental value. Under normal circumstances, land values tend to increase over time. This is because population continues to rise against a limited supply of land. Land resources therefore tend to become scarcer over time. Also, an increasing population means increased demand for goods and services that will engage land as a factor of production. The scarcity element or shortage in supply creates the economic rent. An incremental value tax is therefore a fiscal tool that is sometimes used for capturing economic rent from the landowners and redistributing it back to the broad community -especially in areas where unimproved land is held for speculative purposes.

Value Added Tax (VAT)

VAT is another general tax usually imposed on the process of production or consumption of goods and services. In some cases the tax base could be wide enough to capture taxable transactions related to landed property. Depending on the circumstances, the rental or capital value of land could be used to determine the tax payable.

Conclusions

Despite the apparent merits and demerits of a land value tax from a theoretical

point of view, the choice of tax base is more often based on the very specific circumstances faced by the relevant taxing authority. Sociopolitical views, historic factors, as well as practical realities seem to be the deciding factors - as will become evident in the following chapters.

- Income tax can generally not be equated to a land-based tax. An income tax targets income from whatever source. Where income is derived from real property, the tax will to some extent fall on the property and hence land could be an important object within the tax base. Land-based income is called rent. Rent and land value on the other hand are directly related since rent forms the basis of capital value. Taxing rent as a form of income therefore entails taxing land value. The main difference between annual rental value tax and income tax is that the former falls on hypothetical income while the latter falls on actual income. Secondly, annual rental value tax is a tax that is specifically designed to fall on rent while income tax is a general tax designed to fall on income and captures rent only where rent forms the basis of a specific income.

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