

Report Part Title: An Overview of Land Value Taxation

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Land Value Taxation Views, Concepts and Methods: A Primer

An Overview of Land Value Taxation

Introduction

At present, there are a number of countries that are making use of some form of land value taxation.¹ It is generally assumed that the main interest in property taxes is in its use as a local tax, in either urban or rural conditions, but mainly with urban reference. It is also important to recognize that introducing a land value tax would be commensurate with the elimination of or equivalent reduction in taxes on both real estate improvements (i.e., buildings) and personal property (i.e., machinery, equipment, and inventory). Implementing or furthering the tax on land must not be viewed as a tax increase, but rather an alternative means of allocating the tax burden. The intended result would be a reduction in or possibly the elimination of the regressive nature of taxing improvements and other mobile forms of capital. Again, assuming that we are concerned with a local tax, a major objective must be that it provides a reasonably equitable distribution of the costs of desired local service for those individuals and entities that benefit from the services provided. Redistribution of individual wealth is not a concern of an equitable and uniform land value taxation system.

Decisions concerning how revenue will be used and distributed will also affect the fiscal relation between national, state and local governments because the introduction of a land value tax would also change the relative taxation potential of different local areas. As several states use the property tax as an asset redistribution tool, new allocative mechanisms would be required to accomplish that objective. Therefore, even if a decision to introduce a land-based tax is taken, there are a number of subsequent, subsidiary problems to be faced to ensure that repercussions associated with potential land value changes (and imputed costs of pure land value taxes) are properly assigned to each parcel. In time, an efficient land market, with knowledgeable and capable buyers and sellers, will ensure proper land value adjustments that include the imputed costs of a land tax. To minimize the capital gains and losses accruing to specific landowners, an extended phase-in period might be used.

The idea of land value taxation has a long and varied history. It has operated, in a limited and varied fashion, quite well in Pittsburgh and Scranton, Pennsylvania. In these communities, land is taxed at a separate rate from improvements. Land value taxation also operates in parts of Australia, New Zealand, Denmark, as well as in several African countries.

Additionally, at least eight Nobel Prize winners have endorsed land value taxation, including the 1996 recipient William Vickrey. Vickrey contends, "It (*land value taxation*) guarantees that no one dispossesses fellow citizens by obtaining a disproportionate share of what nature provides for humanity."²

If we are to consider the costs and benefits of a property tax system based to a greater extent on the value of land it is useful to understand the context of the tax itself. To better understand the rationale, motivation and methods of implementing this form of property taxation, we first trace its origins. While property has been taxed in various manners throughout history, often haphazardly, it was only in the latter part of the 19th century when standardization of property taxation techniques was deemed desirable.

Henry George

Land value taxes in force in the world today owe their existence to the thoughts and writings of Henry George. George was deeply concerned by the profits being made by land speculators in the California gold rush of the 1870s.³ From this experience arose his idea of a single tax on land values that would be sufficient to finance the entire needs of government.⁴ Generally, the concept of taxing the profits of the “rich” was gaining strength during this time period. Colossal firms with equally large profits were an outcome of the on-going industrial revolution in both the U. S. and Britain. In the United States, this view of undeserved “profit” accruing to owners was a primary factor leading to the adoption of the sixteenth amendment to the U.S. Constitution, permitted the federal income tax.

As for the property tax, a single tax on land was more plausible during this time period as government spending was but a fraction of its current level. Without various transfers for human services and national defense, federal spending and its revenues needs were significantly less in the nineteenth century than today. Local government functions were equally limited. Thus a single tax was conceivable and not so large as to be confiscatory.

George viewed the objective of the land tax not so much to raise revenue, as it was to break the power of the land speculators and to promote equitable and fair land development. This socialistic, free-trade aspect appears to be as important as revenue in George’s mind, and this aspect became more of his central focus as the idea spread. In parts of Europe, the particular land value taxation approach not only represented taxation on unimproved value, but also the abolition of rents and the nationalization of all industry. Clearly, such ideas were far removed from what could be called “free-trade.”

In 1888 George visited England and had been welcomed by the Liberal Party. The Liberal Party philosophy was that landlords (property owners) were the sole benefactors from all improvements to the land, and as such, they should pay taxes commensurate with the benefits. Legislation to establish some type of land tax was introduced by the Liberal government in the first decade of the twentieth century. An attempt was made to measure the full potential of unimproved value, site by site, discounted to the present, so that there would be no enhanced tax liability no matter what “improvements” were subsequently made. This task proved too much for the appraisers, and very little progress had been made by the time the Conservatives repealed the legislation in subsequent Parliaments.

George had much greater success in the developing countries of South Africa, Australia, and New Zealand, which he visited in 1890. These developing countries did not have an entrenched tax system with which a land tax had to compete. All these countries had

similar situations to the California boom as well, with spectacular, “unearned” profits going to particular landowners. The general public attributed these profits to simple luck, market manipulation or timing, rather than any skill on the part of the landowner in selecting or improving particular sites.

George’s site-value, single-tax arguments seemed to make good sense in the Californian boom. In fact, he was making two implicit assumptions: first, that the spectacular boom in land values would continue indefinitely, and, secondly, that appraisers would always be well supplied with evidence of unimproved land sales, so that improved sites could be valued easily by comparison. In practice, when the first condition was not fulfilled and an economic slump ensued, bankrupt tax authorities quickly abandoned the site value concept since the tax base eroded drastically.

Conditions in Australia in 1890 were in many ways similar to what they had been in California in 1870 and George’s ideas quickly became popular. He found, however, a subtle difference that puzzled him. The rural landowners favored free trade and capitalism, far from the land monopolists George often envisioned. As a result of George’s visit, the states of South Australia, New South Wales, and Queensland enacted taxes on unimproved value. Legislation allowing some form of land tax was passed in New Zealand and South Africa. Johannesburg adopted the idea, but Capetown did not. From South Africa, the concept spread to the British East African territories of Kenya, Uganda, and Tanganyika as well as Rhodesia. Apart from Denmark, these countries are now its leading practitioners.

Modern Adaptations of Land Value Taxation

In recent years the basic objectives of land value taxation have been considerably modified. A likely modern-day economic situation would be one where urban population was rapidly increasing and where some degree of inflation was likely to be sustained, perhaps due to unemployment concerns. It is clear that with the commitments of modern governments, land value taxation would, by itself, be hard pressed to raise sufficient revenue to cover all spending demands. A land value tax would be able to replace part or all of the current property tax system. However, the land value tax can be considered as a supplement to, while not entirely replacing, such taxes as the sales, income and other state and local taxes.

If a land tax substituted for a traditional property tax to some extent it would have several advantages, in terms of income incidence and incentive to invest. It would not be possible to base the assessments on the “original and indestructible powers” of the land. This was attempted in London under the Liberal (Lloyd George) legislation in the first decade of this century, but appraisers found the requirements unworkable. Valuing a particular site as if each was covered only with “sedge, grass or other natural growth,” and yet all other improved parcels (buildings) remained intact, was not a practical approach. In modern conditions one would expect roads and basic utilities to be present.

Even allowing for these less-than-perfect conditions for the land value tax today, it may be less regressive than the present U.S. property tax system or the British local rate. The degree of regressivity is, however, not considered so heavy as to detract seriously from

its general usefulness. A fundamental contrast between British and American points of view should, however, be noted here. Apart from the inelasticity of revenue, the main objection to the local rate in the United Kingdom is the relatively high burden that it could place on low-income households. To meet this hardship a “rate-relief” grant could be offered to reduce the undue hardship where the rate demand is abnormally heavy in relation to income. In the United States, one of the major objections to the property tax is its disincentive effect on development, over and above the regressivity concerns. Most states in the U.S. already provide some sort of property tax relief to low income owners, usually through homestead credits and exemptions. In the United Kingdom the extremely vocal complaints concerning the disincentive effects of taxation are due to income and corporate taxes.

Quite apart from assessment difficulties, a tax that exempts the more valuable element of the property, the improvement, can only be revenue-neutral when tax rates are relatively high. Otherwise, there are serious risks of inequality. Pittsburgh and Scranton, Pennsylvania have been successful because the land tax was discreetly implemented over a fifteen to twenty-year period. Also, tax policies in Pennsylvania allow for the use of other sources of revenue, especially local income taxes.

Benefits of a Land-Based Tax

It is clear that land value taxation is feasible. But for the tax to be implemented there must be sufficient and strong reasons to replace the current property tax system. Several obstacles exist; questions of political will, equity, financial viability and most basically a clear value determination.

Development and Redevelopment

A strong argument favoring land value taxation, as practiced especially by the Australians and South Africans, is that the tax encourages “appropriate” development. Such development can be equated with maximizing the usefulness of buildings on the appropriate site. In an accurate valuation, the net present value of all future developments would be included, so that there would be no additional tax to pay when further improvements were made. The owner has a strong incentive to erect structures that maximize return. There is no incentive to leave the site vacant or hold it for speculative purposes as typically occurs under a property tax system that taxes incremental improvements.

In the assumed conditions of steady growth, a land tax based on maximized land use value (i.e. market value) should lead to full development of the site. This implies that the risks of mistaken or excessive development are so small that they can be neglected. If risk is present or if the market is imperfect, large developments will not be undertaken. Even under a site value tax it may pay to leave a site vacant, to the extent that it may lead to a discreet disappearance of the owner, in the same way as can occur under a traditional property tax. Risks of this nature may be less likely to occur today under the more controlled conditions of urban development, given imposed zoning restrictions, more highly informed market participants and so on. Even in fast-growing economies all areas do not develop equally, and risk-adjusted returns determine the development process.

Nevertheless, any local authority that wanted to reduce the incentive to hold land for speculative purposes could contrive means of thwarting such speculators. As we know, the concept of “value” can be construed in many ways by taxing authorities.

The idea of a land tax serving as a general stimulus to development is often determined in the early stages of a country’s growth. In established economies, the situation is quite different and calls for more selective measures. Generally, there are two particular forms of development where control via taxation is preferred: urban sprawl on the fringes of a city and the promotion of urban renewal in the congested inner core. The latter is especially demanded when urban decay is present. Failure to control urban sprawl may promote development of tax havens in the suburban areas but also greatly adds to the cost of providing basic utilities and roads in the new areas. An especially prominent aspect is “leapfrogging,” where land is left vacant immediately outside the city boundaries with new developments starting only a short distance away. Such land normally pays a tax based on its agricultural valuation, so it is relatively inexpensive for speculators to hold. This application of a common tax rate to all property within specified boundaries is problematic, but less so with a land-driven tax.

Urban renewal concerns are viewed differently than the problem of sprawl because social well being, morals, local politics are involved. To the extent that fiscal needs allow, a redevelopment incentive must be provided. As the land as well as the improvements stagnate and succumb to increasingly inferior, sub-adequate uses, land value would eventually decline sufficiently to make redevelopment an attractive alternative. However, even in areas with an adequate tax base this does not seem to be the usual chain of events.

This process of enticing redevelopment in declining urban areas requires speculative behavior. Since the value of distraught property near the urban core is less than otherwise “normal” in a typical rent-gradient pattern from the urban core, purchasers of such property have an economic impetus to hold the property until the optimal point to develop it into its ultimate use. The result is an ultimate, improved parcel price greater than the cost of acquiring the land plus the holding cost of the land, the subsequent improvement cost, and normal developer profit.

However, once distraught land is purchased at a “low” price, this would trigger a revaluation of the property. Using a potential or highest and best use analysis, the holding cost of the land now becomes high, in turn reducing the holding time of the redevelopment. Ultimately, the revaluation effort spurs transformation of the property to its intended use. The purchaser would make a “normal” developer’s profit, over and above the cost of acquiring the land and erecting improvements. The longer the property is held in its subadequate state, the higher the holding costs, eroding the “normal” profits that developers would otherwise earn.

Equity and Fairness

As the circumstances above illustrate, an equitable tax must be based on market information and not on ad hoc judgment, even if valuations have to be extracted from “extreme” market transactions and conditions. As vacant parcel sales rarely occur in

developed areas, valuation of land is especially problematic due to the existence of improvements. As practiced in Australia and New Zealand, the depreciated replacement cost of the improvement is deducted from the total improved site value (actual or proposed). This brings up yet another possibility: demolition costs. In a developing city this factor may not be of great importance, since a large part of the process of development will consist of razing lower quality, less desirable structures and substituting structures greater use value. The combined effect of a potentially high demolition cost and a small depreciation factor could reduce the site value to zero or even a negative.

A simplified method of land valuation used in parts of Australia and New Zealand is to obtain a ratio that, on the average, represents a typical improvement value to overall property value. This serves as an application of the allocation method, as further discussed below. The overall property values are obtained from recent, market transactions. This method does involve forming some assumptions, and perhaps even may be arbitrary, especially when a percentage derived from one market is transferred to another market.

To what degree can we expect any land valuation method to solve the problems associated with controlling sprawl, while simultaneously enhancing urban renewal? A possible solution is to place two valuations on the land: one based on its present use and the other on its potential use. The difference between the two (or some percentage thereof) would then be collected when and if the site is converted to that potential use. The knowledge of having to pay a tax on the conversion might deter speculative holding, yet it is unlikely to motivate immediate development.

As for urban-fringe areas, the problem of land use intensity is relatively more simple to solve because the economic conditions are more or less those of a developing city—there would be sufficient vacant-site sales to accurately value property based on the sales comparison method.

Valuing land in urban blight areas is a more arduous process as limited numbers of vacant land sales makes it difficult to ascertain site values. If true land values have fallen to very low levels, as they do in “urban decay settings,” a moderate stimulus to redevelopment should emerge, given that the costs of demolition are not too high and potential profits can become sufficiently large. The local authority might meet this challenge by declaring a particular area a “development area” and perform the demolition itself. Subsequently, government could take several measures to enhance the site value, such as imposing a restricted or percentage tax rate, or even a complete exemption of the parcel for a limited period. An even more extreme measure would provide an outright subsidy for the type of redevelopment deemed appropriate.

On the surface it appears that direct expenditures by local governments are a relatively easy manner in which to promote core renewal and control suburban sprawl. This may take the form of subsidies for demolition and particular forms of development or in restricting developments that compete with the redevelopment effort. It is impossible to accurately predict the outcome of such action on developers or speculators who actively withhold land for an increase in prices. Clearly it would impact their decisions, with the

extent depending on relative risk and time preferences, interest rates and other related factors. However, one expects that such planning and control measures would decrease the attractiveness of speculation and ultimately inspire development.

As pure land value assessments assume an undeveloped site, a land value tax may be more effective in promoting development as compared to traditional valuation of both land and improvements. A pure land tax would result in lower values and taxes in decaying areas and higher values and taxes in growing areas. In any case it is unlikely that any effective improvement will be made without public and political support to enable this relatively unique approach. Naturally, taxpayers view any change in valuation and taxing methods with skepticism. This is especially true for those taxpayers that knowingly or unknowingly benefit from the inequities present in the current systems. Thus the implementation of a land-based tax is most likely in jurisdictions where a majority of the public has lost faith in the current system. Unfortunately, while the public generally demands equity, few are willing to pay for it.

Land Value Concepts and Principles

Although the concept of value is based on individual-specific criteria, the principle of market value is more concrete. *Market value* for a specified good represents the price or monetary value at which the good is exchanged between a buyer and seller. Further, the exchange must take place between knowledgeable persons, who are fully aware of all characteristics and factors that are relevant to the transaction. The transaction must occur based on the free will of both parties, and not be made under duress. The exchange must be at “arm’s-length,” without special relationship between the parties. For the selling price to be considered market value, all parties must recognize the current use of the property, as well as all potential uses.

From a valuation perspective, however, the underlying question involves which “market” of buyers and sellers must be considered, the current market or the potential market. While this distinction may be fairly obvious in a fully developed residential area where the current and potential markets are one in the same, the distinction is less obvious in areas in transition.

Potential (Highest and Best) Use Value

Underlying Henry George’s views on value is the concept of highest and best use. In short, it is that use which generates the highest net return to the owner over time. The concept of highest and best use requires some judgement from the appraiser in determining what use, perhaps among several possibilities, returns the greatest value to the owner.

In assessing the highest and best use, four aspects must be considered. First, the use must be physically possible on the particular site. This may be as simple as the acreage of the site, or may pertain to soil and substructure characteristics. Secondly, the use considered must be legal, meeting all zoning requirements. Third, the use must be financially feasible, providing a reasonable rate of return to the owner. Finally, the possible use must