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Equity and Creative Financing

When Benito Mussolini ordered the construction of Rome's first underground railway track, he did more than make the trains run on time. His plan pinpointed the locations where property would rise in value; and sure enough, the speculators moved on to the prime sites adjoining the stations to reap the benefits of the massive investment which connected Rome with the buildings where Mussolini had hoped to stage a world fair in 1942.

That government spending increases the value of land is a well-established fact.[1] But the justification for the private appropriation of this value is a generally neglected issue. This brings us to a consideration of equity, a concept which neatly embodies the two issues of central concern to us here. It is a moral concept that alludes to fairness. At the same time, its economic content refers to the value over and above charges outstanding against a property.

It seems fair to argue that if public projects cause the value of adjoining land to rise, then the community is entitled to capture that value. The landowner has no moral or financial claim on the enhanced equity of his property. Would it not make sense to finance those projects directly out of the increased value of affected land? Would this not be a shrewd way of overcoming the shortage of capital that is given as the principal reason why projects vital to social well-being have to be deferred into the future? These questions can be examined in relation to the global need for energy conservation, the relief of congested highways and the reduction of pollution through the provision of new systems for mass transit.

From Mexico City to Singapore, the town planners entered the 1980s determined to devise efficient means for transporting people from their suburban homes to the cities where they work and play. But no sooner do such plans get laid and the taxpayers' money allocated, than the speculators move in to capture the financial benefits by capitalising them into higher land prices. For example, from the day that the location was identified in 1966, land prices around Tokyo's controversial Narita Airport started rising. They had escalated by a factor of 30 by 1980, most markedly along the line of the Hokuso railway, which was to connect Chiba New Town with the airport.

Government plans are aimed at reducing psychological stress and physical discomfort, improving economic productivity and conserving scarce natural resources (from the consumption of finite energy to the curbing of urban sprawl on to green pastures). The benefits will go almost wholly to the land monopolists.

> If we now focus on urban movements, benefits due to incremental improvements in transportation (either in cost, time, or stress) beween residence and work in a centralized city such as New York seem to be reflected fairly unambiguously in increases in residential rent and land values. Thus, the user benefits only marginally unless he is also the landowner at his residence; as a renter, he may even be put at a disadvantage.[2]

A dramatic illustration is the Metro system built in Washington, DC. In 1980, senators approved a $24.8bn. federal subsidy programme for US mass transit systems, the money to be spent during the following five years. The senators themselves were well-acquainted with the attractions of efficient systems, because the underground railway being built in and around the American capital was the most advanced in the world — what *Fortune* dubbed 'the solid-gold Cadillac of mass transit'.[3]

The original cost of the Metro was put at $2.5bn. From the day of the first ground-breaking, in 1969, the cost escalated to $7.2bn., and 80% of that money was to be paid out of federal funds. By 1980, taxpayers across the continent had generously contributed to the commuting comfort of the residents living within short distances of Capitol Hill.

For the benefit of the *residents*? A congressional staff survey discovered that land values around Metro stations had increased by $2bn. in the five years since the first train slipped out of Farragut North in 1975.[4] This was a calculation based on the most conservative assumptions; the true figure was somewhere up to $3.5bn. Thus, the wage-earners of America had paid their taxes to the federal government, who in turn created an air sprung subway system the financial benefits of which went into the pockets of landowners! Is this a sound way to finance public projects? Is it the *morally*-correct way to distribute the benefits?

The equitable way to finance mass transit systems (as with any public project) is to do so out of enhanced land values. That such values do result from public investment is recognised in an official report which concluded that there were substantial social benefits (such as the conservation of oil) to be enjoyed by main line electrification of Britain's railway system.

> There is evidence that this has occurred with previous electrification

> schemes, but it has not been possible to assess the magnitude of the effect which might arise from a large electrification programme.[5]

That the increase in land values from such investment is considerable was testified to by property developer Nigel Broackes in a letter he sent in June 1982 to the Secretary of State for the Environment (Michael Heseltine). Mr Broackes, the chairman of the London Docklands Development Corporation, justified the expenditure of £65m. of taxpayers' money on a light rail system connecting the East End with the centre of London on the grounds that the impact on land values, 'though impossible to quantify, will in my judgment be considerable, providing benefit to the Treasury on our own land and enhance land values generally to private owners'.

The alleged difficulty of monitoring the increase in land values[6] did not deter the Hong Kong government, which in 1980 selected this method to finance the HK$7bn. Island Line extension to its railway system. Of the total cost, $5bn. was to be raised through the profits on property development around the 13 underground stations. To a criticism that this was a 'somewhat bizarre' way of financing the railway, the chairman of the Mass Transit Railway Corporation replied:

> I would have preferred the description to be progressive or realistic... World experience as well as that in Hong Kong indicates that property values in the vicinity of newly opened underground railway stations tend to increase dramatically. By allowing the corporation to develop the air space above stations and depots, the government has diverted a portion of the profits arising from such an increase in property values towards the financing of the railway. What is bizarre about that?[7]

Thus, the community creates equity in land which it then captures to finance the original project. No-one loses, but everyone gains through access to the improved transportation system.

Examples can be found of this form of creative financing. In the past 30 years Bogotá, in Colombia, has used special assessments on land values (called 'valorization' taxes) to finance much of the capital's urban infrastructure.[8] Each plot of land is assigned a prescribed benefit calculated on the basis of proximity to the project, the size of the plot, frontage, and anticipated changes in use due to improved economic activity. The tax is a lump-sum payment, which from the equity point of view is a shortcoming. For the benefits in the form of increased land values continue after the project has been completed. The continuing benefits, however, remain with the landowners.[9] This is not the case with an *ad valorem* tax on the annual value of land, in which the benefits accrue to the community in perpetuity.

Another problem concerns the price of land. With the valorization tax, the lump-sum payment does not reduce the rate of return to land after completion of the development. The price of land will therefore not be directly affected. It will remain as expensive as ever to first-time users. Under land value taxation, however, the initial cost of land is reduced for potential users. The buying price is reduced by the amount that has to be paid in the form of the annual tax.

The irrigation districts of California afford an outstanding example of how the annual tax on land values overcomes the problems associated with once-for-all lump-sum taxes.

In the early 1880s one of California's legislators, C. C. Wright, realised that the huge ranches owned by the cattle barons would be more productive if water was channelled into the semi-arid zones. In 1887 the 'Wright Act' (known officially since a 1917 amendment as the Irrigation District Act) was passed to deprive large-scale landlords of what Henley called 'a traditional veto of progress'[10]. The purpose was to transform a 'semi-arid land from its normal permanent slumber as an area of absentee baronies to one of prosperous independent farms and rural cities offering social as well as economic rewards'.[11]

The districts created their network of irrigation canals out of money raised through a tax on the value of land that benefited either directly or, according to court decisions, indirectly (land in neighbouring towns was held to rise in value because of the rural prosperity). In 1909 an amendment provided for the exemption of improvements, such as orchards and buildings; a tax on these were held to be a disincentive to new investment.

The big landlords tried to resist the measure. One of then, Henry Miller — the Cattle King who could drive his herds from Oregon to Mexico and camp each night on his own land — branded the Act 'a communist device'. He appealed all the way to the Supreme Court, but lost. The transformation from extensively-used ranches to intensively cultivated small farms was rapid. In three counties (Modesto, Turlock and Stanislaus), a vast semi-arid treeless tract of 81 played-out wheat farms became over 7,000 family-sized farms with an average size of about 30 acres. The change did not come through political controls, land appropriation and arbitrary bureaucratic allocation. The free market provided the framework, and the tax on the value of land stimulated the action. Henley neatly summarized the dynamic forces propelling the landowner.

> He is nudged from behind by the assessment on his land to do something that will permit him to pay it. At the same time he is beckoned by the promise that his effort and investment to make the land produce will not be penalized, since such improvements are not taxed.[12]

The cattle barons were not able to use all of their land to its full potential, so they relinquished some of it to others, and in the process the correct distribution of land (consistent with the local conditions) was attained.

Lest it be thought that the whole of California benefited from such enlightened fiscal action, the story of Kern County Land Co. is worth recounting. In 1877 two speculators, Lloyd Tevis and James Ben Ali Haggin gained title to 150 square miles in the San Joaquin valley through a masterful fraud.[13] Unknown to most people, Congress had hurriedly passed the Desert Land Act, which authorised the disposal of arid public lands in 640-acre holdings to persons who promised to provide irrigation. Haggin and Tevis arranged through their political friends to have the San Francisco land office opened on Saturday for their exclusive use. Scores of henchmen were then organised to enter claims to 640 acres each. These holdings were then transferred to Tevis and Haggin. Settlers already on the land (some of it, located near the Kern River, was fertile) were dispossessed. There was a public outcry, but the evil deed was done.

In 1880, the two men incorporated their holdings under the name of Kern County Land Co., on whose land oil was discovered in 1936. The company was acquired in 1967 by Tenneco, the Houston-based conglomerate. Their fiscal obligations to the community can be measured by looking at the year 1970. California's Williamson Act produced an estimated property tax reduction of $136,911. The federal crop subsidy bestowed $1.3m. on Tenneco, along with an unknown sum conferred by way of a water subsidy under the California Water Project. The value of Tenneco's land holdings in the valley was soaring. The corporation reported profits of $73.8m. But according to documents on file with the Securities and Exchange Commission, far from paying federal income tax that year, it enjoyed a federal income tax *credit* of $20m!

Thus, while we can demonstrate the administrative feasibility and economic efficiency of land value taxation, we are still left with the political problem. How long will the public continue to tolerate the maldistribution of socially-created income? According to Harold Dunkerley of the World Bank:

> Recent international discussions have served to underline the widespread conviction that surplus [land] values which are unearned in the sense of not being due to the savings of the private holder should accrue to the public since this surplus is primarily due to public investments or community development or monopolistic practices.[14]

Despite this optimistic assessment, the monopolists continue to retain their grip over the land; and they do so by turning the argument for equity against the reformers. Their most effective weapon is to deny that landowners have the ability to pay, one of the key Smithian tenets of a sound tax. And the most emotive obstacle placed in the way of fiscal reform is this: 'What about the little old lady living in a cottage on a high-value site? She does not have the income to pay the high tax based on the market value of her land. Is it fair to drive her out of her home during her years of retirement?'

There are indeed many cases of old age pensioners living on valuable tracts in urban growth centres. From the viewpoint of efficient resource allocation, it would be desirable that they moved to less commercialised locations in residential districts with lower land values. But a delicate principle of individual freedom is held to be involved here.

Should the old lady be free to remain where she is without let or fiscal hindrance? Or does the freedom and welfare of the majority take precedence? If a means can be found to overcome this problem, then the public acceptability of the principle and equity of land value taxation is enhanced. Such a solution exists in the form of deferred assessments.

Prof. Donald Shoup has described how political support can be raised for specific public projects that are to be financed out of enhanced land values, *if the tax payments can be deferred until the property is sold and the benefits of the investment have been capitalised into the selling price*. His model relates to special assessments for one-off projects,[15] but its principles can be extended to meet the general issue.

Shoup cites, as an example, the decision to bury underground the utility wires which were blighting an old, largely owner-occupied neighbourhood. The project costs $10,000 per house, and everyone agrees that this amenity would increase house values by more than this sum. Nevertheless, some owners would oppose the proposal if their incomes did not enable them to meet the tax payments. Their objections, however, would be overcome if they could defer the tax payment until the day that they sold the house. Thus, the beneficial investment could be undertaken by the government, using borrowed cash, which then amortizes the debt by annual assessments. Those who deferred their tax payments would have to pay interest at a market rate on the outstanding money when they eventually realized the equity in the property. If a market interest rate is charged on deferred assessment debt, the present discounted value of repayments equals the initial special assessment, so the government loses nothing by the delay. The home owner could reduce his debt at any time (as when his salary rose through professional advancement). If, however, the homeowner died, the government would not lose out: there would be a legal charge on the estate.

Thus, the little old lady on her high-value plot in the middle of a busy commercial district could opt to remain in her home. Payment of the full tax on her land could be deferred until the equity in the property was realised either when she decided to move, or at her death. Something similar to such a scheme exists in California, where the Senior Citizens Property Tax Postponement Law permits owners to delay payment of their local property taxes, and the State recovers the debt plus 7% annual simple interest at the point of the sale of the property. Not only is the income stream of the pensioner raised at a time of life when income-earning prospects are at their lowest, but the exchequer does not lose revenue in the long-run. The land may, in some cases, not be put to its best economic use immediately, but the legitimate claims of the community on the value of the land have been — or will be — met.

And so we can now conclude that there are no inherent administrative, theoretical, social or moral problems associated with the implementation of land value taxation. The empirical evidence demonstrates that imposing a cost on the possession of land moves economic activity in a desirable direction. This review, however, has been restricted to a partial analysis. We now need to address ourselves to the issues from a macro-economic perspective. Fortunately, the impact on a whole economy can be gauged by an examination of Taiwan, which applied land value taxation a full century after the first experiment in Japan.

Land value taxation was absorbed into Chinese thinking through two channels — the one philosophical, the other through what economists today call 'the demonstration effect'. They both feature Henry George in their origination, and they both finally converged on Sun Yat-Sen (1866-1925), the nationalist philosopher and leading member of the Kuomintang.

Sun Yat-Sen incorporated his ideals of land equalisation and land taxation into Kuomintang policies after reading the works of Henry George and John Stuart Mill.[16] In addition, however, he was able to examine at first hand the influence of land value taxation in action *on Chinese soil*. In 1898 the Chinese Government leased the 200-square mile district of the Kiao-chau to Germany. The principal urban centre was Tsingtao, a fishing village on the mouth of the Chiao-chou-wan. The man appointed as civil commissioner was Dr Ludwig Wilhelm Schrameier, an admirer of Henry George.[17]

During the 16 years of German occupation, the colony more than tripled its population. The central policy of the colony was that all land rent should be available for public use. Land was taxed according to its assessed value. The initial rate was 6%. Land bought from the government and not immediately put to proper use was taxed on a scale which rose from 9% to 24%, according to the length of time which the land was held idle. Not surprisingly, therefore, there was rapid development and no speculation. Ironically, land taxation was abolished during the Japanese military occupation of Tsingtao (1915-1922).

Schrameier was invited by Sun Yat-Sen to be his adviser. He went to Canton to assist in drafting the land law and land registration regulations, the draft of which was nearly completed and required only 10 days more to be put into its final form when Schrameier was killed in a car accident on January

5, 1926.[18] In any event, Henry George's ideals lived on through Dr. Sun's *San Min Chu-I* (Three Principles of the People). When the nationalists fled from the communists and took refuge on Taiwan (then called Formosa) in 1950 under the leadership of General Chiang Kai-shek, the *San Min Chu-I* formed the centrepiece of the strategy for economic development.

By the mid-'50s, Taiwan had undertaken the most successful of postwar land reforms. Through the land-to-the-tiller programme, rural incomes were progressively equalised.[19] A quarter of the land was redistributed, and was used more efficiently. Government revenue increased from land taxation, and resources were switched into the industrialisation programme.[20] By 1969-72, industry was growing at an annual rate of over 21%.[21] GDP rose at an annual rate of over 10% in the decade up to 1974.

In 1967, C. F. Koo, the President of the Chinese National Association of Industry and Commerce, reviewed the evidence, and concluded that industrialisation was critically influenced by land reform. Previously, he said, few landlords were willing to invest money in industry. As a result of the government's measures, however, 'capital which used to be active in land transactions or frozen in land has been given over to growing industry since the land reform and thus increased the rate of industrial employment'.[22] And he did not subscribe to a cultural explanation for the pre-industrial state of the Chinese mode of production.

> The reason why China could not catch up with the pace of industrialisation in occidental countries in spite of contacts made with Western countries during their period of overseas expansion in commercial and industrial markets, was not because of her backwardness in agricultural production, but because of the restrictions imposed on industry by the traditional rural-productive relationship. The land reform abolished this irrational rural-productive relationship and the unreasonable tenancy system, thus removing the obstacle that stood in the way of industrial development and creating a remarkable change in the structure of the social economy.[23]

In spite of her undeniable achievements, however, Taiwan's experiment fell short of its full potential. Land value taxation was not applied either fully or consistently. The average tax rate has been under 2% on assessed value and the actual average rate on estimated market value has been under 1%.[24] Nor has the land value increment tax, which falls at differential rates at the point of land transactions, eliminated speculation in land on urban fringes. The Government sought to deal with this problem with the Statute for Equalization of Land Rights (1977). This introduced a new device: a 10% penalty on the value of land sold on which no improvements had been made, and a 20% reduction in the tax on the value of land sold on which improvements

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had been made. There are administrative problems associated with implementing this formula. In addition, the statute appeared to fly in the face of its title — the equalisation of land rights — by removing the penalty on absentee ownership, and reducing the preferential rate for owner-occupied residential land from 0.7% to 0.5% on urban land up to 3 acres and on rural land up to 7 acres. The ideal solution, which would have removed the anomalies and generated an even more successful realisation of the goals set by Sun Yat-Sen, would have been a 100% recovery of annual rental income.

By 1980, the leaders of Taiwan's land reform programme had grown to appreciate that social tensions were emerging as a direct result of unequal rights to land.[25] Although an authoritarian system, Taiwan's politicians expressed a wish to modify their tax system to re-establish harmony, but it seems that the partial solutions ultimately advocated by J.S. Mill (such as taxation of *future* increases in land values), were to succeed over the pure model advocated by Henry George.

The failure to develop the taxation of land values to its logical conclusion can have serious consequences. In Japan it led to a mitigation of the miracle, through the creation of a new landlord class; the economic impact of the speculative motive is in no way ameliorated just because the opportunities for cashing in on unearned rental income are diffused among a larger group of people. The truth of this proposition can be tested against the important evidence that is provided by the history of Australia.

Notes

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