

2

Terra Incognita

RONALD BANKS

DISPUTES over rights to real estate have caused the most vexed problems throughout the ages. Controversies have been variously resolved by civil commotion and military conflict; at other times, consensus has emerged around new theories of political philosophy. The final word about these rights has not yet been carved on tablets of stone: they continue to be redefined by parliaments, civil courts and social conventions. It is one of the greatest ironies, however, that while people argue (and nations fight) over 'Who owns what?', very little attention is directed at the problem of 'What's it worth?'

Government statisticians and university economists devote a great deal of care to collecting information about labour and capital, but they generally show little interest in the scarcest of productive factors — land. We know precisely how many workers there are in the market economies of the world, and have a fair idea of the value of the wealth that they produce. We have measures of the size and value of the capital stock, and detailed records of who owns it and how much they earn from it. But when we turn to land, we are confronted with a dearth of data. This is particularly notable in the United States, where the information-collecting agencies are otherwise exhaustive in their efforts.

In Britain, the Domesday Book of Norman conquest times was the first thoroughgoing nationwide appraisal of the value of real estate. Since then, apart from the survey commissioned by Lord Derby in 1874, little of value about the ownership and value of land (beyond the estates controlled by the aristocracy) has been produced in which we can have confidence. This was the problem that challenged the authors of this study.

The value of land — that is, the value separated from that which must be attributed to undepreciated capital improvements (buildings, roads, drainage systems and the like) — does not receive systematic attention from economists or the civil servants who are the keepers of the nation's books. This does little to enhance the quality of the decisions taken by the politicians who are entrusted with the task of maximising social welfare.

An explanation for this seemingly contemptuous indifference towards land might be found in the view held by eminent university teachers of economics that the rental value of land constitutes a small proportion of the nation's income. Professor Paul Samuelson (1976: 538) guessed that economic rent was 'probably' only about 5% of GNP. Professor Richard Lipsey (1979: 371), in discussing the revenue that might be reaped from a tax on economic rent, contended that it 'would finance only a tiny portion of government expenditures'. Graham Hallett (1979: 88), an authority on the economics of European real estate, has expressed the view that the rental value of land 'can hardly be more than 2% of national income'. These views reflect the opinions of past masters such as Joseph Schumpeter, who — in reviewing the argument that the rent of land constituted a substantial tax base, a view originally expounded by the French physiocrats — asserted that this 'involves an unwarranted optimism concerning the yield of such a tax' (1954: 865). The uniform view that the rent of land is a relatively insignificant value has been associated with an equally startling absence of facts upon which to base the assessment.

The hypothesis that rental income is a negligible fraction of the total revenue of a nation was regarded as testable by the authors of this enquiry. Britain was selected as a case study. The methodology employed is fully reported in the hope that scholars in other countries will conduct similar exercises.

The guesstimates of the authorities cited above were found to be grossly out of line with reality, as can be seen from Table 2: I. The capital value of land in Britain, in 1985, was about £505 billion. Using the interest rates appropriate for that year, and including mineral rents, we arrive at an annual rental value of over £53 billion. To that figure must be added that proportion of income from the rates (Britain's local property tax) which constitute land rents; the

market price of land, which we measure, is net of this tax liability. The yield from rates in Britain totalled £13.37 billion. If we assume that the rental value component constituted 35% of this total (our calculation of the national average ratio of plot prices to house prices), we must add £4.7 billion to our estimate to get near a true figure of rental income (£58.2 bn).

This was equivalent to 22% of national income. Viewed another way, rental income, received or imputed, but not counting rates or mineral rents, exceeded the income tax paid by people. That the sum involved is far from the derisory quantity suggested by economists is rendered clear by the fact that all the rental income of Britain in 1985 was equivalent to 44% of all central and local government tax revenue, including National Insurance Contributions.

These valuations have been criticised as *under-estimates* by

Table 2 : I
The value of land in Britain, 1985

	<i>Capital value</i>	<i>Rental value</i>	
	----- £ billions -----		% rate
In public services	64.4	3.2	5
Farm, wood and forest land	48.3	2.4	5
Housing	249.0	19.9	8
Commerce	107.7	8.6	8
Industry	35.5	4.4	12.5
	505.0	38.6	7.6*
Mineral rents/royalties		14.9	
Local authority rates		4.7	
TOTAL	505.0	58.2	

NOTE: numbers do not add up due to rounding.

* Implicit

experts in the landed professions and property development business to whom they were submitted for scrutiny. We accept this criticism. Owing to the shortcomings in the data, some working assumptions had to be made. As a matter of policy, the authors chose assumptions that would yield conservative estimates.

The buoyancy of income from land can be gauged from the trends in rental income in the last half of the 1980s (Table 2 : II). We estimate that the rental income in 1988 was £86 bn. Our calculation takes into account the weakening of agricultural rents since 1985, and the decline in North Sea oil rent. These losses, however, were more than offset by the dramatic rise in urban land prices, beginning first with residential site values and followed, late in 1987, by the accelerated increase in the price of commercial and industrial land. We estimate the rental income of land in 1990 at about £119 bn.

Table 2 : II
Estimated rental value of land,
Britain: 1985-1990 (£ billion)

	(1)* <i>Land rent</i>	(2) <i>National income</i>	(3) <i>Land rent as a % of national income</i>
1985	58.2	260.3	22.4
1986	55.2	276.5	20.0
1987	66.2	303.3	21.8
1988	85.7	336.7	25.5
1989	104.6	363.6	28.8
1990	118.8	387.3	30.7

* Includes imputed rents and 35% of local authority rates. Explanatory data are in footnote 1.

Without adequate data on rental income we do not believe that the economists who advise governments can offer credible guidance on the macro-economic consequences of the alternative strategies

that are available for achieving social and economic goals. We need a detailed appreciation of the size of the flow of income from land, to present an accurate assessment of the impact of various policy options that might be directed at, say, regional or inner city regeneration, or fiscal policy. As things stand, however, decisions are taken in almost total ignorance of — because of lack of interest in — the impact of the land market, and the consequential effects on people and businesses.

We recognise that, as advisers in the realm of practical affairs, economists start from a point of disadvantage. They have allowed theory to degenerate to the point where it is now difficult to disaggregate their data, so it becomes difficult to know where — in value terms — natural resources (land) end, and man-made equipment (capital) begins. Despite the difficulties, however, it is important that the hiatus in our knowledge should be filled.

The Spatial Methodology

We used the spatial method of assessment: of multiplying areas of land by the price per hectare that the sites would command, given the various uses to which they could be put under the system of planning now in place in Britain. This is the direct route into the problem, and is recognisable as an extension of the use of what is known as the comparative method (the assessment of value in the light of known prices realised for similar sites).

We double-checked our approach by applying the residual method of assessment to commercial and industrial land, the sector in the property market with the least reliable data on the amount and value of land used. This method consists of an assessment of the capital value of a completed development reduced by the costs of the developments on the land and an allowance for the developer's risk and profit. As a first step, this entailed the multiplication of the floorspace areas of buildings by rental values (Chapter 8). This method has been employed by national accounts statisticians at the CSO, although with strong reservations (Bryant 1987: 100).

Our method produced the higher capital value (£143 bn, compared with an estimate of £135 bn achieved by applying the residual method). The two methods routinely produce different results, but

in the real world there are practical ways of resolving such anomalies. As a report by the Department of the Environment noted:

The residual method is commonly used by developer-purchasers and the comparative method by landowner-vendors, though both parties may use both methods as cross-checks on each other. More often than not the two methods give different results and the outcome will be a negotiated price whose level depends on the relative negotiating strength of the parties ... (DoE 1988: 18).

The comparability of the two values which we achieved gives us confidence both in our approach and our estimates for the other sectors.

The significance of our findings suggests the need for an official assessment of the rental income of the nation. Which method ought to be used? Our spatial method would be favoured, if only by default. For the residual method cannot now be applied at the regional and national levels. The Department of the Environment has discontinued collating floorspace statistics, a decision criticised by two of the major firms of property surveyors, Hillier Parker and Healey & Baker (Chorley 1987: 187).

Portfolio Management

An awareness that Britain has wasted part of her precious natural resources has emerged in recent years. Conservative governments have appealed for better use of these resources as part of a strategy to restructure both the economy and taxation.

To clarify the issues and understand why the problem arose in the first place — so that appropriate corrective policies can be formulated — a closer examination of the dynamic differences between the land and capital markets ought to be sponsored by government and the institutions with a direct interest in the property market. For land and capital markets display some uniquely dissimilar characteristics. The consequences of the motives which influence decision-making are also strikingly different, and have major implications for policy.

The work in this field has been limited. Yet the importance of understanding the land market is evident from the continuous pressure on local authorities and State agencies to sell assets that

have been surplus to their requirements. Although the political emphasis has been on the better use of publicly-owned assets, an improved use of privately-owned real estate would also raise living standards: a University of Cambridge study found that one-third of vacant land in England's cities is owned by the private sector (DoE 1988: 35).

Unfortunately, a comprehensive inventory of the nation's stock of natural resources is not available. This gap in our knowledge has been identified time and again. The public, for example, are kept in ignorance of the full extent of property owned by local authorities. This was the conclusion of the Audit Commission (1988: 1), which characterised property as 'a hidden and undermanaged resource'. The value of local authority property was guessed to be over £100bn., excluding council housing. Is it satisfactory that we should have to guess at the value of property administered in the public domain? How can councillors be held accountable for the way in which they manage property if the electorate cannot judge the efficiency of that management in balance sheet terms?

There is nearly always an opportunity cost associated with holding property. But this cost is frequently ignored in local government decision-making. It is not uncommon for development proposals to be perceived to be cheaper than they would otherwise be 'because we already own the land'. Authorities should be aware of the alternative land use values of their property and this awareness should be communicated to all those responsible for taking decisions concerning property. Equally, users should be aware of the opportunity cost of using property inefficiently in terms of excess running costs. (Audit Commission 1988: 12)

In the public domain, then, it would seem — according to the Audit Commission's investigation — that the taxpayer would benefit enormously from a systematic programme of identifying and valuing landed property. The benefits would be measured in terms of untying capital resources that are not fully used; generating capital receipts; cutting the tax burden; and encouraging a dynamic economy. The money involved is not inconsiderable. The Department of Health and Social Security have estimated that annual revenue savings from making better use of their estate may range from between £300m and £500m (National Audit Office 1988a: 4).

Yet few authorities recognise [their holdings] as investment property and manage it accordingly, e.g. by valuing it in order to determine the rate of return being achieved. The value of this property can be very great ... Without knowing the value of the investment portfolio it is impossible to measure the return being achieved. (Audit Commission 1988: 17)

The Land Register, which is supposed to be a compilation of vacant sites available for redeployment to new uses, is evidently an unsatisfactory record both as an inventory of land and as a tool for implementing policy. The Audit Commission discovered that it lacked credibility as a source of information to potential developers.

Not many authorities know how much vacant property they own. The Register of Unused Land on which authorities are required to register their holdings, does not record all vacant property, e.g. if it is being used for some temporary and sub-optimal purpose such as surface car parking or grazing. Few authorities have procedures for periodically reviewing their vacant land holding and justifying its retention. (*Ibid.*)

According to a detailed survey of vacant urban land (Civic Trust 1988), over 60% of unused land and small sites were not recorded on the register, because most of them were in private ownership.

Parts of the private sector can be as negligent as the public sector in failing to record their assets in terms of current market values. The difference, of course, where such assets are owned by public companies, is the prospect of action by ever-alert predatory entrepreneurs. They seek companies at knock-down prices (the direct result of under-valuation of properties) for the purpose of stripping them of their assets.²

It should be acknowledged that the valuation of property at current market prices is not universally accepted as a necessary precondition for judging the efficiency of people who are charged with managing assets. This was the view expressed in 1982 by the Commissioners who administer the Crown Estate, the capital of which belongs to the Sovereign. The Crown Estate had until then never been comprehensively valued.³ The Commissioners, when questioned by the House of Commons Committee of Public Accounts, argued that the absence of a full valuation did not necessarily compromise their performance.

We pressed the Commissioners on whether the absence of a balance

sheet recording all their assets and liabilities made it difficult for Parliament or any interested outsider to form any assessment of their efficiency of operation of the Crown Estate, and whether a proper return was being obtained from the capital expenditure being incurred. The Commissioners expressed some doubts whether formal valuation of their assets would provide a sound tool for measurement of the efficiency of their management (Committee of Public Accounts 1982: vi-vii).⁴

There is merit in the argument that, in some circumstances, non-financial considerations should override the decisions that would otherwise be taken on the basis of the pursuit of the greatest profit. Protecting the environment, for example, is in certain circumstances a good reason for putting conservation before pecuniary gain.⁵ But that is not a justification for not placing a price on the natural heritage, and disclosing that value in the books for all to see. In an open, democratic society, informed decisions can only be taken when the fullest possible information on the 'opportunity costs' — the alternative benefits — of one decision or policy, as against another, are monitored and understood.

It is towards a better understanding of issues such as these that we present this study.

NOTES

1 The national income for 1985, 1986 and 1987 is taken from the Blue Book for 1988. We subtracted 2% for Northern Ireland — approximately its proportion of the UK's GDP at factor cost in 1985 (*Regional Trends*, 1987: 123). Growth at current prices of 11% is assumed for 1988, 8% for 1989, and 6.5% for 1990.

Local authority rates income for 1985 and 1986 is taken from *Social Trends* (1987: 113; 1988: 111) with a small deduction for Northern Ireland. It is assumed to increase in line with national income thereafter.

The estimated land rent of Britain for 1985 is given in Table 2: I. The figures for later years have been calculated after taking into account the rental trends in each of the major sectors:

(1) Agriculture. The *Property Market Reports* indicate that farm rents may not have increased during 1986 and 1987. Thereafter it is assumed that as farmland prices begin to pick up rents increase roughly in line with inflation, say 5% per annum. The Ministry of Agriculture, Fisheries and Foods' weighted price index for vacant possession sales in England rose by

one-third in four months from a ten-year low applying roughly to the spring of 1987.

(2) Minerals. The economic rent of the North Sea oil and gas fields is assumed to have fallen by 60% in 1986 and to have stabilised in 1987 in line with the government's tax and royalty income. This drop accounts for virtually the whole of the decline of rent's share of national income in 1986 (col. 3). Thereafter it is assumed to decline by a further 33% in 1988 as prices weaken and output falls, and then stabilize. No account has been taken of trends in other mineral rents.

(3) Urban land. Urban land rents are believed to have doubled between mid-1985 and mid-1988, for the following reasons.

The Halifax House Price Index rose by 59% from June 1985 to June 1988 and the housing stock probably grew by 2.7% over the same period, raising the total market value of GB housing (including tenants' interest) from about £685bn (implied by the official balance sheet figures — see Chapter 6 and *Regional Trends* 1988: 61) to £1,119bn. Using this study's estimate of the value of the land under houses, the buildings alone were worth £445bn in 1985. *Building* magazine's House Building Cost Index rose by 17.3% over the next three years, Coupled with the 2.7% stock expansion and a notional 3% improvement in the quality of the average product, this raises their value to £552bn. By subtraction, the value of the land under houses in 1988 was £567bn, 136% higher than in 1985 and half the value of the housing stock as opposed to 35% in 1985.

We are dealing here with capital values. Rental values would not have increased as much if yields were falling, which they may well have been in the speculative boom. If we assume they fell from 8% to 7%, then residential land rents would only have doubled during the period.

In the commercial and industrial sectors we may deal directly with rental values. Commercial and industrial rents were slower to start accelerating than house prices, but the former did so in 1987, and the latter followed in 1988. According to the Summer 1988 issue of Healey & Baker's *PRIME* report, prime retail rents rose by 66% between June 1985 and June 1988, prime office rents by 57%, and prime industrial rents by 55%. RICS' General Building Cost Index rose by about 15% during the same period. If we make the same assumptions about stock and quality growth as in the residential sector, and assume that land rents were 40% of land and building rents in 1985, then land rents rose by 125% to £29.3bn in 1988, when they reached 55% of land and building rents.

We conclude that urban land rents at least doubled in the three years after 1985. We assumed a decelerating rate of increase for 1989 and 1990, because of the impact on residential land prices of the government's interest rate policy. But this did not convert the land market into one that favoured buyers, for builders continue to be 'dogged by the fundamental

problem of inadequate supply of land for housing to meet ... demand' (House-Builders Federation State of Trade Enquiry, Feb. 1989). This ruled out the prospect of an early weakening in residential land prices. Taking into account the partial deregulation of the tenanted sector of the housing market, we estimate annual rates of increase from 1985 as follows: 15%, 25%, 40%, 25% and 15%.

The total for each year in Table 1:II, column 1, is the sum of the market rents that would be obtainable from all sites in Britain if they were being used to full economic potential within existing planning constraints. As these rents do not always reflect the existing use of sites, or the actual rents paid or imputable, they are not comparable with the national income. They would be comparable only if all sites were used in an optimal way. Likewise, the capital values associated with these rents (Table 2: I) are not comparable with the capital values in the national balance sheets.

2 Britain's brewers, the owners of a vast estate of prime-site properties, have until recently failed properly to measure the performance of their assets in terms of rental income. One of the biggest, Courage, decided in 1988 to alter its arrangements, giving shareholders a better perception of how their assets were being used. According to David Brierley, writing in *The Sunday Times* on May 15, 1988: 'Courage's scheme is basically a balance sheet operation which forces the brewer to pay an "open market" rent for the pub to [a] property company. "Paying a market rent will certainly concentrate our minds," says Michael Foster, the managing director.'

3 The Commissioners, as trustees, manage 250,000 acres of agricultural land, urban properties which are concentrated in central London, and mineral rights on land and under the sea. Their view at that time can be contrasted with that of the National Audit Office (1988: 2, 12), which argued that 'the absence of a reliable data base is a serious impediment to rationalisation', without which 'there is a danger that surplus land and buildings will be retained or that disposal of the wrong sites will take place'.

4 The Commissioners altered their approach in 1984, when they undertook a comprehensive valuation of the Estate. Within four years, a new system of annual valuations was adopted, which resulted in a significant realisation of asset values. Valuable land that had been locked away in a 'land bank' has been developed, and in 1988 the Estate was valued at about £1.4bn. A new system of portfolio analysis was instituted with the aid of a computer data base, which assisted the Commissioners to undertake a significant diversification of the assets at their disposal. This analysis is now regarded as a major tool for portfolio management. (For a critical appreciation of the new approach, see National Audit Office 1988b.)

5 It remains to be proved that there is a necessary conflict between sound

ecological practices and the free market. The evidence in the main demonstrates that it is monopoly power — exercised within the context of an imperfect market — which permits people to abuse natural resources. The injurious practices of agriculture, for example, are the direct result of State protection. A free market would sponsor sound techniques that relied less on extensive farming methods and the intensive exploitation of chemicals; both these latter approaches to food growing damage the land and the social milieu of the countryside, and are the direct result of Common Agricultural Policy subsidies which enable farmers to sidestep the disciplines of the pricing mechanism and the requirements of consumers (Body 1987).