Congress smiles on landowners

EDWARD DODSON reports from Philadelphia

ASK ANYONE involved in real estate development whether of office parks, high rise buildings or residential homes what the single greatest obstacle to profitable development is, and the answer will be the same: *the cost of land.*

Land values have skyrocketed during the past few years from Maine to Virginia and in many other parts of the country as well. Yet we hear again and again that the bottom has fallen out from under major regional economies from Houston to Anchorage and those "heartland" cities affected by the decline in agribusiness.

Speculative building brought on by rising oil, grain and other commodity prices sits empty as business failures and rising unemployment create a buyer's market. The problem in the Northeast has been just the opposite.

Boston, New York, Philadelphia and Baltimore all experienced their period of decay in the 1960s and early 1970s. They suffered through the abandonment of their urban cores, the loss of manufacturing jobs and an eroding of property values and their tax bases. In response, they slowly diversified into centers of high technology, government operations, finance, insurance and other service-type industries. Global economic forces of the last four years have given these areas a major shot in the arm (although painless only thus far).

Perhaps the most important but neglected observation to be made is that American consumers with fairly stable incomes have benefited immensely by the collapse in world demand for goods and services; the world's debtor nations and their populations have been forced by the need for foreign reserves to curtail domestic demand and export everything they can produce.

As a result, the world's remaining consumers have been flooded with low cost goods. The corresponding decline in global demand for financial credit forced down interest rates as well, despite the ever-growing demand by the US government for deficit-generated borrowings.

What seems to have escaped the attention of economic policymakers and analysts is that each of the reductions in the cost of money and the cost of goods have been effectively capitalized into higher land values.

For owners of land and buildings in areas of strong demand, tremendous unearned gains have been received (admittedly realised only if they have actually sold their properties).

Families who have taken their gain usually put it right back into the purchase of another residential dwelling. Chances are that the new home increased in price as much or more than the one sold. The retiring Boston couple selling their home and moving outside of the Northeast may be taking a good portion of the increased land values with them; and, perhaps we should not begrudge them this "nestegg." But a growing number of families are being seriously harmed by runaway increases in land values, which is a very real social problem.

Unfortunately, our well-intentioned representatives and government officials are moving in a direction that will only make the situation worse. Instead of attempting to understand and work within the dynamics of market conditions, they are ready to put another $11-$16 billion more into the pockets of existing landowners.

Mortgage lenders have become very concerned over the issue of housing affordability for the young and lower income family groups. For these buyers the economic pressures can be very great indeed. A generally-accepted principle of lending is that a homebuyer's monthly obligation, including taxes and insurance, should not exceed 25-28% of total monthly family income; at levels greater than this the likelihood of financial difficulty causing a loan default is an ever-present threat.

Based on a very conservative median housing price of, say, $100,000, a buyer would need around $9,000 in cash and an annual family income of almost $50,000 in order to borrow $95,000 at 10% over 30 years. Based on the median family income figures for even two-income families, a large segment of our population is thus effectively priced out of the market. An additional observation that can be made is that a large number of existing homebuyers could not, based on family income, afford to purchase the homes in which they now reside.

Government now wants to subsidise the purchase of homes for those whose incomes are too low for them to afford housing. Two primary tactics are followed:

- make the financing more affordable by subsidising the rate

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of interest paid by the borrower; and

- subsidize the purchase of land so that housing can be built that will give the developer a market rate of return but permit the purchase price to be lower than if the building lots has been directly acquired.

In the first instance, the tax-paying public (including lower income families themselves) end up absorbing the interest subsidy in the form of higher taxes and/or higher costs for government services. As always, the lessons our elected officials have no desire to acknowledge is that there is no "free lunch". Programs that transfer financial resources must come from either taxation or borrowing.

Interestingly, the distribution of the tax burden tends to treat landownership lightly and labour harshly. As a consequence, that portion of the population best in a position to lend government money for programs — and receive interest income in return – also tend to be the nation's (or the world's) large landowners, who directly benefit from the corresponding rise in land values.

The same principles are at work in the second scenario; we are all putting more money into the landowners' pockets, inasmuch as they receive a market price for any land sold to the government as an intermediary purchase. The subsidy given to the developer is made up for with

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revenues raised by taxation of wages and taxes on other productively-earned income.

Public policy fails to address some very clear economic principles. Land is a relatively scarce commodity; its supply cannot be easily increased.

Special opportunities given to buyers or land in the marketplace beyond a certain level will change the relation between supply and demand; and, if lower interest rates or price subsidies or higher maximum loan amounts are granted to a large enough number of potential house buyers, those in control of land will, naturally, increase the asking price.

At the new, higher price level, the number of families able to afford the price demanded will have fallen. A new demand/supply equilibrium price is established. The market capitalizes all of the subsidies and giveaways into higher selling prices.

There is a solution to this dilemma, one that is deceptively simple. If we can agree that the root problem to be solved is the runaway cost of land, public policy tools can be applied that will stabilize land prices and, hence, the price of housing as well. The opportunity to do so rests in the taxing mechanism and the way people react to the taxation of property.

Adam Smith was one of the first to observe that taxes on productive activity (such as housing construction) will tend to add to the cost of the end good or service and thus discourage its production. Taxes levied against static activities (of which land ownership is a prime example) tend, conversely, to stimulate production.

The reason for this is easy enough to see. If I own a parcel of land worth $100,000 today and its value is increasing at 10% per year, the land will be worth $110,000 in a year and I will have gained $10,000 without lifting a finger.

If this land were taxed at 10% of market value, however, my net gain is zero and I will be induced either to develop the land myself or put it on the market for use by someone who will. The more land thus coming on to the market, the greater will be the pressure toward stabilization of the cost of land for development.

The issues raised by this problem involve more than just economics. Is justice not better served by a system of taxation that rewards our citizens for their productive contributions towards society, as opposed to the current structure, which perpetuates the transfer of wealth to those who gain by simply holding onto land? Landowning itself produces nothing, yet gives to titleholders an unearned claim on the fruits of the labour of others. To the extent this continues we not only discourage economic growth but expose our democratic system to a deeply-rooted injustice.

Diplomats in a squeeze

DIPLOMATS in Tokyo are paying the price for the city's high land prices.

Astronomical rents have forced 17 African and Latin American embassies to gather in one office block.

Even relatively rich nations have been forced to economise. Oil-rich Venezuela switched from its opulent building to the diplomatic ghetto, which is at bursting point.

But the escalating land prices provide windfall gains for some of the foreigners. The Philippines now plans to cut its national debt by selling off part of its landholdings in Japan, which are valued at £281m.

The British are (diplomatically) laughing at the misfortunes of their colleagues. For under the terms of their lease, which dates back to 1873, they pay a peppercorn rent for a spacious site which is valued at £1.7 bn.