

Rationale for Site-Value Taxation

ELI OPHEK

IN ORDER to understand the rationale for site-value taxation, let us consider the following assessment case from the International Association of Assessing Officers (IAAO) in their publication, *Site Analysis and Evaluation*: *

The problem is to find the land value of a vacant lot and the method used is the land residual technique. This method is an appraisal technique used to estimate the value of the land component on an improved property (actual or hypothetical) when no sales of comparable land can be found. This technique is best used when the building is new or in its early life and represents the highest and best use of the land. In the land residual technique, the net income earned by the building is deducted from the total net income of the property. The balance is earned by the land. The residual or leftover income is then capitalized to indicate the land value.

The residual land technique is a legal procedure and an acceptable assessment argument in the courts. Let us then examine it.

The main assertion is that money invested either in a building or in land ought to return a profit of r per cent (8 per cent) interest rate. Otherwise, the investor would deposit his money in the bank to raise a similar interest rate. In this article the distinction between investing money in a building (capital) and investing it in land will be demonstrated and the method of site-value taxation will be presented.

Tenants of a building pay for housing services. The value of these services for the occupants depend on the total value of the asset, building and land. Thus if the total value of the asset is, in our example, \$176,000, the tenants are expected to pay rents at a level that will leave a profit of r per cent interest to the owner after he pays his expenses. All things being equal, when the value of this asset increases or decreases, the tenants will have to pay more or less rent to maintain the r per cent interest rate of profit to the owner.

Let us do a mental experiment to show the effect of this phenomenon on the tenants' rents. Suppose

that the value of the land remains constant for the life-time of the building. In this case because of depreciation (physical, functional and economical) the value of the building will decline with time until it reaches zero (theoretically when the life-time of the building is ended). Therefore, since the value of the asset is declining the rents that the tenants pay will decline correspondingly to the point where a minimum rent will be reached and the building will be written off leaving only the value of the land. Such a process usually operates in any capital investment. The recapture expense or sinking fund enables the owner to re-invest his capital when the life-time of his asset is ended.

However the land values do not remain constant in our society. This is due to population growth, growth in demand, growth in incomes, growth in production and capital investments, the changing patterns of land use, and the changing social impact of a mobile society. The very fact that tenants' rents in a city usually do not decline but often increase, more than compensating for inflationary rates, shows that the value of the land itself (not the building) is increasing. So we can register a dual phenomenon occurring in our cities. While the value of existing buildings is declining with time, the site value of the building is increasing, often at a higher rate than the decreasing value of the building, thus increasing rents for the tenants.

What this means in terms of the landlord is clear. He will continue to collect annually the r per cent interest rate from the tenants based on the value of his asset (building and land). He will continue to collect the recapture fund to replace his building with a new one, when its life time is ended. Also he knows that every year the value of his land will probably go up, which will enable him to charge even higher rents to the tenants occupying his asset. Thus the investment in such an asset, building and land, is much more profitable to the owner than depositing his money in the bank. This is because deposits in the bank only gain r per cent interest rate annually, and if the depositor takes his interest out of the bank, his fund in the bank for the next year remains the same and produces the same profit.

However this is not the case for a landlord. Every

* IAAO Education Material *Site Analysis and Evaluation*, A Programmed Course by the International Association of Assessing Officers, 1313 East 60th Street, Chicago, Illinois 60637, 1971, pp. 58-59.

year, he collects the r per cent interest rate on his asset (building and land), while the value of his asset for the next year increases. He still charges r per cent interest rate the following year, but on an increased asset. (Rent revisions might be every three years or more so that the actual yearly increase demanded is accounted for in the revised rent.) In any case the basic principle is the same. Thus his revenue is increased much more than if he had deposited his money in the bank - and this process continues yearly.

Where does this increase in land value come from? The landlord does not invest a penny more in his land after he buys it and still its value increases every year, as if he had invested in it. If not from the landlord, then where does this investment come from that raises the value of the land? The answer is very revealing and meaningful. It is the community as a whole that indirectly invests in the land of the landlords. By the growth of our economy, the development of the infrastructure of our economic life as well as our cultural life, we indirectly invest in the land and make it more valuable for human activities. The value added each year to our lands comes from the investment of the community as a whole. Public and private sectors invest in transportation systems, municipal service systems, activity systems, and the like. The entire community works to produce these added values. The people are taxed to provide the money for the investments that raise the land values.

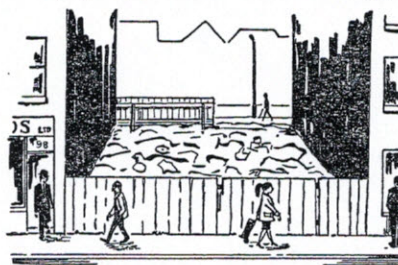
Should the added value produced by the exertion of the community not go back to the community as a whole? All of the money that the landlord invests to improve his building and to keep it up is paid back to him through rents and rightly so. But do we really want to give him a bonus every year in the form of additional value of his asset?

At this point the rationale behind site-value taxation can be understood. The method of site-value taxation aims at shifting taxes from the composite value of the building and the land, to the land only. Thus on the one hand, owners will be encouraged to invest



in the untaxed buildings so as to improve them frequently and, on the other, through taxes, the community will be able to get back at least part of the value it added to the land. This method holds that

it is unjust and immoral for landlords to get additional revenue each year, for nothing that they have done, while so many people in need are struggling for a



fairer share of the community's wealth.

If the government denies these observations and continues to protect the present property tax method, then the consequences are obvious: injustice perpetuated in our society, greater inequity between social classes, more land speculation, more sprawl phenomena in our cities, heavier burdens of taxes on taxpayers, and neglect of improvements in the existing housing stock. An example of the extreme results of the present property tax policy can be seen in one of the richest cities of the world, New York. In New York City there have been influxes of low income ethnic groups to certain core areas which encourages deterioration of the neighbourhoods.

In order to understand why this process was so rapid and acute, let us assume that a landlord is taxed on his land only (and not on the building and the land). In this case the owner knows that if he allows his building to run down it will soon be deserted. He will still have to pay the same high taxes on his asset (land) however. This will force him either to maintain his building in good condition so that he can continue to rent it, cover the taxes, and make profit on it, or he will have to sell it to someone else who will manage it. Such a response by landlords would undoubtedly reverse many deterioration trends in the urban environment.

Now let us look at the property tax method in use today and see its influence on a low income, run down area. When the building begins to deteriorate rapidly, the landlord knows that in a few years he will be left with an uneconomical and unrepairable structure. Often he has written this building off long ago. He has already collected the recapture fund and he is satisfied to continue collecting rents from his low income tenants until his building reaches the demolition state forced by law. Therefore, he is encouraged to let his building run down because the taxes that he pays annually will be cut correspondingly to the reduction in the value of his asset. Not only that, but often after arriving at the demolition stage, he will become a speculator with his land and will wait for an offer from a renewal project to materialise.

What site-value taxation is attempting to do is to

curtail or limit such evils. Under this system the landlord has to continue to pay the same taxes on the land whether he has a building and supplies housing services or not. This means that if he allows his building to run down, he will not get a tax cut from the municipality, but *will still have to pay the same taxes.*

Only recently was it recognized in the United States that the burden of supplying adequate housing cannot be met successfully by public agencies. A Congressional Research Service came to the conclusion that only the private sector could solve the problem through the adoption of site-value taxation by the Government.*

If this is the right policy to adopt, should we wait for a chaotic situation in our cities before considering this method? Or shall we as conscientious people

start to think immediately and adopt policies to prevent these predicted evils? It is in our hands to determine the future we want by adopting the right policies.

If we assume that the total amount of property taxes collected should remain equal to those collected under the present system, then calculations in many places of the world have shown that most home owners will enjoy reduced taxes under the site-value taxation method. The ones who will have to pay more taxes are those who hold big, valuable urban sites with a relatively small capital investment (building) on it. Thus site-value taxation will give incentive to improve the use of land and will enhance equity in our society.

Under the present system, efficient landlords who hold valuable building assets have to pay high property taxes and are actually subsidizing other land owners who hold underused or unused land and who consequently pay less taxes. It is clearly in the interests of efficient landlords, builders, and developers—as well as of the community—to adopt site-value taxation.

* *Property Taxation: Effects on Land Use and Local Government Revenues.* A background study prepared by the Congressional Research Service for the Subcommittee on Inter-government Relations of the Committee on Government Operations, United States Senate, February 24, 1971. Government Printing Office, Washington, D.C.