May 17, 1996

Farm Land Rent and the Renewal of Rural Society: The Self-Financing Model

Nicolaus Tideman

Summary

Citizens in the rural parts of the Russian Federation have strong desires for a wide variety of local public services. They want more and better roads, bus services, reliable electric and telephone lines, water service, and better schools and hospitals. But money is needed to finance any of these services. Where will the money come from?

Under existing fiscal arrangements, such public services can be provided only when money for them is supplied by those in authority in the oblasts or in Moscow. Achieving local success is a matter of having sufficient influence with the central authorities to have one's local projects approved. Public funds are extremely scarce, and competition for them is fierce. Some areas are able to succeed only if others fail.

There is a better way of organizing the provision of public services to rural areas. Instead of having localities dependent on favors from higher authorities, localities can have the power to raise the revenue to finance whatever public services the local residents believe are worth their costs.

If one thinks in terms of the taxes that are usually levied (on income, profits, value added, or on particular commodities) the idea of financing local expenditures from local sources might seem unpromising. Taxes raise the cost of production and discourage people from being productive.

However, there is a way of raising revenue for local public services that does not have these disadvantages. That way is to use a combination of fees for services and public collection of the rent of land.

The rent of land is the amount of money that would be bid for the use of land in an auction. It can be thought of as 100 rubles more than the second-highest bid, that is, the amount of money that the person for whom the use of land is most valuable must bid to outbid the person who places the second-highest value on it.

What land is worth to a person who wants to use it depends on the length of time for which he will be allowed to use it. For the purpose of defining rent, this length of time should be indefinitely long, but with provision for revising the rent as market conditions change. In other words, if similar land rents for 20% more three

years from now, then the person who secures the use of a site this year would be required to pay that additional 20% at that time.

The rent of land also depends on the condition of the land. The rent of land is what people would bid for unimproved land. In a town, unimproved land is land without any structures on it. In an agricultural area, many things other than structures can count as improvements--drainage, stone removal, fertilization, leveling, etc. It might be hard to find agricultural land that had no such improvements. Thus in agricultural areas, one must subtract something from observed payments for the use of land, to account for the value that is being paid for such improvements.

The comments above describe how one might observe the rental value of land. Economics can also say something about how a bidder would decide how much to bid. A bidder would decide how he could use the land most profitably, compute the net revenue from the most profitable use after all costs including the cost of his own entrepreneurial effort and a premium for the risk to his finances, and what was left would be the total rent of the land for the period of the investment. The bidder would then estimate future rent, subtract that from the total rent, and what was left would be rent for the current period.

The rent of land is one of two sources for efficient financing of local public goods. The other efficient source is fees for the use of services. The economically efficient fee for a public service is the cost of providing one more unit of the service. If the cost of delivering a kilowatt hour of electricity to a rural farm is 100 rubles, then that is the price that will motivate rural users of electricity to use electricity wherever its value is greater than its cost, and not to waste it on uses where its value is less than its cost. If a park is never crowded, then the most efficient price for use of the park is no price at all. At any positive price, some people would be discouraged from using the park even though their use would impose no costs on others.

Such "marginal cost" prices will generally not provide enough revenue to pay for public services. To be economically efficient, the remainder of the revenue that is needed to pay for public services must be raised in a way that does not allow people to reduce their tax bills by being less productive. The best such source is charges on the land that benefits from the services, in proportion to the value of the land.

Thus, in the rural self-financing model rural localities decide for themselves which projects to undertake, and finance them from a combination of public collection of rent, and user fees based on marginal costs. This model has a number of important advantages.

The use of local revenue embodies the principle of justice, that people should pay for the services they receive and not for those that they do not receive. When charges are based on the rental value of land, the amounts of money that people are required to pay have a reasonable correspondence to the benefits that they receive.

The rural self-financing model also offers local autonomy. Instead of asking, "How can we get the central authorities to approve all of these things that we want?" the citizens of a community will ask themselves, "Which of these things that we would like to have are so valuable that we are prepared to charge ourselves the costs of providing them?"

The revenue that is used to finance the public services has the virtue of **revenue efficiency.** The fees based on marginal costs discourage people from wasteful use of public services. And as long as charges on land are not greater than the rental value of the land and are independent of how the land is used, it will not be possible for people to reduce public revenue by being less productive.

The rural self-financing model also offers **expenditure efficiency**. Because localities will pay the costs of these projects themselves, they will have an incentive to undertake good project analysis, and proceed with only those projects for which benefits are greater than costs.

Finally, the rural self-financing model offers **sustainability**. If the benefits of a local public service are in fact greater than its costs, then the land that is provided with these services will rise correspondingly in value, thereby expanding the public revenue base of the community by enough to pay for the service.