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Optimal Taxes for a Free Enterprise Zone

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A free enterprise zone prospers by freeing enterprises of controls and taxes that would otherwise burden them. Thus a free enterprise zone works best when the most is done to eliminate taxes on enterprises. But governments need revenue from somewhere. The best place for the government of a free enterprise zone to look for revenue is from its land. This is particularly true when, as in the case of St. Petersburg, the free enterprise zone starts with almost no private capital.

This paper describes the procedures that would be needed to obtain the greatest possible revenue from land, so that other taxes might be unnecessary. But first it offers a brief review of the reasons for concentrating taxes on land and the other conditions needed to make a free enterprise zone work.

I. Reasons for Concentrating Taxes on Land

Capital moves around the world, always seeking the highest return. A region that wishes to attract capital must offer the prospect of a return at least as great as that which capital can secure elsewhere. If taxes are placed on the earnings of capital, these will be taken into account in deciding how much money should be invested. Investment will occur only if the return after taxes is at least as great as that which can be obtained elsewhere. Thus levying taxes on capital cuts down on the amount of capital that can be attracted.

Land, on the other hand, does not move when it is taxed. Furthermore, when taxes on capital are eliminated, land becomes more valuable: Land on which capital can be placed without incurring taxes is worth more than land on which capital is subject to taxes. Thus much of what is foregone when taxes are kept off of capital can be recovered by collecting the greater values of land that results from leaving capital untaxed.

Labor is another potential source of taxes. But like capital, labor is quite mobile. Workers will generally consent to stay in a place, in the long run, only if their earnings are at least as great as what they could obtain elsewhere. Thus taxes on labor earnings will tend to drive wage costs up without benefiting workers, thereby lowering both the values of land and the level of investment that can be attracted. Labor and capital should both be spared. Land should be the first source of revenue for a region that wishes to grow.

II. Other Conditions for a Free Enterprise Zone

To be as productive as possible, a free enterprise zone requires other conditions in addition to a tax structure that concentrates taxes on land. These conditions will now be reviewed briefly.

A policy of free trade is needed. There should be no tariffs, no quotas, no trade prohibitions.

A freely convertible currency is also needed. There must be no restrictions on the buying and selling of foreign exchange or on the prices at which such transactions can occur. It is very helpful to have a currency that has a reliable value, but it is better to have a freely convertible currency of unreliable value than a currency whose official value is maintained only by restricting transactions.

ny private activities that generate harmful effects for the community, such as pollution or congestion, should be subject to charges that reflect the costs imposed on others. Similarly, if there are private actions that have beneficial consequences beyond the actors and their trading partners, there should be subsidies that reflect the value of these beneficial consequences.

Finally, to operate an effective free enterprise zone, St. Petersburg needs assurance that Moscow will not tax the capital it attracts. It is in the interest of St.

Petersburg officials to reach an agreement with Moscow that the amount of support that St. Petersburg will be expected to provide for the center will not depend on how much capital St. Petersburg attracts. If Moscow officials are envious of all the capital that is attracted to St. Petersburg, they can implement their own free trade zone. Under these conditions, one can expect a free enterprise zone to flourish.

III. The Simple Description of How to Collect the Full Rental Value of Land

A simple version of how to collect the full rental value of land will be provided first. Then various concerns that one might have about the simple version will be considered, and the system will gradually be made more complex in response to these.

The rental value of a site for the interval of time from T_0 to T_1 can be defined as the greatest amount of money that a person would be willing to pay for the use of the site for that interval of time, when the user has already secured the right to use the site after T_1 . This concept can be made operational by auctioning the right to use the site for the interval of time from T_0 to T_1 , with the condition that the winner of the auction will have the right to use the site after T_1 , upon payment of the future rental value of the site, as determined by an evenhanded process. The process proposed for determining future rental value is auctions of the right to use similar sites.

Taking the matter step by step, the city of St. Petersburg would begin by identifying about 100 unimproved sites which are presently under public control and which they are prepared to transfer to private control through auctions. The sites would be divided randomly into two groups. The first group would be auctioned under a rule that a bid represented an offer of rent for the first year, with the understanding that the winner would be allowed to use the site for as long as he was willing to pay the rental value of the site, as determined by future auctions of similar sites. The sites would then be transferred to the highest bidders.

The data from the auctions in the first group would then be turned over to experts in land appraisal and assessment. Each expert would be invited to offer an appraisal formula that might be applied to every site in St. Petersburg. After these formulas had been submitted, the second group of sites would be auctioned by the same rules.

The formulas offered by the experts would then be evaluated by a statistical procedure described in detail in the Appendix. Based on this evaluation, administrators would identify the combination of formulas that best explained the results of the auctions of the sites in the second group. This combined formula would then be applied to every site in the city.

Every person or organization that now has the right to use land in St. Petersburg would then be given the opportunity to buy any publicly owned improvements on the site at 90% of their appraised value. (A few auctions would be held to help determine appraisals.) Every improvement that was not purchased by its current user would be auctioned. Every purchaser of an improvement would receive a transferable title to the land under the improvement, subject to payment of the rental value of the land as determined by the procedure that has been described. If any user of land were to ask, "Why should I be required to pay this much?" the answer would be, "Because this is the best estimate of the amount of money that someone else would be willing to pay for the use of your land if it were unimproved."

Philosophically, this approach to taxation regards the land of a nation as the common heritage of all citizens. Anyone who wishes to use land to the exclusion of others must pay what that privilege is worth.

To secure the advantages of a market economy, it is important that there be a free market in the use of land, and that anyone who improves land be assured that he will never be dispossessed of his land with his improvements effectively confiscated. These advantages of a market economy can be secured while collecting the full rental value of land from every user of land, thereby making it possible to reduce or eliminate other taxes.

IV. Complications

A. The Changing Value of the Rouble

One of the first complications that arises is that the rouble has such an unpredictable value. As long as St. Petersburg is obliged to use a currency with such an unpredictable value, it must take steps to adjust to this. If the auctions are not all held on the same date, the results of auctions must be adjusted for changes in the value of the rouble. More importantly, the amount of roubles that each user of land is required to pay must be adjusted for any change in the value of the rouble between the time when the auctions occurred and the time when the payment is due. This adjustment would be made by taking into account at least the change in the value of the rouble as measured by foreign currency prices, and possibly the changing value of the foreign currency as well, through some index like the U.S. Consumer Price Index.

B. The Possibility that Investors Would Fear a Sudden Rise in Rents

It is possible that potential investors would be reluctant to make permanent improvements to land when they have no guarantees about what the use of land would cost them beyond the first year. It is not clear that this would be a serious problem. Whenever companies invest in machinery, they face a corresponding risk that future labor costs will be much different than what they anticipate. With

land they will at least have the assurance that rent will be determined by a market process and will therefore not be arbitrary or monopolistic. However, if investors seem to be reluctant to invest for this reason, then the city of St. Petersburg can consider selling "rent insurance" to users of land. A suitable contract might be that in exchange for paying 1/3 more than the auction result or the current estimate of rental value, the city will guarantee that rent will not rise for five years, except to adjust for changes in the value of the rouble. In exchange for 2/3 extra, the city might promise to keep rents constant for 10 years, apart for adjustments for changes in the value of the rouble. It is questionable whether it would be appropriate to guarantee rents for more than 10 years, because the rent of each year should be regarded as the income of the generation that is alive at that time, and the present generation should respect the limits on its authority to commit future generations.

C. The Possibility that Land Will be Needed for a Public Purpose

All nations limit rights to land because of the possibility that land will be needed for a public purpose such as a highway or a dam. All that can be done about this is to specify that if such a need arises, the possessor of the land will be compensated for the value of any improvements to the land and for his costs of moving. To encourage investment, a nation must develop a reputation for evenhandedness in this matter.

D. Historical Buildings and Historical Districts

St. Petersburg regards many of its buildings as cultural treasures. It does not want to give private owners the right to destroy them. This can be handled by identifying the buildings that are to be regarded as such treasures and the minimal conditions in which they must be maintained. These characteristics of these buildings can be treated as "land." That is, for these sites, "unimproved" would mean "with no improvements other than those that are required to be maintained." The experts in land appraisal would then be asked to provide formulas that might be used to estimate the rental value of all "unimproved" historical sites defined in this way.

There are other structures that are not so precious that they need to be preserved, but they are in historical districts where a radically different structure might cause a great loss of value of the district. For these cases it is important to settle on a set of rules about how such sites can be used, and then expect land valuation experts to take this into account in their formulas.

E. The Possibility of Abandonment of Obsolescent Buildings

A building that is so obsolescent that it is about to be demolished has a market value equal to the negative of its demolition cost. If the full rental value of the land under such a building is collected in taxes, then the land has no significant

sale value, and the combination of land and building has a negative value. The owner of such property could improve his financial position by abandoning the property and disappearing, so that he would not be held responsible for it. If this is thought to be a problem, it can be dealt with by requiring all owners of buildings, or at least the owners of aging buildings, to place with the city deposits that would pay for the costs of demolishing any obsolescent buildings. The city would pay interest on these deposits at a rate equal to the rate at which it was able to borrow money.

F. The Possibility That a Few Eager Bidders Would Make Ridiculously High Bids

With only a few sites to be auctioned, it is possible that interest in securing them would be so great that the results would not be representative of the value of all land. The city could still say, "Because of the great interest in securing land, this is our best estimate of how much we could get if we had just one more site to auction. Everyone who is holding on to a site is preventing us from obtaining a corresponding revenue." Nevertheless, the city might want to avoid subjecting all its citizens to a temporary high level of required rent payments when the market was expected to settle at a lower level.

To avoid a merely temporary rise in rents, the city could employ a rule that every bidder would be obliged to pay at least as much rent as was bid, adjusted for the changing value of the rouble, for at least, say, ten years. Then anyone who was particularly eager to obtain land would only bid an amount that he was prepared to continue to pay for ten years.

Another complication arises when the highest bid is much higher than the second-highest bid. Then a user of land can say, "The second-highest bid represents the amount of money that you can expect to get if one more such site were available, so that it is all you should expect me to pay." There is merit in this arrangement. It would be more theoretically coherent to define the rental value of land in terms of the pattern of second-highest bids. There is also a plausible rationale for requiring each winning bidder to pay only the second-highest bid. The second-highest bid is the value of the opportunity that is foregone by having the winning bidder occupy the land. Furthermore, if the city uses a rule that only the second-highest bid must be paid, then every bidder will have an incentive to bid what the land is actually worth to him, rather than trying to bid barely more than the second-highest bid. This greatly simplifies the process of deciding how much to bid and might therefore encourage more bids.

G. The Possibility That Investors Will Not Believe That the City Will Refrain from Taxing Capital in the Future

This is a significant concern for which there is no perfect response. The city cannot bind itself absolutely not to tax capital in the future, and hence investors

may expect that after their capital is irrevocably committed, new taxes will be imposed. There are several things that St. Petersburg can do to help avoid this expectation and therefore better attract capital.

- First, the city can avoid excessive spending, so that it can be seen to be not desperate for revenue.
- Second, it can publicize the theory of free enterprise zones among the population, to make it more difficult for future politicians to sway the electorate toward taxes on capital.
- Finally, it may be possible for city officials to offer investors "insurance" against the possibility of future taxes on capital. The city might agree that in exchange for a specified payment (perhaps very small), any future tax on capital could be deducted from the rent that was owed on the land. Such a measure would not make it impossible for a future government to impose a tax on capital, but it would make it much less profitable to do so.

H. The Possibility That Some Pensioners and Other Needy Citizens Will Not be Able to Afford the Rent on Their Land

There will always be some citizens who cannot provide for themselves. Our sense of community requires us to make some provisions for them. It is best that provision be made for such persons not by instituting exemptions from the collection of the rent of land, but rather by case-by-case determinations.

Whenever exemptions are granted to broad categories of tax-payers, demands arise for extensions of such exemptions to yet other groups. And there are generally many persons who are not needy in the groups for whom exemptions are proposed. An exemption also removes the incentive for those who receive it to move to less valuable land. For all of these reasons, case-by-case relief is best.

One form of general benefit for pensioners that can be justified is a rule that when money is obtained from the sale of buildings that were formerly owned by the state, the money will be divided among citizens in proportion to the number of years they worked. This can be justified by the idea that state property was acquired by using a political system that deprived people of a significant part of what they produced. The more years people have worked under such a system, the more they are owed when it is ended.

If collection of the rental value of land provides more than enough revenue for the expenses of the city, there is a rationale for giving older persons extra shares of the surplus. Not only do pensioners need it more, but they have also contributed more to making the city as valuable as it is. A rule of distributing a portion of the rent of land according to years worked or years lived in St. Petersburg would also

have the effect of cushioning native residents against a rise in rents caused by an influx of migrants attracted by the city's growth.

V. Summary

The possibility of collecting the full rental value of land entails significant complications. Collecting the full rental value of land before considering any other taxes is both attractive and feasible. Such a policy should be cornerstone of the revenue system of the St. Petersburg Free Enterprise Zone.

Appendix

To evaluate the formulas offered by land valuation experts, a step-wise weighted regression procedure should be used. The dependent variable would be the auction results for the second group of sites. The independent variables would be the assessed values generated by the formulas of the different experts. The weights would be the auction results. The formulas of the different experts would be introduced into the regression one by one, according to which was most highly correlated with remaining weighted residuals. Only positive correlations should be considered. Further formulas should be added to the regression as long as the adjusted R-square increases. The resulting linear combination of expert opinions should then be applied to all the sites in the city.

Something like 1/10 of 1% of revenue should be allocated to prizes for the experts. Each expert's share should be proportional to the amount by which the adjusted R-square rises when his formula is included in the regression.

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