

Should Land in the USSR be Rented or Sold?

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I. INTRODUCTION

The choice of conditions under which land will be turned over to the private sector is among the most important decisions to be made in shaping perestroika. Mikhail Gorbachev has argued that land should be rented, while Boris Yeltsin has proposed that it be sold. This paper argues that the most appropriate way of turning land over to the private sector involves conditions that combine the most attractive features of rental and sale. The resulting institution could be regarded either as rental or as sale. Therefore the debate over the form of privatization of land ought to focus *not* on *whether* land is rented or sold, but rather on the *conditions* under which it is either rented or sold. Whether the institution is to be called rental or sale should then be decided on the basis of which designation offers better political and psychological prospects for sustaining the conditions that promote efficient land use.

Section II of the paper explains the potential equivalence of rental and sale. Section III discusses the issue of security for users of land versus flexibility in the magnitudes of future payments for the use of land. Section IV discusses the most appropriate timing of payments to the government for the use of land, comparing the arguments for large initial payments with the arguments for an enduring flow of payments. Section V describes the use of bonds to guarantee that land will be cleared of remnants of its use. Section VI discusses auctions for reassigning land that is relinquished by its current users. Section VII describes how the information obtained through such auctions can be used to identify the rental value of all land. Section VIII returns to the question of whether land should be rented or sold.

II. THE EQUIVALENCE OF RENTAL AND SALE

To first appearances, selling land rather than renting it has two principal advantages for a nation. One is that sale of land can be expected to yield a large amount of money for the nation in a short time. Call this the cash-flow argument for sale of land.

The second apparent advantage of sale is that sale gives the owner of land security that he will not be removed in the future, so that he will have an opportunity to reap the full value of durable, immobile improvements that he makes to the land. Security of tenure benefits the whole nation because when users of land have security of tenure, they have an incentive to be more productive, thereby creating a larger economy and increasing the potential revenue from users of land. This will be called the security-of-tenure argument for sale of land.

To first appearances, renting land rather than selling it has the advantage of providing an enduring income for a nation. Thus there is a cash-flow argument for rental as well as for sale.

Rental also appears to have the advantage for a nation of making it possible to raise the rent of land in the future, if its rental value (apart from the value of improvements) should rise in the future as a consequence of changed market conditions. This would increase future public revenue. This argument will be called the flexible-future-payment argument for rental.

The issue of whether sale or rental is better might thus be construed as a question of whether the advantages of a large current cash flow and security of tenure for the users of land exceed the advantages of an enduring cash flow

and of ensuring that the nation will be adequately paid for the use of land if the rental value of land rises in the future. But I shall argue that by an appropriate choice of the details of rental or sale, it is possible to give either one the advantages of the other.

Consider first the cash-flow arguments. The ownership of land is often subject to a tax. If one wishes to give the sale of land the advantage of an enduring cash flow, it is only necessary to tax the land after it is sold. The greater the tax that must be paid, the lower will be the selling price of land, and the higher will be the enduring cash flow that the land provides. (One might contemplate selling the land without making any provision for taxing it later, and then surprising the owners with a tax. While it is possible that such an approach would yield greater revenues, it would be inherently dishonest and cannot be advocated in good conscience.) The limiting case of subjecting land to a tax is to specify that the amount of the tax in each future year will be the full rental value of the land in an unimproved state in that year. (How the rental value of unimproved land can be determined is discussed in Section VI.) If land is subject to a tax equal to its unimproved rental value, then buying it confers no economic advantage, and land can be expected to have a zero sale value, provided that the tax is expected to endure indefinitely. Thus the "sale" of land can be arranged in such a way as to provide all of the apparent cash-flow advantages of rental and none of the apparent cash-flow advantages of sale.

It is also possible to rent land and obtain a large initial payment. It is merely necessary to specify that rental payments will be less than the full rental value of the land, and then require the lease to be purchased. In the limit as the rental payments approach zero and the term of the lease is extended, the value of the lease approaches the amount for which the land could be sold if it were subject to no tax. Thus the "rental" of land can be arranged in such a way as to provide all of the apparent cash-flow advantages of sale and none of the apparent cash-flow advantages of rental.

Now consider the issue of security of tenure versus the opportunity to adjust future payments for the use of land to reflect future conditions. The sale of land was said to lack flexibility with respect to payment for the future use of land. But the variability of future taxes can provide as much flexibility with respect to payments for the future use of land as might be desired. In fact, the variability of future taxes could undermine the security of tenure that sale is supposed to provide. If future taxation were to be arbitrary, it would be possible for the "owner" of land to be less secure than he would be with a good lease. If tax assessors in the future were to raise taxes excessively on land on which durable, immobile improvements had been placed, it would be possible for those who had invested to find that the combination of their land and their improvements was worth less than they had spent on improvements. Thus economically valuable security of tenure requires predictability and restraint on the part of those who set taxes.

Similarly, rental of land was said to lack security of tenure. But it would be possible to have a lease that was renewable indefinitely at the option of the renter, either at a fixed rent or at a rent to be computed by a rule that did not threaten to expropriate the improvements of the renter. Thus security of tenure can be achieved with rental. And if rental is mishandled, it can lack flexibility with respect to payments for the use of land in the future. It would be possible for government officials to sign leases for very long terms, fixing the rent of land at an artificially low level for many years. Thus, an arbitrarily large proportion of the flexibility that rental is supposed to provide can be dissipated.

III. THE MOST APPROPRIATE LEVEL OF SECURITY OF TENURE

It was noted above that either rental or sale of land can be designed in such a way as to provide either a high degree of security of tenure or a high degree of flexibility in future payments for the use of land. Thus the question arises as to how much security of tenure is most appropriate?

I argue that the most appropriate level of security of tenure is provided by a rule that the user of land (whether he is called a renter or an owner) will have the option of continuing to use the land for as long as he is prepared to make regular payments (whether these payments are called rent or taxes) equal to what the rental value of the land would be if it were unimproved. This rule does not protect users of land against all uncertainty in future payments, but it does protect them against the uncertainties that are most destructive to incentives to be productive.

The uncertainty that is most destructive is the possibility of being told to leave the land one has been using, without adequate compensation for any improvements that one has made to the land. Only slightly less destructive is the possibility of being subjected to an arbitrary rent increase. When the capital that one has applied to the land is durable and immobile, it can be better to pay an arbitrary increase than to abandon the capital improvements that one has made. But the knowledge that this may happen can be expected to discourage potential users of land from investing in durable, immobile improvements that would otherwise be worthwhile.

Both of these highly destructive uncertainties are avoided by the proposed rule. As explained in more detail in Section VI below, what is meant by "the rental value of the land" is the amount that other potential users of land are prepared to pay annually for the use of similar land that is unimproved.

Because the proposal incorporates the possibility of increases in the amounts that users of land will be required to pay for continuing use of land, it is possible that users of land will feel that they do not have as much security of tenure as they desire. However, the public can equitably respond that a person who wishes to appropriate land for a long span of time can reasonably be asked to accept the risk that the land will have some higher use before the end of the span of time for which the appropriator wishes to use it. Accepting this risk entails paying what someone else is prepared to pay for the use of similar land that is unimproved. Users of land expect too much if they expect the public to forego collecting what land is worth to others, simply because it is inconvenient for the existing users to leave.

If users of land are troubled by even the relatively small degree of uncertainty entailed in being obliged to pay the full rental value of the land they use in every future year, then they will be free to seek insurance from private companies against the possibility that their land will rise in rental value before they wish to relinquish it.

Some people may be troubled by the possibility that certain individuals may have accumulated hoards of unjustly acquired rubles, and will use these to make artificially high bids for the use of land. There are several answers to this concern. First, if the users of land are required to pay for using it on a recurring basis, no one will want to accumulate rights to land unless he plans to use the land. If the money with which some people pay for the use of land was acquired unjustly, at least the public will benefit from the fact that to profit from using land, people will have to invest capital in it, creating a more productive economy. Second, to have a market economy, it must be possible to presume that anyone with money has the right to spend it as he chooses. Unjustly accumulated hoards must be dealt with by criminal proceedings rather than by restricting the purchase of individual goods and services.

Finally, if such hoards are a serious problem and it is hard to know who has them, it may be appropriate to call in all existing currency and issue new currency, disallowing accumulations that cannot be explained adequately.

IV. THE ARGUMENT FOR A UNIFORM CASH-FLOW FROM THE PRIVATIZATION OF LAND

The previous section argued for the level of security of tenure that comes from giving every user of land the option of continuing to use the land that he once begins to use, provided that he pays the full current rental value of the land in each year. This section addresses the question of when these payments should be made.

There is a *prima facie* case for a cash flow that provides an enduring public income, with no extra initial income. The argument is two-fold. First, producing something is the fundamental justification for a claim to own it, but no one produced the land. Thus no one can properly claim to own the land. Still, it is possible to have a respectable claim to the use of land if one has made a payment to the public treasury. Thus the question of whether there should be a large initial payment or an enduring stream of payments is actually the question of how the value of land should be allocated among generations. There is a *prima facie* case that each generation ought to receive the income available from the use of land at the time when it lives. Thus the payment for the use of land in each year should be the full rental value of unimproved land in that year, leaving nothing for an extra initial payment.

The second half of the argument for an enduring public income, with no extra initial income, is that public revenue will be needed in every year. The rental value of land is an extremely attractive source of public revenue, since the collection of the rent of land, unlike almost all other sources of public revenue, does not discourage productive activities. In order to ensure that the full rent of land is available as a source of public revenue in all future years, it is necessary to forego any large initial payment.

This argument for permitting the rental income from land for each future year to be received by those who will be alive in that year might be challenged by the argument that the present is a time of severe public financial distress. Thus it might be argued that the current generation needs the revenue available from land more than future generations will need it, so that it is fair to sacrifice part of the enduring future income for the sake of relieving the current public financial distress. It might further be argued that the costs of restructuring the economy are investments that will benefit many future generations, and therefore it is appropriate to charge future generations for these costs, by privatizing land in such a way that more income comes to the current generation and less to future generations.

There is an element of validity in this argument, but it suffers from being open-ended, and therefore subject to abuse. To what extent is the present generation justified in diminishing future revenues to deal with its crisis? How can one be assured that the present generation is not appropriating to itself too much of the income of future generations?

The present generation can properly claim all of the capital that is now owned by governments, as that is the product of the labor of current and past generations. Thus the costs of dealing with the current economic crisis can properly be paid for by the sale of capital to private individuals. If there is reason to defer the sale of capital, or if the sale of all government-owned capital will not provide enough revenue to deal with the current crisis, then it is better for governments to borrow than to sell land. Then it is at least clear exactly how much future generations are being asked to contribute to the

solution of the current crisis. There is no way of guaranteeing absolutely that the current generation is not placing too much of a burden on future generations, but if the burden is at least explicit and transparent, there is a better chance that it will not be excessive.

V. EXTRA INITIAL PAYMENTS FROM SECURITY BONDS

While the needs of the current generation do not provide a sufficient reason for them to appropriate to themselves an arbitrarily large amount of the future rent of land, there is a rationale for extra initial payments arising from the need to be assured that the private individuals who control land will not misuse it and leave it in a condition worse than bare, unimproved land. This argument is like the argument for requiring a security deposit from a person who rents an apartment.

To elaborate, a renter of land who was paying rent equal to the full rental value of unimproved land, and who owned a building that had come to the end of its economic life, would have an economic incentive to leave the building on the site and disappear, rather than pay the cost of demolishing the building. The natural way to deal with this potential problem is to require every user of land to place in the hands of the government a specified value of government bonds, as a guarantee that the land would be left in a condition no worse than unimproved land. To avoid the need for an individual determination of the required size of each bond, there could be a general rule that the required bond would be such as would pay interest equal to a specified fraction--say 20%--of the rent of the land. Ownership of the bond that guaranteed clearance of the land would run with the land. Once such a bond had been provided, the amount that the user of the land would be required to pay each year would be the remaining 80% of the rental value of the land. If the rental value of the land were to rise or fall, the percentage of the rent that would be paid by the security bond would be different from 80%. The amount of rent due would always be the full rental value of the land, minus the amount of interest provided by the security bond. When the land was transferred to a new user, the amount of the security bond would be adjusted so that the interest from the bond paid 20% of the current rent of the land.

To provide the users of land with a source of bonds, it would be sensible for the government of the Soviet Union to issue bonds like British "Consols." These bonds have no maturity date, but simply pay a specified amount of interest indefinitely. In view of the very great uncertainty regarding the value of the non-convertible ruble, it would be best for these bonds, and for rental payments also, to be specified in convertible rubles. For activities, such as the operation of nuclear reactors, that held the potential of causing costs greater than the regular bond, additional bonds could be required.

For agricultural uses of land, the equivalent of leaving remnants of use on the land is to deplete the soil, so that the land requires extra effort before it yields as much as land in the condition provided by nature. Bonds required of agricultural users of land would ensure that users were not motivated to deplete the soil and then abandon the land.

A user of land would have the option, at any time, of selling the improvements on the land and the security bond, for whatever price someone else was willing to pay. If the user wished to cease using the land without finding another user, that too would be permitted. The user would simply be required to give some specified advance notice (perhaps 60 days) and leave the land in a condition no worse than unimproved land.

VI. REASSIGNMENT OF RELINQUISHED LAND

Upon relinquishing the land in adequate condition, the user would be entitled to the return of his security bond, and a public "auction" would be held to determine which potential user of the land would place the greatest value on the chance to use the land. In this auction, each potential user would submit a single, sealed bid, representing how much he was willing to pay for the use of the land for the first year. The land would go to the highest bidder. But the price that the highest bidder would be required to pay would be the second highest bid. And as a consolation prize, the second-highest bidder would receive 1% of the first year's rent.

The suggested procedure has a resemblance to a standard sealed-bid auction, except that the amount that the highest bidder must pay is not the amount he bid, but only the amount of the second-highest bid. There are two reasons for requiring a payment of only the second highest bid. First, the second-highest bid represent the *opportunity cost* of the land, what the land would have been worth to someone else if the highest bidder had not wanted it. It is fair that the user of land be charged no more than this. Second, If the price that must be paid is the second-highest bid, then a bidder will not be concerned about the possibility that he will be the highest bidder, and the second-highest bid will be much lower, implying that he could have obtained the land for much less than he bid. When bidders have this concern, they have an incentive to bid less than the land is actually worth to them, and it will be possible that the land will not go to the person who can make the best use of it. It can be shown that when the amount that must be paid is the second-highest bid, no bidder can do better with a false, strategic bid than he does by reporting honestly what the land is worth to him.¹ The payment of 1% of the first year's rent to the second-highest bidder provides an incentive to knowledgeable people to participate in the process and reveal the potential value of the available land.

The highest bidder would be obliged to post bonds sufficient to pay 20% of the rent, and then to make regular payments equal to 80% of the rent. In urban areas it would probably be most appropriate to require monthly payments, while in rural areas, a single payment at the time of the harvest might be most appropriate. The highest bidder would be entitled to continue using the land for as long as he was willing to pay the (regularly revised) rental value of his land in an unimproved state.

VII. DETERMINING THE RENTAL VALUE OF LAND IN AN UNIMPROVED STATE

To determine what the rental value of a particular parcel land would be if it were unimproved, one examines the market for similar land that is unimproved. Thus the valuation of land requires regular auctions of the sort described in the previous section. For this purpose, a valuation agency, or "assessor's office" is needed.

The assessor's office would maintain maps and records regarding characteristics of land likely to affect its value. It would conduct auctions of all parcels of land relinquished to the State for reassignment. It would have a budget from which it could purchase the title or lease to sites with little or no improvements, so that it could auction them and thereby add to the available information regarding the value of sites.

From all the available information, the assessor's office would estimate the rental value of land as a function of relevant factors. In rural areas,

1. See W. Vickrey, "Counterspeculation, Auctions and Competitive Sealed Tenders," Journal of Finance 16 (May 1961), 837.

the relevant factors would be such things as soil quality, rainfall, slope, drainage and distance to markets. In urban areas, the factors would be such things as distance to the center of the urban area, elevation (better views), distance to transportation facilities, and proximity to adverse conditions such as noxious smells. These functions would up-dated annually, based on the results of auctions of the use of unimproved land, as described previously.

If the number of auctions was felt to be too low to permit adequate estimates of the rental value of unimproved land, assessors could augment the available information by inviting anyone who wished to do so to offer "land use options." A person who wished to offer land use options would designate a domain containing at least, say, 200 parcels of land. Within the domain that he designated, the offerer of land use options would provide a "land-rent function," that specified the amount that the offerer was prepared to pay for the use of land, as a function of the kind of characteristics that entered into the assessor's land rental value function. The person who placed the highest option value on a parcel would be awarded 1% of the rent collected from that parcel. This would provide an incentive to keep offers high. But the obligation to actually take over the use of the site and pay the offered rent would keep the offers from becoming too high. While the administrative costs of securing options on the use of the land would be significant, such a practice would provide much more detailed, current and reliable information about the rental value of sites.²

VIII. SHOULD LAND BE RENTED OR SOLD?

Since the rental and the sale of land can be made virtually equivalent, economic theory does not provide a basis for asserting that one or the other is more appropriate. But each designation has a different set of political and psychological consequences. Ownership suggests a greater degree of individual control and responsibility. These qualities make ownership attractive. On the other hand, if those who use land are called its owners, there will be a greater tendency to believe that it would be unjust to increase the amounts that owners pay for the use of land (taxes) simply because the rental value of land has increased. If the taxes were to not increase as rental values increased, then the economy would become burdened with other taxes, those who owned land would gradually become a privileged class, and future generations would lose the chance to have access to land on the same terms as the current generation. Calling the users of land renters emphasizes the idea that the land of the nation is the common heritage of all generations, and makes it easy to understand why the users should pay more when rental values rise. But to make rental work effectively, it will be necessary to give renters an indefinite option on to continue using the land they rent, provided that they are willing to pay the current rental value. It will also be necessary to institute the security bonds that were proposed, so that renters will have an incentive to maintain the value of the land they use.

2. This procedure is described in more detail in N. Tideman, "Integrating Land Value Taxation with the Internalization of Spatial Externalities," Land Economics 66 (August 1990) pp. 341-55.

Since neither "rental" nor "sale" has connotations that fit the best way for a nation to manage its land, I recommend that a new term be found. While people who are familiar with the languages of the Soviet Union would be better suited to suggest appropriate terms, the ideas that come to my mind involve terms such as "holder" or "entitled user." Whatever term is selected, it will be important for the public to acquire an understanding that an "entitled user:"

1. has the right and responsibility to decide how land is to be used,
2. is entitled to continue using the land for as long as he or she wishes, upon continuing payment of the current rental value of similar unimproved land, and
3. is entitled to transfer the right to use the land to anyone else on whatever terms are mutually agreed.