LAND VALUES AND INFLATION

A. Ward

"Land has become a sanctuary for those fleeing from inflation."

BETWEEN 1960 and 1970 the average value of all rural freehold properties over fifty acres has increased by 83 per cent. In contrast dairy farmers' incomes were approximately the same in 1970 as they were in 1960, while the sheep farmer's average income in 1970 was less than that received in 1960. Allowing for inflation over the period the real incomes of both groups have fallen substantially. There is thus no obvious relationship between land values and the current profitability of farming. There exists the paradox of an industry faced with falling real income experiencing a sustained rise in the value of its major fixed input. How can we resolve this apparent conflict?

In most economic texts concerned with value theory it is usual for the land market to be quoted as an example of a demand-determined price, *i.e.*, the supply of land for practical purposes is fixed and cannot be increased. It follows that the transfer price will be determined solely by demand considerations.

In my opinion it is more meaningful to argue that with a given stock of land, the price of land will have to adjust itself to a level where land owners are collectively prepared to hold the stock of land. This is not hair-splitting or an exercise in semantics.

It implies that we must consider those factors that induce people to hold land, and a moment's reflection will suggest that the reasons for holding or owning land are many and varied and need bear little relationship to the current income that can be generated from the property.

In the post-war period it can be demonstrated that the most secure investment through time has been real estate.

There are several institutional factors that reinforce or justify this confidence in the real estate market. Firstly the services flowing from real estate are essential. In the rural sector they generate the bulk of our export income and in the urban sector they provide housing. If New Zealand is to survive it must generate export income and its people must be housed.

Secondly, there is no capital gains tax in this country (New Zealand) whereas our income-tax structure is steeply progressive. For any individual paying fifty cents in the $1 in income-tax, a $1 capital gain is worth double an extra dollar of income. It follows that an asset capable of producing a tax free capital gain is worth more, the higher the marginal rate of taxation.

Thirdly, as the purchasing power of the dollar falls at an increasing rate, incomes in money terms increase. In its latest Quarterly Projection the New Zealand Institute of Economic Research expects money wages to increase by 17 per cent in 1970/71. This increase in money incomes with an unchanged progressive income-tax structure takes more and more middle income earners into the higher marginal tax rates. This group is consequently motivated into tax avoidance strategies and we have witnessed the evolution of "syndication" to cater for this need.

Syndication has evolved as a mechanism to combat inflation and to divert tax-deductable insurance premiums into tax-free capital gain per medium of real estate.

Fourthly, a continuing and, as yet, accelerating rate of inflation places a penalty on liquidity. Any individual concerned with avoiding capital erosion will transfer out of a depreciating asset and into an asset that maintains or preferably appreciates in value. This will yet again divert liquid funds into the real estate market.

Fifthly, as money incomes rise with living standards and more people participate in superannuation and retirement schemes, substantial money savings must be invested in approved securities. Again to the extent permitted by the Government, acquisition of real estate or loans secured on real estate are a logical avenue for such funds.

Sixth—If this was not enough we find that the State Advances Corporation provides concessional credit for urban housing, and for farm development and amalgamation. The credit is concessional in that it is available

to restricted groups at below the current market price. These funds by definition can be expended only in the real estate market.

Finally, in the agricultural field we find a wide variety

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of incentives in the form of taxation concessions. A very large proportion of capital development can be treated as a current operating cost. Accelerated rates of depreciation are permitted and stock may be valued at low and even zero values.

These concessions all operate to make apparent costs higher than real costs, and consequently taxable income is understated. The rationale behind this legislation is commendable. It is intended to encourage productive investment in a vital export industry. However, at the

same time it makes farming a more attractive investment and as such this is reflected in land values.

More recently provision has been made to reduce the income effects of the vagaries of climate by way of drought relief and flood relief measures.

There are thus a wide range of complementary influences tending to ensure that land values will continue to appreciate. It is the general expectation that land values will continue to rise that will ensure that they do so.

It is my contention that these factors dominate the current low profitability of pastoral farming. The cost adjustment scheme proposed by Federated Farmers which has as its objective the same relativity between prices received and paid now as existed in 1964-65, in the unlikely event of its adoption, will again be transformed into capital appreciation. Its effect will be analogous to current taxation concessions already mentioned. It will be appreciated that if additional increments of income are translated into capital values a low average rate of return to capital signifies a highly regarded asset rather than an unprofitable enterprise.

Until now I have been talking in very general terms. Within the rural property field we find anticipation of capital gain a potent force. Farmland within close proximity to urban growth centres is appreciating at a greater rate than are the more remote hill-country properties. Properties in the latter category are selling close to Government valuation. On the other hand, a dairy farm close to Hamilton recently established a record price. It is not immediately apparent that the medium term prospects for the dairy industry are superior to those of the meat and wool industry.

Clearly the prospect of capital gain outweighs short-term income possibilities.

A further point of interest emerges—namely that it is customary for a large farm to be offered as a unit and in the event of an unsatisfactory price, provision is made to offer the unit in smaller parcels. Not infrequently a desirable farm is sold off as perhaps three inadequate farms. This does *not demonstrate* that a large farm is undesirable, it merely indicates that capital limitation curtails the number of potential buyers.

Again it is a feature of costly capital items that frequently the asking price is of less concern than the ability to finance the deal. In the hire-purchase field it is now customary for Government in periods of restraint to raise the deposit requirement and to curtail the pay-back period. This has been found to be a more effective restraint than merely increasing the cost of the durable goods in question.

This observation is equally if not more applicable to land purchase where vendors obtain high sale prices by leaving a substantial sum on second mortgage.

We might now pose the question, are rising land values harmful and what measures can be taken to restrain land values? Dealing with measures to restrain land values first:

My argument has been that land, particularly land close to urban growth centres has become a sanctuary for those fleeing from inflation. It follows that a stable currency would be a pre-requisite for redirecting financial resources back to traditional channels.

The next step would be to impose a capital gain tax which would immediately place a greater emphasis on income generation as opposed to capital gain. A fixed annual land tax of significant proportions would again deter investors from merely holding land for capital appreciation. There would appear to be some merit in making the rates on urban building sections progressive through time. This could be done by declaring a certain area a mature area where, say, 90 per cent of building sections have been built on. Once an area is designated "mature," all undeveloped sections would pay a rate compounding at 10 per cent per annum. When developed, a section would revert to the normal levy.

The above measures would restrain land values by reducing or eliminating the attractiveness of real estate as a hedge against inflation.

The ability to finance land purchase could be signi-

ficantly reduced by curtailing State Advance lending.

Practically all of the above measures would be unfavourably received. The farming fraternity has campaigned for years for the abolition of land tax and is currently fighting the suggestion that a "betterment levy" be charged on land when used for building. This indicates that the majority of land-owners realise that rising land values are very much in their interest. This raises the second issue—Are rising land values harmful, and, if so, to whom? Rising land values are harmful in the sense that inflation generally is harmful.

Saving is discouraged and development is made relatively less profitable. Under present conditions it is preferable to purchase a 200-acre fully-developed property within ten miles of Palmerston North than a 2,000 acre remote hill country property for the same price, the reason being that it is more profitable to hold a developed property than to increase the productivity of an under-developed property. Clearly, if we are going to increase the volume of pastoral exports it will require resources to be channelled into sub-division, water reticulation, pasture improvement and so on. This movement of land values in favour of urban use relative to exports is harmful in that it will reduce future exports.

The people who are most harmed by rising land values are clearly those who want land. By and large these people are young. Married couples setting up home or intending farmers are faced with an increasing capital barrier. Both groups are liable to become over-committed servicing the principal and interest, to the extent that productive investment is wasted. In the case of the home-builder, it will result in a poorer standard or smaller home being built than would occur if the building section had cost less.

Thus the main disadvantage of rising land values lies in the barrier it poses to new entrants into farming. If farming is to remain adaptable and vigorous, the industry must continue to absorb young, well-trained and ambitious men. The present situation must tend to increase the average age of farmers and to discourage amalgamation—neither is in the long run interest of farming or for that matter, New Zealand.

Future land values will be determined in the short term by the fiscal and monetary policy of Government. In the long term, the land values will depend on the terms of trade and market access. If the EEC negotiations are concluded so as to deny this country reasonable market access to the enlarged community—then land values will fall along with other prices.

TAXING OUT POLLUTION

From a report by Dr. William J. Baumol, professor of economics, Princeton University and New York University, as chairman of the New Jersey State Economic Policy Council, to the Governor, State of New Jersey, May 1971.

THE PROPOSAL that the economist makes is a very simple one. He maintains that there is no excuse for supplying expensive resources free.He says that those resources should be provided at an appropriate price just like the resources supplied by private industry. More specifically, he calls for a re-orientation of the tax system, one that does not necessarily increase the overall burden of taxes. An example will help to clarify the issue.

Suppose it were decided that the oil industry were currently paying the right total amount in taxes, but that taxation were to be used to help get the lead out of its products. For this purpose one could reduce by, say, $0.03 a gallon the tax on unleaded gasoline and increase it by a similar amount on leaded gasolines. This is clearly not punitive. On the contrary, it gives the industry the opportunity to recoup its money by behaviour consistent with social goals. Nor does this procedure constitute a drain on the public budget or a subsidy to industry. Given the efficiency with which private enterprise is able to proceed in the pursuit of profits I suspect the speed of the changeover to lead-free fuels will truly be impressive.

Similarly, in the neighbourhood of airports much can be accomplished by a substantial differential in landing fees depending on the noise level and pollution emission level of the aeroplane.

In the same way, the flow of trash can be reduced by imposing a significant tax on no-deposit-no-return containers, perhaps matched by a reduction in excise tax on items in returnable containers.

Or, to give yet another illustration, there is much to be said for a re-orientation of taxes on rental property which offers some material advantage to the improvement of buildings, and under which the landlord who pollutes his neighbourhood by creating a slum—by failure to maintain his property or by abandoning his property outright—has to pay the cost that he imposes on society.

In each of these cases the basic notion is the same. By giving virtue its just (financial) reward the rules of the game are changed so that industry is induced to accomplish what society wishes of it.

Besides its obvious attractions, this approach has several additional virtues. In many cases, it is virtually self-enforcing. Its instrument is typically the meter rather than the police inspector. For example, the proposed tax on leaded gasoline requires no more than a record of how much of each type of gasoline has been sold, and the tax can be collected just as it is today. The emission of pollutants by a factory can also be metered and billed. There are no crimes to be discovered, no courtroom hearings, and no legal battles over level of fines. Enforcement is consequently not sporadic—it is continuous, predictable to the business planner and consequently, effective. In this respect it differs markedly from the reality of outright prohibition.

The taxation approach to the protection of the environment also has the virtue of longevity. That is to say, because it is automatic, because it is self-enforcing, it will still be effective five, ten and twenty years after it was