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Sustainable urban development and land value taxation: The case of Estonia

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ABSTRACT

Where real estate taxation differentiates between land uses, size of built structures, developed and undeveloped land, it has an influence on the decisions of landowners what and how to build. Still, real estate taxation is often only used to generate a stable source of revenue for the public administration, rather than as an active control mechanism in land policy and planning, despite its relationship with urban development.

As a form of real estate taxation, a tax on land values only is recurrently discussed in literature to have beneficial effects for urban development. Planners who propose a land value tax (LVT) often argue that it leads to higher building density and a more frequent re-use of brownfields. LVT could curb undesired 'urban sprawl' and lead to a more efficient land use, compliant to zoning and urban planning designations.

In most countries however, the real estate tax is determined by the value or size of buildings, and not by the value of land. Only a small number of countries has introduced a land-based only real estate tax system. Estonia is the only country in the European Union that in 1993 has done so, but there has been no case study of the effects of it on urban structure so far. This is surprising given its relatively rigorous implementation.

In this paper, I will give an overview of the debate on land value tax and urban planning, before I briefly analyse the dynamics of land policy that ensued from the introduction of the land value tax on urban development in the Estonian capital Tallinn since its introduction in 1993. I compare my findings with neighbouring Riga in Latvia, which has retained a building-based taxation system. I conclude that, while statistical results indeed seem to suggest an increased capital-land-ratio and slightly increasing population density in Tallinn as opposed to Riga, both regions show considerable suburbanisation and sprawl, challenging the effectiveness of the LVT implementation in Tallinn. The result also points to the importance of other influences on urban development, and the difficulties in separating the effects of LVT from them.

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1. Introduction

When we talk about land policy, a continuum of policy tools come to mind, from redevelopment contributions and (mandatory) land readjustment to active land policy (Muñoz Gielen and Burón Cuadrado, in this issue). Land taxation is often not among them—one reason being that in many countries, its effects are ubiquitous and not spatially differentiated, so that it is not perceived as a control mechanism in terms of land policy.

But from land ownership and values to land uses, it has far-reaching impacts. Its configuration can especially shape urban development, linking it to planning: The way it differentiates (or does not differentiate) between land uses, size of structures, built

and unbuilt land has an influence on the decisions of landowners what and how to build. Also its rate, especially compared to the taxation of other factors of production, also has an impact. This makes real estate taxation a possible yet underused setscrew for targeted urban development policies. And like with other land policy tools, it is situated in the discursive area of conflict, between the redefinition of what property rights in land are constituted of, and expropriation. Thus, if we conceive of land policy as public interventions in the allocation and distribution of land, and the revenues from it (Davy, 2005; Hartmann et al., 2015), real estate taxation is key.

Although nonrecurring real estate taxes, such as development fees or real estate transfer taxes represent an equally worthwhile topic for discussion here, I want to focus on recurring (often annual) real estate taxes for this paper, as common in many legislations. Nonrecurring taxes discourage one-time adjustments

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to market conditions that would be otherwise generally viable through increased transaction costs, while recurring taxes shift the boundaries of what is permanently viable. Though both can be politically desirable, they differ considerably in market effects, consequences for urban development, and expedience.

Among the various forms of recurring real estate taxes discussed, the land value tax ('LVT') plays a particular role. The idea of a tax levied only on the value of every plot of land without taking into account the value of improvements built on it has since its emergence been popular with planners and urban economists alike. The market value of land typically reflects the discounted future income stream generated by the theoretically possible, not the current actual use: Under LVT, the tax amount remains the same, whether a plot is developed or not. Hence, initiatives for its introduction emphasize the incentives it could create for landowners to put their land to the best use, enhancing market efficiency instead of reducing it.

This makes clear the link between LVT and sustainable urban development: Owners of urban land would be under pressure to use their land most efficiently, but compliant to zoning and urban planning designations, leading to higher building density and a more frequent re-use of brownfields, its supporters argue. LVT could in the long turn curb undesired 'urban sprawl'. Hence, planning organisations have been among the strongest supporters of LVT (DASL, 2000; Town and Country Planning Association, 2000, p. 25).

I start my paper with a review on the general theoretical virtues of recurring real estate taxation, especially LVT, summarizing why it can be described as efficient, effective, just, and legitimate, before examining the discussion on its effects and desirability for urban development. The first part of the paper will be concluded with a review of case studies in which effects of LVT on urban form have already been assessed.

Land value taxation has been introduced in several countries and sub-national entities already. The only EU member state that has introduced pure LVT is the Baltic country of Estonia in 1993, shortly after its independence. LVT implementation in Estonia is strict, with few exemptions and a relatively continuous application throughout the 1990s and 2000s, making it a good candidate for a case study.

As there are no contributions on the Estonian case in the scientific discussion so far, I analyse if the dynamics in land policy represented by the institutional change in Estonia had the asserted effects on urban density, in the second part of this paper. For this aim, I compare urban development in Estonia's largest city and capital Tallinn with that of neighbouring Riga in Latvia, where a conventional building-based tax applies, combining literature review and statistical analyses.

2. Real estate taxation, land value tax and urban development

Recurring taxes on real estate belong to the most established forms of taxation in many jurisdictions (Norregaard, 2013, p. 7). Typically, they amount to a certain share of the value of real estate, based on the value or size of buildings, the number or floor space of rooms, or a combination thereof, sometimes in addition to a land size or value component, levied annually.

2.1. Real estate taxation

Compared to other recurring and nonrecurring taxes, real estate taxes share certain particularities: they are object-based, buoyant, local, and progressive.

Object-based taxes are impersonal, i.e. the payable amount does not depend on individual solvency, leading to relatively predictable

revenues. Also, as the taxed object cannot be 'hidden', and can be confiscated in case of liabilities, tax evasion is near impossible, making real estate taxation highly effective. Buoyancy means that real estate prices generally increase relative to general economic growth, which leads to synchronously increasing tax revenues (Maurer and Paugam, 2000, p. 2).

Real estate taxes are organised as local taxes in many countries, often as the most important independent source of local revenue (Oates, 1969, p. 1). Since the value of real estate generally reflects the local endowment with infrastructure and public services and the demand for housing, taxes on it can be seen as legitimate service contributions to municipalities which are responsible for service provision. Only seldom however are these taxes alone sufficient to cover the entire municipal budget.

Progressive taxes rise with wealth, and real estate owners usually have above-average financial resources. Here, the tax has twofold effects: A recurring burden for landowners, and reduced property values, making it easier for others to step on the 'property ladder', thereby having an effect on distributional justice. The tax is capitalised into the land value, since the anticipated future income stream of a property is reduced. This partially diminishes the tax base itself, until an equilibrium of lower land value and higher tax revenue is reached (Oates, 1969).

Examples for this type of taxation can be found in almost all European Union countries, such as in the UK (council tax), Germany (Grundsteuer), or the real estate taxes in the Baltic states of Lithuania and Latvia (Raslanas et al., 2010).

2.2. Land value tax

As subgroups of real estate taxes, the case of building- or combined building and land-based taxes can be contrasted to land value taxes, for which only the land functions as the tax base. I briefly discuss four main arguments used for LVT in urban economics and land policy: Its non-distortion, inhibition of speculation, use as betterment tax, and equity considerations (Dye and England, 2010, p. 8).

LVT is argued to be non-distortionary to the land market compared to other real estate taxes: A tax on buildings leads landowners to commission less and smaller new buildings to avoid tax, hence reduces their supply, a problem particularly for strained housing markets. A tax on land does not influence the market equilibrium, given that land supply is fixed and perfectly inelastic. There is no new equilibrium price, and the entire tax is levied on supplier. In literature this argument is contested on the grounds that land available for (residential) construction is in fact not completely inelastic, as opposed to land in general (Tony and Whitehead, 2002), leading to deadweight losses in case of a tax. On the one hand, this applies in planning systems based on individual planning permissions like the UK, where landowners would face a disincentive to apply for permission to convert their land to a more profitable use class, e.g. from agricultural to residential land. The system could be reconciled with LVT, however (Connellan, 2004, p. 157). On the other hand, in planning systems based on zoning like in many continental European countries, or without any planning system, the 'best possible use' for every plot of land (and thereby the tax amount) is not directly determined by the landowners decisions but by market forces, making it more compatible to LVT. In any case, however, "the scale of gains available suggests this is unlikely to be a major issue" (Mirrlees et al., 2011: 372).

Another argument is the reduction of land speculation with LVT (Cocconcilli and Medda, 2013, p. 393, 398). 'Land hoarding' of undeveloped urban land for later use or sale, identified as a reason for under-achieving housing targets in increasingly strained housing markets becomes more expensive. In addition, increased land values simultaneously lead to higher taxes, if assessments are carried

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