Chapter 10

The Optimal Reform About Property Tax

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Abstract We present the desirable tax reform on the property tax on land and housing in Japan. Since the property tax on housing, building, and equipment becomes an obstacle to the capital formation on land, it should be abolished. Conversely, the effective rate of property tax on land should be increased so as to attain the revenue neutrality for local government. The abolition of tax on housing induces the higher land price which can bear the increase in the property tax on land, so that such a tax reform would benefit all individuals.

Keywords Property tax on land and housing · Revenue neutral

10.1 Introduction

The government and ruling parties have recently drafted a large package of changes to the tax system. This includes increasing tax on high-income earners, while reducing property tax. Reducing tax on fixed properties is particularly important for facilities owned by small-to-medium enterprises. It is necessary to improve the productivity of workers to deal with labor shortages in the future, and economize on labor to embrace new technology in the form of robots and AI (Artificial Intelligence).

Taxes on machinery and equipment inhibit the introduction of new technology and can curb investment, which is why a reduction on property tax has been incorporated into the package. Traditionally, economists have taken the disapproving stance, claiming that property taxes on investments in equipment and buildings are not undesirable. In that sense, the incorporation of property tax reduction into the package requires further evaluation.

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Accepting that property taxes are indispensable financial sources for the local government, taxes should be placed on land ownership rather than housing and equipment. A fixed tax rate on things, such as land of which supplies do not change depending on price, is ideal because it does not affect resource allocation.

From the perspective of the effective use of land and fair distribution of income, after listing the issues and challenges for property tax in Japan, this paper proposes abolishing property tax on housing and raising property tax rate on land to compensate for the financial deficiency of the local government. Also, the miniaturization of and utilization should be prevented by abolishing the special measure of property tax on small-scale residential plots.

Property tax is an important funding source for local governments in rural areas. Therefore, local governments may strongly oppose the abolishment of property taxes on housing. To overcome this opposition, revenue-neutral tax system reforms should be considered. To this end, I would like to propose raising the effective tax rate of property tax on land.

Alleviating or abolishing tax on housing will promote multi-storied or shared usage, which will increase the demand for land and raise land prices. This increase in land prices may raise the tax capacity of land owners. Thus, politically, it is easy to raise tax on land, which will cover the reduction in tax revenues for prefectures and towns due to the abolishment of property tax on housing. Therefore, opposition from local governments can be restrained. Furthermore, the effect of reducing tax on housing will limit any decrease in land pricing due to raising the property tax rate on land, which is also preferable for land owners.

10.2 Regulation and Taxation System: Causes of Low-Density Land Utilization

10.2.1 Regulations and Inheritance Tax

One of the issues in Japanese cities has been the low-density use of land. Despite the high price of land in shopping areas near stations, these areas comprise shuttered streets rather than multi-story buildings, and land is only developed to a low level. Urban bay areas are lined with multi-story apartment buildings, but in the suburbs of Tokyo, agricultural land is still found and the number of vacant plots is increasing. In this manner, the existence of shuttered streets in shopping areas near stations in city centers and vacant plots and housing in the suburbs results in the ineffective use of land.

The prevention of high-density use of land is caused by land use regulations and land legislation. In general, most land use regulations have been introduced from the perspective of preventing congestion and amending over-concentration. They were introduced with the objectives of preventing excessive burden on urban

infrastructures by means of floor area regulations, and they include regulations on the purpose of use, floor space index regulations, and height restrictions.

However, congestion in urban roads and railways does not seem to have been mitigated despite these measures. Even if there has been some mitigation of congestion, it has produced much more serious side effects. The effective use of land has also been hindered by legal issues. It appears that the Act on Land and Building Leases and the Act on Building Unit Ownership have reduced the supply of rental housing and condominiums.

In addition to these regulations and legal issues, the land tax system has distorted the effective use of land. Therein, the influence of inheritance tax and property tax cannot be ignored.

Inheritance tax, which is a tax on the inheritance of land, can be viewed as taking away profits from landowners who are wealthy individuals. Therefore, while it is generally thought that strengthening inheritance tax would contribute to the fair distribution of income, the current inheritance tax by no means contributes to fair distribution. Rather, it is profitable to a considerable number of land and house owners, and it causes an increase in land prices. Land is more beneficial than financial assets in terms of the inheritance tax system, which is why land is a superior means of handing down assets.

With the current inheritance tax system, even if the land owner has no means of effectively using the land, he or she will not sell it, which makes the land use unchanged in the long term, and the land and land use is fixed as a property of current landowner. This causes land prices to rise and additionally makes unchanged the structure of cities and inhibits joint use and high-density use of land.

Inheritance tax is, thus, the reason why shopping streets in front of stations become ‘shutter- streets’ in which all storefronts are closed for business and the continued existence of huge areas of agricultural land in the suburbs. Furthermore, it is the cause of vacant housing. Inheritance tax raises land prices, which results in an incredibly unfair distribution of income between individuals who own land and people who do not.

Fixed property tax distorts efficient land use in the same way as inheritance tax and produces injustice in distribution. Hereafter, with a focus on fixed property tax, I will propose necessary reforms to the tax system to ensure effective use of land.

10.3 Property Tax on Land and Housing

10.3.1 Property Tax on Land

In general, property tax that is charged on land ownership should be an ideal as it is neutral with regard to resource allocation.

The supply of land as goods is limited. For example, except for reclamation, the land area in the wards of Tokyo is limited. If land owners are taxed, there will be no

change to the use of land, and if the land is sold, the new landowner will be taxed. Landowners who do not use the land in order to maximize profits just accept losses.

It is one of classical theses of Economics that it is desirable to tax assets of which supply does not change regardless of price. It is desirable to charge tax of fixed ratio on goods such as land of which supply does not change irrespective of price as the tax will not affect the allocation of resource; here resource allocation refers to land use.

10.3.2 Property Tax on Housing

Facilities such as buildings and machinery as well as land are charged fixed property tax and city planning tax. While the supply of land is fixed, this is not the case for the supply of buildings, such as houses and offices or mechanical equipment; it can be increased or decreased depending on changes in the market environment. A rise in housing prices increases housing supply and demand. A rise in office rent and building prices gives further incentive for developers to promote the development of commercial buildings.

Therefore, taxation on owners of housing and offices, that is, property tax on buildings, reduces the profitability of such buildings, which results in a negative influence on high-density use of land. In other words, property tax on resources other than land is disadvantageous to housing and office ownership, thereby reducing the demand for buildings and resulting in decreased floor area.

Based on the earlier example, even if land prices change, the land area of the wards of Tokyo does not change, but if land price and rent increase, buildings will be replaced by multi-storied buildings in order to increase the floor area with a limited area of land. The area of land cannot be changed, but the floor area can be changed. By investing funds in the construction of multi-story buildings, a larger floor area can be obtained with a limited area of land. This leads to economization of land that has a high land price. In contrast, imposing a tax on building ownership is disadvantageous to investing in buildings, and it limits the effective use of land. Therefore, fixed property tax on housing and offices inhibits the shared and high-level use of buildings, which is not optimal.

As property tax of fixed tax ratio will be charged on floor area of buildings, a larger amount of fixed property tax must be paid by making solid construction of more shared and higher-storied buildings. This reduces the supply of housing, which hinders the promotion of multi-story buildings and earthquake resistance. The side effects of such property tax on buildings are a delay in the improvement of houses to make them highly earthquake resistant and energy efficient and to the reconstruction of old, dangerous housing. As a special exception to prevent this side effect, fixed property tax reduction measures are in place for newly constructed housing, good quality housing with a floor area of up to 120 m², and earthquake-resistant buildings. However, if there is recognition of this side effect, fixed property tax on buildings should be abolished in any case.

10.3.3 The Benefit Principle

Furthermore, property tax on buildings is not compatible with the benefit principle. The benefit principle is that when the government supplies public goods by using revenue of tax, those who benefit from the supply of public goods must pay for the tax. Essentially, it is a value judgment that those who benefit from the services provided by the government should bear the cost of this through taxation.

Most public services are regionally supplied, and public goods that are equally profitable for all citizens nationwide are almost non-existent, except for national defense services. Other than this, it is difficult to find textbook examples that allow for 'non-competitiveness and non-excludability in consumption.' The goods and services supplied by the government are essentially regional goods, and they cannot be consumed without living in that region. Roads and parks are region specific, as are firefighting and police services, and it is extremely unlikely that a person will consume the road and park service in a region far removed from his or her residence. In general, as the distance from one's residence increases, the frequency of consumption of such services decreases.

As a result, the value of services inherent in a region is reflected in the land prices of that region. An example of the operation of this mechanism can be seen with an increase in land prices when a station is built. This is because commuting to the city center becomes easier. Unless one lives in the region, public services, such as railroads and stations, are meaningless and entirely regional. It is the same for parks, roads, and security. Therefore, the benefits from public services in rural areas supplied by the national and local governments are primarily reflected in land prices. Hence, from the perspective of the benefit principle, the cost of public services should be placed on land owners.

The value of public and administrative services is reflected in the land prices of that region, so the purpose of imposing property tax and city planning tax on land is to collect compensation from landowners for public services as it is difficult to directly charge user fee on the beneficiaries by public services. Local governments that provide excellent public services for free or at a low cost will attract more residents, which will result in higher land prices. The benefit principle is adhered to when the burden for public service costs is placed on land owners by charging tax on land thus having higher land prices.

Therefore, taxing land is compatible with the benefit principle. However, the price of buildings, including housing, is influenced by construction costs, but it is rarely influenced by the quality and standard of public services. The price of a building that does not include land is mostly determined by the cost of construction.

10.3.4 Property Tax That Enhances Small-Scale Land Ownership

Although it has been stated that property tax on land is desirable in terms of resource allocation and income distribution, in reality, there are various special exceptions and measures for adjusting the burden of fixed property tax in Japan, which can distort the optimality.

The current property tax rate is 1.4%, the city planning tax is 0.3%, and the tax base amount when levying taxes is roughly 70% of the disclosed land price. For small-scale housing sites, various favorable measures in the tax system exist. There are special exceptions for fixed property tax evaluations on housing sites with an area of up to 200 m² that reduce the tax base amount by five-sixths and the city planning tax by half. This is an incentive for owning residential land having area of 200 m² or less.

It is difficult to assemble lands of small-scale ownership. In order to develop condominium buildings and office sites in city centers, it is necessary to consolidate small-scale land ownership. When land ownership is miniaturized, it is necessary to hold purchasing negotiations and the settlement of interests with more land rights holders. As a result, great expense and time is required for negotiations when land ownership is miniaturized and land rights holders increase even for the same scale of development. Roppongi Hills was developed over several decades, but most of this time was taken up with these kinds of negotiations and contracts.

The frequency and cost of such negotiations increase in excess of what is proportionate to the miniaturization of the land ownership. Therefore, to save social costs required for future developments and conversion, the tax system should not miniaturize land ownership. Furthermore, special systems for small-scale residential plots that promote such miniaturization of land ownership should be abolished.

Naturally, the scale of land use differs depending on the purpose of its use, and housing differs depending on the scale of the family. There are offices and factories that require major land or floor areas, but offices and individual-use housing exist for which relatively small-scale land use is sufficient. Regarding such land and floor area uses of different scales, the social cost will be lower if dealt with through rental agreements for the land used rather than through division of land ownership.

The consolidation of land ownership rights requires even more money than simply multiplying the per-person cost of negotiations and contracts by the number of land owners. Consequently, if no incentive is given by the tax system for the miniaturization of land ownership, even under market mechanisms, land ownership will be kept to an optimal level.

Nevertheless, it does not seem feasible that a great deal of land should be consolidated under a single owner. The vertically integrated use of land starting from a land owner has a greater economizing effect than rental agreements on the costs that accompany the asymmetry of information, and therefore, it does not seem practical for land ownership to be consolidated beyond a certain level.

While comparatively small-scale land ownership exists in the form of private residences, it is logical that large-scale land with a single owner that is divided for small-scale land use, such as rented stores/offices or homes, is also found.

10.4 Conclusion

What interest economists with regard to land tax is the manner in which the use of the land changes according to the land tax system. They also discuss what type of tax system is preferable in order to achieve fair asset distribution and income distribution by analyzing the effect of changes to the land tax system on income and asset prices. The issue of changes made to land use and asset distribution by changing the land tax system is a theme that has long been discussed among economists.

Certainly, this can also be discussed regarding assets other than land. Financial assets can be taken as ownership of actual assets and/or have the right to claim certain monies. The typical pattern of the former is equity, while the latter takes the form of bonds and deposits.

However, taxes on financial assets do not directly influence the use of resources. Taxes on financial assets first influence the price of financial assets and revenue ratios. Subsequently, changes in asset prices change people's attitude toward risk, which results in an indirect influence on the demand for actual assets.

For example, portfolios are changed by taxing shares through changes in revenue ratios. This has an indirect influence on corporate management and the management of actual assets owned by companies. However, this path is incredibly complex and not easy to analyze.

In contrast, land tax is taxation on actual assets, which changes land revenue ratios, resulting in a direct influence on ownership and usage methods. Further, changes in land prices are directly connected to changes in asset distribution. In this manner, land tax influences the distribution of assets and the usage method of land as an important resource. Therefore, many economists have had a strong interest in this field for a long time.

To summarize the findings so far, property tax on housing and equipment should be abolished. Special measures for small-scale residential plots should also be abolished. However, property tax is an important revenue source for local governments in rural areas; therefore, revenue-neutral reforms to the tax system should be considered. To that end, the author would like to propose an increase in the effective fixed property tax rate on land. Property tax on land is clearly preferable over property tax on housing from the perspective of resource allocation and income distribution. If a tax reduction on housing is packaged together with a tax increase on land, landowners will not lose out.

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