

## Policy review

# REPLACING A 'COMBINED TAX ON LAND AND BUILDINGS' WITH A SIMPLIFIED 'LAND VALUE TAX' IN THE FEDERAL REPUBLIC OF GERMANY

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**ABSTRACT.** In early 2004 the finance ministers of Bavaria and Rhineland-Palatinate put forward a new model for assessing land tax. The model envisages the abolition of the current Land Tax A (tax on agricultural and forestry enterprises); Land Tax B (developed/developable real estate) is in future to comprise a flat-rate tax on the buildings and a more up-to-date and realistic taxation of the land value based on the standard land value. Nevertheless, the question still remains: Why not go one step further and replace this 'combined tax on land and buildings' with a simple 'land value tax'?

**KEYWORDS:** Land tax; Land value tax; Standard land value; Assessed value of property; Land tax assessment basis; Land tax rating

## 1. PRELIMINARY REMARKS: THE NEW LANDTAX# MODEL

In 2000 the finance ministers of the federal administration and the *Länder* launched an initiative which, however, ultimately failed. In early 2004 the finance ministers of Bavaria and Rhineland-Palatinate reached agreement on a new land tax model which the finance ministers of the other *Länder* agreed "served as a very good basis to work with".

In this model, taxes levied on undeveloped and developed real estate property are no longer to be based on the assessed values of proper-

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# In Germany land tax is essentially a combination of a tax on the land and a tax on the buildings erected on it (verbundene Grundsteuer). The term 'land tax' will be used in the following to refer to this combined taxation of land and buildings [translator's note]

ties (the so-called *Einheitswert*) as per 1964. The current proposal suggests a new two-tier model for assessment. The basis for assessment of the simple land value of building land is to be based on the standard land values# which are published by the Committees of Experts for Land Values pursuant to Section 192 to 199 of the Federal Building Code of 27 August 1997 (Federal Law Gazette I, p. 2141). That is standard land values are no longer only to be applied to building land which is subject to local improvement assessments and / or land which

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# The standard land value (Bodenrichtwert) is the average value of plots of land with comparable land use and comparable value that are ready for building. The Committees of Experts determine the standard land values each year as per a qualifying date and enter them in a standard land value map, which is accessible to the public (translator's note)

is exempted from local improvement assessments, but also, based on Section 196 of the Federal Building Code, to the various gradations of building land (such as designated development areas, undeveloped, potential building land, etc.) pursuant to Section 4 of the Ordinance Regulating the Assessment of Value of 6 December 1988 (Federal Law Gazette I, p. 2209).

In the case of undeveloped building plots the land tax assessment is then to be directly based on these standard land values. In the case of developed building plots, the standard land value is first marked down by 30%. However, to make the procedure simpler than was previously the case, a roughly estimated lump sum mark-up is to be added to the land tax assessment basis for buildings and physical structures erected on the land. There are to be five types of mark-ups: three for commercially used buildings, two for residential buildings. For office buildings, banks, hotels, etc. a lump sum of EUR 1,000 per square metre built-up area will be payable; for factories, workshops, multi-storey car parks EUR 400; for other commercially used buildings such as indoor riding arenas and gymnasiums EUR 200; for one-family houses and two-family houses EUR 800; and for flats let for rent and holiday homes a lump sum of EUR 600 per square metre of built-up area. To simplify matters, the previous deduction for ageing buildings is, however, to be abolished.

In addition, Land Tax A, which is currently paid by agricultural and forestry enterprises, is to be completely abolished. The previous tax revenue totalling EUR 330 million per year, it has been claimed, is completely out of proportion with the required administrative expenses. Thus, for example, the approximately 860,000 agricultural and forestry real estate properties in Bavaria only produce EUR 78 million per year in revenue, i.e. on average EUR 90 per case. In future agricultural and forestry residential buildings are to be subject to Land Tax B. Fields and forest land which have remained undeveloped are to be tax free, although an

opt-out clause is to be included for individual *Lander*, such as Mecklenburg-Western Pomerania, without this having to be set off as part of the financial equalisation scheme between the federal government and the *Lander*.

Since the taxing power for land tax is to remain with the local authorities, they will each be able to decide whether this new land tax model is to be neutral in terms of revenue from taxes or whether it is to be used to augment local authority tax revenue.

This land tax model, which aims to retain the unity of land and any buildings constructed on it, thus also in principle constitutes a 'combined tax on land and buildings', albeit in simplified form, and therefore naturally invites critical analysis.

## **2. THE CURRENT LEGAL BASIS FOR DETERMINING THE ASSESSED VALUE OF PROPERTY: AN OVERVIEW**

The generally applicable legal basis for levying land tax results from the Valuation Law of 16 October 1934 (Reich Law Gazette I, p. 1935) and the Land Tax Act of 7 August 1972 (Federal Law Gazette I, p. 965) in their amended versions.

Pursuant to Section 1 of the Valuation Law, the general assessment regulations contained in the Valuation Law are to be applied to all public law taxes regulated by federal law insofar as they are administered by federal administration or Land finance authorities. They are not to be applied if the Valuation Law itself or other tax laws contain specific (special) regulations as regards assessment. The general principle applied pursuant to Section 9 of the Valuation Law is that the assessed value is based on the average value. Pursuant to Section 9 of the Valuation Law, this average value is the price which would be paid for the commodity in normal commercial transactions in accordance with its quality were it to be sold. All and any conditions which influence the price are to be taken into consideration; unusual or personal relationships are not to be taken into

account. This definition of value accords in terms of substantive law with all relevant aspects of the definition of market value pursuant to Section 194 of the Federal Building Code, which is generally applied by the Committees of Experts for Land Values when determining official values. Based on this assessment the Committees annually publish the standard land value maps and real estate market reports. The aim is thereby to improve market transparency as regards real estate property. Any significant differences are merely due to the predetermined qualifying dates and the valuation method applied (cf., for instance, also Kleiber-Simon-Weyers [2002]: *Verkehrswertermittlung von Grundstücken*, p. 99).

Particular (special) regulations pursuant to Section 18 and 19 of the Valuation Law stipulate that as regards real property in Germany, namely agriculture and forestry enterprises, property in land or real estate, business property and business real property, the assessed value of the property must be determined for tax purposes. Pursuant to Section 17 of the Valuation Law these assessed values form the basis for the assessment of land and trade tax. The assessed values of property are now less relevant for tax purposes, especially following the 1997 Tax Act of 20 December 1996 (Federal Law Gazette I, p. 2049). The Valuation Law here applies the term *Einheitswert* (literally: uniform value) to refer to the assessed value of property, without further defining it. The term was introduced in the original sense of the German word as a uniform value serving as a basis for taxation. Pursuant to Section 19 et seq. of the Valuation Law, this value is generally determined by way of a comparative gross rental method with reference to the main qualifying date (the last one being 1 January 1964).

The assessed value of property for agricultural and forestry enterprises is, pursuant to Section 48 of the Valuation Law, the sum of the economic value and the assessed value of residential properties. The economic value is thereby composed of reference values, includ-

ing necessary surcharges and deductions as regards the actually applicable earning capacity and rental value, the individual earning capacity value, as well as, possibly, assets and liabilities that are valued separately (such as auxiliary enterprises, wasting assets, minimum land, etc.). For this, a corresponding earning capacity value is determined - subject to special legal earning capacity guidelines - for various concrete types of use as per the main qualifying date for land used for agricultural, vinicultural and gardening purposes or for their parts of 100 comparative figures. This earning capacity value is then used to calculate the earning capacity value for individual use or that part which is used by the enterprises, with comparative figures serving as a reference value. The reference value per hectare thus corresponds to the value per hectare. In the case of forestry enterprises no comparative figures, but directly corresponding reference values are determined.

Pursuant to Section 68 of the Valuation Law, the assessed value of property for general landed property and for real estate property within the meaning of Section 70 of the Valuation Law comprises the land, the buildings, other components and accessories, as well as hereditary building rights, ownership of residential property, partial ownership, hereditary residential building rights and partial hereditary building rights, insofar as they are not attributable to agricultural and forestry enterprises or special business real property. Natural resources and special plant facilities are not included. In the case of residential real estate let for rent, business property, mixed property, residential property containing one and two residential units, the average value is, pursuant to Section 76 of the Valuation Law, likewise determined according to the gross rental method. The real value method is only applied by way of exception to other developed real estate. In the case of undeveloped real estate, the average value is directly calculated pursuant to Sections 9 and 17 of the Valuation Law based on comparative prices, standard land

values and / or estimated revenues. Further differentiation of the average value calculated using this method for each individual object to be assessed by means of surcharges and deductions for individual features (such as the form of the real estate property, quality of the building plot, etc.) in the end produces the standard land value of the general landed property or the real estate within the meaning of the Valuation Law.

The standard valuation of special business real estate, i.e. assets, other active valuations, debts and other passive valuations belonging to a business establishment, is done pursuant to Section 109 (1) of the Valuation Law for those who are subject to tax and who determine their income according to Sections 4 or 5 of the Income Tax Act in accordance with the respective tax balance sheet values. Those who are subject to tax and who are not subject to the regulations contained in Sections 4 or 5 of the Income Tax Act must have a valuation done based on taxes on income pursuant to Section 109 (2) of the Valuation Law.

These key legal foundations for determining the assessed value of property in agricultural and forestry enterprises, of general landed property, as well as of special business assets form the basis for the levying of land tax pursuant to the Land Tax Act in its amended version (the product of assessed value and basic rate [Steuermesbetrag] or basic federal rate [Steuermeszahl] pursuant to Section 13 Land Tax Act). Pursuant to Section 25 of the Land Tax Act each local authority determines which municipal percentage is applied to the land tax.

Overall, it is also clear that the land tax, just like the 'combined tax on land and buildings', is not very transparent for citizens, that it hardly bears any relation to the current value ratios, and that it is not possible to exercise control over the type of land use (i.e. to ensure it is of advantage to the general public); often such controlling functions are not desirable in tax law anyway.

### **3. THE NEW LAND TAX MODEL: HALF WAY TOWARDS A SIMPLIFIED LAND VALUE TAX**

The new land tax model is, as outlined above, two-tiered. The first component, namely the land value tax assessment, is to be based on the standard land values determined annually and subsequently published by the Committees of Experts for Land Values pursuant to Section 196 of the Federal Building Code. The standard land values are generally derived from currently available market information on purchase prices according to Section 195 of the Federal Building Code. They therefore document estimates made by those working in the real estate market regarding qualitatively and quantitatively permissible land use.

The general qualitative, functional variants are widely known. They range from designated development areas, undeveloped, potential building land to land considered to be ready for building in the near future in accordance with Section 4 of the Ordinance Regulating the Assessment of Value, and, in particular, to residential building land, mixed building land, commercial building land to special building land, in individual cases classified according to the corresponding building regions in accordance with the Land Use Ordinance of 23 January 1990 (Federal Law Gazette I, p. 132). The result is a sophisticated representation of local real estate market conditions with regard to the type of buildings which are legally permissible on the land. Pursuant to the Land Use Ordinance, the same applies to the quantitative functional variants regarding the legally permissible use to which the land may be put, which is likewise widely known as the degree of land use.

The second component of the new land tax model is to comprise the roughly estimated lump sum surcharges to be added to the new tax assessment basis for those buildings or physical structures erected on the land. This would mean that the actual use to which the land was being put would clearly be reflected in the new land tax assessment basis and that

there would be a cumulative effect. This in itself raises a certain amount of doubt regarding the proposed model: Should potential investors indeed face separate tax penalties and potential speculators be given tax benefits for not using the land?

In my opinion the local improvement assessments should be brought to bear in the standard land value model by including roughly estimated lump sum deductions.

This inevitably leads on to the idea that the second component of this new model of land taxation, along with its cumulative effects, should simply be eliminated; this would, in turn, lead to a consistent, simplified land value tax for building land based on standard land values that would always be up to date.

In conclusion I would also like to summarise for readers the advantages of this approach as put forward in 1992 by the Mobilising Residential Building Land Working Group of the Federal Association of Residential Property Ownership and Urban Development, registered society. At the same time the possible controlling function of a land tax - yielding an annual revenue of EUR 9 to 10 million - should not be overestimated:

- The simplified land value tax would constitute a tool for controlling land use;
- Land would become unattractive as an object for speculation or as a store of value;
- The simplified land value tax would at least have a tendency to lower the price of land;
- The legally prescribed intensity of land use would largely be exhausted and underused

real estate to a large extent avoided;

- The simple land value tax would have the effect of upholding the value of the buildings, thus minimising the need for redevelopment;
- The simple land value tax would be fair in terms of distribution policy, since those who use a lot of land would pay a lot of tax;
- The simple land value tax would spare building land, i.e. would be efficient in ecological terms;
- The simple land value tax would be relatively easy to administer and would be transparent for the citizens involved.

Of course, this catalogue of effects also provides the source of counter-arguments to basing land tax purely on a land value assessment. These would ultimately have to be overcome by means of tax law policies.

#### **4. CONCLUSION**

Naturally, a certain amount of social cushioning, in particular for older real estate owners, would be necessary - no senior citizens should be forced to sell off their property once a simplified land value tax were introduced nor should they be forced to relinquish their provisions for old age. At the same time the simple land value tax has consistent, free-market effects and ecological advantages. It also largely simplifies processes for fiscal administrations; finally, those citizens affected by it can easily understand the relevant tax law.