

# TAXATION AND REGULATORY TAKINGS IN SPANISH REAL ESTATE SECTOR

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## **Abstract:**

This article deals with the core of Spanish urban and land planning law: taxation and property rights fashioning in a single regulatory framework. One of the most sophisticated real estate markets in the civilised world largely relies on converting immovable assets into fungible entitlements. Any property is translated into a curious currency, named *land value* or *use of land*. This renders possible in-kind property taxation, paid to municipalities with this special currency. A wide array of techniques is at the service of this purpose, but some counterfeits must be taken into account as an unavoidable outcome of a tight restriction on the supply side.

## **1. STARTING POINT: THE ESSENTIAL FEATURES**

Briefly explained, I argue that the main features of the Spanish Real Estate sector are the following:

- Zoning regulations in Spain are a means to set up the rules of the game between existing residents and newcomers, that is, how to deal with congestion, property transactions values and local public goods endowment.
- Local zoning is the safest-kept tool by Spanish municipalities to feed their budgets and to relieve the pressure on owners via explicit property taxation.
- Equal distribution and shadow taxation devices require a tight control of the urban development process and, as a result, of

the land able to be developed, and this has a remarkable impact on housing prices.

The general outlook assumed by this article is tributary of Professor William A. Fischel's insights on property rights regulation and its interactions with taxation and takings. Instead of a methodology in the strict sense of the word, it may be called a viewpoint and, above all, a *language* to bridge the Anglo-Saxon and Spanish mentalities. The *Tiebout model*, as interpreted by Hamilton-Oates-Fischel, also allows a multidisciplinary approach: law, economics and politics.

This article just intends to shed some light to scholars and practitioners involved in real estate, urban and land planning and property taxation through the understanding of the basic lessons to be taken from the Spanish experience, which could be transferred, at least partially, to other countries.

## **2. BRIEF DESCRIPTION: HOW THE MACHINE WORKS**

R.A. Posner opened an exciting perspective for social scientists in his seminal article *Taxation by Regulation* (The Bell Journal of Economics and Management Science, vol. 2, 1971). This essay provides something like a pocket guide for regulatory researchers and has plenty of brilliant ideas on the potentiality of regulation devices to easily deal with the traditional nightmares of lawyers and economists, mainly taxation. The whole sequence of any public revenue, from the approval by legislative enactment to the effective recollection, can be bypassed. In situations of budgetary restrictions, poorly developed taxation schemes or, simply, better chances for voters' acceptance, zoning emerges as a redistributive device in two senses: *a)* by taxing property values; *b)* by taking property for public use. Posner's article title could be restated in this way: *Taxation and Takings by Regulation*. This makes clear that taxation and takings are the two sides of the same coin and that regulation necessarily involves both. Posner's concerns on the abuse of regulation in comparison with conventional taxation, as far as it reduces or eliminates the *due process* principle and the transparency of the democratic rules also reveal the subtle interactions between taxation and *eminent domain*, formally considered as different institutions but assembled in a single mechanism by regulation.

The crooked timber of regulation is not just a source of unfairness; it can be converted into a reasonable, efficient tool of governance. That happens when some basic conditions are met:

1. The small size of the community (local level).
2. The rules of the game are generally known.
3. Agents can take decisions outside the political sphere, by *voting with their feet or their wallets*.

Typical constitutional constraints on taxation and takings to moderate the majority rule make less sense when the prisoner's dilemma does not shape the scenario, that is, when eventual winners and losers have the chance of avoiding the results of the majority imposition. An informal account comes into practice and when the balance between what one gets and gives is not reached, a quasi-market decision begins to function, because decision-makers know the message they send to other community members and politicians will not be taken for granted.

The point is not whether property tax is fair and efficient or not, but to ascertain the limits of regulation on the light of the notion of *value*, and this is of great importance in local government. *Value* is always subjective. The value attributed by any owner to his/her house depends on personal perceptions and cannot be understood in the vacuum. Alternativeness (opportunity costs) and acceptability of burdens complete the value for the owner. Property value taxation is meaningless without considering the judgements that the members of the *local club* of owners who, at the same time, are liable to pay the property tax. And to issue those judgements, owners take into account the level of public goods and other quality of life parameters (residential concentration, open spaces, variety of commercial facilities, etc.) which they deem related to local politics. Value means personal appraisal, but this does not necessarily involve that *voting with the feet* is the sole response. Moreover, it is in the real world the extreme one, due to the unmovable nature of the asset to be sold off.

Zoning is the ordinary response or, to be more precise, the context of a wide range of responses. The conventional way of thinking associates zoning to some restrictions or specification of land uses, minimum lot size, neighbourhood relations, environmental protection standards and little more. The Spanish urban and land planning law goes much further. The General Master Plan sets up the frontier which separates urban space (existing or future) from the non-urban one: the medieval walls were replaced by lines drawn on the map. Outside the border no urban (civilized?) life is allowed and, as a result, no *urban value* is recognized. The Plan sets up the criteria to know the *value of the use of land* attached to any property. What you physically see *is not* what you legally get. But Spanish zoning is essentially a dynamics as the line is moved from time to time and, once inside the border, the stakeholder must gain and materialize the final use of his/her property. Here we have the game between insiders and outsiders or, in other words, existing owners (or

residents) and newcomers (or future ones) and the rules. If you add the quoted references to know the expected value of your property rights, the essential components of the game are completed. In summary, Spanish zoning regulations are the public vehicle for the consensus.

Spanish zoning converts property rights into values to get back to property rights. Throughout, part of the property has been taken for public use, part of the value has been taxed in-kind by the municipality and a chain of transactions have taken place. Once the ball is kicked off, the game can hardly be stopped, but players are often replaced.

First of all, conventional property taxation is relatively low in Spain. This is an obvious advantage for existing residents, but also for newcomers, as they know the indispensable condition demanded by insiders to accept new members in the club. Secondly, the market price of existing owners' assets never decreases and the reason is pretty clear: there is no urban value beyond the line and this imposes a tremendous restriction on supply, so whoever wants to get in must participate in the process of takings, in-kind taxes and transaction costs which, at the same time, are incorporated in the final price of newcomers' physical assets.

Everybody sees this system as tightly addictive, especially in political terms. The Spanish experience is old enough to show the sometimes massive destructive effects. Housing prices escalate tremendously for long periods (10 to 15 years) and then abruptly fall right down to the bottom. The early 90s *brick crack* is the best example of what happens when the model collapses and the forthcoming real estate crisis, associated with the sub prime breakdown, is more of the same.

Monetary or conventional exactions, impact fees and excise taxes on property transactions and management would merit some analysis here. They are both mainly used in Spanish urban development as a supplement for in-kind taxation and equal distribution techniques, but its importance must not be neglected for local government budgets.

The *Cadastral Office*, a special bureau within the Spanish Ministry of the Treasury is a valuable source of information. The basic data are open to the public and accessible *on line* ([www.catastro.es](http://www.catastro.es)), but the appraisal criteria employed for the different areas to calculate the property tax basis appear in restricted-access documents (called Ponencias Catastrales), subjected to public hearings every 5 years for updating. Municipalities are empowered to adjust the tax property rates inside the scale generally applicable by statute. Our starting conjecture is that the more active the municipality is (from the urban development view) the lower is, in relative terms, the property tax.

This makes good sense if we take into consideration some of the most relevant coastal municipalities on the Spanish Mediterranean seafront and those inland.

Regarding housing prices and rent controls by public bodies we face one of the most typical paradoxes in Spanish real estate market. Once it is done, ownership is not an expensive investment because property taxes generally are at an acceptable level, but this is only possible, as explained above, by a continuous price increase. What can elected officials do to reduce housing prices? The answer is affordable housing and rent-control regulations. But this is a part of the zoning game through equal distribution: what you do not charge *economically weak* residents is shifted onto the wealthier or above average ones.

Spanish legislation and leading court cases give good clues on how to understand all this. One becomes deeply impressed by checking how litigation pathologies reflect reality and the way legislators react to prevent conflicts and to make zoning regulations more capable to deal with. Planners' discretion, due process, just compensation, value capture, equal distribution and political power sharing amongst public governments of different territorial levels are the most relevant issues involved in Spanish land planning statutes and case law.

#### **4. GETTING BACK TO THE FUTURE: EXPLICIT TAXATION WHEN THINGS GO WRONG (TO HELP THEM TO GO WORSE)**

Bloody market! It is unfeasible an everlasting increasing in housing prices and this is the cornerstone of the system. Prices severe correction will come, sooner or later. Revenues from excise taxes linked to real estate transactions fall down as these do so. All kind of public bodies obtain revenues from Spanish real estate market: the State, the Autonomous Communities and Local Authorities. The total taxation income has abruptly broken down, but local administrations are the first line in the combat.

#### **5. CONCLUSIONS AND CONCERNS IN HARD TIMES**

By making real estate properties fungible through the generalization of development rights techniques, Spanish land planning law has created a *deus ex machina* able to give almost everything the

collective action requires to become a reality. But none can get all. Where is the trick?

The demand side of the zoning game is the answer. The reason which explains why everybody comes to play is the expectation of a non-stop property increasing value. It seems as easy as standing on the line: take your ticket and wait. If you want to get closer to the butcher's counter, simply bargain with the people in front of you and pay to jump the line. Nobody wants any relaxation on the supply side and, at the same time, the reduction of land values. Outsiders are not allowed to get in albeit they are in a disposition to pay the highest price for that: the whole capitalization of future plus-values falls onto the newcomer's head in the form of general public and in-site facilities.

The Spanish experience shows us a new version of the Tiebout model, that is, the capitalization of potential gains in terms of public services and future home prices and the inevitable role of zoning.

But it also creates anxieties. There is nothing wrong in linking urban development to value-capture through zoning regulations; this moreover matches the standards of fairness and efficiency. The problem arises when development does not pay its own way and both land and home values are artificially pushed up as a result of an unstoppable process of any sort of costs shifting. Demand may react by diverting financial resources to different applications. This is not a matter of imagination. This has happened.

Instead of a global alternative, I would propose to explore some options to relax the strict dependency of the Spanish real estate market and local government from property rights manipulation. Some effort should be worthy to revitalise other forms of taxation, largely neglected for decades, like impact fees and, above all, more transparency shall be introduced in determining the property tax base to reach reliable thresholds.