THE POLITICAL ECONOMY OF URBAN LAND REFORM IN HAWAII

by

Sumner J. La Croix, James Mak and Louis A. Rose*

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ABSTRACT

In the mid-1960s 26 percent of the single-family homes in Honolulu were on leased land. Dissatisfaction with leasehold led to reform legislation in 1967, allowing lessees to buy leased land. By 1991 only 3.6 percent of the homes were on leased land. We examine why landowners elected to lease rather than sell land and attribute the rise of leasehold to legal constraints on land sales by large estates and the federal tax code. Ideological forces initiated land reform in 1967, but rent-seeking forces captured the process in the mid-1970's. We conclude that Hawaii's experiment with leasehold was a failure due to the difficulties associated with specifying and enforcing long-term contracts in residential land.

*La Croix is Professor, Department of Economics, University of Hawaii, and Senior Fellow, Program on International Economics and Politics, East-West Center, Honolulu, Hawaii 96848; Mak and Rose are Professors, Department of Economics, University of Hawaii, Honolulu, Hawaii 96822. The authors thank Roger Blair, Chris Grandy, Wade McVay, Randy Moore, Randall Roth, Oswald Stender, and participants in the Economics Department seminar at the University of Hawaii for their constructive comments and advice. We thank the Social Science Research Institute for its support of our endeavors. All errors are, of course, our responsibility.

A man is not whole and complete
Unless he owns a house and the
ground it stands on.

Walt Whitman

In many parts of the world, residents own their homes and lease the land on which their homes are built. Residential land leasing is practiced in Great Britain, Israel, Hong Kong, Singapore, New Delhi, Canberra, Amsterdam, and Stockholm. In most cases a municipal government leases publicly-owned land to residents in a competitive land market.[1] In Great Britain, the Church of England owns large tracts of land which it leases to homeowners. Residential land leasing is also widely practiced in many Pacific island countries where land cannot be sold to nonnatives.[2]

Residential land leasing in the United States is relatively uncommon. There are pockets of residential leaseholds in Maryland, Southeastern Pennsylvania and California at Foster City, Coachella Valley and Irvine. The largest of these is at Irvine where, in the 1960s, the Irvine Foundation developed several leasehold housing communities.[3] There are also small pockets

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[1]See I. McDonald, *The Leasehold System: Towards a Balanced Land Tenure for Urban Development*, 6 URBAN STUD. 179 (1969). The U.S. federal government leases land in national forests to private individuals who have built cabins or homes on the land.

[2]In the Pacific (excluding New Zealand and Australia) only Guam and Hawaii permit land to be sold to nonnatives. According to Ward (1992) the desire to protect indigenous landowners from the loss of their land was a feature of colonial policy in many Pacific Islands. See R. Ward, *Pacific Island Land Tenure: An Overview of Practices and Issues*, in D. MALCOLM, JR. AND J. SKOG (EDS.), LAND, CULTURE AND DEVELOPMENT IN THE AQUATIC CONTINENT (1993), 29-40. In Hawaii there was massive sale of land to foreigners after private property was established in 1848, and the legislature approved the sale of land to foreigners in 1850. See S.J. La Croix and J. Roumasset, *The Evolution of Property Rights in Nineteenth-Century Hawaii*, 50 J. ECON.HIST.829 (1990) and L. KAME'ELEIHIWA, NATIVE LAND AND FOREIGN DESIRES (1992) for discussions of the origins of the Great Mahele.

[3]For a description of leasing in Irvine and Coachella Valley, see S. Nakamura, *Case Studies of Residential Land Leasing in California: A Comparative Analysis with Hawaiis Leasehold System*, (1989).

of leasehold homes on Indian reservations and other federal lands across the United States. However, residential land leasing has been widely practiced only in the State of Hawaii, and in particular on the island of Oahu which is coterminous with the City and County of Honolulu (hereafter referred to as "Honolulu"). Residential leaseholds did not become a major factor in Honolulu until after World War II.[4] In 1940, there were fewer than 500 leases to owners of single family homes, but by 1967 single family homes on leased land comprised about 26 percent of the total stock of single family homes.[5] The ownership of these leases was highly concentrated. In 1963 the Bishop Estate owned 33 percent; an individual, Harold Castle, owned 29 percent; and a noncharitable trust, the Campbell Estate, owned 6 percent.[6]

In the mid-1960s, condominiums began to be developed, some of them on leased land. In July, 1989 there were 69,969 condominium units on leased land, comprising 60 percent of Honolulu's condominium stock. Ownership of the condominium leases was far less concentrated than ownership of the single-family home leases. The Bishop Estate owned approximately 20 percent of the condominium leases, with the remainder being widely dispersed.

At the same time that landowners were selling leasehold condominiums and single-family homes in Hawaii, political forces were mobilizing to dismantle the institution. Massive

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[4]Leasehold had, however, a foothold at the turn of the century. The REPORT OF THE U.S. LABOR COMMISSIONER ON HAWAII (1901) surveys 225 families about their housing tenure. Of the 36 families who owned their homes, 12 families leased the land.

[5]See L. VARGHA, AN ECONOMIC VIEW OF LEASEHOLD AND FEE SIMPLE TENURE OF RESIDENTIAL LAND IN HAWAII 9 (1964) for prewar data. See ECONOMICS RESEARCH ASSOCIATES, HAWAII LAND STUDY, STUDY OF LAND TENURE, LAND COST, AND FUTURE LAND USE IN HAWAII VI 9, 10 (1969) for postwar data.

[6]VARGHA at 12. The figures include tenant-occupied as well as owner-occupied leasehold units. After Harold Castle's death in 1967, his holdings were left to the Castle Estate.

conversions from leasehold to fee simple in the wake of legislative and judicial decisions of the past 25 years have left no more than 4,600 single-family leasehold homes out of the approximately 28,000 that were ever built.[7] And although leasehold condominiums today outnumber fee-simple condominiums, recent political activity suggests that the number of leasehold condominiums will also decline in the future.

In this paper, we explain the rise and fall of residential single-family leasing in Hawaii. Our analysis begins in Section I with a description of the structure of residential leasehold contracts in Hawaii. In Section II we examine why leasehold tenure, though rare elsewhere in the U.S., thrived in Hawaii. In Section III we describe the legislative and judicial actions which have provided the framework for the decline of leasehold in Hawaii. We then analyze the economic and political forces behind leasehold's decline. Section IV summarizes our analysis.

Our study extends the earlier analysis of leasehold residential land reform by Cooper and Daws in a number of ways.[8] We explicitly consider legal constraints imposed on trustees of large dynastic trusts as an explanation of why trustees leased rather than sold estate land for residential development. We also provide a more detailed analysis of the tax incentives facing charitable and noncharitable landowners to explain why both stood to gain from leasing rather than selling their lands. Our study also analyzes the political economy of the decline of residential landleasing in Hawaii, based primarily on changes in land rents and tax rates and on the nature of the contract itself.

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[7]LOCATIONS, INC., STUDY OF THE RESALE OF LEASEHOLD PROPERTIES CONVERTED TO FEE SIMPLE OWNERSHIP UNDER THE HAWAIIAN LAND REFORM ACT OF 1967, A REPORT TO THE GOVERNOR AND THE LEGISLATURE OF THE STATE OF HAWAII 19 (1992).

[8]G. COOPER AND G. DAWS, LAND AND POWER IN HAWAII (1985).

I. Structure of Residential Leasehold Contracts in Hawaii

In Hawaii, residential ground lease lengths vary among different properties, but typically have been set at 55 years (e.g. the standard Bishop Estate lease) with an option to obtain a new 55-year lease from the date of subsequent resale for homes sold within the first 20 years of the lease for the purpose of obtaining a new mortgage loan.[9] Land rent usually has been specified as an annual fixed sum (paid semi-annually) for the first 30 years, with the rent for the next 25 years being determined by mutual agreement or appraisal. The long initial fixed rent period has been set "to allow long-term mortgage financing by FHA and other institutional lenders."[10]

Since the unexpected inflation of the late 1960s and early 1970s, the typical Bishop Estate contract has incorporated fixed rents at a higher level. Recent leases have incorporated rents that increase by fixed amounts at specified dates during the first 30 years.[11] The higher and increasing rents reflect expectations of higher future inflation. Another reason for setting rents at a higher level is that under the condemnation laws, the price of the leased fee interest is based on the initial rent. There are two countervailing tendencies towards lower initial rents. First, lease rents are not tax-deductible on state and federal income tax schedules, while mortgage interest payments are tax deductible. Second, lower rents tend to "create" a market by giving

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[9]The Bishop Estate's standard lease runs 55 years, but there is some variation in lease length across different properties. See ECONOMICS RESEARCH ASSOCIATES (1969), at VI-2 - VI-8. Prior to 1940, most leases were 30 years in length. From 1946 to 1952, the prevailing term conformed to the Federal Housing Administration (FHA) standard of 50 years. A 55-year lease became the standard in 1952 to conform to FHA financing requirements. *Id. at VI-3.*

[10]The Bishop Estate, *Information for Kamehameha Schools/Bernice Pauahi Bishop Estate Residential Leases as of March 1, 1975.*

[11]Lease rents are typically adjusted at 10-year or longer intervals.

potential buyers an incentive to examine the new product.[12]

Fry and Mak have argued that an unconstrained lessor is indifferent between receiving either full market lease rents or a front-end lump sum payment plus a stream of smaller lease payments equal to the present value of the stream of market lease rents.[13] Lower lease rents increase the selling price of the house-land package. Since the interest component of repaying a larger mortgage loan is tax deductible while lease rents are not, the lessee is better off under the second alternative. In practice, low lease rents are set for the first 30 years; in exchange the lessee pays more than the market value of the house for the house-land package.

At renegotiation, lease rents rise to "full market levels" (in the absence of government rent controls), as the renegotiation process does not provide a mechanism for prepaying lease rents. In addition, the new lease rent incorporates expectations of inflation over the remaining term of the lease in the same manner that a fixed rate mortgage incorporates inflationary expectations. This means that the renegotiated lease rent will be "front-loaded;" that is, it will exceed spot market rents initially and in later years be less than spot market rents.

Full adjustment of the lease rent at renegotiation has, however, been limited by the

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[12]In 1975, the median lease rent on existing single-family dwellings in Hawaii was $245 per year and the mean lease rent was $512. The data were taken from the 1975 U.S. Office of Economic Opportunity census update survey for Hawaii. It is the only census-type survey which differentiates housing tenure as leasehold or fee simple. A complete analysis of lease rent determination requires an analysis of the effect of taxes on lessors as well as lessees. In the next section we discuss lessor taxes. For an extended discussion of the impact of federal tax law on the demand for leasehold housing, see M. Fry and J. Mak, *Is Land Leasing a Solution to Unaffordable Housing? An Answer from Fee Simple versus Leasehold Property Price Differentials in Hawaii* 22 ECON INQUIRY 529 (1984).

[13]*Id.* at 537-38. Of course, constraints can establish a definite lessor preference for some distribution of payments over time. For example the Campbell Estate is required to distribute all rental income (but not capital gains) to the Estate's beneficiaries in the year in which the income is earned. The beneficiaries may have consumption or tax goals that make a specific pattern of income desirable. The Bishop Estate requires income for a relatively smooth time pattern of expenditures on the Kamehameha Schools.

enactment of "fair rent" legislation. A 1975 state law places ceilings on leasehold rents at renegotiation.[14] The law limits renegotiated rents to four percent of the appraised value of the unencumbered land. It also specifies that lease rents can be renegotiated after the initial fixed rent period no more than once every 15 years.[15] The lease rent control law applies only to single-family homes and does not apply to leasehold condominiums, townhouses, and cooperatives.[16]

A typical Bishop Estate lease in the early 1970s was based on terms negotiated with the FHA in 1967. It specified that the renegotiated lease rent "shall be determined by mutual agreement of Lessor and Lessee, or, if they fail to reach such agreement at least 90 days before the commencement of said period, by appraisal..." The rent "shall be the product of the then prevailing rate of return for similar lands (but not less than the prime rate of interest in Hawaii) multiplied by the then market value of the demised land exclusive of improvements thereon...". The lease stipulates the selection of three appraisers, one each by the lessor and lessee, and the third by the two appraisers. The appraisers determine the "prevailing rate of return" and the "market value" of the land. The decision of the appraisers, or a majority of them, is final and binding on both parties.[17] The cost of the appraisal is divided equally between the two parties. The structure of leases prepared by other landowners is also based on the FHA model.

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[14]HAW. REV. STAT 510 (1975). The original legislation was Act 185. By contrast, in the early 1970s, the Bishop Estate's policy was to set rents at 4.5 percent of the land's value. See Zalburg, *Bishop Estate Trustees Discuss Job*, HONOLULU ADVERTISER II-A-7 (August 1, 1973).

[15]That is, in a typical 55-year lease, the first 30 years comprise the fixed rent period; during the remaining 25 years, the law allows additional rent adjustment in the 45th year.

[16]Hereafter "townhouses" and "cooperatives" are referred to as "condominiums" for the sake of brevity.

[17]Recent decisions by arbitrators in commercial lease rent negotiations have been challenged in court.

Most leases contain provisions restricting lessees from making significant improvements without the consent of the lessor and requiring lessees to maintain property to reasonable standards. A buyer of an existing single-family home or condominium may assume the existing land lease, but mortgagors usually will not issue a new mortgage on a house or condominium located on leased land that is less than 10 years from renegotiation or expiration.

At the expiration of the lease, the lessee has the option to remove his improvements within 30 days; otherwise both land and improvements revert to the lessor. A 1975 state law requires lessors to compensate homeowners for improvements left on the site.[18] The Hawaii State Supreme Court ruled that the law can be applied only to homes built after July 1, 1975.[19]

II. Why Leasehold Rather Than Fee Simple?

Fee simple tenure clearly offers a preferred bundle of rights to leasehold tenure. Why, then, would anyone want to buy leasehold property? Fry and Mak demonstrated that since the market price of a leasehold property is less than the market price of an identical fee simple property, borrowing-constrained households may prefer to buy leasehold property instead of fee simple to obtain more housing.[20] If this explanation is important, we should observe widespread use of residential leasehold contracts not only in Hawaii but throughout the United States. Instead, we observe only limited use of leasehold on estates in Maryland, Pennsylvania, and Southern California.

If the demand-side explanation fails to explain the presence of leasehold residential land

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[18] HAW. REV. STAT. 516-70 (1975). The original legislation was Act 184.

[19] *Anthony v. Kualoa Ranch, Inc.*, 69 Haw. 112, 736 P.2d 55 (1987) (Padgett, J.).

[20] *Id.* at 534-35.

tenure in Hawaii, the answer must come from the supply side. Why would landowners prefer to lease rather than sell? One thread linking leasehold across the U.S. is that almost all lessors are large landowning estates. For example, in Irvine, California, the James Irvine Foundation, a nonprofit corporation, developed its large landholdings (the Irvine Ranch) as leasehold housing.[21]

On Oahu, the largest private landowner and lessor is the Bishop Estate. According to the (most recent) 1964 statewide inventory, the Bishop Estate owned 59,000 acres or 27 percent of all privately owned land. The Estate was established in 1884 under the will of Princess Bernice Pauahi Bishop.[22] Her will mandated that her lands be held in a charitable trust, and that the rents provide for the education of Hawaiians.[23] Her will further specified that the "...trustees shall not sell any real estate, cattle ranches, or any other property, but ... continue to manage the same, unless in their opinion sales may be necessary for the establishment or maintenance of said schools, or for the best interest of my estate." That provision in the will has not entirely excluded the sale of Estate lands. Between 1912 and 1960 the Estate indicated no preference for leasing over selling fee lots for homes. The number of lots voluntarily sold (3356) actually exceeded the number leased (3139).[24]

The second largest landowner on Oahu was the Estate of James Campbell. His 1900 will

[21]J. Tune, *Irvine lessees can choose from various conversion alternatives*, THE SUNDAY STAR BULLETIN & ADVERTISER, Nov. 24, 1991, p. H-3. In 1977 the Foundation sold Irvine Ranch to a for-profit consortium, the Irvine Company.

[22]Will of the Honorable Bernice Pauahi Bishop (1884).

[23]In compliance, the trustees established the Kamehameha Schools in 1887.

[24]F. MIDKIFF, THE ORIGIN, OBJECTIVES, AND DEVELOPMENT OF THE BERNICE PAUAHI BISHOP ESTATE, 24, 25, 32 (1961).

contained a similar clause. It specified "...that the Trustees and their successors keep intact my estate and administer the same under the name of 'The Estate of James Campbell' ...and that the realty thereof shall be particularly and especially preserved intact and shall be aliened only in the event, and to the extent, that the obvious interest of my estate shall so demand."[25]

Additional legal constraints on the five Bishop Estate trustees also help explain the trustees' reluctance to sell land. Several scholars have analyzed the distinction between a caretaker trust and a dynastic trust.[26] A caretaker trust is usually a short-term trust spanning one lifetime or less, established to protect the interests of its beneficiaries. The Bishop Estate, like other large land-holding estates in Hawaii, is a dynastic trust. A dynastic trust is usually a long-term trust whose purpose is primarily the perpetuation of an estate. A dynastic trust has two basic goals: (1) to preserve the trust principal, and (2) to provide a reasonable income for the income beneficiaries. Applying the "prudent man rule," the courts have historically placed higher priority on the preservation of the trust principal.

The prudent man rule sets forth the duties of the trustees in making investment decisions for the trust. It was first formulated by the Massachusetts Supreme Court in **Harvard College v. Amory.**[27] Subsequent changes in the courts' interpretation of the rule have substantially narrowed the breadth of discretion given to the trustees by the states following **Harvard College.** Today, the prudent man rule imposes three duties on the trustees: "The trustee must exercise a reasonable degree of care in selecting investments. He must exercise a reasonable

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[25]The Estate of James Campbell, JAMES CAMPBELL, ESQ. 25 (1978).

[26]See L. Friedman, *The Dynastic Trust* 73 YALE LAW J. (1964), and R. Blair and A. Heggstad, *The Prudent Man Rule and Preservation of Trust Principal* 1978 (1) UNIV. ILL. LAW FORUM (1978).

[27]Mass. (9 Pick.) 446, 461 (1830).

degree of skill in making the selection and use the caution which a prudent man would exercise..."[28] Hawaii has followed the prudent man rule throughout the twentieth century.[29]

In Hawaii, an alleged violation of the prudent man rule provided the basis for a 1980 law suit in which Bishop Estate trustee Hung Wo Ching sued fellow trustee Matsuo Takabuki, chief negotiator in the purchase of the Kawaiahao Plaza office building in Honolulu, accusing him of making a questionable deal that profited the developers of the building at the expense of the Estate.[30] In that trial the investment analyst retained by Ching testified that the purchase was imprudently made.

Thus the Bishop Estate trustee who recommends an investment that proves to be a poor investment is subjected to close examination from the public and other trustees concerning his adherence to the prudent man rule; if he does not adhere to the rule, he is liable for all losses stemming from the investments. His entire personal wealth is at risk. The financial performance of the Bishop Estate is annually reviewed by a court-appointed master whose findings are often highlighted in the daily newspapers. Operating in a fishbowl environment, the decisions of the trustees are frequently second-guessed by critics.[31] Indeed, trustees have

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[28] A. SCOTT, 1806 THE LAW OF TRUSTS (1967), as quoted in Blair and Heggestad at 87.

[29] *Estate of James Campbell, Decsd,* 42 Haw. 586 (1959); *Hyde v. Smith,* 11 Haw. 535 (1899); and *Dowsett v. Hawaiian Trust Co.,* 47 Haw. 577 (1965).

[30] *Trustee Hung Wo Ching Sues Fellow Trustee Matsuo Takabuki Over Kawaiahao Plaza Deal,* HONOLULU ADVERTISER, A-1 (May 14, 1980); K. Titchen, *Witness Hits Kawaiahao Plaza Deal* HONOLULU STAR BULLETIN, B-4 (February 24, 1982). Ching did not prevail in the trial.

[31] See, for instance, *Attorney General Probing Big Isle Sale,* HONOLULU ADVERTISER, A-1 (August 9, 1973); *State Supreme Court Voids Sale of Bishop Keauhou-Kona Land for Tourist Development,* HONOLULU ADVERTISER, A-1 (March 7, 1973); *Recent Sale of 15,000 Acres of Honomolino Land Blasted as Rip-Off,* HONOLULU STAR BULLETIN, B-7 (July 17, 1973); *Spokesman Defends Land Sales; State May Launch Probe,* HONOLULU ADVERTISER, D-1 (July 21, 1973).

often publicly criticized and, as indicated above, even sued each other over allegedly imprudent financial decisions and investment.[32] The Estate has also been sued by beneficiaries for "imprudent" land sales.[33] The same trustee cannot, however, reap all the gains for recommending highly profitable investments, as his income is a very small percentage of the Estate's total revenues.[34] There is, therefore, a bias in the trustees' decision making toward avoiding losses on particular projects rather than maximizing the return on the entire investment portfolio.

We are persuaded that the law of dynastic estates, applicable under the wills establishing the Bishop and Campbell trusts, has been an important factor encouraging conservative investment, including land retention. Had the estate trustees sold the land, they would have had to manage the sales proceeds. Since residential land represented only a small percentage of their land holdings, one could argue that selling would have been beneficial to both estates in that it would have given both land-rich but cash-poor estates more diversified asset portfolios. Managing money, however, is fraught with its own difficulties. Given the provisions of the wills advising against the sale of real estate and the prudent man constraints, it was individually less risky for the trustees to hold on to the land rather than to sell it.

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[32]See, for instance, *Richards Sues Fellow Trustees for Higher Lease Rental for Choice Parcel of Kona Beach Property*, HONOLULU ADVERTISER, A-1 (September 9, 1961); *Royal Hawaiian Center Lost $6.4 Million in 1981 Fiscal Year, According to Trustee Takabuki in his Suit Against Hung Wo Ching*, HONOLULU ADVERTISER, D-10 (February 10, 1982).

[33]See, for instance, *Sued by Friends of Kam Schools Over Kapua Land Sales*, HONOLULU ADVERTISER, A-1 (December 18, 1973); *Kam School Students Law Suit Against Bishop Estate Over Value of Kapua Lands Dismissed*, HONOLULU ADVERTISER, A-12 (March 20, 1974).

[34]State law sets compensation of the Bishop Estate trustees collectively at expenses plus 2 percent of gross revenue and 2.5% on the sale of assets. A. Smyser, *Bishop Management Could be Improved*, HONOLULU STAR BULLETIN, A-14 (July 16, 1993).

There are, however, two good reasons why we cannot rely exclusively on the dynastic estate argument as an explanation of leasehold.[35] First, confidence in the argument is undermined by the Bishop Estate's reliance on selling as well as leasing home lots between 1912 and 1960. Second, the argument cannot explain why Harold Castle and numerous other landowners not classifiable as dynastic estates, or even as charitable entities, leased their lands.[36]

These considerations lead us to argue that federal income taxes also created a strong preference among landowners for leasing instead of selling their land, especially after 1960. If the IRS were to have treated net revenues from land sales as capital gains, it would have taxed the revenues at effective rates of 25 to 35 percent. If the IRS were to have treated the net revenues as ordinary income, it would have taxed them at rates of 70 to 91 percent. These were the effective rates prevailing in the highest marginal income tax brackets between 1960 and 1981.[37]

Hawaii state taxes are generally patterned after the federal taxes; the state tax rates on ordinary income and capital gains are, however, much lower.[38] Thus, the same arguments that

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[35]Estate trustees inform us that they were not explicity aware of the prudent man rule. Rather, they relied on their own interpretations of the Campbell and Bishop wills calling for protection of the estate corpus. Some trustees were, however, aware that their entire personal wealth was at risk.

[36]It could be argued that Harold Castle was planning the incorporation of his holdings into a dynastic estate at his death.

[37]Prior to 1963, the highest tax rate on ordinary income was 91 percent. In 1964-81, it was 70 percent. Prior to 1969 the tax rate applied to capital gains by highest-bracket taxpayers was 25 percent. In 1969-76, it was 70 percent of 50 percent of capital gains. In 1977-80, it was 70 percent of 40 percent of capital gains. With few exceptions, notably Castle & Cooke (a large landowning agricultural firm), the landowners were noncorporate entities.

[38]In 1965-86 the state taxed ordinary income at rates up to 11 percent. In 1965-86 the state taxed capital gains at 4.4 percent. See BOCH, BRILLIANT, AND GERDING, TAXES OF HAWAII (annual).

we shall set forth regarding the effects of federal taxes apply to state taxes as well, with the latter effects being much smaller in magnitude.

The IRS treatment of net revenues from land sales (and rental revenues as well) depended upon its classification of the seller as (1) charitable or noncharitable and (2) dealer or nondealer in land. Noncharitable and dealer classifications implied higher tax liabilities. Among the largest lessors, the Bishop Estate alone was classified as charitable, and Harold Castle and the Campbell Estate were noncharitable. All of the estates were nondealers and retained this classification by resort to leasing their lands.

There are two distinct types of tax considerations that induced landowners to lease rather than sell. The first type is capital gains taxation, which applied to all noncharitable nondealers including Harold Castle and the Campbell Estate. (It did not apply to the Bishop Estate as a charitable nondealer.) The capital gains tax was collected only when capital gains were realized at sale, and could be deferred indefinitely through leasing. Essentially all alternatives to leasing for income required sale.[39] The landlords could have sold land to obtain cash for consumption; or they could have sold land in order to purchase or develop alternative assets that would earn higher income or reduce portfolio risk. By making all of these alternatives less attractive, the capital gains tax tended to lock the landlords into leasing for income.

Of course, the effectiveness of the capital gains tax as an inducement for the noncharitable nondealers to lease depended upon the size of the capital gains. In Honolulu, most

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[39]It was possible for an estate or corporation to defer federal (not to mention state) taxation indefinitely by exchanging land for "like-kind" properties under Section 1031 of the Internal Revenue Code. The method had been available since 1922. As a general rule, it has been so difficult and costly to arrange for timely exchange that only one of the large estates, the Campbell Estate, has employed exchanges to any significant extent, and then only since the mid-1970s. The Bishop Estate has made only slight use of Section 1031.

of the estates' lands had been held over many years at appreciation rates exceeding those on the mainland. Indeed, most of these lands had been held since before 1913 when the IRS would determine the original purchase value of the land being sold. In these cases essentially the entire sale proceeds would qualify as capital gains subject to taxation.

The second type of tax consideration that induced estates to lease was their fear that the IRS would, on review of their land market transactions, reclassify them as "land dealers." (For a summary of this consideration, see Figure 1.) The dealer classification implied higher taxes for both charitable and noncharitable landowners. A noncharitable estate that avoided dealer classification would incur taxes on its net revenues from land sales at the capital gains rate. However, as a dealer, it would incur taxes on these sales at the higher ordinary income tax rate. Regardless of classification, lease rents received by the Kaneohe Ranch and the beneficiaries of the Campbell Estate (pass-through) trust would be taxed at the ordinary income rate.

On the other hand, a chritable Bishop Estate that avoided dealer classification was exempt from all taxes on both land sales and lease rents. However, as a dealer, net revenues from all land sales would be taxed at either the capital gains rate or the ordinary income rate; the Estate was unsure which rate would apply. Moreover, all lease rents would be taxed at the ordinary income tax rate. The gravity of the latter consequence explains trustee Matsuo Takabuki's 1973 interview statement that "(e)veryone of these (transactions) is subject to the Internal Revenue approval. So we have to be careful that we do not under any circumstances do anything that ruins our status as a tax exempt institution."[40]

What then would prompt the IRS to reclassify the Bishop Estate? On review of land

[40]Zalburg, *Bishop Estate Trustees Discuss Job*, HONOLULU ADVERTISER I-A-13 (July 31, 1973).

sales, the IRS could interpret the revenues as either (a) tax exempt if the revenues were related to the Estate's charitable activity, or (b) taxable as ordinary business income if they were unrelated to the Estate's charitable activity. The greater the volume of sales, and especially the greater the frequency of sales, the greater was the likelihood that the IRS would review and find the sales revenues to be ordinary business income. If the IRS viewed some of the Estate's sales as ordinary business income, it could reclassify the Estate as a dealer, thereby taking away the tax exempt status of all of its rental and sales revenues.

Evidence of land sale deterrence due to the threat of dealer classification can be found in a 1950s shift in the Bishop Estate's policy of both leasing and selling its land for residential use. In 1954 the Estate joined with a developer to build nearly 500 homes in the Aina Koa Tract and sell them on a fee-simple basis.[41] When the IRS learned of the sales, it warned the Estate that if such sales continued, it would lose its tax-exempt status. In the years following this warning, according to the Estate, it leased thousands of lots but made only two voluntary sales: 677 leased fees in the Halawa Valley tract in 1967 and 113 leased fees in the Museum Park tract in 1972.[42] These conveyances were each arranged as single bulk transactions to

[41]Initially, the intent was to sell them in leasehold, but the FHA would not insure them. Thus, potential buyers could not obtain mortgage financing on home built on leasehold lots. Since the Bishop Estate could not sell them in leasehold, it sold them in fee simple. Subsequently, major landowners went to Washington, D.C., and worked out standard (and similar) lease forms with the FHA and Veterans Administration (VA) along with agreements that these agencies would insure mortgages on leasehold homes. Bishop Estate trustee Oswald Stender believes that the two standard forms (later reduced to one) were very important in accelerating the rise of leasehold. Ninety percent of all residential leases provided by all lessors since the 1960s have been on these forms. He believes that FHA and VA mortgage insurance were critical factors in the rise of residential leaseholds in Hawaii.

[42]Other sources, viz. OAHU DEVELOPMENT CONFERENCE, XIV ODC PLANNING ISSUES (1981), and a title search at Blue Sky in 1983, indicate that the Bishop Estate also sold 203 lots in Manoa Gardens in 1962 and 512 lots in Manana in 1966. The important point is that there were relatively few sales following the IRS warning. Personal conversation of Wesley Hillendahl, former chief economist at Bank of Hawaii, with James Mak.

avoid IRS dealer classification.[43]

The frequency or regularity of sales was also critical to IRS classification of noncharitable estates. As occasional sellers, the Campbell Estate and Kaneohe Ranch would be treated as nondealers and taxed on net sales revenues at the capital gains rate. However, as frequent sellers, they would be classified as dealers and taxed at the ordinary income rate.

Although the tax consequences of dealer classification were less severe for the noncharitable estates, they were enough to deter them from making frequent sales. Harold Castle seldom voluntarily sold any of his land before he died in 1967, and the Campbell Estate made very few voluntary sales in the 1950s and 1960s. An Estate trustee can recall only two: 200 acres to an oil company and 65 acres to a residential developer. The Campbell Estate paid capital gains taxes on these transactions. Castle & Cooke, the third largest landowner in Honolulu, had a different experience with the IRS. In the mid-1960s the corporation sold an option to purchase 3,500 acres, and then paid capital gains taxes.[44] Subsequently, the IRS audited and required payment of taxes at an effective rate between the capital gains rate and the 48 percent corporate income tax rate.[45]

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[43]The Bishop Estate occasionally had to sell land to meet school operating expenses. In the Halawa Hills transaction, the Estate sold the fee interests in bulk to a non-profit corporation established by lessees; the corporation in turn sold the fee interests to most of the individual home owners. The IRS permitted these sales, because the Bishop Estate was not engaged in a direct retail sale of the land. The problem in selling to an intermediary was that the corporation had to retain the fee interests of those homeowners who did not wish to purchase their lots. In the Museum Park tract, the First Hawaiian Bank set up a non-profit trust fund with the leaseholders who wished to purchase the fee interests in their lots. Eight out of 113 homeowners did not wish to purchase their lots. The Hawaii Housing Authority (HHA) purchased the eight lots, and the State became the new landlord for these homeowners.

[44]Castle & Cooke did not develop any residential leasehold property.

[45]Under Section 1031 of the IRS Code, there could apparently be frequent exchanges without causing a reclassification. The Campbell Estate used Section 1031 in the 1970

In view of the dynastic trust and tax avoidance arguments, it is understandable why such a large percentage -- 26 percent in 1967 -- of single-family residences were on leased private land in Honolulu relative to other U.S. urban areas.[46] First, the dynastic trust explanation is applicable to the Bishop and Campbell Estates, which in 1964 owned 29 percent of the land in Honolulu.[47] They also owned 42 percent of the residential leasehold lots in Honolulu.[48] We are unaware of any other urban area in the U.S. where dynastic trusts owned such a large fraction of the land suitable for residential use. Second, the IRS threat of dealer classification was primarily applicable to large landowners because they alone had sufficient land for frequent sales. In 1964 the Bishop and Campbell Estates and Harold Castle owned 31 percent of the land in Honolulu.[49] They also owned 68 percent of the residential leasehold lots in Honolulu.[50] We are unaware of any other urban area in the U.S. where large landowners owned such a large fraction of the land suitable for residential use.

Finally, many small noncharitable landowners leased land for single-family homes. Although such small landowners are not threatened by dealer classification, they, like the large owners, are deterred from selling by the capital gains tax. This begs the question, why do we observe small owners leasing (rather than selling) in Honolulu but not on the mainland, where the same federal tax laws apply? One possible answer is that, due to the policies of the Bishop

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[46] The 26 percent is calculated from ECONOMIC RESEARCH ASSOCIATES, at VI-9, 10.

[47] R. HOROWITZ AND J. FINN, PUBLIC LAND POLICY IN HAWAII: MAJOR LANDOWNERS (Report No. 3, Legislative Reference Bureau) 84 (1967). See Table 30.

[48] VARGHA at 10.

[49] HOROWITZ AND FINN at 84.

[50] VARGHA at 10.

Estate and the other large estates, home buyers and landowners in Honolulu were familiar with and accepting of the leasehold contract. It was relatively easy for the smaller landowners to lease in emulation of the larger ones in Honolulu. Another answer, equally difficult to substantiate, is that due to cultural differences sometimes attributed to Asian influences in Hawaii, the ownership of land, especially the family's land, is more important in Hawaii than on the mainland.

There is one more plausible explanation which is applicable to the Bishop Estate. This argument is rooted in the history of Native Hawaiians' land alienation. In 1848, a land reform program, the Great Mahele, mandated the swift conversion of traditional land holdings into private property; in 1850 the law was changed to allow foreigners to own land.[51] Over the next 70 years, the original Native Hawaiian recipients of land in the Great Mahele -- the crown, the government, the chiefs, and the common people -- sold, gave away, abandoned, or otherwise lost their land. By 1919, they owned only six percent of the land in the Territory. The Bishop Estate, which was established to serve the educational needs of the Native Hawaiians, owned another 9 percent.

In response to this history and the alleged importance of land ownership as an anchor for the preservation of Hawaiian culture, Native Hawaiian groups have over many years opposed the further alienation of Hawaiian lands. Of course, Princess Bernice Pauahi Bishop's will emphasized the importance of retaining ownership of her Estate. The trustees' commitment to this goal (among others in the Princess' will) has been bolstered by their appreciation of history

[51]See KAME'ELEIHIWA, *supra note* 2, for an analysis of the decision to allow foreigners to purchase land.

and their desire for support rather than criticism from these vocal Native Hawaiian groups.[52]

III. The Fall of Leasehold: Residential Land Reform, 1967-1992

At the same time that leasehold housing was being developed and sold, efforts were underway in Hawaii's legislature to break up the large estates and thereby dismantle the institution of leasehold housing. While the number of owner-occupied detached leasehold homes reached a peak of approximately 22,000 units in the mid-1970s, by September, 1991, remaining leaseholds numbered only 4,600.[53] Leasehold constituted about 30 percent of the owner-occupied detached homes in the mid-1970s but by 1991 it had fallen to five percent of a larger housing stock. Four large estates -- Bishop Estate (57.3 percent), Castle Estate (16.8 percent), Robinson Estate (9.5 percent) and Campbell Estate (6.7 percent) -- accounted for over 90 percent of all conversions.[54]

Below we review the legislative history of the leasehold reform movement in Hawaii (part A) and then explain the factors behind leasehold's demise (part B).

A. History of Leasehold's Decline

After World War II, some viewed concentrated land ownership as an impediment to

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[52]See, for instance, S. Amalu, *Critical of Estate's Decision to Sell Land; Says Land is Better Than Worthless Money*, THE SUNDAY STAR BULLETIN & ADVERTISER, A-25 (August 27, 1978); *Akaka Says Land Sales Create Crisis*, HONOLULU STAR BULLETIN, A-12 (July 20, 1973); *Sales Criticized by Hawaiians*, HONOLULU STAR BULLETIN, A-12 (July 21, 1973).

[53]Data on the number of leasehold homes at any given time during the 1970s are not available. However, VARGHA *supra at 10*, states that in 1963 there were 15,342 leasehold lots in Honolulu. According to Wesley Hillendahl, *supra at xx*, in 1964 through 1975 there were 9880 additional leasehold lots developed on Bishop Estate land. In 1964 through 1967, but not thereafter, there may have been some additional leasehold developments. The Damon Estate sold all of its 1000 leased fees in the mid 1960s; the Bishop Estate sold a total of 1300 leased fees in 1966, 1967 and 1972. These figures are the basis for the 22,000 maximum estimate in the mid 1970s.

According to LOCATIONS, *supra* at 19, by September, 1991 about 28,000 leasehold homes had been built and 23,400 had been converted to fee simple, leaving 4,600 in leasehold.

[54]LOCATIONS, *supra at* 19.

housing development. In 1945, Territorial Governor Ingram M. Stainback told the Legislature that:[55]

> The great land holding monopolies which exist in this Territory have resulted, especially on Oahu, in an artificial shortage and unhealthy increase in the value of lands available for residences --- so extreme as to render impracticable any schedule for adequate housing with private capital unless and until sufficient lands at reasonable prices for new buildings can be made available.

As the number of leasehold residential units increased, there was growing concern that major landowners, who were predominantly Republican in a Republican-dominated U.S. Territory, preferred to lease rather than sell their lands for residential developments. From 1952 the Democratic Party platform called for land reform to enable homeowners to purchase the fee interests in their residential lots. In 1963 Democrats were able to push a bill through the State House patterned after the Maryland Ground Land Act. The bill provided homeowners the opportunity to purchase the fee interests under their homes after living on the properties for five years. Opposition to the bill came from large landowners and trusts, and Hawaiian groups who viewed the bill as a threat to the Bishop Estate. The bill failed by one vote to pass the State Senate.[56] Finally, in 1967, when some of the earliest ground leases were being renegotiated, the Hawaii State Legislature enacted a law which enabled single-family residential homeowners leasing land to acquire it in fee simple.[57] In brief, the Land Reform Act (LRA) states that upon the petition of 50 percent of the owners (or 25 owners, whichever is less) in a leasehold housing

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[55]A.A. Smyser, *Hawaii's Land Law on Trial*, HONOLULU STAR BULLETIN, A-16 (Oct. 23, 1981).

[56]HOROWITZ AND MELLER, LAND AND POLITICS IN HAWAII (1966) provide a good summary of the legislative battles for a leasehold condemnation law during the early 1960s.

[57]HAW. REV. STAT. 516.

tract, the Hawaii Housing Authority (HHA) will condemn the land and resell individual parcels to the lessees.[58]

The LRA's provision for bulk condemnation was designed to obtain favorable tax treatment of leasehold sales from the IRS. The IRS did maintain the Bishop Estate's tax-exempt status and also allowed noncharitable landowners to choose between (a) paying taxes at the capital gains tax rate on condemnation sales and (b) indefinitely deferring such taxes by rolling the gains over into another investment. The IRS policies toward sales by charitable and noncharitable landowners were implemented sale-by-sale, through post-sale audits, until 1978 when, for the Bishop Estate, it provided a blanket ruling.[59]

The passage of the LRA was sufficient to stop all landowners except the Bishop Estate from entering into new leasehold development contracts. The Bishop Estate continued to enter into such contracts until the mid-1980s. The fulfillment of these contracts brought new leasehold homes onto the market as late as 1991. One reason why the Bishop Estate alone continued to enter into leasehold development agreements is that the Hawaiian community pressured the trustees to abstain from selling the fee.

There were few conversions from leasehold to fee simple between 1967 and 1975, partly due to the unwillingness of Governors Burns and Ariyoshi to implement the 1967 LRA. In 1975 the Legislature passed Act 186 reaffirming the 1967 LRA. The LRA was first employed in 1976 when lessees purchased 182 lots from the Pflueger-Cassiday Trust in a negotiated settlement.

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[58]For a chronology of the land reform measures affecting single-family residences, see STATE OF HAWAII, HAWAII HOUSING AUTHORITY, ANNUAL REPORT JULY 1, 1981/JUNE 30, 1982 (1982).

[59]G. Kato, *Bishop Estate Allowed to Sell 15,000 Lots, Stay Tax-Exempt*, HONOLULU ADVERTISER, A-1, A-5, July 18, 1978.

This was followed by a growing number of petitions and subsequent conversions between 1979 and 1982.[60]

Additional legislation was passed in 1975 and 1976 to supplement the LRA. Act 184 (1975) required that at the termination of a lease, the lessor compensate the lessee for unremoved onsite improvements at fair market value. This provision applied to existing and future leases.[61] Act 242 (1976) provided for appraisers' determination of a part of the compensation for the leased fee as the discounted present value of those controlled rents. These acts further reduced the attractiveness of leasehold developments.

In 1979 the Bishop Estate contested the constitutionality of the Land Reform Act in state and federal courts. It argued that government's power of eminent domain was not being used to acquire land for a public purpose. Instead it was being used to transfer land from one private party to another. The Estate alleged in federal court that this action violated the Fifth Amendment's Public Use Clause.[62] In 1979, the Hawaii Federal District Court ruled the taking was for a constitutionally permissible public purpose.[63] In 1983, the Ninth Circuit Court of Appeals reversed on the public use issue.[64] In 1984, the United States Supreme Court ruled unanimously in **Hawaii Housing Authority v. Midkiff** that the law did not violate the United

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[60]There were also some voluntary conversions during the 1970 that were not carried out under the LRA.

[61]*Anthony v. Kualoa Ranch, Inc.*, 69 Haw. 112, 736 P.2d 55 (1987) (Padgett, J.) overturned the retroactive provisions of the law.

[62]The Fifth Amendment of the United States Constitution provides that "nor shall private property be taken for public use without just compensation."

[63]*Midkiff v. Tom*, 483 F. Supp. 62 (1979).

[64]*Midkiff v. Tom*, 702 F.2d 788 (1983).

States Constitution.[65] Justice O'Connor wrote that using the State's eminent domain power to "reduce the perceived social and economic evils of a land oligopoly" was indeed consistent with a public purpose.[66] At the state level, the First Circuit Court upheld the Act's constitutionality, and this decision was affirmed by the Supreme Court of Hawaii in 1985.[67]

The timing of court decisions affected leasehold's rate of decline. Thirty percent of the 23,400 conversions (as of September, 1991) occurred in 1979-82. After the Ninth Circuit ruled the LRA was unconstitutional, conversions slowed, comprising only four percent of the 23,400 conversions in 1983-85. Following the U.S. and Hawaii Supreme Court decisions, conversions in 1986-90 comprised 57 percent of the total conversions, and the Bishop Estate ceased making leasehold development agreements. By 1991 new homes from prior leasehold agreements had stopped coming onto the market.

B. Why did the leasehold system decline?

There are three major explanations for the decline of the leasehold system: political concern about land concentration; rent-seeking, i.e. lessees' pursuit of wealth through the political process; and tax minimization by lessors and lessees.[68]

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[65]467 U.S. 229 (1984).

[66]*Id.* at 245.

[67]704 P. 2d 888 (Hawaii 1985).

[68]Rent-seeking activities use resources to redistribute wealth and may have positive or negative consequences on economic welfare. See J. Roumasset and S.J. La Croix, *The Coevolution of Property Rights and Political Order* in V. OSTROM, D. FEENY, AND H. PICHT, RETHINKING INSTITUTIONAL ANALYSIS AND DEVELOPMENT (1988).

1. Ideology and Rent-Seeking

The political history of land reform in Hawaii has been carefully documented by Cooper and Daws.[69] From 1901 until 1954, the Republicans, who counted among their members some of the largest landowners in Hawaii, controlled both the Territorial House and Senate, usually with large majorities. The Republican party was dominated by an ethnic coalition of Caucasians and Hawaiians; all sugar and pineapple plantations as well as virtually all major businesses in Hawaii were owned by the caucasian minority. While the power of the Republican party was leavened by Democratic governors appointed by Presidents Wilson, Roosevelt, and Truman, Democrats--whose rank and file were comprised mostly of Asian-Americans -- first became competitive in state elections in 1948 and dominant only after 1962. The Democratic party made the practice of residential leasing stemming from Hawaii's concentrated land ownership a political issue. As early as 1949, Democrats started introducing bills in the legislature that would have forced lessors to sell their residential fee interests to their lessees. It took 18 years before the landmark 1967 land reform bill was passed.

Two possible explanations for passage of the LRA in 1967 are suggested by Cooper and Daws, and are worthy of consideration: ideology and rent-seeking.[70] First, consider the ideological explanation. We previously indicated that land reform (dissipation of concentrated ownership) was a central, ideologically-based plank in the Democratic platform. On the other hand, Republican politicians generally opposed government regulation and interference with private property rights. On these ideological grounds, Republicans would be expected to oppose

[69]See chapters 1 and 13 in particular.

[70]*Id.* at 414.

the land reform bill.

Alternatively, consider the rent-seeking explanation. Lessees were the sole economic beneficiaries of the LRA. It provided them with an option to buy and thereby avoid 1) future rent increases, 2) diminished ability to borrow against the property towards the end of the lease, and 3) surrender of improvements at its termination.

The largest concentrations of lessees were relatively affluent residents in East and Windward Oahu. These predominantly leasehold neighborhoods were represented by Republican legislators. If the motivation for the 1967 law was rent-seeking, these Republicans would have joined the majority of Democrats in voting for the bill. Alternatively, if the motivation was ideological, they would have voted against the bill.

Cooper and Daws observed that the House of Representatives voting pattern was contrary to the rent-seeking explanation and consistent with the ideological explanation.[71] Seven of the eight representatives from East and Windward Honolulu voted against the LRA, and all seven were Republicans. Six of the seven were reelected in the subsequent election; the seventh did not run for re-election.

On the other hand, the pattern in the Senate was contrary to the ideological explanation and consistent with the rent-seeking explanation. All seven senators representing East and Windward Oahu supported the bill, and four of them were Republican. One of the four was defeated in the subsequent election.

The mixed voting pattern of Republican legislators on behalf of their Republican-lessee constituents suggests that 1) ideology was an important motivation within the Republican as well

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[71] *Id.* at 431.

as the Democratic party, and that 2) the present value of economic benefits from lease-to-fee conversion was insufficient for the self-interest of Republicans to dominate party principles. In 1967, most of the leases were only a few years old. The present value of avoiding long deferred rent increases, borrowing restrictions and the surrender of improvements would be small. The weakness of support for the rent-seeking argument is confirmed by our examination of concurrent news reports and legislative testimony: we found no evidence of lessee influence on the legislation.

In 1975 and 1976, the motivation dramatically shifted to rent-seeking. In 1975, the Legislature (Act 186) reaffirmed the state's policy of condemnation to transfer the leased fee. What is more revealing, the Legislature passed three previously mentioned laws, each having the effect of transferring wealth from lessors to lessees. Act 184 required that lessors compensate lessees for onsite improvements at market value at the termination of the lease. Act 185 established rent controls on renegotiated leases. Act 242 in 1976 specified a method of appraisal to be used in the determination of the price of the leased fee interest -- a method favorable to the lessees.[72]

The 1975 and 1976 voting pattern was clearly consistent with rent seeking. In the Senate, all four of the Republicans representing East and Windward Oahu joined the other Senators in unanimously passing all four bills. None of the four Senators were defeated in the subsequent election. In the House, where votes in favor of the four bills were near-unanimous, all eight Republicans representing East and Windward Oahu voted for the four bills. Only one of the eight was defeated in the subsequent election.

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[72] *Midkiff v. Tom*, 471 F.Supp. 871 (1979).

What conditions prompted the transition to a more transparent rent-seeking environment? First, the number of lessees increased significantly between 1967 (about 14,632 lessees) and 1975 (about 22,000 lessees), thereby increasing their potential voting power.[73]

Second, the number of lessees with contracts nearing rent renegotiation increased between 1967 and 1975. This is important because voter propensity to participate in the political process depends not only upon the costs of gathering and processing information but also on the amount of wealth at stake. As the date of rent renegotiation and higher rent payments neared, the present value of future higher rent payments increased. Thus, lessees had increased incentives to vote, lobby, or make political contributions to reduce future rents.

Third, the rents available for capture increased substantially between 1967 and 1975.[74] Consider a lessee in 1967 owning a home on land leased in 1957. The lease would not

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[73]G. Stigler, *The Theory of Economics Regulation*, 2 BELL JOURNAL OF ECONOMICS AND MANAGEMENT 3 (1971) and others have emphasized that larger groups have higher costs of organizing for political action due to free-riding problems. Moreover, inclusion of more individuals in the majority group may result in smaller per capita transfers and may dull the incentive of individual members of the group to vote or contribute to lobbying efforts. This analysis presumes, however, that a fixed amount of economic rent is being reassigned to a larger group of claimants, thereby leading to smaller per capita shares. The analysis does not apply to the growing number of lessees in Hawaii, as each additional lessee brings additional economic rent to the political process for redistribution.

[74]Price appreciation data on land are unavailable. Indirect evidence, based on single-family home price appreciation as reported by the U.S. decennial censii, indicates that home prices in Honolulu accelerated after 1970. The mean price appreciation was 5.34 percent per year between 1950 and 1960, 5.09 percent per year between 1960 and 1970, and 13.02 percent between 1970 and 1980. See A. DOWNS, LEASEHOLD TENURE AND HOME VALUES IN HAWAII S-4 (March, 1983). By contrast, the corresponding rates of increase for the Honolulu consumer price index (CPI-U) were 2.58 percent, 2.89 percent and 7.18 percent per year. See STATE OF HAWAII, DATA BOOK, 1990 371 (1991).

By comparison with the census data, John Child and Co., a Honolulu appraisal firm, analyzed resale prices of single-family homes in 20 Honolulu subdivisions between 1967 and 1980. Only those homes that had been sold and then subsequently resold were included in the sample; homes that had substantial improvements made to them since the last sale were excluded from the sample. The company found that the appreciation of the homes during this period averaged 10.75 percent. The range of appreciation across subdivisions was between 9 and 13.7 percent. JOHN CHILD AND CO., INC., APPRAISAL REPORT COVERING LEASED FEE INTERESTS OF THE SINGLE-FAMILY RESIDENTIAL PARCELS DESIGNATED AS THE LUNALILO PARK TRACT, VOL. II, (October 24, 1980 and August 17, 1981). During the same period, the Honolulu CPI-U increased at an annual compound rate of 6.6 percent.

renegotiate until 1987 and would not expire until 2012. Inflation had been low and predictable; real land rents had increased, but renegotiation was still 20 years ahead. Between 1967 and 1975 the situation changed dramatically. A highly regulated land supply coupled with increased demand produced further increases in real land rents. Inflation, much of it unexpected, rose during this period, pushing up nominal land rents. In 1975, renegotiation would take place in only 12 years, and lessees were becoming aware of the difficulties in selling property as renegotiation neared.[75] Given the increased present value of the economic rents, individuals had more incentives to engage in rent-seeking.

Fourth, the structure of the fixed rent leasehold contract also implies a substantial rent hike at renegotiation even in the absence of unexpected inflation or real increases in the price of land. In an economic environment with persistent long-term inflation, the leasehold contract has the same payment structure as a long-term mortgage. The fixed lease rent in a long-term contract exceeds the spot market rent in initial periods and is lower than the spot market rent in later periods. At renegotiation, the fixed lease rent must be raised not just to the spot market lease rent, but to a higher above-spot market rent to compensate, once again, for the effects of expected future inflation.[76]

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[75]Mortgage lenders would typically not make mortgage loans when the lease either was due for renegotiation or expiration within ten years.

[76]One of the earliest rent renegotiations was the 1964 rent adjustment for Portlock Road homes located on Bishop Estate land in Hawaii Kai. Rents jumped by 300 to 600 percent for the first 15 years and another 20 to 25 percent for the final 15 years. See *Portlock Road Residents Fight Bishop Estate Lease Rent Hikes*, HONOLULU ADVERTISER, A-1, A-2 (February 5, 1964). In 1971 a small subdivision on Bishop Estate land in Kailua witnessed a 624 percent increase for the final 26 years of a 48 year lease. See *Bishop Rent Hike Draws a Complaint*, HONOLULU ADVERTISER, A-13 (September 23, 1971). In 1976-77, the Waialae-Kahala Tract A lease rents jumped from $250 per year to nearly $3000 per year, or an increase of over 1000 percent. See COOPER AND DAWS at 424. In the early 1990s condominium lease rents typically increased by 1000 to 1200 percent at renegotiation. See I. Alshire, *Lease Rent Up 8,742% for Townhouse*, STAR BULLETIN AND ADVERTISER, A-1, A-11 (March 24, 1991).

Finally, for another entirely different reason, there would tend to be a substantial increase in lease rent at renegotiation, even if nominal and real spot market land rents remained constant. Although the initial lease rent is for land, at renegotiation there are site-specific improvements, normally with no feasible opportunity for removal. In this situation, the lease rent for the second period of the contract tends to increase to include the value of the improvements as well as the land.

In the mid-1970s, the approaching rent renegotiations and expectations of sharp increases in contract rents triggered lessee rent-seeking. The impetus for such political action would have been much weaker had the original leases incorporated small annual rent increases, or had the contracts tied rents to a consumer price index.[77] The absence of annual CPI adjustments (not to mention real rent adjustments) along with the site specificity of improvements implied impending one-time rent increases with present values large enough to cover the costs of political activity. The transition from ideological politics to rent-seeking owed much to the above-described change in the economic environment during the mid-1970s. Nonetheless, it must be recognized that the politics of ideology laid the foundation for the politics of rent-seeking. The ideologically-based LRA provided the mechanism which, with a few important alterations, became a vehicle for redistributing wealth. The success of the politics of ideology reduced the cost of transferring wealth. Although politicians continued using ideological rhetoric, their actions focused on redistributing economic rents.

2. Tax Minimization

The above analysis of the fall of leasehold ignores the effect of changing tax rates and

[77]Such increases were rejected by mortgage lenders and were forbidden by the FHA.

tax structures, yet in our discussion of the rise of leasehold we assigned a large role to the effect of federal (and state) income taxes on the behavior of trustees governing Hawaii's large dynastic estates. In this section we show how changes in tax law also contributed to the fall of leasehold.

As lease rents increase, the lessee tax benefits of purchasing the land increase. Mortgage interest payments on the fee purchase are tax deductible, while lease rents are not. Income tax bills can therefore be reduced by converting lease rents to mortgage payments. Although no published time series on renegotiated rents and fee and leasehold conversion prices are available, a few observations and some indirect evidence from a series on home price appreciation in 1960-80 suggest that rising rents and prices throughout this period created tax incentives that helped to fuel the fall of leasehold.[78]

Furthermore, as marginal income tax rates in income brackets applicable to homeowners increase, the lessee tax benefits of purchasing the land increase. A study by Barro and Sahasakul shows that average marginal federal tax rates in the United States fluctuated in the 21 to 26 percent range in the years 1960-75, and then increased to 29-31 percent in 1978-82.[79] There was a corresponding rise in leasehold conversions following 1975, for as we previously noted, 30 percent of all conversions occurred in 1979-82.[80] Thus, because the rise in income

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[78]See *supra* price evidence based on DOWNS and CHILD, and rent evidence based on footnote 70 and Aleshire, at part III, A, B.

[79]See R. Barro and C. Sahasakul, *Average Marginal Tax Rates from Social Security and the Individual Income Tax*, 59 J. BUSINESS 555 (1986). There is no corresponding study of changes in Hawaii average marginal tax rates. However, they had to be below the maximum statutory marginal rate of 11 percent during the same 1960-82 period.

[80]See supra at part III A. The direction of changes in average marginal tax rates from 1983 on is unknown, for that was the last year for which estimates were published. Of course, statutory rates fell in 1981 and 1986, then rose in 1991; other changes in the tax law also affected the average marginal rates.

tax rates increased lessees' tax benefits of purchasing the land, it tended to induce leasehold conversion to fee simple and thereby destroy the leasehold system.

Changes in highest-bracket income tax rates may also have affected the incentives of charitable and noncharitable landowners to engage in fee simple and leased fee sales. The IRS posture toward sales of both types was unclear, as it would conduct case-by-case post-sale audits. At least, that was their policy until 1979, when, for the Bishop Estate's leased fee sales, it established a blanket exemption. With that exception, leased fee sales by noncharitable owners and fee simple sales by all owners have to this day been subject to the same type of tax consequences as those described in Section II. The only changes that have occurred over time have been changes in the ordinary income tax rates.

A fall in the relevant ordinary income tax rates would reduce the tax liabilities associated with the feared reclassification as dealer. The reduced liabilities would tend to relax the owners' hard line against the sale of fee and leased fee.[81] Most noncharitable landowners, in particular the large estates, probably generated sufficient rental income -- when combined with the leased fee and/or fee simple sales -- to have been taxed as dealers at the highest federal and state marginal rates. In the case of the Campbell Estate, a "pass through" trust, it is the beneficiary recipients of income who would have been taxed at the highest marginal tax rates. It was possible that the Bishop Estate, as a dealer, would likewise have been taxed at those rates.

The highest bracket tax rates did fall. From the end of World War II until 1964, the highest federal marginal tax rate on ordinary income was 91 percent. In 1964 the Kennedy tax

[81]This tendency was weakened by the possibility that current sales of fee and leased fee could prompt an IRS review of past sales that would result in retroactive tax liabilities.

cut reduced the high rate to 70 percent. Between 1982 and 1984, the Reagan tax cut reduced the high rate to 50 percent. The 1986 Tax Reform Act reduced the rate on high incomes to 28 percent.[82] The drop in marginal tax rate reduced the tax consequences of possible IRS post-audit dealer classification of noncharitable landowners engaging in both fee and leased fee sales. This was a force on the supply side driving the decline of the leasehold system.

We argued in Section II that leasehold was an artifact of federal tax laws governing large concentrated landholdings and of legal rules on the investments of charitable trusts. By minimizing the expected tax liabilities of landowners and the legal liabilities of the trustees of dynastic trusts, leasehold increased returns to landowners and trustees. While leasehold conferred substantial benefits on landowners, it was an institution that also generated substantial transaction costs for the two contracting parties. Compared to a fee-simple purchase of the land and house, a leasehold contract involved higher transaction costs.

Most of the additional transaction costs are incurred at renegotiation. Determining the new lease rent is costly. If a leasehold home is part of a large leasehold housing tract, transaction prices on comparable land may be unavailable. The presence of homeowner-financed site-specific assets increases the cost of determining the price of the unimproved land. Once the price of the land is determined, the two parties must still agree on the rate of return on the asset.

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[82]Taxpayers with incomes between \$80,000 and \$200,000 paid a marginal rate of 33 percent, as certain deductions were phased out over this income range. The only (relatively minor) exception to this downward trend was in 1990 when the "Read My Lips" tax increase pushed the rate on high incomes to 31 percent. Taxpayers could encounter a marginal rate between 31 and 34 percent due to the phasing out of deductions at an income ceiling which varies by the type of filer and number of dependents; the deduction phase-out provisions of the tax code expire in 1996, thereby returning the marginal rate on high income to 31 percent.

Other tax rate changes were relatively minor. The federal tax on capital gains reported by highest bracket taxpayers fell from an effective rate of 35 percent in 1969-76 to 28 percent ever since. The Hawaii state tax on ordinary income in the highest bracket was 11 percent until 1987 when it fell to 10 percent. The state tax on capital gains was at 4.4 percent until 1987 when it rose to 7.25 percent.

If the two parties are unable to agree on a new lease rent, a board of three appraisers determines the rent. Such costs do not exist when a land-house package is purchased in fee simple. Substantial costs are usually incurred by both buyer and seller prior to purchase to determine the attributes of and market valuation of the asset. Such costs are, however, also incurred when a house on leasehold land is purchased. Given that the lessee must also incur upfront costs (time and effort) to understand leasehold institutions, transactions costs prior to sale are also likely to be higher under leasehold.[83]

Additional costs borne by the lessee reduce the lessee's willingness to pay lease rent. Because of this, the lessor tends to reduce the lease rent to compensate the lessee for transaction costs that are not offset by benefits to the lessee from the leasehold contract. Although the increased transaction costs produce a smaller stream of gross revenues to lessors, the benefits from reducing tax liabilities and decreasing legal liability may produce a higher net stream of revenues. As we documented above, changes in IRS tax policy and federal tax rates after 1967 substantially reduced the tax saving accruing to leasehold land holdings. Thus the higher transaction costs adhering to leasehold may have no longer generated corresponding benefits. Setting aside additional considerations, such as the land retention clause in Princess Bishop's will, estate trustees have had increased incentives to dismantle an institution that generates additional costs without corresponding benefits.

IV. Conclusion

We have argued above that the Campbell and Bishop wills, the prudent man rule, the

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[83]See M.A. Polinsky, *Fixed Price versus Spot Price Contracts: A Study in Risk Allocation*, 3 JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION 27 (1987). The fixed rent, long-term leasehold contract allocates price risk differently than a fee-simple purchase of land.

high marginal federal income tax rates on ordinary income, and the tax on capital gains were major factors behind the creation of the leasehold contract. As time passed, the present value of expected increasing rental costs to lessees under the leasehold system increased, strengthening their reasons for destroying the system. Through the political process, the lessees shifted these costs by capturing the lessors' economic rents, thereby weakening the lessors' tendency to preserve the system.

Additionally, the rising rents and average marginal tax rates increased the tax advantage of fee homeownership. As the highest bracket marginal income tax rate declined, and as the IRS (ex ante and ex post) exempted leased fee sales, the tax benefits of the leasehold system to lessors decreased. This further weakened the landowners' reasons to preserve the system.

Ideological forces also played a central role in the downfall of the leasehold system. The 1967 legislative voting pattern on the LRA indicates that Democrats and some Republicans voted in accord with ideological positions. The economic interest of lessees were not well represented by several of their Republican legislators who voted against the LRA and for the sanctity of private property.

The economic forces that we have emphasized in this paper came to the fore during the 1970s. Land prices and lease rents increased dramatically; average marginal income tax rates increased; and leases moved closer to renegotiation and expiration. These forces prompted a switch in legislative voting patterns. Legislators voted on the 1975 and 1976 amendments to the LRA in a manner more clearly reflecting the economic interests of their constituents. While legislators who voted for the 1967 LRA may not have intended to redistribute wealth, legislators in the mid-1970s clearly engaged in rent-seeking for their lessee constituents when they voted on the 1975 and 1976 LRA amendments.

Leasehold condominium owners, not included under the 1967 law, numbered (in 1989) 69,969, comprising 60 percent of the total number of condominiums, and 25 percent of the total number of housing units. Legislation motivated by rent-seeking lessees and patterned after the LRA and its rent control amendment came out of the Honolulu City Council in 1991. Ordinance 91-96 established rent control at renegotiation, and companion Ordinance 91-95 authorized condemnation for the leased fee transfer at a price based in part on the controlled rents. A federal district court recently struck down the rent control law.[84] In the same decision, the court ruled that the city condemnation law was consitutional;[85] it then referred the challenge to condemnation law to the Hawaii State Supreme Court to determine whether the city's law is preempted by Hawaii statutes governing eminent domain and residential leasehold land reform.[86]

It remains to be seen whether or how long the courts will block lessees' political attempts to get the leased fees at acceptable prices. Two points are clear: (1) the same economic conditions that drove rent-seeking in the case of single-family leasehold homes are now present in the case of condominium leasehold homes; and (2) the success of single-family lessees in capturing rents is feeding condominium lessees' political endeavors. It remains to be seen how long the courts will block lessees' attempts to capture the rents and in the process bankrupt the condominium leasehold system.

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[84]*Richardson v. City and County of Honolulu*, 802 F.Supp. 326 (D.Hawaii 1992).

[85]Id. at 343.

[86]Id. at 346.

Figure 1

Tax Status and Tax Liabilities

	Dealer	Nondealer
Bishop Estate	Ordinary business income Net revenues from land sales taxes as capital gains or ordinary income Net revenues from land rental taxed as ordinary income.	Income related to charitable activity No taxes
Harold Castle and Campbell Estate	Frequent seller All net revenues taxed as ordinary income	Occasional seller Net revenues from land sales taxed as capital gains Net revenues from land rental taxed as ordinary income