

# The Political Economy of Urban Land Reform in Hawaii

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**Summary.** In the mid 1960s there were about 22 000 single-family leasehold homes in Honolulu. Dissatisfaction with leasehold led to reform legislation in 1967, allowing lessees to buy leased land. By 1991 less than 5000 lessees remained. This paper examines why landowners elected to lease rather than sell land and attributes the rise of leasehold to legal constraints on land sales by large estates, duties of estate trustees and the federal tax code. Ideological forces initiated land reform in 1967, but rent-seeking forces captured the process in the mid 1970s. It is concluded that Hawaii's experiment with leasehold was a failure due to the difficulties associated with specifying and enforcing long-term contracts in residential land.

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 practised in Great Britain, Israel, Hong Kong, Singapore, New Delhi, Canberra, Amsterdam, Stockholm and Vancouver (Canada). In most cases, a municipal government leases publicly-owned land to residents in a competitive land market (MacDonald, 1969). In the UK, the Church of England owns large tracts of land which it leases to home-owners. Residential land leasing is also widely practised in many Pacific island countries where land cannot be sold to non-natives.<sup>1</sup>

Residential land leasing in the US is relatively uncommon. There are pockets of residential leaseholds in Maryland, south-eastern

Pennsylvania and California. The largest of these developments is in Irvine, California, where, in the 1960s, the Irvine Company developed several leasehold communities (Nakamura, 1989). There are also small pockets of leasehold homes on Indian reservations and other federal lands across the US. However, residential land leasing has been widely practised only in the State of Hawaii, and in particular on the island of Oahu which is co-terminous 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.<sup>2</sup> 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 per cent of the total stock of single-family homes (see Vargha, 1964, for pre-war data, and Economics Research Associates, 1969, for post-war data). The ownership of these leases was highly concentrated. In 1963 a

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charitable trust, the Bishop Estate, owned 33 per cent; an individual, Harold Castle, owned 29 per cent; and a non-charitable trust, the Campbell Estate, owned 6 per cent (Vargha, 1964, p. 12).<sup>3</sup>

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 per cent 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 per cent of the condominium leases, with the remainder being widely dispersed.

In the US, some analysts believe that land leasing could make home-ownership more accessible since land leasing reduces the overall purchase price of the house-land package and thereby decreases the minimum required down payment.<sup>4</sup> Other scholars (Archer, 1974; McDonald, 1969) have further argued that leasehold housing arrangements should be used more extensively because leasing might lower the transactions costs of future land redevelopment.

Yet, even as the supply of condominium and single-family leaseholds was increasing in Hawaii, there was a political movement to dismantle the institution. Over the past 25 years legislative and judicial decisions have resulted in massive conversion of single-family homes from leasehold to fee-simple tenure. Consequently, in 1994 there remains no more than 4600 single-family leasehold homes out of the approximately 28 000 that were ever built (Locations Inc, 1992). And although leasehold condominiums today outnumber fee-simple condominiums, the City and County of Honolulu has passed legislation (currently being reviewed by the Ninth Circuit Court of Appeals) allowing owners of leasehold condominiums to use the power of eminent domain to purchase the lands on which their condominiums are located. In sum, Hawaii's experiment with leasehold housing on privately owned land has been a failure. In this paper, the rise and fall of residential single-family leasing in Hawaii is

explained. The analysis of Hawaii's experience provides important lessons for jurisdictions, landowners and housing developers who might contemplate the development of leasehold residential housing.

### **1. 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.<sup>5</sup> 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.<sup>6</sup> The long initial fixed-rent period was set to facilitate long-term mortgage financing by the FHA and other lenders. Recent leases have incorporated rents that increase by fixed amounts at specified intervals (typically 10 years or longer) during the first 30 years. In some cases 'below-market' lease rents are set for the first 30 years; in exchange, the lessee pays more than the market value of the house. Lessees may prefer this arrangement, as the interest component of repaying a larger home mortgage loan is tax deductible while lease rents on residential land are not.

At renegotiation, the lease specifies that lease rents are to be adjusted to 'market levels'. 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 expectations of inflation. This means that the renegotiation lease rent will be 'front loaded', i.e. it will exceed spot market rents initially and in later years be less than spot market rents.

A 1975 state law constrains lease rent renegotiations by placing a ceiling on leasehold rents at renegotiation (Hawaii Revised Statutes 510; the original legislation was Act 185). The law limits renegotiated rents to 4

per cent of the appraised value of the unencumbered land.<sup>7</sup> It also specifies that lease rents can be renegotiated after the initial fixed-rent period no more than once every 15 years.<sup>8</sup> The lease rent control law applies only to single-family homes and does not apply to leasehold condominiums.

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. 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.

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 (new provisions apply at expiration for post-1975 leases: see section 2). Of course, in many cases the two parties may decide, prior to expiration, to renew their current relationship

by entering into a leasehold contract specifying an initial rent, contract duration and rent renegotiation provisions.

## 2. 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 (1984, pp. 534–535) 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. If this explanation is important, widespread use of residential leasehold contracts should be observed not only in Hawaii but throughout the US. Instead, only limited use of leasehold on estates in Maryland, Pennsylvania and Southern California is observed.

If the demand-side explanation fails to explain the presence of leasehold residential land 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 US is that almost all lessors are large landowning estates. For example, in Irvine, California, the Irvine Company developed its large landholdings (the Irvine Ranch) as leasehold housing.

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 per cent of all privately owned land. The Estate was established in 1884 under the will of Princess Bernice Pauahi Bishop. Her will mandated that her land be held in a charitable trust, and that the rents provide for the education of Hawaiians.<sup>9</sup> It 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.” This provision has not excluded the sale of

Estate lands. Between 1912 and 1960 the Estate indicated no preference for leasing over selling fee lots for homes (Midkiff, 1961, pp. 24–25, 32). The number of lots voluntarily sold (3356) actually exceeded the number leased (3139).

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

Additional legal constraints on the five Bishop Estate trustees also help explain the trustees' reluctance to sell land. Several scholars (Friedman, 1964; Blair and Heggstad, 1978) have analysed the distinction between a caretaker trust and a dynamic trust. 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: to preserve the trust principal; and 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 in a dynastic trust.

The prudent man rule sets forth the duties of the trustees in making investment decisions for the trust.<sup>10</sup> 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 degree of skill in making the selection and use the caution which a prudent man would exercise ...". (Scott (1967), as quoted in Blair and Heggstad, 1978, p. 87). Hawaii has followed the prudent man rule throughout the 20th century.<sup>11</sup>

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 (*Honolulu Advertiser*, 14 May 1980, p. A-1; *Honolulu Star Bulletin*, 24 February 1982, p. B-4). In that trial, the investment analyst retained by Ching testified that the purchase was imprudently made. (Ching did not prevail in the trial).

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 (see *Honolulu Advertiser*, 9 August 1973, p. A-1; 7 March 1973, p. A-1; 21 July 1973; p. D-1; *Honolulu Star Bulletin*, 17 July 1973, p. B-7). Indeed, trustees have often publicly criticised and, as indicated above, even sued each other over allegedly imprudent financial decisions and investment (see *Honolulu Advertiser*, 9 September 1961, p. A-1; 10 February 1982, p. D-10). The Estate has also been sued by beneficiaries for 'imprudent' land sales (see *Honolulu Advertiser*, 18 December 1973, p. A-1; 20 March 1974, p. A-12). 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.<sup>12</sup> There is, therefore, a bias in the trustees' decision-making toward avoiding losses on particular projects rather than maximising the return on the entire investment portfolio.

**Table 1.** Tax status and tax liabilities

	Dealer (frequent seller)	Non-dealer (infrequent seller)
Charitable (Bishop Estate)	Net revenues from land sales taxed as capital gains or ordinary income.	No Taxes
	Net revenues from land rental taxed as ordinary income.	
Non-charitable (Harold Castle and Campbell Estate)	All net revenues taxed as ordinary income.	Net revenues from land sales taxed as capital gains.
		Net revenues from land rental taxed as ordinary income.

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.

There are, however, two good reasons why we cannot rely exclusively on the dynastic estate argument as an explanation of leasehold.<sup>13</sup> 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. Secondly, the argument cannot explain why Harold Castle and numerous other landowners not classifiable as dynastic estates, or even as charitable entities, leased their lands.

These considerations lead us to argue that federal income taxes also created a strong preference among landowners for leasing in-

stead of selling their land, especially after 1960. Taxes on revenues from the sale and lease of land depended partly on Internal Revenue Service (IRS) classification of the seller as charitable or non-charitable. A non-charitable classification implied higher tax liabilities.<sup>14</sup> Among the largest lessors, the Bishop Estate was classified as charitable.

Two tax considerations weighed against sale. The first, applicable only to non-charitable landowners, was the capital gains tax. The Bishop Estate, due to its charitable status, was exempt. It was levied at rates between 25 and 35 per cent from 1945 to 1981. The tax was collected only when the gains were realised, so it could be deferred indefinitely through leasing. Thus, the capital gains tax tended to discourage sale, and lock the landlords into leasing for income. The inducement to lease was particularly effective in Hawaii because most of the estates had held their land for such a long time and at such high appreciation rates that essentially the entire sale proceeds would qualify as taxable capital gains.<sup>15</sup>

Taxes on revenues from the sale or lease of land also depended on IRS classification of the seller as a dealer or non-dealer (Table 1). A non-charitable landlord, as a dealer, would have to pay taxes on revenues from lands sales at the ordinary income tax rate (between 70 and 91 per cent between 1945 and 1981) instead of the lower capital gains

tax rate. The charitable Bishop Estate, as a dealer, would lose its exemption from all taxes: rental income would be taxed at the ordinary income tax rate and capital gains would be taxed at either the capital gains or ordinary income tax rate.

All large estates were non-dealers. Their second tax consideration weighing against the sale of land was their fear of reclassification as dealer. It deterred sale because the IRS tended to review the tax status of landlords making frequent or large sales.<sup>16</sup> The greater the frequency and aggregate value of sales, the greater was the likelihood that the IRS would reclassify the seller as a dealer. In a 1973 interview, estate trustee Matsuo Takabuki summarised the rationale behind the Bishop Estate's reluctance to sell land: "[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." (*Honolulu Advertiser*, 31 July 1973, p. I-A-13).

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 selling as well as leasing its land for residential use. In 1954 the Estate joined with a developer to build homes and sell them on a fee-simple basis.<sup>17</sup> When the IRS learned of the sales, it warned the Estate that if such sales continued, it would lose its tax-exempt status.<sup>18</sup> In the years following this warning, the Estate leased thousands of lots but made only two voluntary sales of 790 leased fees in 1972.<sup>19</sup> These conveyances were each arranged as single bulk transactions to avoid dealer classification.

Although the tax consequences of dealer classification were less severe for the non-charitable 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.<sup>20</sup> 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 3500 acres, and then paid capital gains taxes.<sup>21</sup> Subsequently, the IRS audited and required payment of taxes at an effective rate between the capital gains rate and the 48 per cent corporate income tax rate.

In view of the dynastic trust and tax avoidance arguments, it is understandable why such a large percentage—26 per cent in 1967—of single-family residences were on leased private land in Honolulu relative to other US urban areas (Economic Research Associates, 1969, pp. VI-9, 10). First, the dynastic trust explanation is applicable to the Bishop and Campbell Estates, which in 1964 owned 20 per cent of the land in Honolulu (Horowitz and Finn, 1967, Table 30). They also owned 42 per cent of the residential leasehold lots in Honolulu (Vargha, 1964, p. 10). The authors are unaware of any other urban area in the US where dynastic trusts owned such a large fraction of the land suitable for residential use. Secondly, the IRS threat of dealer classification was applicable only to large landowners because they alone had large enough land holdings to engage in frequent sales. In 1964 the Bishop and Campbell Estates and Harold Castle owned 31 per cent of the land in Honolulu (Horowitz and Finn, 1967, p. 84). They also owned 68 per cent of the residential leasehold lots in Honolulu (Vargha, 1964, p. 10). We are unaware of any other urban area in the US where landowners vulnerable to dealer classification owned such a large fraction of the land suitable for residential use.

Finally, many small non-charitable landowners leased land for single-family homes. Although such small landowners were not threatened by dealer classification, they, like the large owners, were deterred from selling by the capital gains tax. This begs the question, why did small owners lease (rather than sell) in Honolulu but not on the mainland, where the same federal tax laws applied? One possible answer is that, due to the policies of the Bishop 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 landowner to lease in emulation of the larger ones in Honolulu.

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 programme, the Great Mahele, mandated the swift conversion of traditional land holdings into private property (La Croix and Roumasset, 1990). In 1850 the law was changed to allow foreigners to own land (Kame 'eleihiwa, 1992). 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 6 per cent of the land in the Territory. The Bishop Estate, which was established to serve the educational needs of the Native Hawaiians, owned another 9 per cent.

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 Bishop's will emphasised the importance of retaining ownership of her Estate. The trustees' commitment to this goal (among others in the Princess's will) has been bolstered by their appreciation of history and their desire for support rather than criticism from these vocal Native Hawaiian groups (see, for example, *Sunday Star Bulletin & Advertiser*, 27 August 1978, p. A-25; *Honolulu Star Bulletin*, 20 July 1973, p. A-12; 21 July 1973, p. A-12).

### **3. The Fall of Leasehold: Residential Land Reform, 1967–92**

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 lease-

hold homes reached a peak of approximately 22 000 units in the mid 1970s, by September 1991, remaining leaseholds numbered only 4600.<sup>22</sup> Leasehold constituted about 30 per cent of the owner-occupied detached homes in mid 1970s, but by 1991 it had fallen to 5 per cent of a larger housing stock. Four large estates—Bishop Estate (57.3 per cent), Castle Estate (16.8 per cent), Robinson Estate (9.5 per cent) and Campbell Estate (6.7 per cent)—accounted for over 90 per cent of all conversions (Locations Inc., 1992, p. 19).

#### *3.1. History of Leasehold Decline*

After World War II, many people in Hawaii viewed concentrated land ownership as an impediment to housing development. In 1945, Territorial Governor Ingram M. Stainback told the Legislature that:

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. (*Honolulu Star Bulletin*, 23 October 1981, p. A-16)

As the number of leasehold residential units increased, there was growing concern that major landowners preferred to lease rather than sell their lands for residential developments. From 1952 the Democratic Party platform called for land reform to enable home-owners 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 home-owners the opportunity to purchase the fee interests under their homes after living on the properties for 5 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 (Horowitz

and Meller, 1966). 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 home-owners leasing land to acquire it in fee simple (HRS 516). In brief, the Land Reform Act (LRA) states that upon the petition of 50 per cent of the lessees (or 25 lessees, whichever is less) in a leasehold housing tract, the Hawaii Housing Authority (HHA) will condemn the land and resell individual parcels to the lessees. (For a chronology of the land reform measures affecting single-family residences, see State of Hawaii, 1982.)

The LRA's provision for bulk condemnation was designed to obtain favourable tax treatment of leasehold sales from the IRS. The IRS did maintain the Bishop Estate's tax-exempt status and also allowed non-charitable 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 towards sales by charitable and non-charitable landowners were implemented sale-by-sale, through post-sale audits, until 1978 when it provided a blanket ruling for the Bishop Estate (*Honolulu Advertiser*, 18 July 1978, pp. A-1 and A-5).

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 fulfilment 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 Native Hawaiian community pressured the trustees to refrain from selling the fee.

There were few conversions from leasehold to fee simple between 1967 and 1975, partly due to the unwillingness of Governor Burns to implement the LRA. In 1975 the Legislature passed Act 186 which corrected a defect in the 1967 law as well as reaffirming its goals.<sup>23</sup> The LRA (as amended) was first

employed in 1976. This was followed by a growing number of petitions and subsequent conversions between 1979 and 1982.

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 on-site improvements at fair market value. This provision applied to existing and future leases.<sup>24</sup> Act 185 (1975) established effective controls on land rents at lease renegotiation. Act 242 (1976) provided for appraiser 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—"nor shall private property be taken for public use without just compensation". In 1979, the Hawaii Federal District Court ruled that the taking was for a constitutionally permissible public purpose.<sup>25</sup> In 1983, the Ninth Circuit Court of Appeals reversed on the public use issue.<sup>26</sup> In 1984, the US Supreme Court ruled unanimously that the law did not violate the United States Constitution.<sup>27</sup> 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.<sup>28</sup> 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.<sup>29</sup>

The various court decisions affected leasehold's rate of decline. Thirty per cent 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 4 per



cent of the 23 400 conversions in 1983–85. Following the US and Hawaii Supreme Court decisions, conversions in 1986–90 comprised 57 per cent of the total conversions, and the Bishop Estate ceased making leasehold development agreements. By 1991 new leasehold homes from prior developer agreements had stopped coming onto the market.

### 3.2. *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;<sup>30</sup> and tax minimisation by lessors and lessees.

*Ideology and rent-seeking*. The political history of land reform in Hawaii has been carefully documented by Cooper and Daws (1985). 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.

Cooper and Daws (1985, p. 414) suggest two possible explanations for passage of the LRA in 1967; ideology and rent-seeking

First, consider the ideological explanation. It has been 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 the land reform bill.

Alternatively, consider the rent-seeking explanation. Lessees were the sole economic beneficiaries of the LRA. It essentially modified leasehold contracts to provide lessees with a free option to buy their land at a legally specified price. Purchase could potentially avoid: future rent increases; diminished ability to borrow against the property towards the end of the lease; and surrender of improvements at its termination.

The largest concentrations of lessees were relatively affluent residents in East and Windward Oahu. These predominantly leasehold neighbourhoods 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 (1985, p. 431) found that the House of Representatives voting pattern was contrary to the rent-seeking explanation and consistent with the ideological explanation. Seven of the eight representatives from East and Windward Honolulu voted against the LRA, and all seven were Republicans. Six of the seven were re-elected 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-les-

see constituents suggests that ideology was an important motivation within the Republican as well as the Democratic party, and that 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 was small. The weakness of support for the rent-seeking argument is confirmed by the authors' examination of concurrent news reports and legislative testimony: no evidence was found of lessee influence on the legislation.

In 1975 and 1976, the impetus for land reform 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 lessors to compensate lessees at market value for on-site improvements 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 favourable to the lessees.<sup>31</sup>

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 was defeated in the subsequent election. In the House, where votes in favour 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.

What conditions prompted the transition to a more transparent rent-seeking environment? First, the number of lessees increased significantly between 1967 (about 14 600 lessees) and 1975 (about 22 000 lessees),

thereby increasing their potential voting power.<sup>32</sup>

Secondly, the number of lessees with contracts nearing rent renegotiation increased between 1967 and 1975. Voter propensity to participate in the political process depends not only upon the costs of gathering and processing information but also on the 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.

Thirdly, the rents available for capture increased substantially between 1967 and 1975.<sup>33</sup> Consider a lessee in 1967 owning a home on land leased in 1957. The lease would not 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. Lessees were becoming aware not only of the difficulties in selling property as renegotiation neared, but also of the substantial increases in lease rents.<sup>34</sup> Given the increased present value of the economic rents at stake, individuals had greater incentives to modify the 1967 LRA to capture a share of the increased economic rents.

Fourthly, 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 for the effects of expected inflation.<sup>35</sup> 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 indexed rents. Such increases were rejected by mortgage lenders and were forbidden by the FHA. 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 changes in the economic environment during the mid 1970s. Nonetheless, it must be recognised 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 redistribution wealth. Essentially, the success of the politics of ideology reduced the cost of transferring wealth. Politicians continued using ideological rhetoric, but their actions focused on redistributing economic rents.

*Tax minimisation.* In the discussion of the rise of leasehold, a large role was assigned to taxes. Below, it is shown how changes in tax rates and IRS policy contributed to the fall of leasehold.

First, average marginal income tax rates applicable to most home-owners increased after 1975.<sup>36</sup> These changes increased home-owners' tax benefits of fee ownership relative to leasing, as mortgage interest payments on the fee purchase were tax deductible, whereas lease rents were not. Secondly, new and recontracted lease rents increased after 1975.<sup>37</sup> The higher lease rents increased the effect on home-owners of the post-1975 increase in tax rates on ordinary income. A third change occurred in 1979 when the IRS

established a blanket exemption from taxes on leased fee sales by the Bishop Estate. Prior to 1979 the IRS had conducted case-by-case audits on all types of land sales by estates to determine liability and tax status *ex post*.<sup>38</sup> The fourth change was a decrease in the highest bracket marginal tax rates applicable to the estates.<sup>39</sup> The fall in rates reduced the liabilities associated with dealer status. This should have reduced the estates' incentives to retain leased fee or fee land holdings given the reduced cost associated with possible IRS reclassification as a dealer.

It has been argued above that leasehold was an artifact of federal tax laws governing large concentrated landholdings and of legal rules on the investments of charitable trusts. By minimising 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 a costly process. If a leasehold home is part of a large leasehold housing tract, transaction prices on comparable land may be unavailable. The presence of home-owner-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 or return on the asset. 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 lease must also incur upfront costs (time and effort) to under-

stand leasehold institutions, transactions costs prior to sale are also likely to be higher under leasehold.

Additional costs borne by the lessee reduce the lessee's willingness to pay lease rent. Because of this, the lessor tends to reduce the rent to compensate the lessee for transaction costs that are not offset by benefits to the lessee from the leasehold contract. Although the increased transactions 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 documented above, changes in IRS tax policy and federal tax rates after 1982 substantially reduced the tax saving accruing from leasehold land holdings. Thus the higher transaction costs of leasehold may no longer have 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.

#### 4. Conclusion

It has been argued that the Campbell and Bishop wills which advised against land sales, the prudent man rule which further discouraged trustees of dynastic estates from undertaking risky investments in favour of land retention, the distortionary federal income tax code, and Native Hawaiian opposition to Bishop Estate land sales were major factors behind the rise of residential land leasing Hawaii.

The basic problem with long-term lease contracts is that they are exposed to rent-seeking by both parties when there are large, unexpected changes in the asset's price. In Hawaii, land prices rose much faster than anticipated between 1960 and 1990. Thus residential lessees with fixed rents established prior to this period gained windfall profits, while lessors were entitled by contract to reap the windfall profits following rent redetermination. Not surprisingly, as

more and more contracts came up for rent redetermination, home-owners sought governmental intervention to break their contracts to keep the windfalls. Lessors, on the other hand, preferred to exercise the terms of the existing contracts. Lessee efforts prevailed and weakened lessor incentives to preserve the leasehold system. After less than 50 years, the largest experiment with private residential leaseholds in the US is being dismantled.

Hawaii is not the only failed experiment with private leasehold residential development in the US. The Irvine Company's experiment with leasehold residential development in Orange County, California, resulted in a similar outcome. In Irvine and surrounding communities, the terms of the leasehold contracts (set in the 1960s) were similar to those in Hawaii with initial rents fixed for 25–30 years. When the first leases came up for renegotiations in the late 1970s, rents increased by as much as 3233 per cent. The home-owners filed a class action suit charging that the Company was gouging. Organised lessee opposition to the Company further threatened its other commercial developments (*Fortune Magazine*, 14 November 1983, pp. 90–102).

In 1983, the Irvine Company agreed to sell the fee interests to most of the 4000 lessees electing to purchase. Lessees who chose not to purchase were offered new 55-year amended leases with annual rents indexed to the Consumer Price Index. Annual rent increases were limited to 8 per cent, with inflation in excess of 8 per cent recaptured in future years (*Sunday Star Bulletin and Advertiser*, 24 November 1992, p. H-3). As in Hawaii, rent-seeking by the lessees successfully prompted land reform in Orange County, California, and prompted the dismantling of Orange County's leasehold system.

Leasehold residential housing also exists in other countries. In most cases a government leases publicly-owned land to residents. In Canberra, Australia, the national government is a monopoly lessor, since all the land is owned by the government (Neutze, 1989).

Lease rents were fixed for 20 years and then revised every 10 years, "set at five per cent of the estimated market value at the time of revision" (Neutze, 1989, p. 195). Land rents were abolished in 1971 during a by-election for a Canberra seat in the national parliament, and the national government has indicated that residential leases will be renewed without additional payments. Thus, leasehold tenure is now virtually identical to freehold tenure.<sup>40</sup>

By contrast, in Vancouver, Canada, the municipal government leases some land for residential use, but is a small player in a competitive housing market dominated by fee-simple ownership. Public residential leaseholds in Vancouver have been relatively problem-free. This can be explained by the lengthy lease terms (99 years) and low fixed lease rents which are prepaid for the entire period of the lease.

However, ground leases eventually expire. Experience with public residential leaseholds demonstrates that government leaseholds do not preclude rent-seeking activities. Pugh (1991, p. 329) noted that in Delhi, India, public leaseholds may have encouraged illegal bargaining between public officials and leaseholders. Public leasehold residential developments impose additional administrative costs on governments. And it may also be politically difficult for municipal governments to persuade the relatively wealthy and politically influential lessees to vacate the land at the end of the lease.

The analysis presented here has three broad implications. First, it is difficult to design and enforce a long-term residential leasehold contract that achieves efficient results. In retrospect, had the leasehold contracts in Hawaii and Irvine specified annual rent adjustments tied to the CPI instead of fixed rent contracts with renegotiation, the economic incentives might not have been large enough many years later to cover the lessees' costs of political activity to enact land reform legislation enabling them to break their contracts. Institutional constraints—specifically, mortgage lenders' reluctance to accept and the FHA's prohibition

of annual rent adjustments—ruled out indexed rents in Hawaii from the 1950s to the 1970s when many leaseholds were being developed.

By contrast, the amended Irvine leasehold contracts contain a provision for annual rent indexation. In Palm Springs, California, a major leasehold residential development on Agua Caliente Indian Reservation land also specifies rent adjustment every 5 years using the CPI, with typical leases running 65 years (Nakamura, 1989). Indexation of rents may lessen destructive rent-seeking activities on the part of lessors and lessees but is unlikely to eliminate them. Land values can rise or fall at a much faster pace than overall inflation, and since both parties of the contract cannot accurately anticipate the change and adjust the initial base rent accordingly, there is still the likelihood that opportunistic behaviour will occur even with indexation.

Secondly, the rise of leasehold was largely the unintended result of the interaction between the federal tax code and the incentives faced by the trustees of large dynastic estates. In this case income taxation did more than distort individual choice within a given institutional arrangement—it distorted the choice of institutional arrangements. Traditional analysis of the deadweight losses from taxation takes the institutional structure as given and assumes that individual choices are distorted within this fixed institutional framework. In most instances this assumption is appropriate, as individuals often find it less costly to adjust choice variables more directly under their control than to organise politically to adjust institutional variables. In this case, the threat of IRS 'dealer' classification and high marginal tax rates increased the benefits to landowners of adopting a new land market institution. In sum, leasehold in Hawaii is a case study of the potential for taxation to affect institutional choice as well as more immediate individual choice variables.

Thirdly, land reform legislation established to improve the land markets enables particular interest groups or coalitions of interest groups to capture rents. This tendency

has been well established in the case of regulatory commissions (Stigler, 1971; Noll, 1989). Although ideological forces provided the main push for the 1967 LRA, the land reform process was captured by rent-seeking lessees in the 1970s. Successful land reform legislation must take into account future rent-seeking in its original design or ultimately it may not achieve its original objectives.

In Hawaii the redistribution of land was accompanied by the redistribution of wealth. Urban land reform in Hawaii redistributed wealth by imposing rent ceilings and mandating compensation by lessors to lessees for fixed improvements at the end of the lease (La Croix and Rose, 1995). Wealth redistribution via land reform is not uncommon. Rural land reform in developing countries has occasionally redistributed wealth to poor tenant farmers. However, urban land reform in Hawaii redistributed wealth to leasehold home-owners, an already wealthy group. The losers of wealth were Native Hawaiians served by the Bishop Estate's education programmes. In this case, rent-seeking not only dissipated economic rents, but also was at odds with an equitable distribution of wealth.

Few in-depth examinations of residential leasehold developments exist, and more research is clearly required before general conclusions can be drawn. However, this case study of leasehold in Hawaii and the brief examination of other residential leasehold developments have raised serious questions concerning the long-term viability of residential leasehold tenure. In sum, this analysis points to the conclusion that the disadvantages of private or public residential leasehold development tend to outweigh its potential advantages.

## Notes

1. In the Pacific, only New Zealand, Australia, Guam and Hawaii permit land to be sold to non-natives. According to Ward (1993) the desire to protect indigenous landowners from the loss of their land was a feature of colonial policy in many Pacific islands. In Hawaii there was a 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 La Croix and Roumasset (1990) and Kame'eleihiwa (1992) for discussions of the origins of the Great Mahele.
2. Leasehold actually had a foothold at the turn of the century. The Report of the US Labor Commissioner on Hawaii (1902) surveyed 225 families about their housing tenure. Of the 36 families who owned their homes, 12 families leased the land.
3. 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.
4. This was especially true in the late 1970s and early 1980s when housing prices were rising rapidly in the US. See, for instance, Booth (1980) and *Wall Street Journal*, 24 March 1980, p. 42).
5. 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, pp. VI-2-VI-8)). Prior to 1940, most leases were 30 years in length. From 1946-52, 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.
6. 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 US 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. For an extended discussion of the impact of federal tax law on the demand for leaseholding housing, see Fry and Mak (1984).
7. By contrast, in the early 1970s, the Bishop Estate's policy was to set rents at 4.5 per cent of the land's value. See *Honolulu Advertiser*, 1 August 1973, p. II-A-7.
8. 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.
9. In compliance, the trustees established the Kamehameha Schools in 1887.
10. It was first formulated by the Massachusetts Supreme Court in *Harvard College v. Amory*. Mass. (9 Pick) 446, 461 (1830).
11. *Estate of James Campbell, Decsd.* 42 Hawaii

- 586 (1959); *Hyde v. Smith*, 11 Hawaii 535 (1899); and *Dowsett v. Hawaiian Trust Co.*, 47 Hawaii 577 (1965)
12. State law sets compensation of the Bishop Estate trustees collectively at expenses plus 2 per cent of gross revenue and 2.5 per cent on the sale of assets.
  13. Some estate trustees inform us that they were not explicitly 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. Other trustees were, however, aware that their entire personal wealth was at risk.
  14. Hawaii state taxes are generally patterned after federal taxes, albeit with lower rates. Thus, the same arguments that we shall set forth regarding the effects of federal taxes apply to state taxes as well, with the latter effects being smaller in magnitude.
  15. In principle, it was possible to transfer title without incurring a capital gains tax. An estate or corporation could defer federal capital gains taxes indefinitely by exchanging land for 'like-kind' properties under Section 1031 of the Internal Revenue Code. The method has been available since 1922. As a general rule, it was so complex 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.
  16. The frequency or regularity of sales was also critical to IRS classification of non-charitable estates. As occasional sellers, the Campbell Estate and Kaneohe Ranch would be treated as non-dealers 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.
  17. 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 homes 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, DC, 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 Oswald Stender believes that the two standard forms (later reduced to one) and the importance of FHA and VA mortgage insurance were important in accelerating the rise of leasehold. Ninety per cent of residential leases provided by lessors since the 1960s have used these forms.
  18. Interview with Bishop Estate trustee Oswald Stender, 30 August 1994.
  19. Some sources indicate 715 additional leased fee sales by Bishop Estate. Regardless, there were relatively few sales following the IRS warning. Personal conversation of Wesley Hillendahl, former chief economist at Bank of Hawaii, with James Mak. The Bishop Estate may have sold land during this period to meet operating expenses of the Kamehameha School.
  20. A Campbell Estate trustee can recall only two sales: 200 acres to an oil company, and 65 acres to a residential developer.
  21. Castle & Cooke, did not develop any residential leasehold property.
  22. Data on the number of leasehold homes during the 1970s are unavailable. Vargha (1964, p. 10) stated that in 1963 there were 15 342 leasehold lots in Honolulu. According to Wesley Hillendahl, from 1964 through 1975 there were 9880 additional leasehold lots developed on Bishop Estate land. 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. Locations Inc. (1992, p. 19) reports that by September 1991 about 28 000 leasehold homes had been built and 23 400 had been converted to fee simple, leaving 4600 in leasehold.
  23. There were both technical and philosophical reasons why Governor Burns refused to implement the 1967 LRA. The technical flaw in the LRA was that it required the state to purchase an entire tract, resell to those lessees willing and able to buy, and become landlords to the remaining lessees. Burns did not want to use state funds to become a landlord to wealthy lessees. The matter rested until George Ariyoshi became Governor in 1974. See Cooper and Daws, 1985, ch. 13.
  24. *Anthony v. Kualoa Ranch, Inc.*, 69 Haw. 112, 736 P.2d 55 (1987) overturned the retroactive provisions of the law.
  25. *Midkiff v. Tom*, 483 F.Supp. 62 (1979).
  26. *Midkiff v. Tom*, 702 F.2d 788 (1983).
  27. *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984).
  28. *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229, 245 (1984).
  29. 704 P.2d 888 (Hawaii 1985).
  30. Rent-seeking activities use resources to redistribute wealth and may have positive or

- negative consequences on economic welfare. See Roumasset and La Croix (1988).
31. *Midkiff v. Tom*, 471 F.Supp. 871 (1979).
  32. Stigler (1971) and others have emphasised that larger groups have higher costs of organising 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.
  33. Price appreciation data on land are unavailable. Indirect evidence, based on single-family home price appreciation as reported by the US decennial censii, indicates that home prices in Honolulu accelerated after 1970. Downs (1983) reports mean price appreciation of 5.34 per cent per year between 1950 and 1960, 5.09 per cent per year between 1960 and 1970, and 13.02 per cent between 1970 and 1980. Corresponding rates of increase for the Honolulu consumer price index (CPI-U) were 2.58 per cent, 2.89 per cent and 7.18 per cent per year. By comparison with the census data, John Child and Co., a Honolulu appraisal firm, analysed resale prices of single-family homes in 20 Honolulu sub-divisions between 1967 and 1980. John Child (1980, 1981) found that the appreciation of a carefully selected sample of homes during this period averaged 10.75 per cent. The range of appreciation across subdivisions was 9–13.7 per cent. During the same period, the Honolulu CPI-U increased at an annual compound rate of 6.6 per cent.
  34. Mortgage lenders would typically not make mortgage loans when the lease was due for either renegotiation or expiration within 10 years.
  35. One of the earliest rent negotiations was the 1964 rent adjustment for Portlock Road homes located on Bishop Estate land in Hawaii Kai. Rents jumped by 300–600 per cent for the first 15 years and another 20–25 per cent for the final 15 years. See *Honolulu Advertiser*, (p. A-1, A-2, 5 February 1964). In 1971 a small sub-division on Bishop Estate land in Kailua witnessed a 624 per cent increase for the final 26 years of a 48-year lease. See *Honolulu Advertiser*, 23 September 1971, p. A-12. 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 per cent (Cooper and Daws, 1985, p. 424). In the early 1990s condominium lease rents typically increased by 1000–1200 per cent at renegotiation. See *Sunday Star Bulletin and Advertiser* (24 March 1991, pp. A-1 and A-11).
  36. Barro and Sahasakul (1986) showed that average marginal federal tax rates fluctuated in the 21–26 per cent range in the years 1960–75 and then increased to 29–31 per cent in 1978–82.
  37. Although no published time-series on contracted rents, leasehold conversion prices and fee simple 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 (Downs and Child, 1980, 1981).
  38. Despite this change, uncertainty persisted in regard to the Bishop Estate's fee simple sales and all other owners' sales of leased fee and fee-simple properties. There remained a strong fear of dealer reclassification.
  39. From the end of World War II until 1964, the highest federal marginal tax rate on ordinary income was 91 per cent. From 1964 until 1981, the highest rate was 70 per cent. Between 1982 and 1984, it was gradually reduced to 50 per cent. The 1986 Tax Reform Act reduced the highest rate to 28 per cent. Between 1990 and 1993, the highest rate increased to 39.6 per cent. Despite the recent increases, rates are still much lower than in 1981 or 1964.
  40. The two types of tenure "differ in that residential leases can be converted to non-residential use only by application to the Supreme Court and after payment of a 50 per cent betterment charge" (Neutze, 1989, p. 197). Neutze's article also contains an insightful analysis of the complex residential leasehold system in Stockholm, Sweden.

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