GOVERNMENT INTERVENTION IN HONOLULU'S LAND MARKET

by

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ABSTRACT

Honolulu's unique natural environment and history have fostered the development of unique land and housing market conditions. The distribution of land ownership is highly concentrated. A substantial portion of owner-occupants lease the land under their homes. Land and home prices are extremely high and homeownership is low.

These conditions have brought about equally unique state and local government intervention, with interesting results. There is a two-tier state and local government monopoly in zoning and permitting restrictions, which has contributed to the high prices of land and housing. There is a state land reform act based on the power of government to condemn land for a public purpose which has reduced the importance of the leasehold system. More recently, there are state and local government housing exactions programs which set housing prices and outputs in new subdivisions; these are not likely to succeed in decreasing the price of housing or increasing homeownership.
GOVERNMENT INTERVENTION IN HONOLULU'S LAND MARKET

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Honolulu's natural environment and history have fostered the development of unique land market conditions. These, in turn, have brought about equally unique state and local government intervention, with interesting results.

In Honolulu, Hawaii, the stated goals of government regarding urban land are similar in some ways, different in others, relative to those in urban areas on the United States mainland. The most noteworthy goals here are to modify the market's allocation of land to various uses and users so as to (1) enhance the natural and man-made environment, (2) economize on the provision of infrastructure, and (3) make housing and homeownership more accessible to households of moderate income. Although the effectiveness of government in achieving these goals is problematic, it is unlikely that the extent of and controversy surrounding government's intervention in the Honolulu land market are surpassed by any other U. S. urban area.

GOVERNMENT'S ROLE

The bounds of any land market are the same as the bounds of the contiguous urban area where people live and work. To understand government's involvement in this market, it is necessary to keep in mind the system of government in the U. S.. The typical urban land market is influenced by four distinct levels of government: the federal government, one of the 50 state governments, two or more
county governments, and a larger number of municipal (city) governments. The county and city governments are called "local".

An unbridled urban market can yield man-made "nuisances", "blight", and "sprawl". It can destroy common property resources such as the purity of air and water. One goal of U. S. governments at all levels has been to protect the natural and man-made environment from these tendencies. The primary means for achieving this goal has been restrictive zoning and permitting, almost exclusively by local governments. The Honolulu local government does likewise. What is more, it is joined by the Hawaii state government in the use of these means of market regulation.

In the U. S., local government is the planner and provider of urban infrastructure (roads, water, sewerage, flood control, etc.). The infrastructure not only uses land, it greatly influences the market's development of land over time and space. To economize on the provision of infrastructure, while ensuring that its services are adequate for the safety and welfare of the community, government at the local level has employed zoning and permitting to restrict development over time and space. In Honolulu, the state has joined the local government in exercising these controls over land use.

Of course, the market may provide less than the government thinks is adequate. A case in point is housing and homeownership. Since the end of World War II, one of the federal government's goals has been to promote housing consumption and especially widespread homeownership. It has done this through federal income tax subsidies. Although most state and local governments have not adopted this goal, the Hawaii and Honolulu governments have. We shall discuss the means employed below.

HONOLULU'S PHYSICAL UNIQUENESS

The city of Honolulu covers the entire island of Oahu; it is over 2000 miles from the U. S. mainland, and too far from other Hawaiian islands to make commuting between them feasible. It is a small island of only 380,000 acres; at no point can one be more than eight miles from the ocean. The island's visible shoreline and isolation
ensure a conscious awareness of the severe natural limits to land supply.

Rose\(^1\) provides an index that measures the extent to which water restricts the supply of urban land. The Honolulu land supply index is 0.47, meaning that due to the ocean's restriction, Honolulu has only 47 per cent of the land that would be available in an urban area unrestricted by bodies of water. There is also unusable mountainous terrain that the index does not account for.

In comparison, the mean index for the 40 most populous urban areas on the mainland is .87 (The lowest mainland index is 0.52 for San Francisco.) Because there is a negligible amount of unusable terrain in almost all of the mainland areas, we conclude that Honolulu has only half of the usable land that is available to the typical mainland area.

The physical beauty of all of the Hawaiian Islands is both spectacular and fragile. Since Hawaii became the 50th state in the United States in 1959, population growth and development of the land have been rapid. The Honolulu resident population has grown from under 500,000 in 1960 to almost 850,000 in 1989. The creation of the man-made environment has rapidly changed the face of Honolulu. Residents are not alone in wanting to ensure attractive development and to protect nature. They are joined by the tourism, the largest industry in the state, which is based on the physical beauty of the Islands. In 1989, state visitor expenditures of $10,907,000,000 relative to a gross state product of $23,960,000,000 are testimony to the physical attractiveness of the Islands and the political influence of an industry that recognizes the importance of maintaining an attractive environment.

THE DISTRIBUTION OF LAND OWNERSHIP

Land ownership in Honolulu is highly concentrated. One third of the land is owned by the federal, state and local governments. Most of the remaining land is held by three landlords. Both the extent of

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government ownership and the concentration of private ownership are unparalleled in the U. S..

This concentration has its roots in the nineteenth-century Hawaiian monarchy and Oahu's sugar plantation economy. Between 1845 and 1855 property rights in land were converted from a feudal land system into a system of alienable private property rights. Large blocks of land were retained by the king and the government, and foreigners bought large tracts of land for the young sugar plantations. Concentration of land ownership increased during the next 100 years as operators of large-scale plantations acquired government lands and small holdings from Native Hawaiians. Sugar industry consolidation after 1930 further concentrated land holdings. The number of plantations in Hawaii fell from 47 in 1930 to 25 in 1965 and 14 in 1985. In addition, the five firms which served as trading companies for plantations acquired majority holdings in virtually all sugar plantations during the Great Depression of the 1930s when sugar producers were unable to repay loans tendered to them by the trading companies.

Concentration also resulted from the large land holdings left by Princess Bernice Bishop, heir to many of the king's lands. Upon her death in 1887, her will mandated that the lands be held in a charitable trust, the income from which is dedicated to the education of Native Hawaiians at the Kamehameha Schools. Since her will specified that the trustees should refrain from selling the trust's land, the Bishop Estate was in 1964 the largest private landowner, owning almost 23 per cent of the private land on Oahu.

The table provides the most recent set of ownership and concentration statistics. In 1964, 68 per cent of the island was privately owned and 32 per cent publicly owned. The three largest private owners had almost 59 per cent of the privately held land. The state and federal governments each owned approximately 45 per cent of the public land and the local government had the remainder.

THE LEASEHOLD SYSTEM

One might think that the large migration of residents into Honolulu since World War II and its accompanying demand for residential land
ownership would have induced the landowners to sell some of their land to the new residents. Some landowners did sell, and homes were built on fee simple lots. However, the three largest owners leased large amounts of land to residential developers. Although this was partly due to legal obstacles to sale in the estates' trusts, the major impediment to sale was the potential federal tax liability attached to the sale proceeds. This potential liability varied with tax rule changes over the years, but at its peak, it would have been 90 per cent of the land sale proceeds. It would have become effective if the estates had made more than a few transactions annually. Thus, the large estates were locked into owning their land, and new homes were increasingly built on leased land.

This is how the leasehold system of homeownership came to exist alongside the standard fee simple homeownership. In 1940 there were probably less than 500 owner-occupied homes on leased land. The number of leasehold homes increased steadily until about 1980 when they numbered 35,278, or almost 34 per cent of the total number of owner occupied units.

Lease lengths typically have been set at 55 years with some leases containing options to renew for an additional 20 years to satisfy mortgage requirements. Land rent is usually specified as a constant monthly payment for the first 30 years with the rent for the next 25 years being determined by mutual agreement or appraisal. Most leases contain provisions that restrict lessees from making significant improvements without the consent of the lessor; and there are requirements that the lessee maintain the property to reasonable standards. A buyer of an existing single family home or condominium may assume the existing land lease. However, mortgagors will seldom issue a new mortgage on a unit located on leased land which is less than ten years from renegotiation or expiration. There is no other urban land market in the U. S. with anything approximating such a leasehold system.

HIGH PRICES AND LOW HOME OWNERSHIP

The prices of home sites and homes in Honolulu have been relatively high for as long as statistics permit comparison. In 1980, the mean
price of a residential lot was $8.60 per square foot.\(^2\) In comparison, in the 40 most populous U. S. urban areas, mean prices ranged from $.48 in Atlanta to $5.57 in San Diego, and averaged $1.73. In 1983, the median price of a single family home in Honolulu was $187,628;\(^3\) the corresponding figure in a sample of major U. S. urban areas was only $66,400. It should be noted that household income in Honolulu in these years is only slightly above the 40-area mean income.

Homeownership has also been relatively low in Honolulu. In 1980, only 50 per cent of the households were owner occupants. The corresponding figure on the mainland was approximately 70 per cent. Of course, the extent of ownership rights possessed by one-third of the Honolulu owner-occupants -- those on leased land -- was restricted by the provisions of the lease. Thus, in a sense, the rate of homeownership in Honolulu was substantially less than 50 per cent.

There are two fundamental reasons for Honolulu's extraordinarily high residential land prices and low homeownership. The first reason is that Honolulu has only half as much land as do typical urban areas on the mainland. The second reason is that government has the zoning (and permitting) power to severely restrict the amount of land in housing use.

**ZONING RESTRICTIONS ON HONOLULU DEVELOPMENT**

Hawaii's State Land Use Law, enacted in 1961, was the first such law in the nation. It established the State Land Use Commission which exercises zoning powers throughout the entire state. Hawaii is the only state with such widespread powers to regulate land use. Resort to these controls surely was due to the anticipation of growth in tourism and the resident population, and concern that


unbridled development would be unattractive as well as harmful to the natural beauty of the Islands.

The City and County of Honolulu also has zoning powers throughout the urban land market. It is unusual for an urban population the size of Honolulu's to be governed by a unified city and county government, and it is unheard of that a single local government has zoning jurisdiction throughout an urban land market. According to a 1980 count, the numbers of local governments with zoning powers in the 40 most populous urbanized areas of the U. S. ranged from two in Charlotte to 360 in New York, and averaged 72. In addition to zoning, there are numerous other means by which the local government controls, or denies permits for, development. There are subdivision and grading ordinances, a building code, and special permits required for shoreline developments.

Thus, government zoning (including permitting) power over the Honolulu urban land market can be characterized as a two-tier monopoly, with the state at one level and the local government at the other.

THE MONOPOLY ZONING THEORY

The monopoly zoning argument, as initially set forth by White, and elaborated by Hamilton and Fischel, begins with homeowners who seek to maximize their property value by persuading their local government to zone restrictively. By curtailing development and construction of new homes, restrictive zoning increases the prices of their homes. This strategy works best if a single zoning authority has jurisdiction over the entire urban land market. It could also work if a few separate jurisdictions were to collude effectively.


However, if there is a large number of small local governments, the strategy will probably not work because of the difficulty of coordinating zoning by the different governments.

One of many small local governments cannot, by restricting the number of homes in its jurisdiction by 50 per cent, have any significant effect on the supply of homes in the urban area. However, a monopoly government with jurisdiction throughout the urban area can, by the same zoning policy, curtail the urban area's supply of homes by 50 per cent, thereby substantially increasing their price. Thus, the extent to which the zoning strategy raises home prices is positively related to government's monopoly zoning power.

THE EFFECT OF SUPPLY RESTRICTIONS ON HONOLULU'S LAND PRICE

Rose\textsuperscript{7} tested the ability of these two variables -- natural land supply and monopoly zoning power -- to explain observed variation in residential land prices across the 40 major U. S. cities. The multiple regression analysis reveals that the two variables explain typical interurban price differentials of 40 per cent of the mean price. About three-fourths of this explanatory power is commonly due to natural restriction and one-fourth to contrived government monopoly zoning restriction.

Of course, Honolulu is an extreme outlier in the distribution of both of the land supply variables, so their effect on land price in Honolulu is surely much greater than could be demonstrated for the 40 area sample. Rose and LaCroix \textsuperscript{8} examined the ability of other (demand) variables to explain Honolulu's high land price, finding all other variables to be relatively unimportant.

There is plenty of anecdotal evidence about the effectiveness of the regulations in Honolulu. Developers incur costs of (1) applications for zoning changes, (2) studies required by the state and local


government agencies, (3) infrastructure to meet subdivision ordinances, and (4) project design changes mandated by the agencies. There are costs of project delay, as the amount of time required for approval is typically four to seven years. Some projects are delayed forever, for the obstacles to development are so great that some developers do not even apply for permits to build potentially economic developments. It is the two-tier zoning monopoly that makes these regulations effective.

THE EFFECT ON HOMEOWNERSHIP

The higher price of housing that results from its restricted supply implies a lower rate of homeownership. Consider the household's tenure decision. At housing market rents, prices and interest rates, many households are nearly indifferent as to whether to rent or buy housing. Their decision depends on the rent relative to the user cost of owning, where the user cost is (to keep things simple) the product of the interest rate and the price.

The housing supply restriction increases both the rent and the price, so that alone has no effect on the tenure decision. However, the higher price raises the level of lender risk for a home buyer with given income. This raises the effective interest rate to buyers, increasing the user cost of buying, and decreasing the percentage of households that own. The effective interest rate takes account of special charges on the mortgage contract, second as well as first mortgages, and interest rates imputable to agreements of sale. Of course, households well below the margin of indifference simply cannot obtain mortgage financing from the conventional lending institutions.

In sum, the natural restrictions and especially the government restrictions on land and housing supply have raised the price of land and housing. The higher price of housing has had two effects: it has reduced the extent of housing consumption by tenants and homeowners alike; and it has reduced the extent of homeownership.
LEASEHOLD REFORM

The high land prices and low homeownership invited another form of government intervention in Honolulu's land market. In 1967 the state government passed the Land Reform Act. This law enabled the owner occupants of single family dwellings in any leasehold subdivision tract to join in petitioning a state agency to assist them in obtaining the (fee title to the) land. The agency was empowered to condemn the tract, purchase the land from the lessor, and sell it to the lessee. The agency would be required to justly compensate the lessor, and charge the lessee the same amount.

Government condemnation of private land for public uses such as transportation route casements and slum clearance prior to urban renewal, always with payment of just compensation, has considerable precedent in U. S. federal and state courts. It is consistent with the U. S. Constitution. However, the state's powers of eminent domain do not extend to the taking of private land for a private purpose, whether justly compensated or not.

Bishop Estate filed suits in state and federal courts in 1969, arguing that the law attempted to legitimize condemnation for private use; the Estate argued that the law was unconstitutional because the land was to be transferred from one private owner to another with no change in land use. Finally in 1983, the U. S. Supreme Court upheld the constitutionality of the law.

JUSTIFICATION FOR THE LAW

There were two arguments for the law. The first begins with the purpose of reducing the price of land, presumably to increase consumption of housing. The high concentration of land ownership, i. e., the oligopolistic structure of the land market, was thought to be the obstacle to achievement of this goal. It was alleged that the few large estates were acting as a cartel to restrict the supply of land to housing use, to support a monopoly price. Redistributing the land would break up the cartel, and reduce the price of land.
Economic history has, in general, shown the ineffectiveness of cartels without government support. Coase\textsuperscript{9} notes the special difficulties that a cartel in land would have in maintaining a monopoly price. In Honolulu's case, Rose and LaCroix\textsuperscript{10} argue that any attempts of the large estates to collude were likely to be ineffective without government supervision and enforcement of the collusive agreements. We previously emphasized the importance of government's withholding land from housing use. A government monopoly, rather than a private cartel acting as a monopoly, is the primary explanation for the high price. The law has not lowered the price of land.

The second justification for the law is straightforward. A purpose of the law is to increase the extent of full homeownership. We earlier noted some of the property rights restrictions on leaseholders. In addition, we should note the opportunistic situations, and heightened tensions between landlords and tenants, that result at times of rent renegotiation and lease termination, due to the immovability of the lessee's improvements on the lessor's land. Widespread full homeownership was a goal in itself; in addition, it would eliminate these problems. By forcing transfer of the leased fee interest to the lessees, the law would clearly achieve this goal.

\textbf{WEALTH AND LAND DISTRIBUTION EFFECTS OF THE LAW}

The amount of compensation prescribed by the law was the capital value of the land (\textit{per se}, i.e., excluding any improvements) net of the present value of the lease rents over the remainder of the lease. This compensation was low relative to the open market price for two reasons. First, the lessor's offer price on the open market would be sufficiently high to pay the federal tax on the proceeds and, by investing the remainder, earn comparable income. Second, even if there were no tax, the open market price would reflect not only the capital value of the land, but also the present value of improvements to the land which would revert to the lessor at the termination of


\textsuperscript{10} Rose and LaCroix, "Urban Land Price".

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the lease. (Even though the lessee was legally entitled to remove the improvements, including the house, this was not generally feasible.)

The law enabled transfer of the land in such a way (viz., bulk condemnation) that the Internal Revenue Service agreed to forgive taxes, or to defer them indefinitely. This lowered the lessors' open market offer price very substantially. However, that price remained well above the capital value of the land per se. Thus, condemnation at court determined compensation, or the threat of condemnation leading to a negotiated price, resulted in a forced redistribution of wealth from lessors to lessees.

The first petition for condemnation was filed with the state in 1979. Long before this, the law began to take effect. Soon after the Act's passage, the two family estates with the most leasehold land, Campbell and Kaneohe Ranch, began to sell rather than lease land for residential use. They also began to sell the existing leasehold lots to homeowners. Today these two estates own a negligible amount of leased residential land. On the other hand, the charitable Bishop Estate has been unwilling to sell its leased fee interest except when there was a threat of condemnation, and has continued to lease new land for residential development.

The law has been effective in achieving the goal of fuller homeownership in spite of Bishop Estate's reluctance. In 1970 the number of leasehold homes (including condominium units to which the law did not apply) was 20,802. This number peaked at 35,278 in 1980, and decreased to 26,498 in 1990. During these 20 years, as the number of owner-occupied homes was increasing, the percentage that were leasehold increased from 30 per cent in 1970 to 34 per cent in 1980, and then decreased to 22 per cent in 1990.

The diminishing importance of the leasehold system in Honolulu is partly in response to other actions taken by the state government. In 1975, as a large number of leases were about to be renegotiated, the state amended the Land Reform Act of 1967. It passed a law applicable to existing leases that set a ceiling on renegotiated rents at four per cent of the fair market value of the land. It also required that at the termination of existing and future leases, the lessor pay
the lessee the fair market value of improvements. A court subsequently struck down the law's applicability to existing leases.

HOUSING EXACTIONS

Local and state governments have recently responded to the high housing prices and low homeownership rate by permitting certain subdivision developments on private and government land. The primary condition for the permit is the developer's promise to include in the project a substantial percentage of lower priced units for sale to households of moderate income. (There is also sometimes a requirement for a smaller amount of rental housing.) These projects are spared the uncertain and lengthy zoning variance and permitting process. That is why the government is able to exact its desired type of housing.

Such housing exactions programs, sometimes called inclusionary zoning programs, have been adopted by a few local governments on the mainland, but not on the scale practised in Honolulu.

The characteristics of each development are determined jointly by the government and developer. The government is involved in both the physical planning and the pricing of the lower priced units. These prices are supposed to be within the reach of households eligible to buy. The government segregates the market into households with different incomes, and gives some households with moderate income access to the exacted housing.

The stated purposes of the housing exactions program are to reduce the price of housing and increase homeownership for a selected group of households. Unfortunately it is likely to increase the average price of housing and reduce the rate of homeownership for all households taken together. This is partly because the program replaces the market system, with its incentives to produce at least cost what consumers demand, with a bureaucratic system that lacks such incentives. Because the costs of production rise, the housing stock must shrink, and the price of the product must rise.

In the long run, it is unlikely that the exactions program will even change substantially the mix of dwelling sizes or qualities. There
are two reasons for this. First, the program fails to affect the basic determinants of the market-demanded housing mix, such as the distributions of household income and size. Second, there is massive "filtering" by owners of both exacted units and the much larger number of nonexacted units. Filtering is the process by which unit owners change the size and quality of their units, through depreciation and improvement. Their response to the exactions program is to filter their units away from the size and quality of the exacted units, so as to restore the market-demanded mix. This works against the creation of a housing stock with a larger proportion of smaller, lower quality units.

CONCLUSION

In summary, Hawaii's fragile beauty, along with its potential for tourism and residential population growth, invited strong state government intervention in the land market to maintain environmental standards. This, along with the unified, island-wide local government, resulted in a unique two-tier zoning monopoly, which further restricted the naturally small supply of land for housing. This, in turn, increased the price of land and housing to extraordinary levels, reducing housing consumption and homeownership.

The Hawaiian monarchy and plantation economy left modern Honolulu with a high concentration of land ownership. Federal tax laws tended to "lock" the landlords into leasing, rather than selling their land for housing use. The resulting leasehold system invited government condemnation as the means of more widely distributing the land. While the Land Reform Act has begun to decrease the importance of the leasehold system and increase the extent of full homeownership, it has not achieved its other purpose of decreasing the price of land and housing. In an attempt to achieve the latter purpose, the state and local governments have adopted large scale housing exactions programs.

The leasehold issue is not dead, particularly with respect to condominiums. In 1987 there were 25,203 owner occupied condominium units in Honolulu, which is 22 per cent of all owner occupied units. Almost 65 per cent of these condominium units are
on leased land. Bishop Estate is the lessor for 15-20 per cent of the units, but the remainder of the land under the condominiums is owned by many small landlords. At the (spring)1991 legislative session, three bills were introduced to force the transfer of leased fee interest from lessor to lessee. This induced Bishop Estate in August to place some of its condominium leased fee interests on the market. A new "land reform act" for condominiums may pass next year.

We applaud the rapid dismantling of the leasehold system, although we seriously question the wisdom of the court's extension of the applicability of "public purpose", and the means by which the land was redistributed, for these undermine the private property system. We favor strict zoning to protect the fragile environment, and to economize on the provision and usage of infrastructure. However, we eschew the government's exactions program, including its heavy involvement in planning the pricing and output in new housing subdivisions. This task should be left to the market, and facilitated by government's freer dispensation of permits to develop where the environment will be least harmed. Although government has an important role to play in protecting Honolulu's natural environment, it should not be promoting homeownership through usurping the traditional role of developers. Appropriate government intervention in the land market has its limits.
## CONCENTRATION OF LAND OWNERSHIP ON OAHU, 1964

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