

## THE SECRET THAT ELUDES THE WEST

*Ronald Banks is working with officials in Syktyvkar, capital of resource-rich Komi - the republic recently devastated by a massive oil spillage - to change the tax system. The Mayor has secured permission from the republic to implement the reform. In this essay, Mr. Banks outlines the case for transforming the Russian economy.*

**O**UR PROPOSALS would lead to the reduction and eventual abolition of taxation and the collection of the rent of land for the purposes of public revenue.

The economic basis underlying these proposals is described in the economic literature of the great classical economists in the 18th, 19th and 20th centuries. It was recently endorsed by 30 economists, including three Nobel Prize winners, in a letter to the Russian president in 1992.

Russia already has empirical evidence of the harm that heavy taxation does to the economy. In the West, economists have analysed the effects of taxation and their conclusions match the empirical evidence of Russia. One economist concluded that when taxation exceeded 25% of the nation's product, inflation necessarily followed, increasing sharply as the percentage rose well above 25%.

In addition to being one of the prime causes of inflation, taxation's main effect is to impede production. The taxation of profits, incomes and spending depresses economic activity, penalises private enterprise and impoverishes the population. The poverty which results then requires greater public expenditure and, therefore, higher taxes, which result in more poverty. This vicious circle can be seen in most Western economies at

the present time.

TAXATION distorts the economy, but specific taxes have specific consequences. Payroll taxes and other taxes on incomes increase unemployment. Investment in capital is adversely affected by profits taxes, while consumption, and therefore production, is harmed by spending taxes such as VAT.

But although taxation is harmful, public revenue is necessary to pay for the infrastructure within the economy and for the protection and social requirements of citizens. And yet, among most economists and politicians in the West, there is no perceived alternative to taxation as the basis for public revenue, despite the recognition that there exists a particular factor which could provide public revenue without economic distortions.

This factor is variously labelled as land, location or site. Its importance derives from its value or rent. In a market-based economy, rent represents the payment people are prepared to make to enjoy the benefits of occupying, exclusively and securely, a particular location, the benefits of which would include public services, trading position and proximity to population.

• A letter to the President of

Russia from 30 economists makes it clear that the flow of income from rent should not be allowed to be appropriated by the private sector but, instead, should be retained as public revenue.\*

• One Nobel-winning economist, Professor Milton Friedman, states: 'In my opinion, the least bad tax is the property tax on the unimproved value of land, the Henry George argument of many, many years ago.'

• Professor Martin Feldstein, economic adviser to President Reagan, also agrees: 'One of the reasons that economists have long been interested in the tax on pure rental income is that it is a tax without excess burden. Because the owners of land cannot alter the supply of land, the tax induces no distortions and therefore no welfare loss.'

• Professor Bela Belassa of the World Bank urged Red China to adopt a tax on land values as a necessary part of its new economic strategy.

The 18th century economist, Adam Smith, said it very clearly: 'Land is peculiarly suitable for taxation, since such a tax falls on an economic surplus and cannot be

\* See Richard Noyes, *Now the Synthesis*, London: Shephard-Walwyn, 1991.

passed on to consumers in the price of goods.'

In the 20th century economic thought divided into two schools. The 'demand side' school emphasised full employment. The 'supply side' school emphasised monetary targets and the need to curb inflation. Each school was looking at one side of the coin only and economic policy alternated between them, with the result that western economies did not achieve the level of success possible.

THE CAUSE of error in much economic policy-making stems from the confused definition of taxation.

Western Governments use taxation as the main source of public revenue, a system which is based on taxing private endeavour. Whether income tax, sales taxes, social security taxes, profits or payroll taxes - they all fall on private enterprise and act as disincentives in the economy. In addition, the payment of taxes bears no relationship to the benefits received. They are an indiscriminate charge on private endeavour.

The payment of rent, on the other hand, is a payment which reflects, precisely, the benefits received. It is a contradiction to speak of rent and taxation in the same terms. In the quotations above, it is important to keep in mind their approval of rent as the source of public revenue, but dismiss from the mind their use of the term 'tax'.

Rent arises from public value, which itself arises from the growth of communities; their congregation around chosen locations; improvements in the arts, sciences, technology, and methods of production; economic growth and the provision of public services including roads, lighting, parks, bridges, water provision and sewerage, law and order, health and social services.

Location values are public values. Not everyone can occupy the best locations, but everyone can benefit equally from this public value. Rental payments should provide the revenue required for public expenditure and, in this way, every citizen

shares in the value of all locations, including the very best ones, and every citizen paying rent receives a benefit equal to his payment.

UNFORTUNATELY, Western governments not only use a system of taxation which penalises private endeavour and depresses economic activity. They also leave land rent largely in private hands, enabling just a relatively few people to benefit from increases in public value. The gains for these few are so vast that the land market, and the financial mechanisms which complement it, is one of the largest sectors of the economy in the West.

Economically, the weaknesses in this system - the depression of economic activity - are compounded by an inordinate interest in the land market. This leads to speculation, a wide-ranging banking structure to support and finance the speculation, and the creation of 'boom and slump' conditions on a regular basis. Empirically, countries such as the United Kingdom, the U.S.A. and Japan, where land speculation is greatest, experience the worst of these 'booms and slumps'. To these countries can now be added China, whose southern region is experiencing one of the worst land market cycles in the world.

The Organisation for Economic Co-operation and Development (OECD) studied the impact of the land market and listed the problems that stem from the West's system of property rights and taxation. This list is given in *Urban Land Markets: Policies for the 1990s* (Paris, OECD, 1992, p.15):

'Excessively high and rising land prices are a significant concern for most of the OECD countries. They often occur in markets which have overheated concomitantly with economic success. Some of the criticisms levelled against very high land prices are the following: they impede the purchase of land for needed public purposes, especially infrastructure; they encourage urban sprawl in peripheral land where prices are lower; they lead to overly extensive use of

land, resulting in negative environmental impacts; they induce monostructures of highrise central office buildings which crowd out residential and other land uses more sensitive to high prices; they have negative distributional effects by increasing the price of housing; and finally, they contribute to speculation and hoarding and de-stabilise land markets.'

The 'cure' for these conditions by Western governments is extremely painful for the people. During the height of the 'boom', inflation usually gets out of hand and high interest rates are imposed to 'squeeze' the inflation out of the system. This then leads to lower economic activity and higher unemployment. During the 'slump' which follows, revenue from taxation is lower, leading to a rise in taxation or cuts in public services (or a combination of both). This causes a deterioration in the capacity of society to meet the needs of its most vulnerable citizens. Despite the 'booms and slumps', the value of land, over as short a period as ten to twelve years, rises inexorably, the benefits largely accruing to the private sector.

RUSSIA has a clear choice. The 'land' phenomenon can be either a de-stabilising influence on the economy if rent is placed in the private sector, producing riches for the few, poverty for the many. OR, land rent can be used as the basis for public revenue, with little or no taxation, and provide Russia with the opportunity to plan not just for the short term, but to put down roots for sustainable growth.

The additional economic consequences of the system of public finance we are proposing are wide-ranging.

The most notable of the general consequences is the change in the dynamics of the economy. Instead of the unproductive activity of land speculation and its financing, effort is directed towards productive operations. Likewise, finance and investment are encouraged to build real capital and employment, and is not wasted on unproductive, although

personally profitable, land investment. The economy is revitalised in a way that encourages the allocation of land and capital to people who wish to create jobs and raise the levels of productivity.

Taxation in general depresses economic activity, but each individual tax has its unique effect. The corollary is that the reduction or abolition of a specific tax has its own consequences.

The increase of consumption follows both the reduction of income tax or spending taxes. The real value of the wages of workers is increased by the abolition or reduction of both these taxes. Income tax abolition has the extra effect of increasing productivity and enterprise as workers are able to keep the extra they earn by working harder, longer or better. In all, people will have more spending power which will lead to higher productivity as that spending power is satisfied, largely from the creation of thriving small enterprises, which will be labour intensive, leading to higher employment. This will have the added effect of facilitating redeployment from inefficient State enterprises. The dynamics of these tax reductions also include the nurturing of competition and the learning of the disciplines of the market economy.

The abolition of the profits tax would stimulate the use of withheld profits into capital investment and research and development. These areas are vital if Russia is to compete successfully in world markets.

One of the most pernicious of taxes is the 'payroll' tax, which has a devastating effect on employment. This tax can also have a cumulative effect at every level of manufacture, distribution and marketing. This can have a large effect on the selling prices of goods and result in demands for higher wages. This type of taxation has been a major cause of economic pressures that have led to unemployment and spiralling inflation in Western economies.

Since this tax in Russia is used to create funds for the welfare of the old and the sick, an alternative would be

to finance the funds from a rental charge on the vast natural mineral wealth of Russia. Professor Dmitry Lvov of the C.E.M.I. research institute in Moscow estimates that a rental charge on natural resources would create sufficient revenue to take care of the welfare of the sick, old and unemployed.

THE TAXES mentioned above (income tax, VAT, profits tax and 'payroll' tax), all enter into prices. Their abolition would give Russian exporters a price advantage in world markets, thus encouraging inward foreign investment.

But there are some taxes we would recommend retaining, such as those taxes relating to health (for example, duties on tobacco and alcohol). Although revenue is gained from these taxes, their main function would be to limit health risks.

Abolition of taxation has one other advantage which in present-day Russia is important. The figures on which taxation is based are easily 'massaged' to maximise tax evasion. So much can be hidden. On the other hand, the collection of public revenue from the rent of land gives no opportunity for evasion of rental payments. Land cannot be hidden. The assessment of the rental values of locations, if our Code of Principles and Practice is applied, would be seen by all to be certain, open, fair and just. Cheating, bribery and corruption could not exist.

THERE ARE other positive economic advantages to be gained from the collection of land rent.

Land use efficiency is a vital ingredient in any economy. Full payment for the rent of land ensures that the most valuable sites are used by those enterprises most suited to use them best. In putting these proposals to work, it is necessary to put land to good use. At the beginning, there should be easy access to land sites with, perhaps, a low or zero rental payment at first. This stimulates the use of land, awakening the economy as people become self-employed entrepreneurs. The use of such land sites

on these favourable terms, however, must be accompanied by the recognition that the full rental value should be paid after a specific period. Without this recognition, there is the likelihood that private interests in land will gather hold and a landed class will develop.

Pollution is another area where land rent collection has an economic consequence. Pollution is not just a health hazard. Ugly industrial buildings in the middle of a good residential or commercial area are not just an inconvenience; they destroy public value. When buildings and enterprises are not appropriately located, not only does the economy suffer, but there is massive loss to public revenue. For example, when carrying out a land valuation in a pleasant residential area which has an ugly, polluting industrial site in its midst, the value of all the residential sites is assessed lower than it would be without that industrial site.

This is a problem most Russian cities will face over the next few years. However, the free market, incorporating the collection of land rent on an annual basis, can bring about the pressures which will begin the process of solution in a reasonably short period of time.

For example, the polluting industrial site is valued in the normal way, taking into account the maximum permissible development for the site, the quality of the surrounding area and adjoining properties, the availability of public services, etc. The land rental to be charged to the industrial occupier may be higher than he can afford. Furthermore - and consistent with our principles - the site values of all the adjoining properties are assessed, both with the industrial site in place and then without it. The difference between the two assessments represents a destruction of public value, a loss to public revenue, and should be added to the rental charge on the industrial site which is causing that loss. This financial pressure would encourage the industrial enterprise to move to a cheaper, more appropriate site.

However, public finance should be available to help industrial enterprises to re-locate. It is probably not their fault that they are in the wrong place. The public authority should offer to help the re-location with grants or subsidies. Discounts on rental payments should not be offered; these are not easily quantifiable in a fast-growing economy and they could give rise to profiteering from land speculation.

These grants or subsidies are not a complete loss to the community, because a valuable site has been released and can be re-developed to its full potential. This ensures that maximum public revenue is collected from the occupiers of the development.

ONE FURTHER point needs to be understood. This is clearly stated in economic literature but ignored by Western governments.

The size of land rents (in aggregate and for particular sites) is determined, in part, by the level of taxation on the incomes of labour and capital. Taxes on these incomes have the effect of reducing the rent available for collection in the land market. So, high taxes on profits and wages means lower rents. The corollary is also true; the greater the reduction in taxation, the greater will be the rents that people would be willing to pay for exclusive occupation of land sites.

Russia, in reducing taxation and collecting the rent of land, should also reduce the size of the public sector by allowing the market to provide goods and services which, at present, are provided publicly. The obvious examples are water, electricity and the telephone, where people should be charged on the basis of their use of these services, which would discourage waste.

FROM THE standpoint of economic analysis, where land rent is seen as deriving from public value, it is clear that the contributions to public value come from different aspects of society.

The general contributions, such as growth of communities, growth of

knowledge and trade, etc., are difficult to quantify. However, it is important to develop an understanding of the relative importance of the contributions from the different levels of administration which provide public services.

The highest level of administration, the Federal Government, provides for the nation's defence and safety, law and order, much of social welfare, and even the national routes for rail and road. These services contribute to public value and, therefore, to the rent of land. Financing them should, therefore, be out of land rent.

Likewise, the regional and local administrations are responsible for public services, which should be provided on the basis of 'what is best done locally should be done locally and what is best done regionally should be done regionally'. These services contribute to public value and should be financed out of the collection of land rent. The actual sharing out of the land rent is a task to be negotiated among the various levels of administration.

THE ECONOMIC case for Russia is supported by ethical and social considerations. Our proposals recognise that land and natural resources are a

gift to humanity and no-one has the right to dispossess another of their equal right. Our proposals, fully implemented, would deny the possibility of anyone monopolising land and natural resources.

As Winston Churchill, the former British Prime Minister, once said: 'It is quite true that land monopoly is not the only monopoly which exists, but it is by far the greatest of monopolies - it is a perpetual monopoly, and it is the mother of all other forms of monopoly.'

Our proposals accord well with the concepts of social and natural justice. They are fair and just! To achieve optimum economic results, it is necessary to resolve the apparent conflicts between the strengths of the market economy and the welfare needs of society. What we propose for Russia does just that - Russia's 'third way' between the market economies of the West and the command economy.

The basic economic formula - the private market for goods and services, coupled with individual possession and use of land, but with socialised rent - is the secret to full employment, prosperity and natural justice. That 'secret' has eluded the West.

### The Missing Clause in the Bill of Rights - Land for the People

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