

## ■ CHAPTER TWO

# *Theory and Principles of Land Value Taxation*

**T**his chapter summarises the economic and moral thinking that argues the case for land value taxation, dealing first with economic theory and then with the moral aspects and principles that emerge from that discussion, with a focus on the influence of Henry George.

### **Principles of General Taxation**

Before pursuing the economic background of LVT, however, let us first take a brief look at some of the established principles of general taxation. Here we are reminded that, in examining any tax-raising proposal, it is almost traditional to revisit the precepts of one of the early founders of those principles.

Adam Smith (1776) first systematised the rules that should govern a rational system of taxation, and Stanlake summarised these rules as follows:

Taxes should be based on the individual's ability to pay in that there must be equality of sacrifice—as instanced by progressive taxes, certainty with knowledge of how much tax, when and how it must be paid and not be subject to arbitrary demands, convenience in collection as to form and timing, and economy in that costs of collection should be small in relation to the total revenue. (1989, 433)

Smith describes these maxims as having “evident justice and utility.” So they may have, but the fact was insufficiently appreciated in Smith's time (Raphael 1985, 83). However, the ability to pay was viewed by Smith as conditional on income *actually being received* (“revenue which they respectively enjoy”), rather than potential income that could be imputed to the possession of a revenue-yielding resource (Harrison 1983, 28). This point has later important implications in deriving a workable methodology for land value taxation, as we shall see in Chapters 9 and 10.

Before moving on from the initial precepts of Smith, it is pertinent to this review that modern criteria of tax systems also include revenue productivity and considerations of social justice. As submitted in the *Encyclopaedia Britannica*,

a tax system should provide adequate revenues to cover government expenditures and should be capable of producing more on short notice when circumstances require (1997, vol. 11, 584). Conceptions of social justice may require, in addition, that taxes be more or less progressively redistributive of income, wealth or both. Furthermore, as governments have come to play a larger part in controlling their national economies, taxes have been used to moderate cyclical economic fluctuations, to promote a higher level of economic activity, and to affect the application of economic resources. All these factors have implications in our subsequent examination of LVT.

### **Economic Theory: Why Tax Land?**

The main form of extant property tax around the world is based on a combination of land, buildings and improvements thereon, so let us now focus on land itself as a particular source of taxation and on the fundamental question: Why tax land?

The answer to this question has been heavily explored in economic theory over the last two centuries. As Prest (1981, 8) indicates, such a tax was favoured by the Physiocrats, a group of economic thinkers, in eighteenth-century France on the grounds that only in agriculture does a country have a surplus *and* source of wealth, so that there is a case for levying an *impôt unique*<sup>1</sup> on land rents. As we shall examine later, the Physiocrats in essence set out to exhibit the way that products of agriculture (then considered the primary source of wealth) would, in a state of perfect liberty, be distributed among different classes of the community (Robinson 1991, 6).

Following this stimulus, the topic was explored, for both rural and urban land, by an array of other classical economists including Smith, David Ricardo, John Stuart Mill, Alfred Marshall, Arthur Pigou and Henry George. On the whole, theories are consistently in favour of taxing land, but there are important variations. The total view can be briefly summarised here by referring to the historical analysis of the Simes Committee of Enquiry (1952, 6) in its report *The Rating of Site Values* for the British government. (The committee's findings are discussed in Chapter 5.)

It is worth emphasising that the Simes Committee was considering the taxation of site (land) values, ignoring the value of any improvements such as buildings, fences or crops: the land valued as a bare site available for development in accordance with its situation and other physical characteristics but subject to the extant system of planning control (Clarke 1965). The committee concluded

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1. Or *impôt inique*, as described by Voltaire.

that the case for taxation of economic rent<sup>2</sup> arising from site (land) values rests upon the following propositions:

- that it is unearned income, brought into existence not by anything that the owner, as such, has done but by the activities of the community generally;
- that a tax on it does not curtail the supply of goods and services and raise their price as many other taxes do; and
- that, in particular, it is a means of relieving the burden imposed by rates (extant property taxes in Britain) as presently levied upon dwelling houses, shops and other buildings and improvements to land.

From these propositions the Simes Committee concluded that there might therefore be a *prima facie* case for a tax on such economic rent as a source of local revenue. As already indicated, such a case for accruing increased values in land to the community rather than to landowners relies partly on the argument that it is public expenditure on supporting infrastructure that is a primary cause of such increases. Consequently, those public efforts should be recognised in a form of taxation redress to the community.

### **LVT and Economic Rent**

The fact that the total supply of land in a country is fixed, and the view that the income derived from the ownership of raw land is a kind of “unearned” surplus, continues to lend support for measures to tax economic rent. As Stanlake points out, in many countries, expanding populations and rising incomes have increased the demand for land, and landowners have benefited from rising land prices, although they may have contributed little or nothing to the increase in the value of their land. Furthermore, “the main attraction of a tax on economic rent is the arguable case that the whole of the tax would fall on the landlords” (Stanlake 1989, 284).

Kay and King also indicate that one of the oldest ideas in public finance is that there are advantages in basing tax on economic rent. Most people are familiar with what is meant by the rent of land or buildings, but the concept of rent in economics has a specific technical meaning: it is the amount that a factor of production earns over and above what it could earn in its next best use. They conclude that “therefore rent is the result of the scarcity of particular factors of production and therefore rent could be taxed, or otherwise reduced, without any economic distortion arising” (Kay and King 1990, 177).

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2. Pareto defined economic rent as “a payment over and above what is necessary to keep it in its present employment” (Whitehead 1992, 200), but see also the later sections in this chapter.

Starting from the basic premise that the best price (i.e., rent) one could get for land would be determined by demand and supply, Whitehead then develops the argument, previously cited, by examining the effect of taxation on economic rents when a factor is in inelastic supply, as in the instance of land. He maintains that the landlord owners are able to command economic rents and that imposing the tax will not cause any change in demand or supply. The tax will have to be borne entirely by the supplier (the landlords) and will reduce the benefits being enjoyed hitherto, and consequently, “landowners earning economic rents cannot alter their position, which is already the most profitable one, and the tax will simply cream off their profits” (Whitehead 1992, 413).

Whitehead’s argument supports the view that a tax on land values cannot increase the market price<sup>3</sup>—the tax must fall on the landowners and must, therefore, reduce the revenue they receive as landlords—but he also points out that “economic rent is not unique to land; it accrues to any factor, which is fixed in supply and faces an increasing demand” (Whitehead 1992, 414). The differentiation appears to hinge on whether these other factors can generally be increased in supply over time as contrasted with the comparatively finite nature of land supply. If supply can, over time, respond to increasing demand, then this must reduce the economic rent element. But, as we have already seen, this is difficult to achieve with the supply of land.

### **Arguments for LVT**

The various arguments put forward to support land value taxation are succinctly enumerated in the *Encyclopaedia Britannica* (1997, vol. 28, 416), particularly the argument that much of what is paid for the use of land reflects socially created demand and is not a payment to bring land into existence. The community can capture in land taxes some of the values it has created, including those resulting from streets, schools and other facilities. This, it is maintained, would be a more equitable way of financing local government. Another argument is that the revenue from a tax on land would permit reducing taxes on buildings, which tend to deter new construction. A third argument is that higher land taxes would make for a more efficient use of land.

These arguments are developed on the supposition that a heavier tax would also change the conditions of ownership. The total collected from users would not change, but private owners of land would retain less and the public treasury more. The price system would still affect land use, subject to planning control. Taxes on improvements could then be reduced greatly. The tax relief on dilapidated buildings would be slight, but for high-quality buildings the reduction could be large relative to net return on investment. More buildings, new and

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3. Although the market price may well decrease over time by a process of capitalisation of the tax.

better ones, would be supplied. Modernisation and maintenance of existing buildings would become more profitable. Thus, in the long run, it is argued, landowners would receive less of the increments in land values and the public would receive more. Socially created values would then be channelled into governmental rather than private uses. Taxes could be related more closely to the cost of governmental services.

However, as Prest (1981, 11) indicates, there are contrary views. Opponents of LVT point out that the unearned increment in land value has been capitalised in the purchase price, and they question the fairness of imposing a heavy tax on present land values for which owners have paid in good faith. They doubt the ability of assessors to make fair enough appraisals to support much heavier taxes on land. They also doubt that land alone, excluding buildings, would be an adequate tax base. Feldstein (1977) argues that not the whole of the land tax burden falls on landowners nor do relative outputs remain unchanged, thus expressing some doubt on the traditional neutrality of land taxation with respect to resource allocation. In turn, there are counterarguments to these views, as will emerge in later chapters.

### **Combining Economic and Moral Rationales**

As noted earlier, there exists a relationship between classical economic thought and the moral aspects of land taxation. We now look more closely at these influences.

The ethical arguments concerning the ownership and rights over land were pronounced in the eighteenth century onwards, when the French Physiocrats began to articulate the economic and moral rationales for land taxation. Land had been a recognisable target for tax gatherers since ancient times, but more modern taxation rationales were developed from the thinking of the Physiocrats and refined by such exponents as Smith, Ricardo, Mill, Marshall and Pigou. Henry George, with his plea for a single tax on land as a panacea for all economic and fiscal problems, made the biggest impact in the nineteenth century, and despite peer criticism and academic strictures, his influence remains today. We now turn again to these influential thinkers in more detail.

The Physiocrats were founded by François Quesnay (1694–1774), court physician to Madame Pompadour and Louis XV, but his followers preferred to be known as *economistes*. However, as further explained in the *Encyclopaedia Britannica* (1997, vol. 9, 414), the term *physiocrats* became current only in the nineteenth century, and this school of *economistes* was characterised chiefly by a belief that government policy should not interfere with the operation of natural economic laws. Generally regarded as the first scientific school of economics, it considered land as being the source of all wealth. Physiocrats, emphasising the role of nature, envisaged a society in which natural economic and moral laws would have full play and in which positive law would be in harmony with

natural law. They pictured a predominantly agricultural society and therefore attacked mercantilism. Given their assumptions and the social system they desired, the Physiocrats were logical and systematic. They rationalised medieval economic ideals, employing to that end the more modern philosophical and scientific methods. As to practical outcomes, a land tax was established by the French Revolutionary Constituent Assembly in December 1790, which also followed Physiocratic concepts, but it eventually foundered.

Adam Smith (1723–1790) distinguished the varying types of taxes on land and traced out their differing effects. He also set in motion the train of reasoning about the taxation of urban land rents, saying, “ground-rents, and the ordinary rent of land, are therefore, perhaps, the species of revenue which can best bear to have a peculiar tax imposed upon them” (Smith 1776, 843–844).

Prest summarises Smith’s arguments as follows:

- Taxes on urban land rents are neutral in their resource allocation effects.
- It is fair to tax away surpluses that are more due to extraneous circumstances than to individual efforts.
- People should pay for government actions and services, which are to their advantage. (Prest 1981, 9)

However, Smith would not accept the solution that a tax levied on the market value of *all* land would constitute a continuous pressure on the possessors and would induce those who possessed land to play the game of competition and cooperation. It is true that Smith regarded land as “peculiarly” suitable for taxation, since such a tax falls on an economic surplus and could not be passed on to consumers in the price of goods. But he resisted the application of the tax on the value of *all* land. In fact, he explicitly opposed a tax on the rental income that could be imputed to idle land (Harrison 1983, 28–29).

David Ricardo (1772–1823) is generally attributed with formulating the law of rent. He argued that the rent of land is determined by the excess of its produce over that which in the same application can be secured from the least productive land in use. Ricardo also supported a tax on rent and bolstered the idea of a single tax on land (Robinson 1991, 7).

But Prest (1981, 910) makes the point that, although no one can fail to recognise the immensity of Ricardo’s intellectual achievement in isolating the concept of economic rent and attaching it to “the original and indestructible powers of the soil” (Ricardo 1951, 67), his contribution to the subject of urban land taxation is relatively limited. In his comments on Smith, Ricardo was content to say, “The effect of these taxes [on ground-rents and the ordinary rent of land] would be much as Adam Smith has described” (Ricardo 1951, 204). Furthermore, having developed the concept of intensive and extensive margins of cultivation with rural land, Ricardo did not apply them in the context of urban land.

It used to be common practice, following Ricardo, to define land as “the original and inexhaustible powers of the soil,” but, as noted by Lipsey (1989, 286), Ricardo wrote before it was widely known that many present-day deserts had once been fertile areas. Lipsey also writes that, in his famous argument, Ricardo maintained that the rent of corn land was high because the price of corn was high and not vice versa (1989, 300–301). Lipsey points out that modern students of economics will recognise in the Ricardian argument the idea of *derived demand*. Given the fixed supply of land, its price depended on the demand for land, which was itself a function of the price of corn. Rent, which originally referred to the payment for the use of land, thus became the term for a surplus payment to a factor over and above what was necessary to keep it in its present use. The concept of economic rent, the surplus of total earnings over transfer earnings, is analogous to the modern economists’ concept of profit as a surplus over opportunity cost.

In a further explanation of the concept of economic rent, Stanlake (1989, 280) emphasises that the essence of Ricardo’s theory is that the supply of land, unlike the supply of capital and labour, cannot change in response to a change in demand. Land has no supply price. The amount available does not depend on the market price; higher prices do not lead to larger quantities being supplied, and falling prices do not reduce the actual supply. The *supply price* of a factor may be defined as the minimum reward necessary to retain a factor in its current employment. Any payment to a factor of production that is greater than its supply price is a kind of surplus, and it is this surplus that is known as economic rent.

But Stanlake also reiterates the argument that most land can be put to different uses and that the “supply of land for any one use is not fixed” (1989, 280). Removing the assumptions does not invalidate the idea of economic rent as a surplus, but modern economists maintain that this concept can be applied to other factors of production besides land. Whenever a factor is earning more than its supply price, it is receiving a part of its income in the form of economic rent; this happens when demand increases and the supply cannot fully and readily respond to the increased demand. But this does not recognise the unique feature of land: with minor exceptions (e.g., tall buildings or coastal reclamations), the increased demand cannot create an increased supply.

In summary then, and in consideration of the concept of attributing value to land, for a factor of production to have a cash value it must have utility, be capable of ownership and be limited in supply. Turner (1977, 1) again illustrates these principles with respect to land by looking at Ricardo’s theory of rent, but with a specific proviso. The economist usually uses the word *rent* to refer to *economic rent*, the surplus earned by a factor of production over the minimum necessary to bring it into production. But using the legal definition of land as real property and including buildings and other improvements that the economist would

regard as capital rather than land, the income received from the land in the form of *contract* rent will include elements of interest, or return on capital.

John Stuart Mill (1806–1873) declared that rents were “created by circumstances” and justifiably could have been expropriated from the time of Adam and Eve onwards. However, Mill saw two obstacles to taxing rents at an extreme rate. First, it is not always easy to distinguish between the elements of current values, due to private endeavour and “circumstances.” Second, the present owners of land may be not the people who have drawn rents over the centuries but recent purchasers, who bought at market values based on expectations of future rent levels free from confiscatory taxation. A third obstacle is that there are many other cases where people may enjoy monopoly-type surpluses, and, as Prest concludes, “it is hard to see the equity case for taxing one lot of monopoly rents specially without taxing as many of the others as one can” (1981, 28).

Mill’s solution was to ascertain the present value of all land, urban and rural; thereafter, all future increments in value could be safely taxed at a high rate, unless it could be shown that they were specifically due to the endeavour of individuals. In other words, the principle was to tax unexpected windfalls in land values. In the end, a land tax could be thought of as a public rent-charge or a substitute for the state’s retaining part of the land (Prest 1981, 12).

Alfred Marshall (1842–1924) also contributed to the theory of urban rents by demonstrating that Ricardo’s notion of intensive and extensive margins of cultivation to agricultural land could also be applied as a principle to urban land. Urban site values, like agricultural land values, were determined by demand levels, and for Marshall, as for Ricardo, land was distinct from all other agents of production because of its long-term fixity of supply and because the whole of the return on it was a surplus. Marshall argued that taxing site value was analogous to taxing monopoly profits in that there was surplus, which could be tapped without any deleterious effects on resource allocation. Taxes on site values would reduce these excess profits of owners, but that would be all.

From this analysis, Prest (1981, 16) concludes that Marshall distinguished three different solutions. First, the state should buy land plus buildings at full market price. Second, the state should purchase the inherent value of the soil. Third, all land should become state property 100 years hence—a plan Marshall deemed to be less objectionable than the others.

Arthur Pigou (1877–1959) in 1909 made a clear distinction between taxes on the public value of land (i.e., LVT as an annual tax) and taxes on windfalls (i.e., unexpected increments in land values), and he declared himself in favour of both taxes, arguing from both economic theory and practical experience in other countries. In the case of site value taxes, the main theoretical plank was their neutrality from a resource-allocation standpoint, essentially along the lines of Ricardian rent theory. The case for taxes on windfall increments was held to be



similar to that for wartime excess profits taxation: if increments arose that were neither foreseen nor due to the recipient's effort, they were ideal objects of taxation from a resource allocation viewpoint, and they were also likely to be distributionally commendable.

Prest sums this up rather neatly in his assessment of Pigou's distinctive approach: "[It seems] fair to summarize Pigou's position as being a synthesis of Marshall and J. S. Mill in that he could claim the authority of the former (but not the latter) for arguing for taxation of site values but the authority of the latter (though not the former) for taxing increments in land value" (1981, 18–19).

### **Distinctive Theory of Henry George: The Single Tax**

In *Progress and Poverty* (1879), Henry George, an American who was probably the best-known exponent of land value taxation, drew upon economic analysis in the tradition of Ricardo and Mill to argue persuasively for a single tax on land and the abolition of other taxes, which then were predominantly levied on other property (Harrison 1983, chs. 15–16). George argued that since land values were exclusively due to general forces, whether of a natural or social character, landlords had no moral right to land values, and so there was no case for their being allowed to retain existing rents or the increments that were likely to eventuate in the future as economies expanded (Prest 1981, 13).

George originally advocated replacing all existing taxes with a single tax upon land values. Supporters of George argued that since land is a fixed resource, the economic rent is a product of the growth of the economy and not of individual effort, and society would be justified in recovering it to support the costs of government. (They accepted Ricardo's view that a tax on economic rent could not be shifted forward; as we have already noted, the main attraction of such a tax is that the whole of the tax would fall on the landowners.) George's supporters also argued that a single tax on land would eliminate taxes on buildings, which would stimulate construction and economic growth, and that a single tax would be very simple to administer.

### ***Impact of Henry George in Britain***

During the 1880s, George visited Britain five times; three of those visits were extended speaking tours. Among progressive thinkers his impact was considerable. Testimonials by Bernard Shaw, Sidney and Beatrice Webb, H.G. Wells and other eminent Fabians explicitly credit George as the most potent single instrument in converting both individuals and the working class itself to trade unionism and socialism (Lawrence et al. 1992, 57; Prest 1981, 14). (Lawrence points out the interesting paradox that Henry George, the apostle of frontier individualism and free trade, should have gone down in history as the godfather of British socialism [Lawrence et al. 1992, 83].)

By the late 1880s, the radicals of Britain's Liberal Party allied themselves with George in supporting land taxation, an alliance that affected legislation some 20 years later in the Finance Act of 1909–1910 and then much later on, from the Labour Party, in the Finance Act of 1931. (Although enacted, these measures were abandoned before they could be fully implemented.)

Despite his wide influence, George did have to contend with much adverse comment from current and later economic critics. Marshall dubbed him “a poet, not a scientific thinker” (Stigler 1969); Marx said, “theoretically the man is thoroughly backward” (Barker 1955, 356); and J. M. Keynes attributed George's thinking to “the underworld of economics” (Prest 1981, 21). But Schumpeter, the doyen of the history of economic thought, frames George more generously. In recalling “[a] few of those men who helped to prepare the ground for developments from the 1880s on,” Schumpeter states:

[W]e cannot afford to pass by the economist whose individual success with the public was greater than that of all the others on our list, Henry George. The points about him that are relevant for a history of analysis are these. He was a self-taught economist, but he *was* an economist. In the course of his life, he acquired most of the knowledge and the ability to handle an economic argument that he could have acquired by academic training as it then was. In this he differed to his advantage from most men who proffered panaceas. Barring his panacea [the Single Tax] and the phraseology connected with it, he was a very orthodox economist and extremely conservative as to methods. They were those of the English “classics,” A. Smith being his particular favourite. Marshall and Böhm-Bawerk he failed to understand. But up to and including Mill's treatise, he was thoroughly at home in scientific economics; and he shared none of the current misunderstanding or prejudices concerning it. Even the panacea—nationalisation not of land but of the rent of land by a confiscatory tax—benefited by his competence as an economist, for he was careful to frame his “remedy” in such a manner as to cause the minimum injury to the efficiency of the private-enterprise economy. Professional economists who focused attention on the single-tax proposal and condemned Henry George's teaching, root and branch, were hardly just to him. (1954, 864–865)

### *Contemporary Views on Georgism*

More than a century later, the supporters of the Henry George tradition, in various groupings of societies and foundations around the world, are still actively pursuing George's precepts on land taxation and arguing his case. As Lee (1996, 78) points out, the hope for supporters of LVT must lie in promoting their ideals to the general public and educating future politicians to appreciate the merits of such a tax. Several bodies are actively trying to do this in Britain: the Henry George Foundation UK (founded in 1907 as the United Committee for the Taxation of Land Values), the Land Value Taxation Campaign, the Land Policy Council and the Scottish Ogilvie Council.

But the survival is deeper than just the campaign. Lawrence et al. (1992, 56) comment that *Progress and Poverty* had a dramatic impact on George's British economist contemporaries, and although George's theory did not shape economic theory, his ideas were present in the minds of those who did. Fundamentally, his ideas on land taxation persisted even into the minds of twentieth-century economists.

Quite apart from the ongoing campaign for LVT, there is also a contemporary exploration of the relevance of the ideas and philosophy of Henry George to today's issues and problems in the modern world. This is brought out, for example, in the collection of essays, titled *Land Use and Taxation: Applying the Insights of Henry George*, edited by H. James Brown (1997). In his introduction, the editor states:

Although George could never have anticipated all the changes in real estate development, public finance and property rights that would occur over the following century, the fundamental policy issues that he analyzed are as pressing today as they were 120 years ago. In essence, we are still asking the same question: How do you strike an equitable balance between private property rights and public interest in land?... The essays collected here explain why Henry George's basic ideas about land use and taxation issues still have currency, despite how radically different the world has become as we arrive at the end of the twentieth century.... While they offer markedly different perspectives, each of the authors who contributed to this volume would agree that Henry George's ideas have much to add to the ongoing debate over land policy and taxation issues. (Brown 1997, 1-5)

The questions and answers raised in Brown were echoed in another exploration by the Lincoln Institute at a conference in Arizona, "Land Value Taxation in Contemporary Societies: Can It and Will It Work?" The conclusion states:

Thus, more research on the use of the most immobile of tax bases is warranted, especially research on the land value tax in the "real world". . . the land value tax should be taken seriously by researchers, not neglected as it has been over the years, as no more than another quaint idea from bygone years. (Netzer 1998, xviii)

Having reviewed the economic and equitable arguments underpinning LVT, including the influence of Henry George, we may proceed to examine the extant tax system in Britain as a background for any proposed introduction of LVT into that system.