

P A R T II

THE TERMINOLOGY OF CLASSICAL TAX ANALYSIS

"I have heard a man calculating the revenue of a province by saying: There are so many men; each man, in order to live, spends so many sous per day, therefore the province has so much revenue. Tax a similar revenue proportionately, and these people must die of hunger, or at least from misery. I believe that it all comes back to the great question of the soup of the Franciscans; it is in them when they have eaten it. It is the same with the so-called revenue from industry. When a man has eaten the reward proportioned to his talent or to the usefulness of his service, he has nothing left, and taxation cannot be levied on nothing."

A.R.J. Turgot (1763)¹

CHAPTER 19

FUNDED VERSUS UNFUNDED STATE REVENUES

Taxation is as familiar and inevitable to modern man as death and, indeed, probably more familiar: for mediaeval man taxation was an extraordinary occurrence. As Viner explains,

"To understand the Scholastic treatment of taxes one must bear in mind that taxation, as we now know it—namely, as a routine, normal and respectable method of providing for the financial needs of government—is a comparatively modern phenomenon. In feudal times, on the other hand, rulers derived their revenues mainly from personal estates, customary tributes and dues paid by their vassals, tolls on strangers and on traffic on roads and rivers, war booty, rapine and piracy, and, in times of special need,¹ from 'aids,' subventions, donations, etc., in form at least voluntarily granted to them . . . All of St. Thomas' references to taxation that I know of treat it as a more or less extraordinary act of a ruler which is as likely as not to be morally illicit."²

Since taxation was thus regarded as, more likely than not, a form of legalized theft, Popes could threaten to excommunicate rulers who sought to impose them and moralists could excuse those who evaded paying what was not seen as Caesar's "due."³

Max Beer has shown that the essence of Physiocracy can be seen as an attempt

"to re-create a mediaeval society which should be of greater permanency and excellence than the old one had been . . . There are in this ideal realm three estates, similar to those of the old feudal society: (1) the nobility and the clergy, who own the lands and bear the whole burden of administration, defence and spiritual care. This burden is represented by the single tax of the landowners, from which the State expenditure is met."⁴

The Physiocrats, with their emphasis on natural law, their careful distinctions between "impot" and "imposition," and "spoliation,"⁵ clearly viewed taxation, properly so called, as the natural revenue to the State from its ultimate ownership of natural resources⁶—an idea at once both radical and reactionary.

Hence it is clear that when Adam Smith begins his discussion of the sources of State revenue, it is not accidental that he commences with a review of funds (such as landed estates) which may supply the State without recourse to taxation and that when he does discuss taxation he turns first to a tax on land rent. He accepts, as we shall see later, the Physiocratic doctrine that a tax on land rent will be capitalized into a lower private land value and remarks that tithes and church lands have at times served as a mode of directly funding social services, representing in effect a substitute for unfunded taxes.⁷

After Smith, the question of funded versus unfunded sources of State revenue tended to slip into the background. Whereas the Physiocrats had conceived of taxation in terms of a natural revenue to the State from its ultimate landownership (a view with which Smith sometimes seems to sympathize), Ricardo and Say explicitly ignore the

obvious problem of the conflict between taxation and property rights: "In the science of political economy, taxation must be considered as matter of fact and not of right . . . The best scheme of finance is, to spend as little as possible; and the best tax is always the lightest."⁸ There is no natural fund to supply the State, all property is equally sacred and all taxation is a necessary evil.

After J.S. Mill and Henry George, however, the question was reopened and the following statement by Davenport sums it up neatly:

"I believe that the principle at the heart of the single tax agitation--that the fiscal revenues should be derived from the social estates (the regalia principle in ultimate essence), from sources to which the justifications for private property do not attach--is right and vastly important. The rents of mines, forests, waterfalls, franchises, town lots, and also, if practicable, of agricultural lands should be retained as fiscal properties. Not a society single-taxed, but a society free from all taxes of any sort, is the logic of the principle--a goal well within the reach of a wise and provident public policy."⁹

It is this view that taxation should be looked at as an appropriation of types of factor earnings rather than as a levy upon persons that causes the ethical arguments for land value taxation to be set in terms of entitlement to natural resources rather than in terms of utilitarian notions of horizontal equity. We shall see later that ultimately this results from a clash between natural law and utilitarian ideas of distributive justice.

From the point of view of economic efficiency and capital for-

mation we shall see that revenues funded for the State by the ownership of land have singular advantages which taxes levied against labour and capital, not the property of the State, do not have. Income received by the State from property ownership no more distorts relative prices per se than it would in the hands of another owner and, what is more, to the extent that individuals cannot satisfy their savings needs by land-ownership, they are encouraged to produce real capital. In contrast, other taxes may distort relative prices and reduce the after-tax reward to investors, while public debts or social security schemes tend to discourage real capital formation by substituting a fiduciary asset for real assets in investor portfolios. Feudal fiscal theory is perhaps more modern than one realizes.

CHAPTER 20

THE "ABILITY TO PAY" PRINCIPLE OF TAXATION

Adam Smith is often quoted for his first maxim of taxation that "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities"¹--and then he is interpreted as favouring some kind of utilitarian interpersonal equity: thus J.S. Mill takes Smith to favour equality of sacrifice,² failing to include in his abbreviated quotation³ Smith's comment that

"Every tax, it must be observed once for all, which falls finally upon one only of the three sorts of revenue above-mentioned, is necessarily unequal, in so far as it does not affect the other two. In the following examination of different taxes, I shall seldom take much further notice of this sort of inequality."⁴

If equality of sacrifice was what Smith had in mind, why does he feel so disinclined to pursue it?

The answer, I suggest, lies in the observation that "ability to pay" has been used in an older and different sense to the Benthamite interpretation. Whereas the utilitarian interpretation is a proposition of distributive justice, what was in the minds of the Physiocrats and Adam Smith when they talked about "ability to pay" was ability to bear a tax. For them the question was: Does this or that tax tend to destroy or diminish the base upon which it is levied?

Thus Quesnay saw the problem of taxation as one of properly

defining national income, net of wage and capital costs, and not allowing taxation to be levied upon these costs since it would be self-defeating.⁵ Similarly, Turgot rejects the taxation of interest because interest is a cost of production and such a tax would reduce its base.⁶ in his Plan for a Paper on Taxation in General he stresses the "necessity of never injuring the sources of wealth,"⁷ judges non-land taxes as undermining themselves,⁸ rejects in personam taxation⁹ and again emphasizes that only the "produit net" can bear a tax without being diminished thereby.¹⁰

Now Adam Smith is much closer to the Physiocrats than to the Benthamites (in the Theory of Moral Sentiments "utility" means "appropriateness" rather than "desiredness") and his general discussion of taxes reflects the "ability to bear" criterion as his underlying meaning of "ability to pay." Smith differs from the Physiocrats in his tax recommendations only in suggesting that there are other surpluses than agricultural rent: he would thus tax urban as well as agricultural rents,¹¹ also luxuries¹² and sinecures.¹³ In all these cases he is guided by his long run incidence and shifting analysis rather than horizontal equity.

The interpretation of "ability to pay" as "ability to bear" is briefly reflected by Ricardo when he argues that taxes can only be laid on net, not gross, revenue (which he identifies as rent plus profits)¹⁴ but it remained for Henry George and J.A. Hobson to re-emphasize this canon of taxation as meaning that taxes can only fall upon surpluses.¹⁵

There are thus two strands of interpretation of "ability to pay"

in classical political economy: the Physiocratic-Smithian positive canon of "ability to bear" which underlies all the economic (as opposed to ethical) arguments for land value taxation, and J.S. Mill's normative prescription of "equality of sacrifice." Correspondingly, the older strand sees its normative questions arising from the conflict between taxation and private property, whereas the utilitarians subordinate property rights to the ethical goal of maximizing aggregate utility; "optimal taxation" represents an attempt to merge these two strands by keeping the major utilitarian normative goal of maximizing utility but linking it with the "ability to bear" rather than the "equality of sacrifice" interpretation of "ability to pay." To get back to Quesnay one has only to link "utility" to "income" to "net product."

CHAPTER 21

THE "BENEFIT" PRINCIPLE OF TAXATION

The benefit principle has generally been used by the advocates of land value taxation and it is therefore of some interest to survey the senses in which it has been used.

The most common sense in which it has been understood is that of the "quid pro quo" or what one might call the idea of posterior benefit. On this view taxes must be spent to benefit those who pay—it is not contended that they have received any antecedent benefit. Since J.S. Mill felt this notion implies regressive taxation, he rejected it.¹

However, there is another sense in which the term has been understood: that of prior benefit (the feudal theory). On this view it is not necessary that the State expend its tax revenues for the benefit of the precise taxpayers if it has already provided them with the benefit for which the tax is a charge.

Thus the argument can be put that the right to occupy land is a franchise² and a benefit to the owner. The higher the rent the land commands, the greater the benefit the owner enjoys from society, since rent is a community created externality. The Crown, as trustee for the community, can therefore appropriate the rent as a charge for this prior benefit. Of course, if it spends tax revenue so as to raise the rent, it is entitled to take this posterior benefit as well; conversely, if the tax is wasted the tax base naturally shrinks, via tax capitalization, so that the owners are not taxed on a greater benefit than they actually

receive.

The origins of both these ideas of benefit are found in Adam Smith. In regard to public goods he enunciates the idea of posterior benefit: "It is unjust that the whole society should contribute towards an expense of which the benefit is confined to a part of the society."³ More than a hint of the feudal idea of prior benefit is included in his elaboration of the ability to pay principle: subjects should contribute "in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation, is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate."⁴

This hint of feudal fiscal theory is reinforced by his later remarks that ground rents are specially suitable for taxation because "ground rents, so far as they exceed the ordinary rent of land, are altogether owing to the good government of the sovereign, which by protecting the industry either of the whole people, or of the inhabitants of some particular place, enables them to pay so much more than its the real value for the ground . . . Nothing can be more reasonable than that a fund which owes its existence to the good government of the state, should be taxed peculiarly, or should contribute something more than the greater part of other funds, towards the support of that government."⁵

J.S. Mill himself modified his emphasis on equality of sacrifice to stress that a tax on rent could simply represent a rent charge in

favour of the public to recover the prior benefit yielded to landlords by the community-created unearned increment.⁶

Henry George, working from the ethical theory of land as inalienable common property, argued the prior benefit case for rent taxation most forcefully: "the value of land expresses in exact and tangible form the right of the community in land held by an individual; and rent expresses the exact amount which the individual should pay to the community to satisfy the equal rights of all other members of the community."⁷ He notes that Adam Smith speaks of incomes enjoyed under the protection of the state and argues that "The basis of this idea is evidently that the enjoyment of property is made possible by the state-- that there is a value created and maintained by the community . . . Now, of what values is this true? Only of the value of land."⁸ This conclusion rests upon his idea that rent captures natural community-created externalities, which labour and capital cannot, since the mobile factors are subject to competition.

Marshall acknowledged in his "public value" of land the role externality played,⁹ but chose to restrict the idea of benefit to the case of posterior benefit exemplified by "beneficial" rates.¹⁰

The relevance of these arguments to the theory of local public goods is apparent, and one can see the suggestion that government needs for revenue should not be above or below the amount of land rent. Take, for example, the provision of police protection: no police, no property values but too many police paid for out of rent taxes represents an onerous rate and depresses rent just as wasteful expenditures would. In between, there is an optimum where incremental public expenditure just

pays for itself by making labour and capital more productive. This excess productivity is appropriated by rent which is thus maximized. This, then, is the process by which some of Adam Smith's "unproductive labourers" create a value and why he could argue rent was due to the wise government of the sovereign.¹¹

CHAPTER 22

EXCESS BURDEN OF TAXATION

Political economy owes its origins to the attempts of the Physiocrats to deal with evident excess burdens imposed upon the people of France by her system of taxation. It is, I think, quite clear that neither the Physiocrats nor Smith were particularly interested, as was Ricardo, in the relative shares of rent, wages and profit in a given "value" but were much more interested in the growth of what Ricardo called "riches."¹ I shall argue that they and many of their successors were much more interested in the sub-optimality and excess burden that results when a tax drives a wedge between product prices and factor returns. And they were interested in this excess burden in a general equilibrium rather than a partial equilibrium setting. This concern for welfare loss due to artificial divergences of price from cost is illustrated by Smith's parallel reasoning in regard to the welfare losses of monopoly and taxation.

It should also be pointed out that neither the Physiocrats nor Smith were in the habit of assuming fixed supplies of capital or labour, nor did they separate the question of incidence from that of excess burden. However, for them incidence was discussed in terms of after-tax factor rewards (or in terms of pseudo-distribution) rather than in terms of after-tax relative shares in national income. Nor does neutrality mean for them no alteration in the price solution to a general equilibrium system--no tax can be neutral in that sense because of its

income effects on saving. Neutrality for them seems to mean the avoidance of a tax-induced wedge between price and cost. Finally, Smith and the Physiocrats agree that such tax induced distortions will lower national income and aggregate rent, which serves as a welfare criterion for them, since it is the only "costless" part of the national income.

That the unique freedom of rent taxation from excess burden was at the centre of Quesnay's concerns can be illustrated by repeated comments such as the following:

"A properly organized tax, i.e. a tax which does not degenerate into spoliation² by reason of a bad form of assessment, should be regarded as a portion of revenue taken out of the net product [i.e. land rent] . . . for otherwise . . . it could imperceptibly ruin everything before the administration became aware of it. Thus the contribution should be assessed only on the revenue, i.e. on the annual net product . . . and not on the advances of husbandmen, or on labourers, or on the sale of commodities, for in the latter cases it is destructive. On the advances of husbandmen it would represent not taxation but spoliation, which would wipe out reproduction, cause the land to deteriorate, and ruin the farmers, the proprietors, and the state . . ."³

Adam Smith reformulated this idea in his dictum that "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury . . ."⁴ One of the reasons a tax could have this excess burden was that

"it may obstruct the industry of the people, and discourage them

from applying to certain branches of business which might give maintenance and employment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy some of the funds, which might enable them more easily to do so."⁵

Smith then applies this principle to reject, like Turgot before him, the taxation of interest since capital can emigrate.⁶ He also argues that taxes on the wages of labour (or their equivalent, taxes on necessities) are to be rejected because aggregate rent and output would be less than if the same amount were raised by taxes on rent and luxuries.⁷

Unlike the Physiocrats, Smith seems to feel that taxes other than taxes on rent can have no excess burden--that there are other surpluses which can be safely tapped. Thus he recommends taxation of sinecures⁸ and luxuries.⁹ However, his contention that a tax upon luxuries will fall upon consumers without effects upon wages, profits and rents seems to be contradicted by his later admission that the taxation of luxuries does indeed generate excess burdens.¹⁰

Although Turgot was well aware of the nature of excess burden at a partial equilibrium level,¹¹ he shared the Physiocratic view that the theory of taxation was a corollary of a correct definition of national income¹² and therefore we must turn to Smith to see a closer analysis of how excess burden is generated by taxes which drive a wedge between price and cost and thus violate the necessary conditions for Pareto-optimality.

The key to understanding Smith's treatment of excess burden is

to return to his definitions of monopoly which essentially depend on the idea of a price in excess of cost: in the case of land such a surplus in the form of rent is natural but, in the case of artificial monopolies, capital in a privileged position is able to secure a super normal profit to the detriment of the consumer.

Smith enunciates the proposition that free competition will secure Pareto-optimality in the following terms:

"It is thus [i.e., by the equalization of the rate of profit] that the private interests and passions of individuals naturally dispose them to turn their stock towards the employments which in ordinary cases are most advantageous to society. But if from this natural preference they should turn too much of it towards those employments, the fall of profit in them and the rise of it in all others immediately dispose them to alter this faulty distribution. Without any intervention of law, therefore, the private interests and passions of men naturally lead them to divide and distribute the stock of every society . . . as nearly as possible in the proportion which is most agreeable to the interest of the whole society."¹³

Smith's objection to the mercantile system is that it necessarily deranges this beneficial result through various types of monopoly.¹⁴

Smith argues that artificial monopoly represents an absurd kind of tax; that is, it raises price above cost and thereby prevents the best allocation of resources.¹⁵ His analysis of the manner in which excess burden arises is thus identical for monopolies and bad taxes. For example, a tax on profits in one industry will derange a nation's

stock;¹⁶ taxes upon necessities are like an artificial poverty of soil and a "curse" which only a rich country can afford¹⁷ and the wider the gap between price and cost which a levy creates the more it becomes an instrument of monopoly and excess burden rather than of revenue.¹⁸

Aggregate Rent as a Welfare Criterion

We have previously seen that the Physiocrats and Turgot regarded agricultural rent as the only true national income¹⁹ and hence the obvious quantity for economic policy to maximize. They did not regard urban rent as a similar net revenue, though Turgot at least was in favour of taxing it as well.²⁰

Adam Smith rejected their definition of national income and formulated the modern definition of national income as rent plus wages plus profits. However, he realized that when it came to taxation policy he needed the concept of taxable surplus to serve for his analysis as the product net had served for the Physiocrats; he is not entirely clear on what he thought was this surplus but he does so regard agricultural and urban rent²¹ and other incomes not subject to competitive pricing.²² What is abundantly clear, however, is that in his discussions of the general equilibrium excess burden imposed by various taxes he turns back towards the welfare criterion of the Physiocrats--which tax system is least injurious to aggregate rent?

Adam Smith tells us in his chapter on rent that all economic progress must result in a rise in aggregate rents;²³ conversely, restrictions such as the monopoly of the colonial trade depress aggregate rent as well as aggregate wages and profits²⁴ and likewise any attempt to favour agriculture by discouraging manufacturing will also

lower aggregate rents.²⁵ In the same vein, Smith argues that a tax on interest will lower rents and wages as capital emigrates.²⁶ Similarly, taxes on wages will lower rents,²⁷ as will taxes on necessities.²⁸

In summary, Smith is less clear than the Physiocrats about what is taxable surplus, but he does regard the impact of a tax system on rents as a matter of great importance in forming his judgments.

When we come to Ricardo, the old concern with excess burden tends to drop out of sight. Ricardo criticizes J.B. Say for his partial equilibrium approach to excess burden and points out that capital driven out of one industry will be employed in another. This leads Ricardo to minimize the problem,²⁹ and Say was quick to see it.³⁰ However, Ricardo also had to have a welfare criterion to measure taxable surplus and he criticizes Smith for vagueness on this topic, arguing that the taxable net revenue of a community consists of aggregate profits plus rent.³¹ In fact Smith was closer to Ricardo's position than Ricardo realized.³²

Once the idea of net revenue or taxable surplus was severed from the identification with land rent it was to undergo successive metamorphoses, notably at the hands of J.A. Hobson³³ and Abba Lerner.³⁴ However it is worthwhile to summarize what seems to be the essence of the argument that the maximization of land rent is the appropriate social goal.³⁵

Suppose that in a homogeneous community utility is a function of output ($U=U(Q)$), and that output is a function of land (R), labour (L), and capital (K). Now, the Physiocrats and Smith assumed that population and labour supply were responsive to the wage rate and capital could migrate whereas land was fixed. Thus

$$R = R$$

$$L = L(w)$$

$$\text{and } K = K(i)$$

Now to increase welfare, we must increase output, Q ; but since land, R , is fixed this can only be done by increasing labour supplied, L , and/or capital, K . However, we are given, by subsistence requirements and the threat of emigration, exogenous prices, w^* , and i^* for labour and capital. Any attempt to tax labour or capital to returns below these will lead to some factor withdrawal, lower output, lower rents and lower welfare. Conversely, any attempt to subsidize capital and labour to increase output could only be done by taxes on rents: but the increased output thus purchased must be less than the required subsidies by the nature of the previous equilibrium since, rent being a surplus over labour and capital costs, capital and labour will only have ceased to be forthcoming when no more incremental surplus was being generated.

Thus, maximization of rents and national income on these assumptions amount to the same policy goal. Global excess burden is seen as the loss of output due to the loss of labour and capital resources to the domestic economy. It may be noted that neither the Physiocrats nor Smith asserted that capital or labour were infinitely elastic in supply at these exogenous prices, w^* and i^* and this assumption was not necessary for them to conclude that there was a one to one correspondence between increased welfare and increased rents.

To sum up, this idea of global excess burden was a major concern of the Physiocrats and Smith: they shared the view that any tax which disturbed the equality of price and cost would diminish capital and

labour supplies, or distort their employments, resulting in lower output, lower welfare and lower land rents.

CHAPTER 23

THE INCIDENCE OF TAXATION

We have seen that the Physiocrats and Smith, unlike Ricardo, tended to view incidence in terms of pre- and post-tax factor rewards and in terms of the aggregate levels of rent, wages and profits. National output would be at its highest if there were no distortions, whether due to taxes, tariffs or other regulations, which upset the condition of price equals cost: any tax which upset the conditions for a Pareto-optimum was to be condemned as an unthrifty tax which took more from the people than the sovereign gained.

As Turgot put it, "if, through any disarrangement, whatever it may be, . . . the Entrepreneurs cease to get back their advances together with the profit which they have a right to expect from them, it is obvious that they will be obliged to reduce their enterprises; that the amount of labour, the amount of consumption of the fruits of the earth, and the amount of production and of revenue will be reduced in like measure . . ."1

Adam Smith, as we have seen, agreed with the Physiocrats that artificial enhancements or distortions of relative prices were destructive and that the replacement of monopoly by free competition would secure the greatest output for a nation.²

Smith, however, gives a more detailed account of incidence than is found in Quesnay or Turgot. He follows Turgot's approach³ in setting out the problem of incidence as dependent upon a functional analysis of

the effects of taxes on the different types of income--rent, wages and profits and remarks that many taxes "it will appear from the following review, are not finally paid from the fund, or source of revenue, upon which it was intended they should fall."⁴

Smith then goes on to show that such shifting will result if the introduction of tax drives a wedge between an existing equality of price and cost; conversely, shifting will not occur if the tax is levied upon a pre-existing divergence of price from real cost. What Smith is, of course, doing is groping towards the idea that only taxes on surpluses cannot be shifted. While he agrees with the Physiocrats that a tax upon agricultural rent is a tax upon surplus and cannot be shifted, he declines to accept completely the doctrine that all taxes fall upon rent.⁵

Among the taxes which Smith considers as taxes upon costs and which will therefore be shifted are taxes upon building rents,⁶ upon interest,⁷ upon the profits of particular trades⁸ and upon wages⁹ and necessities.¹⁰ In all these cases the shifting mechanism is supposed to operate via the withdrawal of capital or labour from the taxed activities. Smith also notes that this withdrawal can mean the effects of a tax are passed backwards to lower rents as well as forward to increase commodity prices.

The taxes which Smith definitely states will not be shifted are taxes upon agricultural and ground rents,¹¹ sinecures,¹² and commodities selling at a monopoly price.¹³ In all these cases, Smith argues that the tax simply shares in an existing surplus of price over real cost.

Thus he states that "A tax upon ground rents would not raise the

rents of houses. It would fall altogether upon the owner of the ground-rent, who acts as always as a monopolist, and exacts the greatest rent which can be got for the use of his ground."¹⁴ Similarly, he argues that

"The emoluments of offices are not, like those of trades and professions, regulated by the free competition of the market, and do not, therefore, always bear a just proportion to what the nature of the employment requires. They are, perhaps in most countries, higher than it requires . . . [They] can in most cases very well bear to be taxed."¹⁵

Smith's basic argument that taxes will be shifted until they settle upon a surplus is well illustrated in his reasoning in regard to taxes on luxuries (shifted forward to take surplus income)¹⁶ and on commodities at a monopoly price (shifted backwards to specialized factors).

"When the ordinary price of any particular produce of land is at what may be called a monopoly price, a tax upon it necessarily reduces the rent and profit of the land which grows it. A tax upon the produce of those precious vineyards, of which the wine falls so much short of the effectual demand, that its price is always above the natural proportion to that of the produce of other equally fertile and equally well cultivated land, would necessarily reduce the rent and profit of those vineyards. The price of the wines being already the highest that could be got for the quantity commonly sent to market, it could not be raised higher without diminishing that quantity; and the quantity could not be diminished without still greater loss, because the lands

could not be turned to any other equally valuable produce. The whole weight of the tax, therefore, would fall upon the rent and profit; properly upon the rent of the vineyard."¹⁷

He goes on to apply the same argument to sugar and concludes that the price of sugar, likewise "had, it seems, before the tax been a monopoly price; and the argument adduced to show that sugar was an improper subject of taxation [that the tax fell on the producers] demonstrated, perhaps, that it was a proper one; the gains of monopolists, whenever they can be come at, being certainly of all subjects the most proper."¹⁸

It may seem that Smith is not being consistent with his general view that monopolies should be abolished; but in fairness we note that he seems to hold the view that artificial monopolies and other barriers to trade should be abolished while the gains from natural monopolies should be taxed.

It is also interesting to note that Smith's difference with the Physiocrats seems to derive from an idea that there are surplus elements in all incomes, not just rent, and for this reason, he seems to hold initially that taxes can ultimately fall in four places, upon rent, wages and profits or upon the consumer. Thus "Taxes upon luxuries are finally paid by the consumers of the commodities taxed, without any retribution. They fall indifferently upon every species of revenue, the wages of labour, the profits of stock and the rent of land."¹⁹

The weakness of the argument that consumers represent a fourth category becomes evident when it is recalled that the distinction between luxuries and necessities is a matter of custom,²⁰ that taxes on luxuries

are admitted to have excess burdens due to excise effects²¹ and that consumers are spenders of factor incomes.²² Smith does not fully explain why this indirect tax on profits or wages will not have the same effects as direct taxes on wages or profits: the argument seems to be that expenditure on luxuries is a surplus part of wages over cost of production of labourers (the subsistence wage)²³ and that a tax on luxuries is a voluntary tax.

Thus, Smith's doctrine of incidence may be summed up in the observation that taxes must fall upon surplus, that they will be shifted (albeit with an excess burden) until they rest upon surplus and that land rent is not the only surplus. Correspondingly, a tax falling on surplus would lower the value of the asset from which the surplus was derived by the process of tax capitalization.²⁴ On the other hand, if a tax is levied upon a cost of production, shifting will occur as factors are redeployed to equalize after tax rates of return. If a factor is fixed in total supply a general tax upon its reward could not be shifted.²⁵ What should be noted is that Smith's theory of tax incidence is not so far removed from that of the Physiocrats as it might at first seem.²⁶

Ricardo attempted to overthrow Smith's analysis of incidence in which Smith had argued that taxes on profits, wages and necessities could be shifted to rent. Ricardo argued that, apart from a tax on pure land rent, taxes will fall upon profits²⁷ and a tax on profits will not be shifted to rent.²⁸ In short, Smith maintained that all taxes would be shifted till they fell upon surplus (rent, monopoly returns or luxury expenditure)²⁹ whereas Ricardo, from his analysis of value at the

margin, argued taxes (other than a tax on pure rent) would be shifted until they fell upon profits and wealthy consumers.³⁰

Ricardo, however, fails to prove Smith wrong in his theory of incidence. As is well known, Ricardo paid little attention to the role of demand in altering the margin of production,³¹ he at times seems to forget that when a tax is passed on in higher consumer prices landlords' real rents must fall,³² and he failed, as Senior and J.S. Mill noted, to recognize that if profits did bear taxes, the stationary state would be reached sooner with a correspondingly lower population and lower rents.³³ In the particular case of taxes upon agricultural produce, which Smith maintains are shifted back upon the rent while Ricardo objects that they are shifted forward to the consumer, we may note that: (1) both men admit that cultivation will be discouraged³⁴ and (2) Smith, like Turgot, assumed capital and land tended to be used in fixed proportions.³⁵ It would therefore seem to follow that the margin will indeed shift and rent will fall.

Ricardo was in turn to be criticized by J.B. Say for the former's apparent disregard of the problem of excess burden,³⁶ but in regard to the questions of shifting and incidence it seems fair to suggest that Say abandons the attempts of the Physiocrats, Smith and Ricardo to enunciate general equilibrium conclusions and prefers the partial equilibrium approach. He seems to accept that all income above a subsistence minimum is a surplus available for taxation³⁷ and, like Ricardo, stresses equality of taxation and the necessity of not injuring capital.³⁸ However, the argument for equality is presented on ethical grounds while the distinction between taxes on revenue and taxes on

capital fails to distinguish between private and social capital.

In regard to incidence, Say argues that in "a complex social organization the pressure of taxation is often imperceptible";³⁹ taxes will always be shifted and it is wrong to assert "as a general maxim, that taxation falls exclusively upon any specific class or classes of the community. It always falls upon those who can find no means of evasion . . ."⁴⁰ Say does, however, agree that a tax on rent cannot be shifted though he does not agree that all other taxes will be shifted back to rent.⁴¹ We may say then that in Say we find an abandonment of any attempt to deduce general macroeconomic laws of tax incidence based upon a functional division of national income into rent, wages and profit and the responsiveness of these factor supplies to after-tax rates of return. Tax incidence is handled purely at the microeconomic level.

J.S. Mill largely follows Ricardo but with the important reservation that he reverts to Smith's doctrine in regard to taxes on agricultural produce and taxes on profits ultimately causing rents to fall, since accumulation would be less, population less and the Ricardian margin changed so that rents would also be less.⁴² We may note that since taxes on (customary) wages and taxes on necessities are, in reality, taxes upon profits, they too should have the same effect--a fall in rents.⁴³ This concession by Mill to the arguments of the Physiocrats and Smith is, however, largely overshadowed by Mill's idea that much of the remuneration for labour is a surplus over the customary subsistence wage⁴⁴ and his insistence, like Ricardo and Say, upon the general principle of equality in taxation on ethical grounds.⁴⁵ In

general, Mill argues that all consumption expenditure above a subsistence minimum is a surplus available for taxation.⁴⁶

In summary, we may say that the essential message of classical tax analysis is that taxation must fall upon surplus and not upon costs. If it falls upon costs, shifting will occur and in this process excess burdens will be generated. It was universally agreed that land rent is a surplus, that a tax upon it cannot be shifted and will be capitalized to reduce land's selling price. It was not agreed that rent was the only surplus as the Physiocrats had asserted. Smith had thought luxury expenditure showed surpluses in wage and profit incomes. Ricardo argued that taxes must fall upon profits. Say denied general statements were possible while J.S. Mill drew closer to Smith by arguing that rent was a surplus as was consumption over the subsistence level. However, Mill's rejection of the taxation of savings would seem to suggest that interest was not a surplus,⁴⁷ and if wages were a customary subsistence, how was one to know how much of the earnings of labour was a surplus over this customary minimum and any costs of human capital?

The general conclusions of classical tax analysis are neatly summarized by Henry George:

"Taxation which lessens the reward of the producer necessarily lessens the incentive to production; taxation which is conditioned upon the act of production, or the use of any of the three factors of production, necessarily discourages production. Thus taxation which diminishes the earnings of the labourer or the returns of the capitalist tends to render the one less industrious and intelligent, the other less disposed to save and

invest. . . . Taxation which falls upon labour as it is executed, wealth as it is used as capital, land as it is cultivated, will manifestly tend to discourage production much more powerfully than taxation to the same amount levied upon labourers, whether they work or play, upon wealth whether used productively or unproductively or upon land whether cultivated or left waste."⁴⁸

George went on to follow Adam Smith in arguing that the "class of taxes from which revenue may be derived without interference with production are taxes upon monopolies--for the profit of monopoly is in itself a tax levied upon production, and to tax it is simply to divert into the public coffers what production must in any event pay."⁴⁹

It is clear, then, that the labour/leisure and consumption/saving choices and their impact upon tax policy are not questions of recent origin and the unshiftability of a tax upon a monopolist or "pure" profits is also a theorem of long standing--as J.A. Hobson and A.P. Lerner were well aware.⁵⁰ What has been a question of continual dispute is what, in practice, does constitute that surplus of price in excess of cost which is the characteristic of monopoly? Or, to put it another way, are there surpluses in the long run apart from land rent? We have set out our reasons above for agreeing with Marshall that the answer to this question is in the negative, but there is another question which concerned some earlier writers--can a tax be super-neutral, i.e., raise national income?

CHAPTER 24

NEUTRALITY AND SUPERNEUTRALITY

It appears to be received doctrine in the history of economic thought that taxes upon economic rent or upon land value are justified by their historical advocates on the grounds of their neutrality with respect to economic behaviour. This is partly true but there is also a tradition in the literature of land value taxation that asserts its superneutrality—that such a tax would raise national income and welfare.

To understand the source of this tradition we must, as usual, return to Adam Smith who is generally regarded as asserting the proposition that free competition will, via the invisible hand, maximize economic welfare. He did, but with some rather important qualifications about systems of property rights necessary to ensure Pareto-optimality. It is particularly important to note that some advocates of land value taxation argued that uncontrolled private property in perpetuity of natural resources would under free competition result in a sub-optimal outcome and they urged the taxation of economic rent or land values to penalize such sub-optimality. Thus the argument runs: the taxation of land values is indeed neutral with respect to optimal behaviour, but the system of private property in land induces privately profitable yet socially sub-optimal decisions, hence in practice such taxation is superneutral—it penalizes socially bad choices which would otherwise be made, yet does not distort optimal decisions. National income and

welfare hence rise under such a tax.

First, however, it is readily conceded that property in, or rather possession of, land is essential if economic rent is not to be dissipated through the over-exploitation of a common resource. As J.B. Say realized, "paradoxical as it may seem at first sight, it is, nevertheless, perfectly true, that a man, who is himself no share-holder of land, is equally interested in its appropriation with the share-holder himself."¹ The tragedy of the commons consists of a misallocation of resources caused by the use of rent to subsidize submarginal uses of labour and capital.² In fine, the existence of rent is necessary to avoid congestion externalities and ensure the most productive allocation of labour and capital. The question remains, however, in whom should beneficial ownership of natural resources be vested--the individual or the community? Many economists, from Adam Smith through J.S. Mill and Henry George, have argued that the alienation in fee simple of natural resources to individuals will result in a converse problem to that of the commons--that labour and capital will under-use rather than over-use the superior natural resources due to speculation, that is, their withholding from use in the hope of gains from resale.

We are now ready to turn to Adam Smith and see his reasons for rejecting absolute private property in land as conducive to Pareto-optimality. The most obvious problem is the inter-generational one--any system of absolute private property in land must respect entails and restrictive covenants which may be utterly inappropriate for allocating land to its most productive use later.³ Entails, says Smith, "are founded upon the most absurd of all suppositions, the supposition that

every successive generation of men have not an equal right to the earth and to all that it possesses; but that the property of the present generation should be restrained and regulated according to the fancy of those who died perhaps five hundred years ago."⁴ Thus, says Smith, great tracts of land which have been engrossed are prevented from subdivision and more intensive cultivation.⁵ The result, he argues, is that land prices are kept artificially high by these regulations which "keep so much land out of the market . . . that what is sold always sells at a monopoly price."⁶ Smith therefore advocates abolition of entails and primogeniture to secure a free market in land, increasing its productivity.⁷ J.S. Mill seconded Smith's argument.⁸

However, Smith went further in his rejection of absolute private property in land as not being conducive to Pareto-optimality—not only would he unprise the dead hands of past owners but also the grasping hands of living landowners who would not use their lands.

Smith argues that plenty of good land and liberty are the great causes of colonial prosperity and that although the English colonies have less good land than the Spanish and Portuguese colonies, the English colonies have prospered because

"First, the engrossing of uncultivated land, though it has by no means been prevented altogether, has been more restrained in the English colonies than in any other. The colony law which imposes upon every proprietor the obligation of improving and cultivating, within a limited time, a certain proportion of his lands, and which, in case of failure, declares those neglected lands grantable to any other person; though it has not, perhaps,

been very strictly executed, has, however, had some effect.

. . . The plenty and cheapness of good land, it has already been observed, are the principal causes of the rapid prosperity of new colonies. The engrossing of land, in effect destroys this plenty and cheapness. The engrossing of uncultivated land, besides, is the greatest obstruction to its improvement."⁹

Edward Gibbon Wakefield took apparent exception to Adam Smith's view that "plenty and cheapness of good land" was the cause of colonial prosperity. On the contrary, Wakefield

"pleaded for a sufficiently restrictive price—a relatively high price—on the colonial lands. This price above the free market price was necessary to prevent the immigrants from becoming landowners too soon. . . . For Wakefield the history of colonial failure was replete with extensive land grants and sale of land at outrageously low prices, encouraging dispersion over the land in such a fashion as to preclude an effective division of labour."¹⁰

The operative motive for such suboptimal behaviour was that every immigrant in becoming a landowner sought the future benefit of the unearned increment to be generated by future expected colonial growth. Smith had realized that land speculation could artificially force labour and capital to worse land by holding better land out of use; Wakefield was arguing that the prospect of an unearned increment from cheaply sold Crown land could lure capital and labour to prematurely settle on less productive lands. This would mean lower rates of wages and profits in the colony and hence would strangle the very inflow of labour and capi-

tal necessary to generate that future increment.¹¹ In short, fee simple grants of land as unencumbered private property would not lead to Pareto-optimality.

J.S. Mill, as we have seen,¹² endorsed Wakefield's criticism of laissez-faire in this case. Just as in the case of the over-exploitation of a community-access resource, there would be, as Mill realized, the free rider problem and the conflict of individual versus collective rationality.¹³

As we have seen before, to the extent that private property in land allows the "unearned increment" to subsidize the application of capital and labour to land, then to that extent private property in land condemns itself, for resources will be misallocated and aggregate rent dissipated. To hold out the discovery value of minerals as a reward for prospecting, to alienate land to the first occupier in unencumbered fee simple are actions which closer reflection shows to be suboptimal precisely because the unearned increment is subsidizing a misallocation of capital and labour in the same manner as an open-access resource.¹⁴ Thus advocates of land value taxation have been able to claim that, for example, "mine rents would be created by the very act of socializing them—an interesting reversal of the more usual case where taxes impose an excess burden."¹⁵

It was, of course, Henry George who first argued that Smith's and Wakefield's worries about the optimality of private property in land extended to old as well as new countries. George made much of land speculation: if speculation could mean that inferior new land may be prematurely used, could it not mean that existing land might be prema-

turely forced into a new use? Just as Smith's land engrossers would force settlers to worse lands so, George could argue, would land speculators force urban development of rural land near cities by locking up nearer and better sites in the hope of selling for a profit.¹⁶

Thus the advocates of land value taxation have simultaneously advanced the following apparently contradictory positions:

(1) land value taxation is neutral with respect to optimal decisions and does not interfere with Pareto-optimality by driving a wedge between price and cost;

(2) land value taxation is superneutral in practice because private property in land encourages the misallocation of resources (due to gambling on future land value increments) and the dissipation of aggregate rent. Land value taxation by enforcing marginal pricing (in preventing expected unearned increments from subsidizing suboptimal allocation of capital and labour) will prevent this dissipation of economic rent.

Much of the discussion of land value taxation has been fruitless because of a failure to sort out the underlying views on speculation in natural resources. Opponents have said speculation is necessary and good; proponents have tended to say it is evil. On a closer investigation we see that the correct position of the proponents must be that:

(a) land value taxation is neutral with respect to "optimal" speculation;

(b) it penalizes "bad" speculation;

(c) in practice, in spite of devices like leasing,¹⁷ much speculation is necessarily bad because capital and labour must be tied to the

land held.¹⁸

If capital and labour could freely move off and on to land then it would of course be true that "bad" speculation would never be a problem--it would be silly of an owner to refuse a land user's rental income while waiting for a value increment if the owner could eject the tenant at will when selling.¹⁹ But this is manifestly not the case. The whole problem arises from what Gaffney has called the "time-indivisibility of space" and the future generations of would-be users of land who cannot enter their bids in the market now. In effect, the grant of fee simple ownership in permanent natural resources to one generation allows it to operate as a blocking coalition to the result which would have been achieved if all generations had been able to tender rental bids for the usufruct of those resources seriatim. The taxation of land values or rents is then urged as a means of overcoming this breakdown in the conditions necessary for Pareto-optimality by making these resources available over time to the highest yielding users. This, it is argued, maximizes the present value of aggregate rents.

P A R T III

GENERAL ECONOMIC ARGUMENTS IN FAVOUR OF
LAND VALUE TAXATION

"For it is an eternal truth, that if the tax assessed exceeds the size of the revenue [the net product], it destroys it, and undermines itself as it destroys the revenue."

Mirabeau (1760)¹

"As to the tax on the revenues of land, it is evident that it is he who possesses the land, at the moment in which the tax is established, who pays it really without being able to throw it on any one . . .

. . . From hence it follows, that when once all the land has changed owners since the establishment of the tax, it is no longer really paid by any one."

Destutt Tracy (1817)²

CHAPTER 25

THE DOCTRINE THAT A TAX ON RENT CANNOT BE SHIFTED

Although it is almost universally held that a tax on rent or upon land values cannot be shifted, there are some arguments, both old and new, that such a tax will be shifted.

These arguments may be summarized thus:

(1) Rent is a component of all product prices; therefore, a tax on rent will be shifted to the consumer.

(2) Even if a tax on rent cannot be shifted, a tax on land values (capitalized rent) may well be shifted, because a tax on land values, in the case of appreciating land, represents a current tax outflow in excess of current rent income. Since the tax is then in excess of rent, it must drive land out of use.

(3) A tax on rent can be shifted, because the theory of tax capitalization is wrong. If a tax is levied on all property, capital values will not be affected but the rate of return will be. Changes in capital formation will then pass the burden on to consumers. This argument rests on the assimilation of land into capital in economic theory.

(4) Even if a tax on rent in general cannot be shifted, this is not true of a tax on the rent of land in some uses but not others.¹ In terms of opportunity cost, rent is a cost of production like any other which the consumer must ultimately pay.

(5) A tax on rent or land values can be shifted because what is called rent is, in fact, often a reward to labour or capital. This

argument flows naturally from the contention that rent is a reward for risk or foresight.

(6) A tax on rent, like every other tax, must be a check to capital accumulation. Because it is a deterrent to thrift, it will be shifted over time, in the sense that the community's capital stock and productivity will be less.

(7) Even if a tax on rent cannot be shifted, this applies only to permanent and indestructible qualities of land. It does not apply to exhaustible resources: the rent concept does not apply to these.

Such, then, are the arguments we shall encounter among the critics of the orthodox doctrine that a tax on rent cannot be shifted. Often enough, the criticisms are mentioned in passing by writers who do not seriously intend to press them but in this discussion we must consider them carefully indeed.

The doctrine that a tax on rent cannot be shifted is the oldest precept of political economy. From the time of its formulation by John Locke² and the Physiocrats, through Adam Smith who saw the same principle in adding the allied doctrine that a tax on monopoly profits cannot be shifted, to the modern formulation that a tax on a factor in fixed total supply will be borne by the factor--through the whole history of economic thought this doctrine has been a dominant and recurring theme. We see it generalized by J.A. Hobson³ and Abba Lerner⁴ as the dictum that a tax on surplus cannot be shifted and its influence is reflected in Hotelling's endorsement of site value taxation in his famous 1938 paper on marginal cost pricing.⁵

Turning now to John Locke's "Considerations of the Consequences

of the Lowering of Interest and Raising the Value of Money," we find that he argues that a tax on rent cannot be shifted, for the now familiar reason that we may assume land to be let at its competitive rent. The tenant is as little concerned by a tax on rent as he is by the way that the rent he pays is divided between superior tenants and the landholder:

"it being the same thing to him, whether he pays all his rent to the king, or his landlord; or half, or a quarter, or none at all to the king . . . All this is but changing the hand that receives the rent, without any influence at all upon the yearly value of the estate; which will not be let for one penny more, or less, to the renter, however, or amongst whomsoever, the rent he pays be divided. From hence it is evident, that taxes laid on land do not in the least make rents [i.e., public plus private shares of rent]⁶ fall."⁷

Locke does not, however, go on to enunciate the proposition that the tax will therefore be capitalized and cause a lower market price for land. This is because he doubts the validity of the idea that land values are capitalized rents, since he observes that individual land values are not the same number of years' purchase of their respective current rents.⁸ His objections can be answered by pointing to psychic income from land and different expectations of future rents. Apart from this difference, we may note here that Adam Smith seems to follow Locke very closely in the views expressed in the Wealth of Nations about the relationship between prosperity, taxes and rents.

The doctrine that a tax on rent will be capitalized is alluded

to by Quesnay in his notes on The Royal Economic Maxims of M. de Sully when he argues that a landholder "should not regard ordinary taxes as a charge laid on his portion, for it is not he who pays this revenue; it is the portion of the property which he has not acquired and which does not belong to him who pays it to those to whom it is due."⁹ We may note in passing that this manner of describing the phenomenon of tax capitalization is fully in keeping with what Max Beer has described as the Physiocrats' neo-mediaevalism--a conception of society as governed by natural law with a natural revenue to the Crown derived from its lands.¹⁰

When we turn to Turgot, the twin doctrines of the non-shifting of a tax on rent and tax capitalization are very clearly stated indeed. Turgot points out that the purchase of land is the acquisition of a capitalized existing rental income rather than a capital investment which generates an income which would otherwise not exist.¹¹ Hence, there can be no shifting of a tax on rent. He also notes that market values for land are derived by capitalizing rent, net of taxes or tithes.¹² Consequently, when Turgot describes the mode of calculating Physiocratic net national income, he is careful to add back the publicly-appropriated share of rent to the private share.¹³

Adam Smith accepts the capitalization theory of land values¹⁴ and endorses the view that a tax on rents cannot be shifted.

"A tax upon ground-rents would not raise the rents of houses. It would fall altogether upon the owner of the ground-rent, who acts always as a monopolist, and exacts the greatest rent which can be got for the use of his ground . . . The more the inhabi-

tant was obliged to pay for the tax, the less he would incline to pay for the ground; so that the final payment of the tax would fall altogether upon the owner of the ground-rent . . .

Both ground-rents and the ordinary rent of land are a species of revenue which the owner, in many cases, enjoys without any care or attention of his own. Though a part of this revenue should be taken from him in order to defray the expenses of the state, no discouragement will thereby be given to any sort of industry. The annual produce of the land and labour of the society, the real wealth and revenue of the great body of the people, might be the same after such a tax as before."¹⁵

Smith clearly formulates here the dictum that a tax on rent is neutral, though he was also aware that the provision of public goods, such as defence, could affect land values.¹⁶ From a practical point of view, Smith is concerned that the returns to capital sunk in the soil should not be taxed.¹⁷ He also suggests that unoccupied houses not be taxed,¹⁸ which would, however, hardly appear to be neutral when speculation is taken into account; neutrality dictates the taxation of potential, or market, rent rather than actual rent.

In discussing whether taxes on different products of land can be passed back to reduce the rent of the land which produces them, Smith seems to be implicitly aware of the fact that a tax on rent will be shifted to the consumer, if that tax is only levied upon that land when employed in one use rather than another.¹⁹ To be neutral a tax on rent must, of course, be levied on the basis of the highest and best use, regardless of the particular actual use.

The doctrine that a tax on rent cannot be shifted is given its classical formulation at the hands of Ricardo, as is well known. The tax is a tax on infra-marginal surplus, which does not enter into price, and hence cannot be shifted.²⁰ However, Ricardo, unlike Smith, does not favour the special taxation of rents.²¹ One of Ricardo's reasons is the apparent breach of interpersonal equity,²² an objection we will consider later. Another objection is the practical difficulty of assessment and the consequent danger of taxing the returns to capital sunk in the soil,²³ an objection McCulloch presses with even greater vigour.²⁴

There is, however, another objection Ricardo mentions:

"if it be considered that land, regarded as a fit subject for exclusive taxation, would not only be reduced in price, to compensate for the risk of that taxation, but in proportion to the indefinite nature and uncertain value of the risk would become a fit subject for speculations, partaking more of the nature of gambling than of sober trade, it will appear probable that the hands into which land would . . . be most apt to fall would be the hands . . . of the gambler than of . . . the sober-minded proprietor, who is likely to employ his land to the greatest advantage."²⁵

This argument obviously implies that a tax on rent is not neutral, that it will cause land to be less well used. What is startling about this argument of Ricardo's is that later debaters both pro and con the taxation of land values have agreed that such a tax does deter land speculation by raising the holding charges paid by the speculator or other under-user of land. It is hard to disagree with Shoup's conclusion that

Ricardo's argument here is "forced" and that his real objection to rent taxation is based on concern for property rights.²⁶

James Mill shared Ricardo's concern for established property rights but felt that this could be accommodated by only taking the unearned and unforeseen increment of rent as State revenue.²⁷ He did not, however, add anything new to the basic Ricardian doctrine that a tax on rent could not be shifted.

J.B. Say, in his Treatise on Political Economy, accepts the non-shiftability of a rent tax and its capitalization into a lower market price for land: he also notes that the same reasoning can be applied to a tax on the quasi-rents of fixed capital, but does not discuss this in detail.²⁸

Say does, however, make another interesting comment which bears on the common saying that "a tax on rent cannot be shifted because it is a lump sum tax." Say points out, quite correctly, that the neutrality of a tax on rent does not depend on its being a fixed charge on the land--on the contrary, a fixed charge on land in Tuscany drove some land out of production because changes in market conditions led to the charge exceeding the economic rent of land (which had fallen).²⁹ To be unshiftable, a tax on rent need not be a fixed charge, nor even must it be at a uniform rate³⁰ on the rent of all land, but it must in no case be levied so as to exceed the economic rent of any parcel of land.³¹

In John Stuart Mill, the taxation of land rent becomes a very practical issue. He accepts completely that "A tax on rent . . . has no effect, other than its obvious one. It merely takes so much from the landlord, and transfers it to the state."³² When J.S. Mill discusses

the capitalization doctrine, however, he discovers, like Leon Walras and Destutt de Tracy,³³ that it implies that a tax on rent is borne once for all by the owner of the land when the tax is imposed, since future purchasers of the land will buy free of the tax.³⁴ For Mill, this application of the capitalization doctrine seems to point to a real conundrum in distributive justice, namely, that to be fair among generations we ought neither impose new taxes on rent nor abolish existing taxes on rent.³⁵ As is well known, Mill sought to avoid this ethical problem by following his father's recommendation of taxing the unearned increment of rents.³⁶

Questions of distributive justice will be discussed later but we ought to note another contribution of Mill's. It will be remembered that Adam Smith had seemed to suggest that a tax on rent could be passed on if it applied to the rent land could earn in one use but not another.³⁷ Mill picks up the point: a tax on ground-rents

"will not however fall wholly on the landlord, unless with the tax on ground-rent there is combined an equivalent tax on agricultural rent. The lowest rent of land let for building is very little above the rent which the same ground would yield in agriculture . . . If, therefore a tax were laid on ground-rents without being also laid on agricultural rents, it would . . . reduce the return from the lowest ground-rents below the ordinary return from land and would check further building quite as effectually as if it were a tax on building-rents . . ."³⁸

In this comment of Mill's we see the germ of the idea that taxes on a factor in fixed total supply can generate excise effects, if levied

on that factor in some uses but not others, though Mill does not consider, as H.G. Brown was to do later, how the burden of the tax will be borne by that fixed factor in both taxed and untaxed uses, because of the equalization of after tax returns.

It is important to note that this "excise effect" of a rent tax analogous to the excise effect produced by geographically varying taxes on capital depends on the fact that a particular parcel of land is taxed in one use and not in another use. It is a misunderstanding to argue from this case of Mill's that an urban site value tax can be shifted unless adjacent rural counties also levy such a tax:³⁹ the geographical limitations of a land-value tax do not affect its neutrality; it is the fact that in this case the tax is levied in one use but not another that allows it to be passed on. To be unshiftable a tax on rent must be levied on potential rent in highest and best use regardless of actual use, i.e., it cannot be contingent upon any action of the individual landholder.

So far in this discussion I have said that a tax on rent, or upon land values, cannot be shifted. The writer who appears responsible for the switch in economic discussion from the taxation of rent to the taxation of land values appears to be Henry George, who simply noted that "When land is purchased, the payment which is made for the ownership, or right to perpetual use, is rent commuted or capitalized . . . Wherever land having a value is used, either by owner or hirer, there is rent actual; wherever it is not used, but still has a value, there is rent potential."⁴⁰

George's suggestion that land values rather than rent be taxed

does, however, represent a new development. George is, indeed, essentially correct in asserting that "Taxes levied upon the value of land cannot check production in the slightest degree, until they exceed rent, or the value of land taken annually . . .⁴¹ but this is to invite the question as to whether a land value tax on land which has a low current rent but much higher expected rents, may, in fact, represent taxation in excess of current land income and therefore become a shiftable tax. The timing of tax receipts under a land value tax is, indeed, different than under a tax on rent but we shall see later that, in fact, the unshiftable property still holds.

The taxation of capitalized land values rather than rent turns out to have, in fact, a definite advantage. In theory, to be unshiftable a tax on rent should be on potential rent in highest and best use; in practice, any attempt to tax rents will tend to follow current use. The ad valorem levy on land value avoids this problem since, as George noted, capitalized value reflects potential rent.⁴²

It is interesting to note that George realized, as did J.B. Say, that to be neutral with respect to maximizing behaviour, a land value tax did not need to be a fixed charge but rather a levy unaffected by the landholder's actions. George's levy would, in fact, simply follow the results of the competitive land market--the landholder's competitors for the site would ultimately set the levy.⁴³

Although Alfred Marshall basically agreed that a tax on land values could not be shifted,⁴⁴ he gave several cases in which he thought that such a tax could be passed on.

He argues, correctly, that to be neutral "the true rent on which

the tax is levied" must be "assessed with reference to its general capabilities, and not to the special use which the owner makes of it."

However, he then proceeds to argue that "If an improved method of cultivation develops latent resources of the soil, so as to yield an increased return much in excess of what is required to remunerate the outlay with a good rate of profits; the excess of net return above normal profits belongs properly to true rent; and yet, if it is known, or even expected, that a very heavy special tax on true rent will be made to apply to this excess income, that expectation may deter the owner from making the improvement."⁴⁵

This argument would be correct if the tax base were actual rent rather than potential rent, but land values, as we saw in Chapter 18, do reflect the "general capabilities" of land and not the "special uses" the owner may put it to. In fact, the experience of land value taxation is that it forces improvement to the highest and best use implicit in the market value of the land.⁴⁶

Another case of a tax on land values being shifted would appear to follow from Marshall's example of the settler in a new country being rewarded by the increment in land values—the "rent as a reward for risk" argument.⁴⁷ This argument has been discussed before under the rubric of the rent concept and it will be discussed again but we may note that the disposal of public lands gratis on the lottery principle may well over-motivate settlement and cause economic loss as so many jockey for the prizes which only a few can win. If, on the other hand, the public lands were to be sold at market prices, the process of tax capitalization would mean that the settler would simply pay less for the

fee simple of the land he took up—a land value tax would thus be no burden and no deterrent to the settler.

Marshall also wondered about supposed cases where rent could be perceived as profit on invested capital. He argued that the "unearned increment" might in fact represent an internalization of external economies created by an enterprising business which established a new factory town such as Pullman City or Saltaire—the inference is that the situation value of land is created by the investor.⁴⁸ Consequently, taxation of land values would deter such enterprises and the tax would be shifted.

There are several answers which can be given to this line of argument. One answer is that the location value depends as much on the people who come to these towns—the enhancement of value is not, in fact, the unilateral work of the business that started the town. "Had the corporations put up similar improvements in an isolated desert, it is doubtful that there would have been much of an increase in land values."⁴⁹ This objection is borne out by the casual observation that such new towns have been created near established cities, e.g., Pullman City and Gary are quite close to Chicago.

Another pertinent question to ask is why did corporations sometimes feel they needed to establish such new towns? It seems that, in fact, Mr. Pullman did not wish the viability of his works hampered by having to pay large sums to land speculators for the acreage needed for his enterprise.⁵⁰ Since land value taxation strongly discourages the holding of land out of use, one may well argue that land value taxation might eliminate the need for businesses to try to beat the land specula-

tors at their own game.⁵¹

A third objection to this "unearned increment as a reward to the investor" argument may be found in the marginalist approach to efficiency in resource allocation. Is it sensible to subsidize capital in an enterprise earning subnormal rates of return from future expected rents? Does it not, perhaps, represent a social waste by dissipating rent, much in the same way as happens in a free-access resource such as a fishery? This question will be pursued further but we may note in passing that the very next example given by Marshall falls foul of this objection: he states that

"Some what similar instances are those of a group of landowners who combine to make a railway, the net traffic receipts of which are not expected to pay any considerable interest on the capital invested in making it; but which will greatly raise the value of their land. In such cases, part of the increase of their incomes as landowners ought to be regarded as profits on capital which they have invested in the improvement of their land: though the capital has gone towards making a railway instead of being applied directly to their own property."⁵²

Let us examine this carefully. Ex hypothesi, the railway is per se unprofitable. The landowners who financed it are therefore losing interest on their capital as compared with what they might have got elsewhere. This loss can only be worthwhile if their land values rise by more than the capitalized value of the annual opportunity loss on the railway. But if this is so, a complete outsider could have built the railway, charged enough to earn the normal rate of profit and the land-

owners would be in exactly the same net position. (It would, of course, be a different story if the landowners hoped to keep the land values and put the losses of the railway on the shoulders of the taxpayer—which seems to be emerging as the ultimate result of the American policy of fostering railroads by land grants.)⁵³

In fine, the argument that a tax on land values could be shifted because the increment of land values is sometimes a necessary reward to capital simply leads us to question whether, when this occurs, we are really observing a rational and efficient allocation of resources from a social, rather than a private, point of view.

Another argument that a tax on rent could be shifted grew out of Marshall's concept of quasi-rent. In discussing the effects of a tax on meteoric stones, freely given by Nature, Marshall argues that the shiftability of a tax depends on the durability of the stones:

"In the first extreme case the stones cannot be worn out or destroyed, and no more can be found . . . A uniform tax on them . . . will fall wholly on the owner . . . At the opposite extreme of our chain of hypotheses, the stones perish so quickly, and are so quickly reproduced at about a uniform cost . . . that [their] services can never yield much more or much less than normal interest on the money cost of obtaining additional stones . . . A tax on the stones under these conditions would fall entirely on any one who . . . gave out a contract for anything in making which the stones would be used."⁵⁴

The inference seems to be that exhaustible resources are capital, not land, and that a tax on exhaustible resources will be shifted

and hence the theorem that a tax on rent cannot be shifted is applicable only to permanent resources. That this is wrong can be seen by noting that what Marshall has said is that a tax on all the stones, whether Nature-given or man-made, will be shifted--which is true enough. However, land value taxation represents taxation of the Nature-given stones and not a tax on man-made stones. Consequently, it need not be shifted for a reason Marshall himself gave in earlier editions: "A tax on any set of things that are already produced, falls exclusively on the owners of those things, if it is not accompanied by a tax, or the expectation of a tax, on the production or bringing into use similar or rival things."⁵⁵

Marshall was responsible for bringing to attention the fact that whether a tax on rent would be capitalized into lower land values or not depended on whether the proceeds of the tax were spent beneficially or not. For example, taxes spent on lighting and draining could increase the attractiveness of an area and its land values rather than depress them.⁵⁶

This conception of Marshall's really fits into the Lockean-Physiocratic-Smithian-Georgist line of thought that land values will gain or lose from any differential benefits or burdens on capital or labour, the mobile factors, but its significance in the context of capitalization theory is to suggest that the substitution of land value taxes for other taxes may not in fact cause land values to fall, in which case much of the argument over compensation to landowners would be unnecessary unless land value taxation were pressed so far as to drive land values toward zero. This would seem to explain why polls of land-

owners in local government areas in Australia and New Zealand have generated the apparent paradox of landowners voting to change over to land value taxation, an unshiftable tax upon themselves!⁵⁷

Having reviewed in chronological order the development of doctrine up to Marshall, let us now return to the arguments set out at the beginning of this chapter.

The first argument was that since rent is a component of product prices, a tax on it can be shifted to the consumer. This view, which has at times been erroneously attributed to the Physiocrats,⁵⁸ was strongly argued by Edward Atkinson⁵⁹ and T.S. Adams,⁶⁰ while Edwin Cannan⁶¹ and F.Y. Edgeworth⁶² seem to sometimes admit it.

The answer to this argument is that, although rent is a component of prices, it does not follow that a landholder faced with a rent tax can freely increase those prices. If, like John Locke, we assume the landowner is rational, he will already be getting the most he can for his land, hence how can any reaction of his get him more? Since land is given, how can such a tax raise its price by checking its production or availability? This, in short, is the classical answer and it remains valid.⁶³

The second argument suggests that a tax on land values may be shifted, even though a tax on rent may not be. The argument suggests that the landowner may find it profitable to alter the time pattern of rental income in response to a tax on its present value, even if the land itself is indestructible. As H.J. Davenport put it,

"the taxation of a present worth in the absence of a present income, or any taxation disproportionate to present income, is

an affront to the fundamental principle of taxation in general
 . . . To tax at present an income which does not exist at present, and thus to support the current state expenditures at the cost of future productive activity is a fiscal improvidence
 . . . Current revenue is the only proper object of current taxation . . . Ad valorem taxation consistently applied amounts to almost an absolute veto on all investments promising remote returns."⁶⁴

The problem posed by this argument is essentially whether capital gains in land values represent income accruals and it will be examined further in a later chapter. The answer to the argument depends on capitalization formulae which will now be developed.

Henry George, as we noted, and his followers⁶⁵ contended that a tax on land values was equivalent to a tax on rent. The truth of this proposition may be shown thus:

Let i = interest rate

τ = the ad valorem tax levied annually

R = economic rent

V = present value of the untaxed rent

V' = present value after tax is imposed

STATIC FORMULA (R assumed constant)⁶⁶

Since land values are capitalized rents, we have pre-tax:

$$V = \frac{R}{i}$$

Post, tax, the equilibrium land value must equal capitalized net rent:

$$V' = \frac{R - \tau V'}{i}$$

$$iV' = R - \tau V'$$

$$V' = \frac{R}{i+\tau}$$

$$= \left(\frac{i}{i+\tau}\right) V \text{ since } V = \frac{R}{i}$$

This formula shows that an infinite tax rate on land values is required to drive the market (after-tax) value of taxed land to zero, i.e., to take all the economic rent. This immediately disposes of the specious objection that land value taxation is impossible because, as the tax takes the rent, it leaves no value to tax,⁶⁷ and therefore will raise no revenue.⁶⁸

The tax rate of τ is equivalent to a once for all capitalized loss on the owner at the time the tax is introduced, which loss is given by

$$V - V' = V - \left(\frac{i}{i+\tau}\right) V$$

$$= \left(\frac{\tau}{i+\tau}\right) V$$

Thus, the State becomes a co-proprietor of the land: the public share of the rent is $\frac{\tau}{i+\tau}$ and the private share is $\frac{i}{i+\tau}$.

The static formula for tax capitalization is well established and is useful in showing that future purchasers buy free of the tax. However, what happens when R is no longer constant?

DYNAMIC FORMULA⁶⁹

Let V_n' = market value at beginning of year n

V_{n+1}' = market value at end of year n

R_n = rent received in year n

τ = tax rate (assumed constant)

In equilibrium, land values must be such that the net return obtained from holding it must equal the rate of interest applied to its salable value:

Income = cash receipts + capital gains

$$= R_n + (V'_{n+1} - V'_n)$$

Net Income = income - taxes

$$= R_n + (V'_{n+1} - V'_n) - \tau V'_n$$

$$= iV'_n$$

= return on any investment

Hence

$$(1 + i + \tau)V'_n = R_n + V'_{n+1}$$

$$V'_n = \frac{R_n + V'_{n+1}}{1 + i + \tau}$$

$$= K(R_n + V'_{n+1})$$

where we let

$$K = \frac{1}{1+i+\tau} < 1$$

Likewise, we obtain

$$V'_{n+1} = K(R_{n+1} + V'_{n+2})$$

The formula is recursive and substitution gives the result:

$$V'_1 = KR_1 + K^2R_2 + K^3R_3 + \dots + K^nR_n + K^nV'_n$$

This formula includes the pre-tax case when $\tau = 0$, which may be written

$$V_1 = kR_1 + k^2R_2 + k^3R_3 + \dots + k^nR_n + k^nV_n$$

where

$$k = \frac{1}{1+i}$$

As in the static case, the tax rate, τ , must rise to infinity to

drive the market value of land to zero. Hence, the land value tax cannot drive land out of use, since, so long as it has a market value, we have a sure sign that its possession is worth having. Davenport's argument, as Edgar Johnson noted,⁷⁰ essentially depends on refusing to take account of capital gains to the landowner. The only essential difference between a tax on rent and a tax on land values is that a different time pattern of tax payments occurs--when rents are rising, a land value tax will take a higher percentage of cash rent than a rent tax which takes an equal percentage of the present value of the land and vice versa.

The argument that a tax on rent is borne by the consumer because a general tax on property affects the rate of interest and not capital values is due to T.S. Adams.⁷¹ It is extremely important to analyze Adams' argument because it has been partly revived in the present time under the guise of the "new view" of the property tax and has been used by some (but not all) writers to assert that land value taxation is not neutral with respect to optimal resource allocation because it is not a uniform tax on all investment assets.⁷²

Adams' argument proceeds thus:

(1) Land and all other investment assets compete in investors' portfolios.

(2) This competition ensures that after-tax returns on all assets will be equalized.⁷³

(3) Therefore, any special tax on one kind of investment asset will have two effects:

(a) The required pre-tax rate of return on that asset will

rise, creating an excise effect for consumers of goods produced with that asset.⁷⁴

- (b) As funds flow out of that taxed investment asset, they will drive down the after-tax rate of return elsewhere, so that the after-tax rate of return will be reduced generally. All investors will, therefore, bear the average burden of taxation in a reduced after-tax rate of return.⁷⁵

(4) Applying this argument to taxes on land values, we see that such a tax may well not be capitalized in a once for all loss by the current landowner. Instead, the tax will be borne by consumers and all investors, including subsequent owners of the taxed land.

This argument against the traditional theory of the capitalization of land value taxes can be severely attacked on several counts:

(1) Even on its own terms, the argument does not deny partial tax capitalization, since "unless the demand for the funds which flow from land to the other investments is perfectly inelastic the interest rate will not fall sufficiently to maintain or restore the original land values."⁷⁶ The usual result would be partial capitalization and a somewhat lower after-tax rate of return.

(2) How are after-tax returns equalized anyway? Adams suggested this was because funds flowed out of land, for example, into other assets. Seligman objected that, on the contrary, equalization of after tax returns occurs precisely through capitalization. Capitalization occurs instantaneously once the tax is announced—"Capitalization is equalization; equalization is capitalization."⁷⁷ Seligman, however, argued that a general tax on property would, indeed, not lead to capita-

lization though an exclusive or excess tax on land values would.⁷⁸

(3) However, the most devastating critique came from H.J. Davenport,⁷⁹ H.G. Hayes⁸⁰ and H.G. Brown.⁸¹

Davenport objected that Adams was implicitly talking about the imposition of two taxes simultaneously—a tax on existing assets and a tax on new investments. If the tax were levied on existing assets and not on new investments it would be capitalized, since the rate of return is not determined by existing assets but by the return to new investments.⁸²

Hayes and Brown went further. They pointed out that Seligman was wrong in claiming that capitalization depended on a tax being exclusive or excessive. They noted that taxes on existing capital goods would not be capitalized, if accompanied by a like tax on new capital goods. The value of the old must equal the value of the new which would be higher due to the increased cost of production caused by the tax.⁸³ In contrast, the rent of land was not alterable by supply responses. Moreover, if a general tax on property should decrease saving, the net rate of return might not be altered, so that capitalization of a land value tax would still occur even if it were part of a general tax.⁸⁴

The essential problem inherent in Adams' argument and the "new view" of the property tax as applied to land is that implicitly the following assumptions are made:

- (a) land is capital
- (b) capital is in fixed total supply
- (c) the distinction between existing and new assets does not exist, since capital is a J.B. Clark-style "jelly" which can flow from

one form to another

(d) the rate of interest is determined by the ratio of the quasi-rents earned by this "jelly" to its value

(e) a tax on rents and quasi-rents is therefore a tax on interest.

Ultimately, therefore, the doctrine that a tax on land values will be capitalized must be accepted unless one is willing to accept these implicit assumptions. I see no reason to accept them and have set out previously my reasons for rejecting the view that land is capital.⁸⁵

A more interesting argument over the shiftability of land value taxes is raised by the suggestion that a tax on land values in one use but not another will be shifted to consumers.

We have seen⁸⁶ that Adam Smith and John Stuart Mill were aware of the possibility and did, in fact, agree that a tax on the rent of land in some uses but not others could generate an "excise effect" in that the consumer would pay more for what was produced by land in the taxed use.⁸⁷

It was the singular merit of Harry Gunnison Brown to have perceived that while the above was true enough, it was not the end of the story. Brown noted that the withdrawal of land from the taxed use to untaxed uses would depress the rents received in those untaxed uses and thus lower the cost of production of goods produced in those uses.⁸⁸

Thus, he concluded that

"the tax on land used in some way or ways becomes shifted to or spread among the owners of land used in all ways. It is not shifted upon consumers. For while the goods indirectly discri-

minated against are raised in price by the tax, other goods tend to be lowered. Consumers of the former goods may lose. But consumers of other goods may gain. If these consumers are of the same class or are the same persons, the result may be regarded as cancelling. But landowners, as such, must and will receive somewhat lower net rents. After minor qualifications are made, it remains true that the main burden of the tax is upon the landowners."⁸⁹

One presumes that a qualification of this statement would be the observation that, in contrast to a land value tax independent of use, taxes on land in specific uses would generate an excess burden through misallocation of land and that this burden could be partly reflected in a lower marginal value product of labour and capital.

It is interesting to note that analogous reasoning was applied by Brown to taxes on capital in some industries and not others⁹⁰--the burden would be borne by capital in general. This is, of course, the line of reasoning now familiar in Harberger type models of partial capital taxes. In effect, such models assume fixed total supplies of labour and capital⁹¹--in these models, capital and labour earn rents, rather than interest or wages.

Brown himself, we may note, was much more cautious about the actual validity in the real world of the assumption that capital is in fixed total supply⁹² and, to that extent, regarded this reasoning as more valid for land taxation than capital taxation.

Another class of arguments that a tax on land values can be shifted logically flows from the thesis that the "unearned increment" is

really earned by labour and capital. This is the "rent is a reward for risk" argument we have seen before.⁹³

It was, as we have seen, suggested by Alfred Marshall and J.B. Clark that rent could be a reward to the settler for his low pioneering wages. However, it was pressed vigorously by A.S. Johnson,⁹⁴ T.S. Adams⁹⁵ and C.C. Plehn.⁹⁶ The central argument is that, in Plehn's words, "The so-called unearned increment so far as it can be anticipated is a part of the normal return to workers on and investors in land," or, as Adams put it, the unearned increment is "diffused" as a benefit to the consumer in a lower cost of production because receipt of the unearned increment allows capital and labour on appreciating land to take subnormal rewards.⁹⁷

If this argument is correct then it obviously follows that a land value tax can and will be shifted to the consumer in higher prices,⁹⁸ because land value taxation will deter such activities.

The answers to this line of argument are fairly obvious:

It may be objected in rebuttal that if rent is a reward to capital and labour, is there any return to land? If there is not, then is land a free good? Are there no scarce or valuable sites? And if there is a return to land how can it double as a return to labour or capital? Is it not more correct to say that rents in these cases are being spent on subsidizing capital and labour?

But if this is what the diffusion of the unearned increment amounts to, "Ought we not to consider carefully the social loss of misdirected labour and capital; and ought this not to count on the other side of the balance?"⁹⁹ Since both Adams¹⁰⁰ and Johnson¹⁰¹ had admitted

that those who laboured to thus gain the unearned increment lacked shrewd business judgment the question is well taken. If an unforeseen, unknowable unearned increment is what Adams and Johnson had in mind, their argument seems to imply that the greater the pioneers' errors of foresight the greater will be the national gain.¹⁰²

If, on the contrary, the unearned increment is anticipated then the pioneer will have to pay for it in a higher capitalized present value of land:¹⁰³ the unearned increment will not spur him on nor, as we noted above,¹⁰⁴ will a land value tax deter him.

In short, the "lure of the unearned increment" argument against land value taxation can be stood on its head: we shall see later that it can be turned into an argument for land value taxation, as a corrective for this misallocation of resources.

Another argument that land value taxes can be shifted is attributable to Ricardo and J.B. Say.¹⁰⁵ They argued that all taxes were evil because they discouraged capital formation by the private sector out of the income lost to government.

As H.G. Brown pointed out, this hardly represents an argument that land value taxes can be thus indirectly shifted since "on this hypothesis every tax must diminish accumulation"¹⁰⁶ and, moreover, the existence of government and the security it provides may result in more capital formation than in a state of anarchy. The real point, however, is that "some taxes do not at all discourage accumulation except in the sense that the individual cannot accumulate what the state takes from him and that other taxes may affect adversely the motive to accumulate."¹⁰⁷

As we shall see later, work by Nichols,¹⁰⁸ Skouras¹⁰⁹ and Feldstein¹¹⁰ has suggested that land value taxation might not only deter capital formation in this sense but may, in fact, encourage it by forcing individuals to satisfy their savings requirements by substituting real capital for land in their portfolios.

This survey of the doctrine of the non-shiftability of a land value tax has, I think, shown that either the objections to it are mistaken or that they raise questions about the objections themselves. Subsequent sections will therefore take up in detail the questions of land value taxation in relation to timing of land uses, location and land settlement, the competitive allocation of resources and the discovery and depletion of natural resources. However, before returning to these topics, let us return to examine the history of a Physiocratic doctrine which has fared less well in the textbooks--the idea that "all taxes fall upon land."

CHAPTER 26

THE ARGUMENT THAT ALL TAXES FALL ON LAND

The prevailing opinion today regarding the doctrine of the Physiocrats that all taxes fall upon land would probably not much differ from the judgment of J.B. Say: "The economists were quite correct in their position, that a land or territorial tax falls wholly on the net product, and consequently, upon the proprietors, but they were wrong in extending the doctrine so far as to assert, that all other taxes were defrayed out of the same fund."¹

I shall endeavour to show that perhaps a kinder judgment is in order: that if the Physiocrats were not entirely correct they were by no means entirely wrong either, and that their attempt to trace the shifting of taxes to surplus and the identification of that surplus as land rent still has practical significance.

One obvious difficulty presents itself in regard to Say's judgment: if all taxes were "defrayed" from rent anyway, why were the Physiocrats so emphatic about the desirability of their "impôt unique"? The answer is obvious from the previous discussion of classical approaches to tax incidence theory--the Physiocratic belief was that other taxes not only were defrayed out of rent but also diminished it. This will become clear in a review of the historical development of the argument that all taxes fall upon land.

The first notable proponent of this idea is John Locke.² His argument starts with the suggestion that "When a nation is running to

decay and ruin, the merchant and monied man, do what you can, will be sure to starve last: observe it where you will, the decays that come upon, and bring to ruin any country, do constantly first fall upon the land."³ Locke's reason for this is that capital can emigrate or be held in sterile hoards and he proceeds to argue that

"This by the way, if well considered, might let us see that taxes, however contrived, and out of whose hands soever immediately taken, do, in a country, where their great fund is in land, for the most part terminate upon land . . . perhaps it will be found that those taxes which seem least to affect land, will most surely of all other fall the rents . . . A tax laid upon land seems hard to the landholder, because it is so much money going visibly out of his pocket: and therefore, as an ease to himself, the landholder is always forward to lay it upon commodities. But, if he will thoroughly consider it, and examine the effects, he will find he buys this seeming ease at a very dear rate: and, though he pays not this tax immediately out of his own purse, yet his purse will find it by a greater want of money there . . ."⁴

How will a commodity tax cause rents to fall? Locke argues that merchants will simply raise the price of their goods, in turn the labourer must receive more wages to maintain his subsistence and then the farmer, to compensate for the higher wage bill, must reduce the rent he pays. The farmer cannot recoup these costs by increased prices because the excise has lowered the net price he, the producer, receives while simultaneously raising the gross price to the consumer with the

foregoing effects.⁵

Locke's conclusion is that

"the gentry will, but the worst way, increase their own charges, that is, by lessening the yearly value of their estates, if they hope to ease their land, by charging commodities. It is vain, in a country whose great fund is land, to hope to lay the public charge of the government on any thing else; there it will terminate. The merchant (do what you can) will not bear it, the labourer cannot, and therefore the landholder must . . . A country may thrive, the country gentlemen grow rich, and his rents increase . . . whilst the land is taxed: but I challenge any one to show me a country, wherein there is any considerable public charge raised, where the land does not most sensibly feel it, and, in proportion, bear much the greater part of it."⁶

There are some comments worth making about Locke's views:

(1) He does not deny that others can be made eventually to bear some tax burdens, but he does assert this cannot be done without causing rents to fall.⁷

(2) In contrast, a direct tax on rent in no way causes rents to fall. The sum of the publicly and privately appropriated shares remains the same.⁸

(3) He has assumed that labour earns a subsistence wage and capital is mobile and very elastic. There seems to be little producers' surplus to capital or labour which taxation could appropriate.

Locke's views were widely cited in the eighteenth century English debates over Walpole's excise scheme⁹ and there were not wanting

landholders such as Sir William Wyndham who argued that landholders' rents would suffer less from being directly taxed than from attempts to place the burdens on labour, industry and trade.¹⁰ It is, however, at the hands of the Physiocrats that Locke's argument receives much fuller treatment.¹¹

The essence of the Physiocratic argument is that a tax on costs of production must be shifted to net revenue or surplus. Now all labour and capital costs are costs of production, the only surplus is, in fact, agricultural rent¹² and therefore all taxes must fall upon it.¹³

It is certainly not, however, a matter of indifference whether rent is taxed directly or indirectly by this sort of shifting. Taxes on labour and capital will diminish their supply, reducing not only the very factor incomes they seek to tax but also reducing land rent, the only true net revenue available to be taken.¹⁴ For how can rent arise, without the application of capital and labour to land?

It may be thought that the Physiocratic argument depends on the assumption that labour and capital are in infinitely elastic supply at certain natural wage rates and interest rates, which in turn are determined by a subsistence theory of wages¹⁵ and international mobility of capital. Obviously, in this case, any attempt to tax labour and capital would lead to their total disappearance from the national economy and there would be no wages, no profits, no rent and no tax revenue. If this is so, then the Physiocrats "proved" their conclusion that all taxes reduce land rent by the simple expedient of assuming away any producers' surplus to capital and labour.

In fact, however, the Physiocrats did not assume there were no

producers' surpluses enjoyed by capital and labour.¹⁶ All they assumed, and all they needed to assume, was that labour and capital were not inelastic with respect to their returns. It is true that a subsistence theory of wages was advanced but it should also be pointed out that emigration of labour and capital was also mentioned¹⁷ as was the obvious fact that higher wages might induce more work effort.¹⁸ Obviously the more elastic in supply labour and capital were, the more serious would be the impact of the withdrawal of labour and capital upon rent.

Were then the Physiocrats perfectly correct in the contention that, as Say put it, all taxes were "defrayed" out of the rent fund?

In an obvious sense they were clearly wrong, if it is thought that they meant to argue that the net returns to labour and capital would be unaffected by taxation and that labour and capital could without loss throw the entire burden onto the landowners. Unless perfectly elastic in supply, labour and capital must suffer a reduction in net returns since there is in that case some producers' surplus which can be tapped even if some of it is partially destroyed by the effects of taxation on marginal factor supply.

However, I am not convinced that this is what the Physiocrats were really trying to say. If, for example, they really believed that wages were fixed by a subsistence standard they would not have been so concerned about the impoverishment of the peasantry: it would have been illogical. The real point of the Physiocratic argument seems to be as follows:

(1) There are three factors of production; land, labour and capital.

(2) The supply of labour and capital is dependent upon their earnings and therefore upon taxation of those earnings.

(3) The rent of land depends on the amount of capital and labour expended on it.

(4) Hence, taxation of labour and capital will have several effects:

(a) it may reduce their net earnings;

(b) which will, in turn, reduce the supply of labour and capital and thus

(c) reduce the rent of land.

In contrast, a tax on rent will only reduce the privately appropriated share of rent and in no way reduce either the gross rent itself or the revenues received by labour and capital.

There is nothing wrong in theory with this Physiocratic argument;¹⁹ in practice, however, the damaging effects attributable to taxation of labour and capital do depend on their long run elasticities of supply. The Physiocrats obviously thought these elasticities were considerable.

When we turn to Adam Smith, we discover, as several writers have noticed before,²⁰ that his theory of incidence implies a large acceptance of the doctrine that all other taxes will reduce the rent of land.²¹ Smith basically accepted the Physiocratic notion that a tax upon costs will be shifted so as to reduce surplus and that, conversely, a tax on surplus would not be shifted. He also agreed that the process of shifting would be destructive. His only real difference was that Smith thought rent was not the only surplus available for taxation,²²

even if it was the only true producers' surplus.²³

We have seen that Ricardo objected to Smith's acceptance of much of the Physiocratic doctrine that all taxes fall on rent²⁴ and argued instead that taxes would fall on profits or wealthy consumers. However, Senior and J.S. Mill were able to argue against this Ricardian conclusion within the terms of the model itself. They pointed out that taxes on profits would lead to an earlier arrival at the stationary state with lower population and lower rents.²⁵

Parallel with the type of reasoning which suggested that all burdens on labour and capital would cause rent to fall went another line of reasoning which argued the converse proposition: that economic progress and all boons to labour and capital would cause rents to rise. We have seen this view expressed by Adam Smith.²⁶ The argument is that all local subsidies, public goods or favourable externalities will be captured by land rents in the favoured area since capital and labour there are subject to competition from less favoured capital and labour.²⁷

This argument need not be interpreted to mean that only rent gains any benefit from such things, any more than the argument that all taxes on labour and capital depress rent must be taken as meaning that capital and labour suffer no loss thereby. All that both arguments require is that labour and capital are sensitive to their rates of return in a particular locality or nation and that the productivity of land increases with the capital and labour employed upon it.

Returning to the argument that all taxes fall on rent, in modern times it has been reformulated by writers such as H.G. Brown in his

discussion of the effects of a general tax on capital. Brown noted that

"In proportion, however, as a tax on capital, by diminishing the net income of capital, discourages capital accumulation, the owners of capital shift the burden upon other classes . . . the marginal productivity of capital and hence the interest on capital (including the part collected as tax) rises relatively to the marginal productivity of labour and wages and relatively to the marginal productivity of land and economic rent. The tax then tends to be shifted, to some extent, upon workers and landowners.

If the bearing of a part of this burden by workers, in the form of lower real wages . . . tends to reduce population and so make the supply of labour smaller, real wages tend upward and the tax falls in relatively larger proportion upon the owners of land. The demand for land is reduced . . . On the assumptions here made as to the effect of taxing capital on capital accumulation and as to the effect of a burden on wages upon population, we should arrive at something like the physiocratic doctrine that all taxes must finally fall upon the owners of land, in the form of diminished rent. But we should need to include among landowners the owners of urban and other non-agricultural land, whose status the physiocratic theory seems to have overlooked. And, also, we should need to distinguish between such indirect taxation of land . . . taking all their rent from the owners of near-marginal land while only taking a small proportion of their rent from the owners of superior land, and a

direct tax upon land rent, which would take the same per cent."²⁸

It is, of course, now commonly accepted that in an open economy from which capital and labour can migrate we can regard the wage rate and interest rate as exogenously fixed so that any tax on capital and labour must necessarily lead to emigration of these factors till after-tax rewards are restored. Ignoring any depressing effect the migration of capital and labour may have on their rewards elsewhere, it is quite clear that the effect in the taxing jurisdiction will be a fall in rents. This does not necessarily mean, however, a fall in the relative share of rent in output since output, capital stock and labour force will have all fallen.²⁹

In a closed economy, capital can "emigrate" as Brown noted by dissaving while labour can "emigrate" by lower population, lower work effort or the choice of leisure and untaxed household production. In this case, however, net wage rates and interest rates after tax are endogenous and we would expect them to fall with a corresponding fall in capital and labour supplied. In this sense, we can say that capital and labour can be made to bear the burden of taxation. However, as Brown observed, even in this case the marginal productivity of the fixed factor (land) must fall so that we are back with the result that taxes on capital and labour must cause rents to fall.

It is, therefore, correct to argue, as Locke and the Physiocrats did, that taxes on capital and labour will cause rents to fall, in contrast to a direct tax on rents which would only alter their division between owner and government. It is not, however, correct to argue (I leave open the question whether anyone ever did) that capital and labour

cannot be made to suffer a fall in net returns as a result of taxation and that a fall in rents is the only result of such taxation.

So far I have implicitly confined this discussion of Physiocratic tax doctrine to a three factor model of land, labour and capital under the classical assumptions that land is physically fixed in supply whereas the other two factors are not. There were, however, some writers who suggested that a more micro approach to tax incidence theory be adopted in which it would be seen that rent is not the only surplus. This approach characterizes the views of Seligman, Hobson and Lerner³⁰ and is closely allied to modern attempts to generalize the rent concept.³¹

The basic propositions common to these authors are that:

- (1) A tax on surplus cannot be shifted.
- (2) All other taxes, which are taxes upon costs of production, will be shifted till they fall ultimately upon surplus.
- (3) However, the process of shifting may well involve the destruction of some surplus.

These propositions clearly parallel those of the Physiocrats-- the obvious question they raise is whether there are other producers' surpluses than land rent and, if so, are they capable of being isolated for the purposes of taxation?

There have been several suggestions of other surpluses:

- (1) Wages above subsistence levels. This idea, of course, goes back to Ricardo and J.S. Mill. The obvious objections are that different jobs have different disutilities and different incomes are therefore necessary to elicit workers for harder jobs. Moreover, labour has

the choices of leisure or emigration.³² Again, if "subsistence" is a social concept, labour may choose not to reproduce in order to keep accustomed or reach desired living standards.³³

(2) Quasi-rents.³⁴ The Marshallian objection to taxation of these is obvious.

(3) Monopolistic advantages.³⁵ It was, of course, recognized by Adam Smith that the profits of monopoly were uniquely suitable for taxation but surely the first best solution is to abolish artificial monopolies and tax, if one wishes, the natural monopoly--land.³⁶

(4) Pure profits, disequilibrium surpluses and speculative gains.³⁷ The objection to regarding these as surpluses is that they are self-eliminating; in fact, they serve the very useful purpose of guiding the allocation of resources towards equilibrium. To tax them is, therefore, to reduce the incentive for economic adjustment.

(5) Special and rare talents such as those exhibited by opera singers, baseball stars, doctors, lawyers, etc. The objection to calling these surplus incomes is that, to the extent they are due to barriers to competition those barriers were better eliminated. In any case, such occupations exhibit uncertain prospects of success,³⁸ demand much practice and human capital investment in training and substantial risks of loss of income through injury.³⁹

(6) Bequests and gifts.⁴⁰ These are surpluses only from the point of view of the recipient, not from the point of view of the donor. One could argue that taxes on bequests could in fact deter capital formation aimed at providing such bequests.

(7) Finally, it may be suggested that even homogeneous capital

and labour in a three factor model could generate aggregate producers' surpluses. Now this may well be true but the question then becomes whether such surpluses can be isolated for taxation. The problem arises from the fact that we cannot speak of the "marginal product of the 39th man" but rather must speak of the "marginal product of 39 men." Every unit of capital of labour when it is homogeneous is equally marginal⁴¹— we cannot isolate "a surplus earned by a particular⁴² part of a factor of production over and above the minimum earnings necessary to do its work."⁴³ In contrast, the rent of particular units of land can be isolated for taxation. Consequently, attempts to tax surplus components of interest and wages would seem to be impossible.⁴⁴

In summary, there do seem to be good reasons for thinking that surpluses other than land rent are either not surpluses at all or are not capable of being isolated for purposes of taxation.⁴⁵ Consequently, the modern proposition that all taxes fall on surplus does not seem for practical purposes much of an advance on the arguments of Locke and the Physiocrats. The general conclusion of the history of doctrine in this area would seem to be:

(1) All taxes on factors in variable supply will lead to lower returns for factors in fixed supply. This will occur through excise effects which reduce surplus, by rendering some activities sub-marginal.

(2) If the factors in variable supply are not infinitely elastic, they too will suffer from an inefficient indirect taxation of their aggregate surplus.

(3) In contrast, taxes levied directly on surplus will not reduce its amount but simply alter its division between individuals and

the State.

(4) In practice, the only fixed factor in the long run is land and the only surplus which can be clearly isolated is land rent. It would therefore seem to be a practical proposition to assert that taxes on labour and capital do, in fact, cause land rents and values to fall. Consequently, the substitution of land value taxation in lieu of taxes on capital and labour may create an induced rise in land values which may offset the fall in land values caused by tax capitalization.⁴⁶ The strength of any such compensating rise in land values obviously depends on the elasticity of supply of capital and labour.⁴⁷

The practical relevance of the argument that all taxes on labour and capital reduce land rents should by now be obvious. One argument against land value taxation has been that landholders are entitled to compensation. That question can be pursued elsewhere and refuted on its own premises but we can now see that there is a possibility there will be no loss to landholders anyway, so long as land value taxation is in lieu of other taxes.⁴⁸ Just as the capitalization doctrine furnishes one argument for the ultimate burdenlessness of land value taxation per se,⁴⁹ so the doctrine that all taxes reduce rent furnishes another argument for the immediately burdenless nature of land value taxation when substituted for other taxes. A gradual transition to land value taxation could, by creating a higher, even if terminable, stream of rents largely compensate landowners for the loss of a perpetual stream of rents depressed by alternative taxes.