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The Unplumbed Revenue Potential of Land Part 3: ATCOR (All Taxes Come Out of Rents)

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When we lower taxes, the revenue base is not lost, but shifted to land rents and values, which can then yield more taxes.

This is most obvious with taxes on buildings. When we exempt buildings, and raise tax rates on the land under them, we are still taxing the same real estate; we are just taxing it in a different way. We will show that this "different way" actually raises the revenue capacity of real estate by a large factor. There is much recent historical experience with exempting buildings from the property tax, in whole or part. It has shown that builders offer more for land, and sellers demand more, when the new buildings are to be untaxed. The effect on revenue is the same as taxing prospective new buildings before they are even built, even though the new buildings are not to be taxed at all.

Land value is what the bare land would sell for. It is specifically and immediately most sensitive to taxes on new buildings, and on land sales, as well as to new and more stringent building code requirements or zoning that often discriminate against new buildings. Where new buildings are "coded" more severely than old, it enhances the value of the old land/building packages. This premium should be considered part of land value, and taxable as such.

We have numerous historical experiences with exempting buildings leading to land booms: New York City 1922-33, Western Canada, Hong Kong, Taiwan, Australia, South Africa, San Francisco after the fire, Chicago after the fire, California Irrigation Districts, Cleveland 1903-20, Toledo, Detroit, Portland, Seattle, Houston, San Diego.

Familiar Micro Cases

The general principle that tax cuts shift to higher rents is, in many ways, like the forest: too ubiquitous for most to see clearly. But here are a few of the trees:

- Lowering corporate income tax rates raises stock markets.

- Lowering the income tax rate on capital gains has doubtless contributed to the following runup in land prices.
- Private commercial rents in leases are usually multipartite. A lower share of gross revenues is traded off for a higher fixed rent, or vice versa. It's like the law of conservation of energy in physics: everything must be accounted for, and for every action there is an equal and opposite reaction. Commercial rents in retailing usually contain at least two elements: 1) a fixed monthly rent and 2) a share of sales (or sometimes of profits). If the rate in element (2) is higher, then element (1) will be lower, to compensate. Reports by the city-owned Port of Milwaukee show how they handle industrial leases the same way.
- Payroll taxes and disincentive kinds of business taxes make firms leave states, lowering demand for land. This does not, of course, discourage the minority of business activity that does not contribute to production; Walter Rybeck has sagely suggested that we distinguish two functions of "business": wealth-creating and resource-holding. A good tax system will not make people pay for creating wealth but for simply holding resources.

The Resource Curse Effect

Economists and historians have noticed that nations and regions that are rich in natural resources to export often lag in manufacturing. This is often now called "The Dutch Disease," although obviously they did not catch it until modern times, with the oil and natural gas booms. These prized exportable items raised the value of the Guilder, making Dutch manufactures cost foreigners more, and letting Dutch consumers import competing foreign products. Canada exports lumber and energy products to the same effect; so does Alaska, which also collects great federal largesse, military and porkbarrel. Canada taps into resource revenues to lower national taxes; Alaska, to lower other State taxes and distribute social dividend to each resident. Thus, resource rents help raise other land values.

Utility-Rate Effect

Lower rates mean higher land values. During the Progressive Era, rapid growth of cities called for providing costly utilities and transit on a new and massive scale. Many big-city mayors, some directly instructed by Tom Johnson of Cleveland, saw that providing these services raised land values, which could be taxed to pay for them. Private franchisees saw they could profit by squeezing monopoly profits from the franchises. It became a running battle.

The economics profession lagged in responding. A number of professors were removed from leading universities after writing or speaking too openly against the

franchises (Tom Johnson hired one of them, Edward Bemis, to advise him on rate regulation). Rich franchisees, after all, might help endow universities as Chicago traction magnate Charles Yerkes did with his observatory. But in 1938 Professor Harold Hotelling of Columbia drew the point sharply in a leading article in the obscurely statistical journal Econometrica. He was followed over time by a school of thinkers who favor "Marginal-cost pricing," which often means lowering user rates on mass transit and utilities, making up the deficits by taxing the benefited lands. Theorist Abba Lerner even tried to squeeze all of economics into what he called "The Rule": set price equal to marginal cost. More recently Martin Feldstein, William Vickrey, Joseph Stiglitz, Richard Arnott and others have popularized what they call "The Henry George Theorem" wherein lower utility rates lead to higher land rents.

The Logic of ATCOR

The thesis that all taxes are shifted to landowners follows logically from two premises. One, after-tax interest rates are determined by world markets. The local supply of capital is perfectly elastic at a fixed, after-tax rate. Two, the wages of labor has been reduced to so low a level that it cannot bear any more tax burden. Anyone may test the premises by observation.

The Frank Ramsey Rule of taxation, as stated by himself in 1927, and by his mentor, Arthur Pigou, says that to minimize the excess burden of taxation we should tax only those items whose supply or demand is least elastic. We should tax no item at all if we can find another one whose demand or supply is less elastic. This rule leads directly to obliterating all taxes except on land values.
Inelastic demand over a range of prices is impossible, because buyers inevitably run out of money as prices rise. (Economists like to call that the "income effect," but it involves wealth and liquidity as well as income.") That leaves supply, and only land is supplied inelastically. If there are exceptions they are too rare and contrived to concern anyone except as debating ploys. Ramsey cautiously left that to inference (and then died young). Later economists, citing this rule over the years, have quietly dropped the word "supply". Charles McLure and George Zodrow and Laurence Lindsey, and most texts on public finance, are examples. The only exception I have found is Stiglitz. — M. G.

If there are unemployed workers, then the supply of "work" (as opposed to "labor," defined as so many warm bodies) is highly elastic. When we find work for the unemployed and underemployed, labor gains without costing land or capital anything at all. Even better, in fact, labor gains while benefiting other taxpayers, because of

lower dole costs, lower crime costs, etc. The enhanced psychic benefit of universal job security is also worth a lot (although not in direct money). In the era when Keynesianism was in flower, many alleged that the social cost of putting the unemployed to work is zero.

Nowadays, of course, Keynes is out of style with the dominant anti-labor schools. Unemployment is considered simply as leisure — a voluntary choice, a matter of personal taste. And yet, Chicagoans like Gary Becker freely postulate elastic labor supplies when they blame unemployment, as Becker routinely does, on minimum wage laws. It's not clear whether Becker sees the parallel, but that is a Keynesian assumption.

It is likely that real wage rates would rise, as more-efficient land use increased demand for labor and lowered product prices. Compact settlement would create new rents via the synergies that are not aborted by scatter. This was the theme of *Progress and Poverty*, and the primary goal of Henry George's reforms. True, that was before we had heavy payroll and income taxes on labor. In real terms, though, the outcome is the same: it is likely that the abolition of such taxes would let after-tax wage rates rise, even while before-tax wage rates remain the same, or fall. To the extent that this process diminished, if it did, the overall public-revenue potential of land, few would call it a calamity.

Capital Supply is Elastic

Most economists assume this, emphasizing world markets, rapid transfers, arbitrage. However (and in addition), even in small closed economies, there is underemployed capital, just like labor. This is because the return is held down by taxation. So it goes into untaxed consumer goods, and tax-exempt forms of capital, like housing, foundations, government works or personal property. When all uses of capital are untaxed, these forms would be placed on equal footing with higher-yield opportunities. From this would spring a large supply — voila! elasticity in the supply of capital. George recognized this, although he had his own way of expressing it. He did not regard consumer capital as being "really" capital (as it was not actively being used in production), but he did observe people living on it while they produced other capital. During World War II we experienced a vivid example of how people can draw down consumer capital to meet an emergency need.

Logic and experience both overwhelmingly support the idea of ATCOR. To summarize: the revenue capacity of land, when it is substituted for other tax bases, is comparable to current revenues. Owing to efficiency effects, and renewal effects, it may well be higher. The major reservation is that the supply of labor is not totally

elastic, so some of the revenue gains may be "lost" in higher wage rates, but on the whole higher wage rates are socially desirable, and serve to lower many public costs as for welfare, policing and jailing, aggressive military spending, make-work projects, etc.

Multiplier Effect of Taxing Absentee Owners

Transferring rents from them to our fisc, and spending the proceeds locally, improves the state economic base and balance of payments. It is alleged that we must avoid taxing absentees, because they will remove their capital from our state, but they cannot remove most land. The only way they can remove oil and gas is by producing them. The present owners of most of our oil and gas became so by acquiring it from existing local owners and producers, so it is hard to argue they ever did bring capital into the state. It is easy to argue, however, that a democratic sovereign state reports to and is responsible to the resident electors, not absentee owners. It is easy to argue that the quality of life is worsened when absentee owners displace local owners and turn local people into tenants. There is no social value in encouraging absentees.

A high percentage of real property is owned from out of state and even out of the country. The percentage is much higher than we may think. It is not just Japanese banks and the Arabs in Beverly Hills. It is corporate-held property which comprises almost half the real estate tax base. If we assume that California's share of the stockholders equals its share of the national population, then ninety per cent of this property is absentee-owned; the percentage may be higher because many of these are multinational corporations with multinational owners.

There is a curious silence on the matter. Some critics of capping the property tax rate talk about "business" securing the lion's share of benefits. No one seems to have seized on the fact that half the taxable property in California is owned by people not voting in the state, and not spending their incomes in the state. Here is one instance where localism (which can be ugly, as we know) may be harnessed to help create a more healthy society. The purpose of democracy is to represent the electorate, not the absentee who stands between the resident and the resources of his homeland.

California's legislative analyst, William Hamm, estimated in 1978 that over fifty per cent of the value of taxable property in California was absentee-owned. This is such a bold, bare, and enormous fact it is hard to believe that Californians could be misled into resisting the urge to levy taxes on all this foreign wealth. They may be put off by the argument that they need to attract outside capital, but that carries no weight when considering the large percentage of this property which is land value.

Some half of any reduction in California property taxes leaks to out-of-state owners. Nor is this the only leakage. Net federal income tax payments have risen because sales and nuisance taxes raised to replace lost property taxes are not deductible. Sales of local general obligation bonds have stopped and will stay stopped. Revenue bonds are sold instead, with higher interest rates. Fire insurance rates must rise. And private spending substituted for public spending will have a higher propensity to import. Public spending goes for policemen, firemen, teachers, local contractors, and so on.

This substantial leakage of economic base results in multiple declines in state income. One drastic example of this is offshore oil and gas, which is outside state sovereignty and escapes all state and local taxation. One result is unbalanced state hostility to offshore leasing, for the locals suffer the degradation without sharing the gains. Some provision for state sharing in offshore revenues seems indicated.

The Picture So Far

In this article and our two prior installments, we have discussed fourteen new elements of land's taxable capacity. Previous estimates of rent and land values have been narrowly limited to a fraction of the whole, thus giving an entirely false impression that the tax capacity is similarly narrow. We are adding the following elements to the traditional narrow "single tax" base:

- Correcting omissions and understatements in standard data sources
- Updating ancient sources that use obsolete low values
- Raising the Land Fraction of Real Estate Values (LFREV)
- Adding rents that are best taxed by use of variable excises
- Adding rents taxable by income taxes
- Substituting taxes for subsidies to foster conservation
- Adding current unearned increments as part of ongoing rent
- Adding previously invisible and undervalued resources to the tax base
- Adding lands held under variant forms of tenure
- Adding rents that are now dissipated, but need not be
- Noting the feasibility of much higher tax rates on a base that is both non-erosive, and concentrated in ownership
- Noting the great mass of holdout prices (WTA values) exceed visible market prices (WTP values) by a large factor
- Adding the revenue from most existing taxes to the potential land tax base, on the ATCOR principle
- Multiplier effect of taxing absentee landowners

Any one of those Fourteen Elements indicates a significantly higher land tax base than economists commonly perceive today. Taken together, they are overwhelming, and cast an entirely new light on this subject.

One Final Rent-Raising Factor: Mortgage Interest as Land Rent

Here is one further supplement to the land rent tax base, which I am not counting among the basic fourteen because it involves novel thinking, and is fraught with controversy, which might divert us too much from the main chance.

One kind of paper is systematically recorded at the county level: mortgages, or deeds of trust. It is administratively feasible to put these into the property tax base, as Professor Don Hagman kept urging. But is it desirable? A tax on mortgages would be mostly shifted to borrowers in the form of higher interest rates, the supply of mortgage funds being highly elastic. Thus, to tax mortgages is indirectly to tax real estate.

It is widely assumed that cheap long term credit is essential to let most people buy real estate. Unfortunately that reasoning overlooks the nature of land values, which makes it circular. The main effect of long term loans has been to inflate land prices,***creating the very problem it offsets***. It is a treadmill effect, like keeping up with the Jones's. It must be conceded that holders of existing mortgages would suffer. But someone suffers with any change of tax or other public policy; there are always winners and losers. It is a risk all investors take knowingly. Phasing-in is possible, and it should be remembered that in a Georgist tax shift, most holders of mortgages would be relieved of some or all of the income-tax burden they currently endure. (Another benefit of including mortgages in the property tax base is to counter the argument that the property tax discriminates against equity holders of real estate. Many have questioned the equity of focusing taxes on the person with 5% equity in a parcel, while exempting his bank.)

Would new lending be discouraged? Yes, at the margins. The most sensitive margin is one which most people would not perceive at first, that is the margin of durability or longevity. The more deferred the benefit of an investment, the more interest-sensitive is its present value. But, is that bad? We are conditioned to answer "yes," but as an economist, I doubt it. The financial system will adapt by basing loans less on land collateral, and more on buildings, inventories, accounts receivable, crops, personal reputation, and appraisal of specific projects. This is more labor-intensive banking, and less capital-intensive. Untaxing labor, as proposed herein, makes this more feasible. On balance this will help stabilize the financial system, whose worst fiascos, like the South Sea Bubble of 1720, the world banking collapse of 1932, the American

Savings-and-Loan debacle of 1987-91, the Japanese collapse after 1992, and so on have resulted from speculative loans on land.

It is time to revive the old “commercial loan” theories of banking, with their emphasis on liquidity and quality of credit, achieved mainly by sticking to self-liquidating short-term commercial loans, and avoiding long and speculative loans secured by real estate. It is a subject too big to open here, but you will find plenty of support in the history and theory of banking for keeping lenders out of mortgages.

Rent as Revenue: Quantity and Quality

I hope that this brief survey has demonstrated land’s suitability as a tax base in terms of quantity. It is eminently suitable in terms of quality as well. The macro-economic benefits are deep, wide, high, and temporal. To produce the added goods the owner invests more capital and hires more labor, or sells parcels to laborers wanting to go into business on their own. The newly employed labor earns incomes to buy the newly produced goods and services. Here is supply-side economics coupled with demand-side economics. The conventional left-wing objections to Say’s Law do not apply here, because we are untaxing capital at the same time, and raising investment opportunities. We are financing government to provide needed infrastructure to develop new lands, or redevelop brownfield lands, to open new investment opportunities for private capital. The conventional right-wing objection that capital is limited does not apply, either, because we are stimulating saving, stimulating import of capital, and raising turnover of capital. (Turnover raises the ratio of income-creating investing to capital.) It is the macro-economists dream, leveling upwards while balancing supply and demand, saving and investing.