Reagan's adviser and the land tax

CONSIDER these words, taken from a paper by none other than President Reagan's chief economic adviser, Prof. Martin Feldstein.

> **"One of the reasons that economists have long been interested in the tax on pure rental income is that it is tax without an excess burden. Because the owners of land cannot alter the supply of land, the tax introduces no distortions and therefore no welfare loss."**

Shorn of the jargon, this statement asserts that the land value tax – unlike other taxes – does not interfere in the processes by which wealth is produced. Other taxes alter the proportions in which the factors of production are brought together.

A tax on steel, for example, causes other materials to be substituted for steel in applications where steel would be the most efficient choice. Factor proportions are distorted, efficiency suffers and output falls.

Taxes other than land-value taxes thus impose a burden on production. More generally, they reduce welfare in the sense of making people feel less well off. This happens because people alter the pattern of their purchases away from the pattern which gives them most satisfaction.

But the main message of Prof. Feldstein's paper* is that economists have been wrong in supposing that a tax on land values cannot be passed on. Since this is an attack on a proposition which has never before been seriously questioned, it has attracted a good deal of attention among those interested in the subject.

But it is important to be clear about what Prof. Feldstein is, and is not, saying.

What *is* being attacked is the contention that the income from land ownership will be reduced by precisely the amount of a land value tax and that land prices will therefore fall by precisely the capitalised value of the tax.

Prof. Feldstein makes an assumption which is crucial to his analysis ... that those who acquire land do so for the purpose of disposing of it later, to provide for their old age.

If the land value tax reduces the value of land, a larger proportion of the desired wealth must be accumulated in the form of capital. The capital stock is therefore increased, which raises the marginal productivity of land and therefore increases land rent. This increase in the amount of capital reduces interest rates and if land is not to become more attractive to hold than capital at the reduced interest rate, its price must rise. These effects offset the fall in land prices which result from the imposition of the tax.

● **Prof. Martin Feldstein**

Report by PAULA JAMES

WHAT is *not* in question is the statement quoted at the beginning of this article. To quote from Prof. Feldstein's conclusions:

> **"The conclusion of no excess burden is unaltered ... the tax induces no distortions and no welfare loss."**

Thus, what the paper is concerned with is the possibility of a once-for-all price movement which would favour the existing generation of landowners and partially (or, possibly, fully) offset the loss which they would otherwise suffer as a result of a land value tax.

Even if this did happen, the beneficial effects upon the economy as a whole would not be lost; only the initial distribution of these benefits as between landowners and others would be affected. This is tantamount to saying that, contrary to the accepted view, the existing generation of landowners *would* be able to pass on some of the land value tax.

Whether this effect would happen at all depends upon whether Prof. Feldstein's hypothesis – about the way in which people manage portfolios of assets – is borne out in practice.

It is a hypothesis which has often been adopted for other purposes, but it is not an established fact. And in order to make it possible that all of the tax is passed on, it is necessary also to assume that savings rise strongly in response to a fall in interest rates.

No evidence is offered to suggest that this is likely.

The paper also discusses the incidence of a land value tax in the short run, but this is of less interest.

It is a commonplace that changes in the market's view concerning the riskiness of holding land and in particular, of the prospects of increases in the rate of a land value tax, are likely to have an influence upon land prices, and that windfall gains and losses will therefore occur. In practice, the mode of introduction of the tax would require careful planning.

Nonetheless, the land value tax retains its status as the ideal form of taxation.

After more than a century of governments' failure to act upon this fact, the theoretical possibility that the initial distributional effects might not be precisely as has generally been assumed should not cause too much concern!

Martin Feldstein; 'The Surprising Incidence of a Tax on Pure Rent',** ***Journal of Political Economy, **Vol. 85, No. 2, April 1977.**

'LAND VALUE TAX – THE IDEAL FORM OF TAXATION'