The Losses of Nations: Deadweight Politics versus Public Rent Dividends

Fred Harrison (editor)
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Review by ROGER SANDILANDS

THIS BOOK is an impressive sequel to *Costing the Earth* (Shepheard-Walwyn, 1989), in which a team led by Ron Banks estimated the true annual rental value of Britain's land and natural resources for 1985, a fairly representative year, at 22% of national income. The official figure for rent's share in Britain, as in most other countries, is much lower than this because of the modern economist's casual lumping together of land (including natural resources) with buildings ("total capital investment") from which the income is mostly regarded as "return on investment", or interest income rather than rent.

The tragic consequence of this modern convention is that though influential economists happily agree that the "taxation" of rental incomes uniquely induces no "deadweight efficiency losses" because land is in fixed supply, they dismiss the idea as a serious replacement for other taxes when these amount to 30-50% of GDP.

One of the contributors to this volume, Professor Mason Gaffney of the University of California, recently gave us a brilliant exposé, in *The Corruption of Economics* (Shepheard-Walwyn, 1994), of the way in which the neo-classical revolution fused land with capital. This conveniently (for the propertied classes) diverted attention from the distinctive treatment of land, in the classical economics of Smith, Ricardo, Mill and Henry George, as a separate factor of production and the natural and prospectively buoyant source of public finance.

In *The Losses of Nations* Banks, Gaffney and others extend their earlier contributions in terms both of empirical and theoretical support for the hypothesis that rent-based public finance can fairly, efficiently and fully replace the current system of distortionary and extortionary taxation (though, as Fred Harrison emphasises, taxes on cigarettes and fuel may be retained on health and environmental grounds).

The first half of the book is written by Harrison and surveys the general issues. His main concern is that the private expropriation of rents and land values is at the heart of the boom-and-bust cycle, most dramatically exemplified by the way in which soaring land values, artificially inflated by speculative holdings of land in idle or suboptimal use, brought financial crisis to Japan after 1990 and collapse to much of the rest of Asia in 1997. The IMF, a citadel of neo-classical economics, can only prescribe a dose of deflationary medicine via increased taxation of all incomes and expenditures, as the price of their massive salvage operations. These are designed to prop up the Asian financial system, fed by western bank credits, whose loans were collateralised by land whose value boomed and then slumped when it had cut too deeply into the returns on productive activity. Meanwhile, in Russia the IMF continues to urge Boris Yeltsin to privatise land so that there too it can be used as collateral for loans (domestic and foreign)!

Harrison coins the term "the law of economic absorption" to describe the process whereby improvements in economic efficiency, such as the liberalisation of world trade and capital movements, tend to be at least partly captured by the owners of land rather than by labour and capital. This in turn induces speculative purchases of land. Unlike speculation in reproducible commodities, speculation in land does not induce an increase in its overall supply to bring down its price. It is a zero sum game. Eventually there is a price collapse as hoarders become offloaders, and this plunges banks into crisis.

If ownership or exclusive occupancy of land were viewed as a privilege, with rights purchased from the state as guardian of the community interest, then it is argued that the revenues would permit the abatement of almost all taxes on labour and capital, and eliminate the speculative motive for holding land. By contrast, the system we do have actually takes on the character of a negative-sum game. For the law of economic absorption means not only that taxes on labour and capital adversely affect the supply of labour and capital - which explains the "excess burden" or "deadweight losses" of these taxes - but also that they cut deeply into rents that owners can charge tenants or impute to themselves. This then persuades economists and politicians, looking only at the surface phenomena in economic life, to dismiss land as an important source of revenue for the modern state.

The late Nobel Laureate William Vickrey had deeper insight. Get taxes off the backs of labour and capital. And price public utilities at their (low) marginal cost - an important efficiency criterion - to boost demand and exploit economies of scale. Land values will rise thanks to the cheap services and higher disposable income, and because augmented supplies of labour and capital increase the demand for space. Then "tax" those enhanced land values. (Insofar as the state asks for rent proportional to the amenity and location value of sites, the charges are based on the benefit principle. Thus they are not taxes but fees, like the price of theatre tickets or parking charges.)

FOLLOWING Harrison's lively scene-setting come several chapters packed with further deep insights and empirical support. First, Ron Banks updates the earlier investigation into the underlying value of Britain's natural resource rents, put at 22% for 1985. This figure made no allowance for the depressive effect

of taxation of buildings and people. For 1996/97 Banks conservatively assumes the figure to be 17.5% of GDP, but introduces a new notion: that there is an irreducible minimum of government spending - mainly defence, law and order, and much of the transport system - that is required to maintain land values and for which citizens would always need to pay a rent to the supreme landlord. Most other items of public spending could, in principle, be provided privately, so their counterpart revenues are not land rents. Banks puts the "socially necessary" (rent counterpart) items of spending at £108 billion or a further 16% of GDP. Moreover, he notes that a significant proportion of mortgage interest, currently counted as interest on savings (capital), is actually a return on the land element of "housing" and other structures.

Drs. Nicolaus Tideman and Florenz Plassman tackle the "excess burden" issue more directly. They ask how the inputs of land, labour and capital would respond to a change to a rent-based fiscal system. Heroically, they test a famous version of an "aggregate production function" that relates aggregate output to the three main inputs, which in turn are supplied in accordance with their marginal after-tax returns. Partly building on the work of Harvard economist Martin Feldstein who calculated the elasticity of labour supply to a change in the marginal tax rate, Tideman and Plassman reckon that removal of the deadweight losses of the current tax system would increase GDP by nearly 30% for the USA, where taxes are relatively low, and by over 90% in countries with higher taxes. Their estimates may be conservative because they assume that the production function is "augmented" by an exogenous rate of technical progress of just 1% a year. In reality technical progress is likely to be endogenous to the opportunities thrown up by the much larger size of market that is implied by their estimates of the elasticities of supply of land, labour and capital to a change in incentives and relative prices.

Mason Gaffney and Richard Noyes corroborate Tideman and Plassman by comparing those US states that rely more heavily on property taxes with those relying more heavily on income and sales taxes. The former are very significantly richer or fast-growing than the former. The authors give convincing reasons why the direction of causation is almost certainly from fiscal structure to income rather than from income to fiscal structure. The finger of suspicion points firmly at Proposition 13 as the origin of California's relative decline since 1978.

THE LOSS of wealth attributable to taxation has been computed by Prof. Nic Tideman and Dr Florenz Plassmann. Their model estimates the value that would have been enjoyed by citizens in the G7 countries if a rational public finance had been in place. The gain in Net Domestic Product (NDP) for the seven countries would be of the order of $6.8 trillion (£4,357 billion).

G7: Gain in Output and *Per Capita* Income under the Rent Revenue Policy (1993)

	NDP $ bn	NDP *per capita* $
USA	1,602	6,902
Canada	275	9,142
France	879	15,166
Germany	1,018	12,406
Italy	815	14,128
Japan	1,535	12,284
UK	716	12,133
Total	*6,840*	

Source: Derived from Table 6:I, page 147, *The Losses of Nations*

Another chapter by Gaffney, "The Philosophy of Public Finance", is tough but highly rewarding. He explains rigorously how and why the ultimate incidence of taxation falls on rent. Harrison's law of economic absorption becomes Gaffney's ATCOR principle: All Taxes Come Out of Rent. Building taxes, for example, reduce the amount that the buildings' occupants are willing to pay in rent, or that landlords are able to charge. If taxes on buildings were abated, a proportional increase in the rate levied on sites would yield the same revenue because there would be a proportional increase in the value of the site. The revenue base would be maintained. Indeed, Gaffney shows that this is the very minimum we could expect. In reality the base would expand significantly because of the way the new system enhances incentives to build and develop.

Since building taxes fall most heavily on new relative to old buildings, "challenge values" offered for land would rise relative to the "defence values" of existing owners and tenants who have been holding sites off the market or in suboptimal uses under the old regime. Urban renewal would generate more compact, more synergistic cities. Land values at the extensive margin (catering for horizontal sprawl) may fall, while those at the intensive margin would rise. But building costs, relieved of taxes on capital and labour, would fall. And so would the public costs of urban infrastructure. There would be a gearing effect because private and public borrowing costs would then also fall. This is equivalent in its effect to a fall in interest rates. Building is highly sensitive to the interest rate through its effect on expected returns on the supply of new structures relative to the return on the old stock. The sensitivity to tax changes would be even greater.

It is an exciting story. The message is that a rent-based fiscal system can reconcile the libertarian ideals of limited government with the communitarian view of man as a social animal with both rights and obligations. (This builds on Richard Noyes's book, *Now the Synthesis* [Shepheard-Walwyn, 1991].) As Fred Harrison puts it: Privatised rent is the last great injustice inherited from previous civilisations dominated by landed interests. By reforming public finance, rather than merely tinkering with the existing system, we may herald an age fit for a new millennium. L&L