

# Land Tax versus Income Tax: A Historical Assessment of Success and Failure in South Africa

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## **I. Introduction**

The writers of the 1996 Constitution of South Africa were aware of the special significance of land. Section 25 (5) of the Constitution says, ‘The state must take reasonable legislative and other measures, within its available resources, to foster conditions which enable citizens to gain access to land on an equitable basis’. The writers of the Constitution can be presumed to have put this clause into the Constitution because they understood that lack of access to land makes citizens second-class proletarians. The state must ensure this does not happen.

The most economical way to enable citizens to gain access to land is by taxing land instead of incomes. This works in two ways. First, other things being equal, taxes on land cause the selling price of land to fall. When land has a lower selling price, it is easier for people to buy land. It is true that they must pay the taxes, but for most people an annual tax on land is less of a burden than the higher price that must be paid when land is not taxed. A personal exemption in a land tax provides a second way in which taxing land enables citizens to gain access to land. If there is a land tax with a personal exemption of, say, R 1,000 per annum, then any citizen can possess a plot of land on which the tax is up to this amount, and there will be no tax to be paid, making it possible for the citizen to possess the land at no out-of-pocket cost.

For more than 200 years, South African policies regarding land have fluctuated, sometimes intersecting with policies regarding income taxation. This paper traces some of those fluctuations and intersections. We begin with the historical events surrounding the first significant land policies.

## **II. Nineteenth Century Fluctuations in land policy**

The Cape of Good Hope had been occupied by the Dutch East India Company (Vereenigde Oost-Indische Compagnie; VOC) for 147 years, from the time of Jan van Riebeeck in 1652 to 1799. After it had changed hands twice in the Napoleonic Wars, its final status was determined by the Battle of Blaauwberg, Cape Town, between British and French/Batavian forces on 8 January 1806. The sea route around the Cape to India was deemed vital for British interests, so they attacked the French. Two British infantry brigades,

under the command of Lt Gen Sir David Baird, won the battle, inflicting 353 casualties and desertions and losing 212 men. This established British rule in the Cape of Good Hope Colony. The losses were a small price to pay for securing the route to India and gaining a foothold in Africa.

At that time land in the colony was controlled by the VOC and lent to mainly Dutch and French burghers, many of whom were employees of the VOC. This did not provide the security of land tenure that English Governor John Craddock (1811-1814) deemed necessary to attract settlers and also to provide revenue for the colony, so he introduced perpetual quitrent tenures (PQT) in 1813.

Quitrent is a form of ownership in English law, under which a freeholder is obliged to pay an annual rent to the lord of the manor so as to be quitted, or unburdened, of all other services, even military ones. It is comparable to rates and taxes currently levied by Municipalities in South Africa under Act 6 of 2004 as amended, but quitrent excludes improvements from taxation. PQT is therefore reminiscent of the site value rating system that prevailed in the Gauteng provinces until 2004. A vital condition for the quitrents that Craddock introduced was that 'all improvements to the soil should indisputably belong to the holder as his own and be exclusively secured to him and his heirs'.<sup>1</sup> In this he differed from the Hon Julius Malema MP, leader of the Economic Freedom Party, who has proposed in the South African Parliament that all land and improvements be expropriated without compensation.<sup>2</sup>

PQT enables even the poor to afford land and allows the state to rely for its revenue on the benefits provided by nature, state infrastructure and state services, and not the work, savings or consumption of citizens.

A typical PQT deed of transfer, lodged in the Grahamstown Deeds Office in 1827 in favour of Mr John Bailie (see Figure 1), includes the following conditions:

*[The land] shall become forfeited to Government, in case the Party shall abandon the Estate, or not bring it into due cultivation, within Three Years from the Date hereof.*

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<sup>1</sup> Quoted in Milton, J.R.L., 'Property,' in R. Zimmermann (ed.) *Southern Cross: Civil Law and Common Law in South Africa*, Juta and Company Ltd, 1996, p. 665.

<sup>2</sup> See, for example, <http://effighters.org.za/economic-freedom-fighters-reject-the-r1billion-land-purchased-by-the-south-african-government/> .

Figure 1: A Typical Quitrent Deed

Registered in Bathurst 2174 19 2-20  
 NEW Town Register Folio 220  
 Bathurst register folio 157

ISSUED FOR INFORMATION ONLY  
 ALLEEN VIR INFORMATIE SIEGEGELIENDES UITGEREIK

By His Honor Major-General RICHARD BOURKE, C.B.  
 Lieutenant-Governor in and over the Settlements at the  
 Cape of Good Hope, and Commanding the Forces.

I do hereby Grant on Perpetual Quitrent, unto  
*Mr. John Bailie*  
 a Piece of *One Thousand Seven Hundred and One*  
*Hundred and Forty four square rods*  
 of Land, situated in the *District of Albany*  
 Extending *N. W. to Mr. Mounsey's Location - N. E. to*  
*Mr. Owen's, and Mr. Brand's Location - S. E. to*  
*the remaining part of Mr. Bailie's Location; and*  
*S. W. to Government Land.*

as will further appear by the Diagram, framed by the Surveyor; on condition, that, in  
 pursuance of Directions from His Majesty's Secretary of State, respecting Settlers, the  
 Land hereby granted, shall be Cultivated by Free Labourers only, and be resumable in  
 the event of any Slaves, whether hired, or of whatever nature or description, being em-  
 ployed thereon. That the said Land shall be further subject to the following Clauses,  
 (beyond the usual reservations of the Right of the Crown to Mines of Precious Stones and  
 of Gold and Silver, and to making such Roads as may be necessary for the convenience of  
 the Colony): That it shall become forfeited to Government, in case the Party shall  
 abandon the Estate, or not bring it into due Cultivation within Three Years from the Date  
 hereof. And that he, the said *Mr. John Bailie*  
 shall be excused the reserved Rent of *£ 15-2 Sterling*  
 for the first Ten Years, from the First of July, One Thousand, Eight Hundred and  
 Twenty, subsequent to which Period, he shall be bound to Pay, or cause to be Paid, at  
 the expiration of every Twelfth Month, unto the Receiver of Land Revenue, the Sum of  
*Fifteen Shillings and Two Pence Sterling*

and be bound, (according to the existing Laws of this Settlement,) to have the Boundaries  
 properly traced out, and sufficient substantial Landmarks affixed at the Angles thereof;—  
 the Land thus granted being further subject to all such Duties and Regulations, as either  
 are already, or shall in future be, established respecting Lands, granted under similar  
 Tenure.

Given under my Hand and Seal, at the Cape of Good Hope, this *6<sup>th</sup>* Day of *July 1821*

By His Honor's Command,  
*Richard Bourke*  
 Lieutenant-Governor

*Wm. D. ...*  
 Secretary to Government.

REPRODUCTION OF QUITRENT.  
 The original provided on the land  
 held under this Title deed was fully  
 reduced on the 25<sup>th</sup> day of Sept 1888.  
 Vide folio S. 1574.  
 Per: W. H. 1905, *W. H. ...*  
 for Acting Surveyor-General.

*And that he, the said Mr. John Bailie shall be excused the reserved Rent of £ 0-15-2 Sterling for the first ten years, from the First of July, One Thousand, Eight Hundred and Twenty Seven, subsequent to which Period, he shall be bound to pay, or cause to be Paid, at the expiration of every Twelfth Month, unto the Receiver of Land Revenue, the sum of Fifteen Shillings and Two Pence Sterling, or whatever sum may be determined to be a fair annual market rental for the land.*

Note the following conditions in the quitrent deed:

- After ten years rent free, rent is to be paid every year.
- The rent to be paid can be revised to an amount equal to ‘a fair annual market rental for the land’.
- There is a requirement that the land be brought into production.

Access to land on these terms was attractive. After the Napoleonic Wars, unemployment in England was so rife that PQT in South Africa attracted approximately 4,000 immigrants, including the 1820 Settlers. They were encouraged to settle in the frontier area of what is now the Eastern Cape. This also helped to consolidate and defend the colony against the neighbouring, and warring, Xhosa.

In the 1830s the Government, eager for money, decided to sell crown lands for single payments, as freeholds, and allowed PQT holders to redeem their quitrents by the payment of fifteen years rent in advance. Then in 1844 it was decided not to grant any further quitrents.

The sale of land and the redemption of quitrents allowed the then-current generation to appropriate all future rent, to the detriment of future generations. One wonders whether these actions might have been part of an Nkandla-type scandal, considering the mansions of retired Governors in England. Sir John Craddock, for instance, became Baron Howden and lived at Grimston Park, Yorkshire (Figure 2), an estate that is impressive even today.

Figure 2: Grimston Park, Yorkshire, to which Sir John Craddock Retired



There seems to have been a love-hate relationship with PQT, for in 1854 the new Government decided to return to Cradock's PQTs, and further conversions from quitrents to freeholds were terminated. In 1860 the Crown Lands Act gave legislative effect to the revived system of quitrent tenure. PQT's remained a recognized payment for land in the Cape until 1934, when the obligation to pay quitrent was terminated by the Abolition of Quitrent Act 1934. Only in 1968, some 150 years after its promulgation, was PQT finally removed from the statute book.

### III. The Twentieth Century Struggle between Land Taxes and Income Taxes

Twenty years before PQT was ended, there was a time when politicians considered first land taxes and then income taxes, to deal with the need for more revenue. The parties at that time were as shown in Table 1:

Table 1: Parties in the House of Assembly in 1913

South African Party	General Louis Botha	67 seats	Afrikaans
Unionist Party SA	Dr L. S. Jameson	39 seats	Conservatives
Independents		11 seats	
SA Labour Party	Colonel F. Creswell	4 seats	Labour

When an income tax was proposed in 1913, the Labour Party proposed a land tax instead. In the background was the implacable hostility to land taxes in the British House of Lords, which rejected Winston Churchill and Lloyd George's People's Budget of 1909 because of its introduction of land taxes. To the aristocracy land taxes were anathema. And the majority of the members of the House of Assembly were members of the new South African aristocracy.

In this environment, the opposition, most vocally Colonel F. Creswell, leader of the Labour Party, was quite specific in his rejection of income taxes. In the April 3<sup>rd</sup> 1913 budget debate he raised issues which today's critics of income taxes would find commonplace:

*The wealth of this country was produced by hand or brain. Would somebody tell [the Finance Minister] what the landowner produced in his capacity as landowner?*

*He wanted to put it to them whether it was not a more legitimate subject to tax land than the loaf of bread and boots, and the paraffin with which he lighted the house of the worker of this country—that they should place taxation upon the mere land value, the mere ground rent of the landowner.*

*Let them tackle, first of all, those sources of wealth which were really taken out of the people's pockets and went into private pockets for no services whatever rendered.*

*If they would base the taxation on the unimproved value of all land, direct taxation, they would be a great deal better-off. Let the taxation be taken off the other articles. The effect of it would not be to transfer taxation from the town population to the country population, but to transfer taxation from the worker in the town and the country to the man who was holding up the resources of this country and not turning them to any account. (Labour cheers.)*

*He wanted to show hon. members opposite that that taxation would fall just as heavily upon people in the town as upon people in the country. He was going to confine himself in his figures of valuation to town figures. When they talked about land values they did not mean simply a few outside country values. They meant all land values, all site values throughout the Union.*

*He would take the Witwatersrand Township Companies in the three divisions of Jeppe, Doornfontein, and Wolhuter. They had done nothing through their own exertions to improve the value of that land which had increased from £40,000 about 14 to 20 years ago, to £450,000 to-day. So it is<sup>3</sup>.*

*I only wish the hon. member for Vrededorp were really taxed as he should be. It is a new principle of taxation to say that because you live in a municipality, and pay municipal rates, you should be exempt from taxation. Proceeding, he said that national taxation and municipal taxation should rest upon this unimproved value of land, which merely represented the degree to which the owner may levy a private tax upon the worker. (Hear. hear.)*

*Let them take the agricultural population. The working farmer paid taxes on every cup of coffee and loaf of bread he consumed. The proposal was, not that the working farmer should be taxed any more, but that the burden of taxation should be shifted on to the shoulders of the owners of tens of thousands of morgen of land, who were possibly doing nothing with their land, and who were probably living elsewhere.*

*The burden should also be shifted on to the shoulders of the large land owning companies, which did not contribute anything in taxation, ...*

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<sup>3</sup> Ironically, in the last twenty years (since Nelson Mandela became President in 1994), the price of an urban residential plot in South Africa has increased even faster, by a factor of 14 (ABSA Bank Report Q2 2014).

Neither a land tax nor an income tax was passed in 1913, and the issue was debated again in 1914. In that year there was an initial setback for the effort to pass an income tax. Even with an outright majority of 55% of the seats, the South African Party's proposed income tax was defeated in the House of Assembly at the second reading of the bill on Thursday 11<sup>th</sup> June 1914.

It is not clear from Hansard's what the real reason for this defeat was, but the next day Jan Smuts, the Finance Minister, presented an equivocal case for income taxes. He asserted that they were the right thing without explaining why; he said that they will burden only those who can best afford it and warned of administrative difficulties, particularly that 'very often you tempt people to say what is not true in their assessments'. Finally, the bill was intended to include a land tax, to prevent speculation in land:

*I think it is the wisest course for any Government in South Africa to go slow, ... and so the Government proposes to do the right and wise thing, and to settle the economic policy of this country on a sound basis without delay. And I think that the best and fairest thing to do would be to go in for an income tax. (Hear, hear, and laughter.)...*

*So if there is any fresh burden to lay, on the shoulders best able to carry it, and from the point of view of policy and social justice, if further money is required for public requirements we ought to supplement our present Customs policy by an income tax, which will lay the burden on the shoulders best able to bear it.*

*There is no doubt, in abstract argument there is the very strongest case to be made out in favour of an income tax, but the difficulty that is experienced is in relation to administration. It is a more difficult tax to administer, you pry more closely into the concerns of the people, you make returns and very often you tempt people to say what is not true ...*

*There are very large numbers of people who want land in this country, but they cannot get it because of other people holding the land and doing nothing to develop it. ... The Government proposes, with certain exemptions, to apply the principle of an unimproved land tax to those areas. Our object is to exempt all improvements made on the land and to tax only the value of the land itself in those cases in which individual holders own more than 10,000 morgen of land valued at more than £10,000*



The land tax that was proposed in 1914 would '*exempt all improvements made on the land and ... tax only the value of the land itself in those cases in which individual holders own more than 10,000 morgen of land valued at more than £10,000*'. Thus it would tax only very large holdings of agricultural land. (A morgen is about 6/7 of a hectare, so only holdings of more than 8,570 hectares were to be taxed. A square plot 9.25 kilometres on a side would be just below the minimum size to be taxed.) Cities, where most land speculation occurs, would not be affected.

#### **IV. Land taxation and Land Speculation**

Jan Smuts was right in thinking that a tax on land can curb land speculation. It is something of a puzzle as to why he would propose a tax that could be avoided by reducing the size or the value of one's holdings. The reason that a general tax on land reduces land speculation is related to a phenomenon that economists call 'the winner's curse'. This is the phenomenon that when a thing of uncertain value is sold to the highest bidder, the highest bidder will be the person who has made the greatest overestimate. Thus parcels of land tend to be most valuable to those who make the greatest overestimates of how rapidly the land will rise in market value. These people, with beliefs at the extreme of market participants, think, often mistakenly, that it is efficient to hold land out of use in the present, so that it will be available for use when the market realizes its possibilities. The concentration of land in the hands of those who are biased toward leaving land unused creates an artificial scarcity of land. Taxing land takes the profit out of land speculation and therefore relieves the artificial scarcity of land that is caused by the winner's curse.

Land speculation continues as a cause of reduced economic productivity in South Africa today. In an examination of the possibility of producing biofuel in South Africa, the market research firm of Frost and Sullivan concluded that there were 27 million hectares of unused arable land in the country.<sup>4</sup> And this is just the unused agricultural land. In cities, vast amounts of very valuable land sit unused or severely underused, by parking lots and single-storey structures.

Jan Smuts failed to appreciate that it would have been in the economic interest of the nation to obtain as much revenue as possible from a land tax before resorting to an income tax. Beginning with the Physiocrats in 18<sup>th</sup> century France, and then with Adam Smith, economists have recognized that an annual tax on land, levied according to an estimate of value that does not depend on how the land is used, has economic benefits that other taxes

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<sup>4</sup> Frost and Sullivan, proprietary report v383.



lack. Smith said of the English land tax of his time, ‘As it has no tendency to diminish the quantity, it can have none to raise the price of that produce. It does not obstruct the industry of the people’.<sup>5</sup> In the terminology of modern economics, a properly administered land tax is a ‘lump-sum’ tax, a tax that does not increase or decrease depending on the actions of the taxpayer. If the amount of a lump-sum tax on land is less than or equal to the rental value of the land then, as Smith said, the tax ‘does not obstruct the industry of the people’, does not offer them incentives to act inefficiently in order to reduce their taxes.

## V. The Logic of Taxing Land

The characteristic of not interfering with economic incentives is quite rare in sources of public revenue. The most prominent source of public revenue other than taxes on land that does not interfere with economic incentives is charges for harms such as pollution and congestion, provided that the charges are no greater than the harms. One way of understanding why a tax on land shares this characteristic with charges for pollution and congestion is that the act of appropriating land for one’s exclusive use creates more of a shortage for land for others to use, and a tax on land can be seen as a charge on this harm.

Some economists have claimed that a head tax, like Thatcher’s ‘Poll Tax’ of the 1990s is a tax that does not interfere with economic incentives. But this is not correct. A head tax or community charge motivates people to emigrate from the jurisdiction that levies the tax. It also discourages people from having children.

A number of misunderstandings about land taxes circulate. One is that all taxes are equally objectionable in appropriating for the state something that truly belongs to the taxpayer because he or she made it or acquired it legally from whoever did. While this is true of some taxes, it is not true of a land tax. There are three sources of the value of unimproved land: nature, public infrastructure, and private development. To the extent that the rental value of land is due to nature, a tax on land gives expression to the idea that the gifts of nature are everyone’s common heritage. To the extent that the rental value of land is due to public infrastructure, a tax on land represents an obligation to pay for the value that one prevents others from receiving, by choosing to live where particular public services are provided. To the extent that the rental value of land is created by private development in the vicinity, a tax on land collects value on which the land holder has no moral claim. However, the moral claim of the public on this component of rent can also be challenged. The most efficient use of the component of rent created by surrounding private development is

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<sup>5</sup> Smith, A., *Wealth of Nations*, Book V, Chapter 2.

subsidies for activities that add to the value of surrounding land, so that there will be economic incentives to undertake efficient amounts of these activities.

Another misunderstanding is that over-reliance on a land tax can be economically harmful, because a good tax system must be balanced among a number of different sources of revenue. The reason that this is not true is that there are no economic distortions associated with a properly administered tax on land. The economic loss from a combination of taxes is a somewhat complex matter, because of the interactions among taxes, but the economic loss from any one tax is quite straightforward. Elementary public finance texts state that the excess burden (economic loss) from any one tax is

$$B = \frac{1}{2} t^2 E \eta_S \eta_D / (\eta_S + \eta_D),$$

where  $t$  is the tax rate,  $E$  is expenditure on the commodity,  $\eta_S$  is the income-compensated elasticity of supply, and  $\eta_D$  is the absolute value of the income-compensated elasticity of demand.<sup>6</sup> Since land, properly defined, has an income-compensated elasticity of supply of zero, the excess burden of a land tax is zero. Thus a tax that collects up to 100% of the rental value of land has no excess burden. Since other things that might be taxed have non-zero income-compensated elasticities of supply and demand, they have positive excess burdens. Thus minimization of the excess burden of a tax system requires that as much revenue as possible be collected from land and from harmful activities such as polluting before any tax is placed on other things.

Another misunderstanding is that a land tax will not work because the tax will cause land values to fall. Our response is that sometimes a land tax causes land values to fall and sometimes it does not, but in neither case is this an impediment to levying a land tax.

If an increase in a land tax is accompanied by a decrease in taxation of improvements that leaves revenue collected unchanged, then there is likely to be a rise in land values. For example, if the Municipal Property Rates Act 6 of 2004 were altered to collect the same revenue from a tax that excluded improvements and taxed only land, then land values would probably rise. This is because the average property would pay the same tax as before, but with the change in the tax base it would be possible for those who held land to put additional improvements on their land without paying additional taxes,

If, to give expression to the idea that land is everyone's common heritage, a government wishes to place a tax on the selling price of land that is not offset by decreases in other taxes, there is nothing prohibitive about the fact that this will cause land values to fall. One must

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<sup>6</sup> See, for example, Gruber, J., *Public Finance and Public Policy*, Macmillan, 2012.

simply proceed intelligently. Good assessment will take account of the interaction between taxes and selling prices and assign an assessed value that will be accurate when the tax is imposed.

It is also possible to tax land without being concerned about the consequent fall in its value, by defining the tax base as the rental value of land rather than the selling price of land. Rental values do not decline as taxes on land are increased, so any proportion of the rental value of land can be collected through taxation in this way.

There is a related misunderstanding that because of the effect of taxes on prices, a tax on the sale value of land can collect only a small fraction of the rental value of land. This is not correct. Mathematically, any proportion of the rent of land less than 100% can be collected by a properly designed tax on the sale value of land. The fraction of the rent of land that is collected by a properly administered tax on land is  $t/(t + r - g)$ , where  $t$  is the tax rate,  $r$  is the interest rate, and  $g$  is rate at which land rent is growing. While it might seem that the upper bound of 100% on the tax rate would ensure that there is an upper bound less than 1 on the fraction of rent that can be collected, it must be remembered that the frequency with which land is taxed can be varied. Instead of being taxed once or twice a year it can be taxed every month, every week, or every day. As the period between tax bills shortens, the interest rate and growth rate per period shrink, and a given tax rate per period collects a proportion of rent that approaches 100%.

Another concern is that collecting a substantial fraction of the rent of land would cause a collapse of the financial system, since mortgages on land form a large proportion of the assets of financial institutions. Two versions of this concern should be distinguished: concern for the consequences of shifting taxes from improvements to land, and concern for the consequences of collecting all of the rental value of land publicly. The first is a totally groundless concern. As mentioned above, changing rates from a tax on both land and improvements to a tax that collects the same revenue by taxing land at a higher rate is more likely to raise land prices than lower them.

The concern for the financial system is understandable when the tax that is contemplated is one that would collect all or nearly all of the rental value of land publicly. The impact of such a tax on financial institutions would depend on how much of their portfolios were in land mortgages. Prudent financial institutions recognize that land prices collapse from time to time, and they therefore refrain from putting high proportions of their assets into land. Furthermore, even if borrowers find that their loans exceed the value of their property, they will not necessarily default, either out of honour or because they do not wish to abandon their

property. But still it is possible that a sudden increase in taxes on land would cause financial institutions to become insolvent. There are three ways to deal with this. The first is to have the monetary authority stand by with capital (printed money) to inject into insolvent institutions. Since this money would replace land value that fell, the printing of the money could reasonably be expected to not cause inflation. The second way of dealing with the risk to financial institutions from a sudden increase in taxes on land would be to implement financial reform before increasing the tax on land. The financial reform that would take care of the problem is the ‘Chicago Plan’, of 100% reserves for banks, devised in the 1930s primarily by professors at the University of Chicago, to ensure that banks would not collapse. Renewed interest in this plan has been developing.<sup>7</sup> Under the Chicago Plan, depositors in banks would decide whether they wanted their money stored in the vaults or invested. If it was to be stored, there would be modest storage and transaction fees. If they wanted it invested, they would need to participate in the risks of investments. If banks operate on 100% reserves and those who participate in providing loans do so through mutual funds, then asset values can decline without causing a collapse of the financial system. The third way of dealing with the risk to financial institutions from taxing land would be to implement an increase in land taxes slowly enough that financial institutions would not be threatened.

Another concern with respect to concentrating taxes on land taxes is that this would leave some sectors of the economy, particularly those associated with electronic commerce, with very little if any taxation. This concern reflects an inappropriate, grab-from-everyone attitude toward taxation. Taxation that collects from people the value of the privilege of exclusive use of land or other natural opportunities or that collects from them the costs of the harms caused by their actions is categorically different from taxation that simply takes from people to pay the costs of government programs. Of course, steps should be taken to ensure that the latter form of taxation is spread evenly. But before we begin to implement taxation that simply takes, we should see how much of the costs of government programs we can satisfy by taxes that do no more than require people to pay for the costs they impose on others, including the costs they impose by exclusive control of land or other natural opportunities. And we should be aware that if the rent of land were collected publicly in place of taxes on labour and capital, the magnitude of rent would rise considerably, both because land that

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<sup>7</sup> See Kotlikoff, L.J., *Jimmy Stewart is Dead: Ending the World’s Ongoing Financial Plague with Limited Purpose Banking*. John Wiley & Sons, 2010; Benes, J. and M. Kumhof, *The Chicago Plan Revisited*, IMF working paper WP/12/202.

would be taken out of speculation and put into production would make the economy more productive, and because land that has access to untaxed labour and capital is more productive.

A final common misconception about land taxes is that they are primarily taxes on farmers. Nothing could be further from the truth. In any developed economy, the overwhelming majority of land value is found in cities. Under a land tax, the overwhelming majority of tax revenue will come from cities.

## **VI. The Harm from an Income Tax**

When Jan Smuts proposed an income tax, he did not claim explicitly that it would be better than a land tax. He said, *'So if there is any fresh burden to lay, on the shoulders best able to carry it, and from the point of view of policy and social justice, if further money is required for public requirements we ought to supplement our present Customs policy by an income tax, which will lay the burden on the shoulders best able to bear it.'* In other words, it is better to implement an income tax than to add to the taxation of imports.

Indeed it is true that taxes on imports tend to fall more heavily on the poor than income taxes do. It is also true that an income tax has the virtue, compared to a system of tariffs on imports, of not distorting the relative prices of different goods and thereby adding unnecessarily to harm caused by taxation. But these virtues of an income tax relative to an increase in tariffs do not make an income tax a good tax. The income tax is an economically harmful tax because, even though it keeps the relative prices of goods in line, it discourages people from working and saving, and thereby it reduces economic productivity, economic opportunity, and economic growth.

The harm that an income tax does has an individual component and a social component. The individual component of the harm from an income tax can be understood in terms of the fact that when incomes are taxed, a taxpayer can lower his income tax bill by working less or saving less, and having taxpayers respond to this incentive by working less and saving less provides no benefit to society. The magnitude of this aspect of the economic loss from an income tax can be conceived in the following way. Consider a taxpayer with a tax bill of R 5,000. Suppose that the Treasury could make a special deal with the taxpayer: 'You pay us R 6,000, and you can make as much money as you want; your tax bill will not change'. Taxpayers would generally be willing to pay something more than their current taxes under the tax law (possibly R 1,000 more, possibly more or less than that) to have a tax bill that did not rise when their income rose. The sum of the greatest extra amounts that all taxpayers would be willing to pay to have their tax bills fixed at the amounts that they actually pay is a

measure of the individual component of the economic cost of the income tax, the component that considers only the losses to taxpayers one at a time, from the inefficiency that the income tax induces in their own working and saving decisions.

There is a second, social component of the loss from an income tax, a component that arises from the loss of profitable interactions among citizens, and between citizens and foreigners, because of the inefficient incentives generated by the income tax. An economy without an income tax will be filled with citizens who are more productive and who save more because they are not taxed. The nation will attract more capital from foreign countries if it taxes only land and does not tax the profits of foreigners who invest in the country. It will be valuable to all citizens to be in a nation that is filled with fellow citizens who are efficiently motivated, and with access to capital that is not diminished unnecessarily by the discouraging effects of taxation. Prices of goods will be lower, wages will be higher, opportunities to work will be more plentiful, and the rate of economic growth will be greater. To estimate the magnitudes of these components of the benefits to South Africa of not having an income tax requires a general equilibrium model of the nation's economy, and that is beyond the scope of this paper. Still, it is reasonable to expect that these benefits would be considerable. A published analysis of the effects in the United States of shifting to a land tax concluded that the short-run impact on take-home hourly wage of workers would be a rise of 13%.<sup>8</sup> In response to this increase in wages, work effort would increase by 28%. The rate of return on capital would double in the short-run, while saving and investment would more than double. The annual benefit of the combination of higher wages and better saving opportunities would be 15% of Net Domestic Product (NDP). In the longer run, the economy would settle into a smooth growth path with a steeper trajectory. It would be reasonable to expect similar relationships for South Africa.

## **VII. The Relevance Today**

When the writers of the Constitution of 1996 declared in Section 25 (5), 'The state must take reasonable legislative and other measures, within its available resources, to foster conditions which enable citizens to gain access to land on an equitable basis', they were mandating new institutions. Even though the Katz Commission's Provisional Report of 1994 was delivered two years before the Constitution was adopted, one might reasonably have expected the Katz Commissioners to have understood that special concern for access to land was brewing, and

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<sup>8</sup> Tideman, T.N., A. Johns, E. Akobundu, and P. Wutthicharoen, 'The Avoidable Excess Burden of Broad-Based U.S. Taxes,' *Public Finance Review* 30, (2002), pp. 416-441. See particularly page 434.

that the country would be interested in adopting tax policies that would facilitate access to land where this was feasible. However, the Katz Commissioners either did not understand this to be in their mandate or they believed that it was not feasible. Facilitating access to land by endorsing a land tax can reasonably be understood to be in their mandate because their terms of reference include the words, ‘to inquire into the appropriateness and efficiency of the present tax system and make recommendations on its improvement’. Since a land tax is highly efficient and entirely appropriate for a country that wants to ensure that its citizens have access to land, one might reasonably have expected the Commission to evaluate a land tax and endorse it. Alas, that did not happen,

The Katz Commission was supported in coming to the wrong conclusions about a land tax by public comments based on bad economics. Richard Grant wrote, ‘The distinction between man-made and natural factors of production, that is, between capital and land ..., is irrelevant when discussing intervention and taxation: the consequences will be the same for any asset’.<sup>9</sup> Grant was following in the tradition of Frank Knight, who in 1920 wrote, ‘If there are any agencies not subject to reproduction through investment at all, they conform to the classical description of land. It is the writer’s view that such agents are practically negligible and that in the long run land is like any other capital good’.<sup>10</sup> Knight’s statement that ‘in the long run land is like any other capital good’, he explained in 1924, is based on the idea that ‘in real life, the original ‘appropriation’ of such opportunities by private owners involves investment in exploration, in detailed investigation and appraisal by trial and error of the findings, in development work of many kinds necessary to secure and market a product—besides the cost of buying off or killing or driving off previous claimants’.<sup>11</sup> In other words, land is produced, just like capital is produced, because you may need to kill or drive previous users of land off of it to get possession. Thus in worrying that a tax on land may cause a diminished incentive to produce, Grant is in essence concerned about the possibility that there will be an inadequate incentive for entrepreneurial types to kill people or drive them off of the land that they are using, so that the entrepreneurial types can obtain the land for themselves. We can certainly accept a reduction in the incentives to engage in such activity without concern about undermining incentives to be productive.

Leon Louw wrote, ‘*Some claim that a single tax, such as on land, income, transactions, consumption or currency holdings (the “inflation tax”), would be easiest to administer, but*

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<sup>9</sup> Grant, R.J., *Nationalisation; How Governments Control You*, The Free Market Foundation (1994).

<sup>10</sup> Knight, F.H. *Risk, uncertainty and profit*. Courier Dover Publications, 2012 [1920].

<sup>11</sup> Knight, F.H. ‘Some fallacies in the interpretation of social cost’, *The Quarterly Journal of Economics* (1924), p. 591.



*clearly that would maximise distortion*'.<sup>12</sup> Louw's training is in law. It is unlikely that anyone with professional training in public finance would have made such a statement, because the consequences of a single tax on any one base vary greatly from one base to another.

To an economist, a 'distortion' is a deviation of relative prices from the values that they would have under competitive markets with no taxes and no external costs or benefits. Because a tax on land does not diminish the supply of land, a tax on land is borne entirely by those who hold title to land. There is no effect of a tax on land on the cost of using land. Thus there is no distortion associated with a tax on land.

No land reform does a better job than the taxation of land at making land available to those who do not have it. By substituting an annual charge (the land tax) for a one-time change (the selling price of land), a tax on land makes it possible for the landless poor to bid successfully against the rich. By taking the profit out of land speculation, a land tax ensures that those who want to use land need only bid against other users of land; they do not need to out-bid speculators in land.

The eighth (Land Tax) Katz Report of August 1998 explored the advisability of a land tax. The report is generally favourable for such a tax as a source of funding for additional services for rural areas. This is sound policy in general, but the report includes several recommendations that weaken the power of a land tax. The subcommittee that wrote the report recommended that the taxation of agricultural land be based on use value rather than market value.<sup>13</sup> The Commission as a whole recommended that taxation according to market value also be permitted.<sup>14</sup> Taxation according to use value has the effect of distorting land use decisions in favour of agricultural uses. Concern for farmers whose land rises in value because of its prospects for development is better handled by allowing them to postpone taxes (with interest) until they transfer their land.

The Report also recommends that the tax be treated as a provisional tax, with respect to the income tax.<sup>15</sup> The Commission rightly rejected this recommendation because it would shift the burden of the local tax to the central government.<sup>16</sup> It would also distort land

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<sup>12</sup> 'A Neutral Tax Structure Shows Respect for the Consumer' 4 Feb 2010.

<http://www.freemarketfoundation.com/issues/a-neutral-tax-structure-shows-respect-for-the-consumer>.

<sup>13</sup> Eighth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa, Subcommittee recommendation 22, p. 55.

<sup>14</sup> Commission's findings, p. 5.

<sup>15</sup> Subcommittee recommendation 26, p. 55.

<sup>16</sup> Commission's findings, p. 4.

allocation by making land relatively more valuable to those who paid income taxes than to those who did not.

The inquiry into a tax on land could have gone in many directions. The subcommittee notes that there were many responses to a media statement that it released: ‘At one extreme Georgists held to the view that a site value tax on all land should be introduced, while all or most other taxes should be abolished. Alternatively, some respondents fiercely resisted the prospect of a land tax as an unjust impost on only one form of wealth that would discriminate against certain sectors of the economy’.<sup>17</sup>

One might expect from the analysis above and in view of the terms of reference of the Commission ‘to inquire into the appropriateness and efficiency of the present tax system and make recommendations on its improvement ...’ that the Commissioners would have welcomed the opportunity to study the effect of replacing all existing taxes with a single land tax and to test the claims that a land tax is unjust and discriminatory. Unfortunately, it chose not to go in that direction.

### **VIII. Conclusion**

In this historical assessment of the relative success and failure of land taxes and income taxes in South Africa, we have shown not only that income taxes burden GDP and growth, but also that replacing land taxes with income taxes transfers wealth to landowners. This choice of income taxes over land taxes also renders unused land unaffordable for the poor, thereby preventing unemployed citizens from providing for themselves by growing, rearing and building things.

The 19<sup>th</sup> century PQR tenures, embodying the principle of land taxation, led people to cross the earth for the affordable land that PQR tenures engendered. As people in South Africa migrate to the cities today, there is a similar, more desperate search for opportunity. Migrants settle on a few square metres of desolate ‘free-land’. Yet South Africa has 27 million hectares of unused arable land, and only one tenth of a hectare is needed to grow all the food necessary for a family of four and build a decent house, becoming self sufficient.

It is to be hoped that South Africa will recover from its mistaken turn to income taxes. We trust that income taxes will one day give way to land taxes. Yet change in tax structures cannot happen overnight. The counsel of economists, political scientists, and valuers will be needed to guide the process, so as to maintain public understanding and acceptance, and to maintain the state’s revenue expectations. The sooner the process starts, the better.

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<sup>17</sup> Subcommittee report, p. ii.