**SUBMISSION FROM ALTER ON FUNDAMENTALS OF TAXATION TO COMMONS TREASURY SELECT COMMITTEE**

## Executive Summary

‘Resource rents’ are a major component of national income. At present taxes are only collected from it very indirectly and without regard to its chief economic characteristic as a surplus. By shifting taxes off labour and capital and on to economic rent, growth and employment would be stimulated and many distortions in the economy would be avoided. Annual land taxes would be the simplest means of collecting rent as public revenue.

In particular, the margin of production, both geographically and in specific areas of the economy, would be relieved of taxation, whilst taxes would be borne instead by recipients of the surplus attributable primarily to location. This would be both efficient and fair, since providers of labour and capital would pay less tax and rentiers would pay more.

Simultaneously, excessive rises in land prices would be modified by a tax based on regularly reassessed land values. This would prevent the kind of speculation fostered by the banking system that led to the crisis of 2008/9 and would also greatly stabilise trade cycle fluctuations.

Taxes assessed on economic rent are certain and easy to collect, unlike most current taxes. They help secure efficient allocation of factors of production and hold down consumer prices. Complicated provisions to make tax assessments fair are not required. This tax shift would move the U.K. economy away from rent-seeking and towards a genuinely free market economy based upon equitable rewards for those who actually produce goods and services.

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1. The basic recommendation on taxation from ALTER is that public revenue from the economic rent of land, otherwise known as resource rents, should be maximised, rather than taxing labour and capital. Such a ‘tax shift’ would have fundamental beneficial effects on the economy. The case for it is both moral and economic. Since the submission that follows is largely concerned with the latter case, the moral case is briefly stated first. The economic case is then made in answers to the questions posed by the Committee.

2. The moral case, acknowledged by virtually all economists since Adam Smith, is that the economic rent of land arises not from the actions of landowners but as a surplus from the nature and location of the particular land itself. Ricardo, Marshall, J.S.Mill, Henry George, Samuelson and Milton Friedman all recognised that whilst labour and capital may receive short-term quasi-rents, only land attracts a permanent surplus over and above the value of inputs from labour and capital. Such economic rent in relation to a particular site has three causes: natural resources such as fertility and minerals; local population providing labour and markets; and public services in the form of

transport facilities, police, schools and so on. Since none of these three are the outcome of individual effort or capital, there is no moral case for economic rent to be appropriated by individuals. Therefore it belongs by right to the community which plays a major part in its creation and which has an inherent claim to the natural attributes of the land, if not to the land itself. This moral case was clearly recognised in the case of North Sea oil, when Chancellor Lawson introduced a system of royalties for oil production that took account of the differential value of output from oil wells i.e. in recognition of economic rent in the North Sea.

**What are the key principles which should underlie tax policy?**

3. Most important is the principle that taxation should support production and not impede it. Taxes on labour and capital always tend to inhibit production, because both factors require a reward in the form of wages and profits in order to enter and be sustained in the productive process. Land and natural resources do not require such a reward, since they are present *ab initio.* Of course, if they can be withheld from production by owners some reward may be required, but this assumes that no charge is levied on unused land and resources, which would not be the case if a tax on annual land values were introduced.

4. The principle of fairness is perhaps universally acknowledged. In our view, fairness means rewarding effort, ability and initiative and recognising need, whilst withholding reward from those who contribute nothing. It is hard to see how a claimant to economic rent contributes to the economy, since rent is a surplus arising as outlined above. On the other hand those who offer labour and capital are providing factors of production that actively participate in creating value: arguably all taxes on these factors are unfair.

5. Taxation must be adequate to meet current public expenditure needs, both central and local. Current conditions demonstrate that tax policy is severely strained to meet this requirement. Economic rent is the great untapped fund available to remedy this.

6. The tax collection system must to simple, efficient, certain and transparent. The present system has become unduly complicated. Taxes on labour and capital are bound to be complex if they take account of individual circumstances. Taxes levied on economic rent, however, are simple to assess, in so far as particular pieces of land have a single annual value, which can be updated easily, particularly if a land registry is used.

7. Non-evasion and non-avoidance: both illegal and legal methods of reducing taxes decrease the tax take. A tax on annual land values cannot be nullified by such means, for example, as a change in the domicile of the owner or concealment of the asset taxed.

**How can tax policy best support growth?**

8.Taxes on labour and capital inhibit growth by reducing the rewards for effort, skill, enterprise and innovation, including the use of new technology. This is especially so in relation to incremental use of both factors, since tax rates tend to be progressive. Indirect taxes, such as VAT, have a similar effect by their impact on firms' revenues, which forces them to reduce demand for factors. By contrast, a tax levied on economic rent has no impact at all on the returns to labour and capital. Such a tax is diverting an income flow from private recipients of rent to the public purse, where these recipients are strictly rentiers and not active contributors to production.

9. The way in which a land value tax (LVT) would encourage growth is best seen in relation to the margin of production, a concept too often ignored in current economic theory and practice. The margin may be regional or local. Firms in more remote regions and those on less central sites tend to produce less value added than those at more favoured locations. A tax levied on economic rent does not strike at these vulnerable marginal firms, for the simple reason that it falls only upon the excess of the value of output over that produced at the margin for the same input of factors. Only the rentier who takes this excess, not the productive firm, would pay the tax.

10. This principle, that a tax on the economic rent has no disincentive effect at all on production, implies that firms could be relieved of present taxes if these were replaced by it. Hence they would immediately have a strong motive for increasing their employment of factors and their output. At the same time, new firms could enter an industry without the burden of incurring taxes on their production. They would have a permanent 'tax holiday'! A complete tax shift of this kind may be politically impossible, but to the extent that it might be carried out there would be a corresponding new dynamic in the economy: growth by existing firms and by new ones.

11. This cardinal feature of relieving the margin of production is not the only way in which growth would be encouraged by LVT. Provided the tax were levied on all sites, including those left out of use, land utilisation would become much more efficient. On one hand, derelict but potentially productive sites would be brought into use as landowners found that leaving land idle would incur a cost. (The present empty property tax suffers from the serious drawback of taxing just the buildings, thus encouraging their destruction.) There is a great deal of derelict land, including valuable sites in cities, that could be developed for production or for housing. On the other hand, sites would gradually be allocated to their most efficient use. At present there is little incentive for this to happen, because economic rent may not be maximised if it gives a good return when it could in fact yield a better one. That this is the case is proved conclusively by the large increases in the capital value of sites that are granted planning permission. They are clearly under-utilised until the permission is granted. Of course, planning would remain necessary under a LVT regime, but it would be carried out within a framework of best land use under pre-existing plans.

12. Finally the situation for business start-ups would be transformed by the tax shift. LVT tends to reduce land prices *pro rata,* so that land costs, whether as capital payments for land purchase or rent under leases, would be reduced or eliminated for new firms. Moreover, new firms would become more creditworthy, both because they would not need to incur heavy start-up costs

and because their growth prospects would be considerably better under such a tax regime. Firms that were no more than speculators in land would be correspondingly less creditworthy, thus relieving the banking system of a major form of risky loans.

**To what extent should the tax system be structured to support other specific policy goals?**

13. The tax shift outlined above has other merits besides supporting growth in the economy. Growth implies increased employment, reducing social and economic costs of joblessness. Taxes taken off labour mean it costs every organisation less to employ; taken off capital, it improves employment in manufacturing. Self-employment might also be stimulated by a reduction in start-up costs from a fall in land prices and the easing of bank credit for small businesses no longer burdened by high rents and taxation. Partnerships and co-operatives, as opposed to large oligarchic organisations, might be encouraged. The employment market would thus be more flexible and less dominated by ponderous wage bargaining processes.

14. Such changes would go some way to make a fairer distribution of income and wealth a realisable policy goal. Wage rates could rise in keeping with greater labour productivity, and incomes derived from private capture of economic rent would diminish. So too would the capital values associated with valuable land now held free of any tax on its annual value. Speculative fortunes made from rising land prices would, in particular, be cut back as an annual LVT began to bite. This need not mean that land prices would fall dramatically, if at all. As the economy grew under the impetus given by the tax shift, land might become more valuable, even whilst a tax on land value were imposed. This would enable the tax rate to be increased, yielding yet more public revenue.

15. LVT would support regional policy goals, tending to significantly ‘level the playing field’ as between poorer and wealthier regions, without incurring public expenditure. There would be a concomitant improvement in the relative economic conditions of poorer regions, such as parts of the North and of Wales, for the reasons given above. Overheating of the economy in more prosperous areas would similarly be modified, for these would pay over a relatively higher amount of rent as public revenue, thus reducing speculative investment and the claims of rentiers. The genuinely productive activities of the City of London, for example, would become more easily identified as they were freed from taxation, whilst the rentier activities would become subject to the new tax. A more balanced distribution of production throughout the country would be the outcome, enabling population, public services, transport facilities and much else to become more equitably distributed.

16. An interesting side effect of the tax shift would help to achieve a further major policy goal. A most significant element in the asset price bubble of 2008 that brought the U.K. economy almost to its knees was the huge upward rise in land prices that had developed over the previous decade or so. This led to a great deal of unwise bank lending for commercial and housing ventures. Banks were bewitched by the expected continual rise in land values that

underlay the prices of commercial property and private housing. 'House prices' were, and are, largely a function of the prices of the land on which they are built. A tax on land values would prevent such a harmful surge in prices, and *a fortiori* such a corresponding bonanza in speculative lending by banks.

17. Policy regarding the banking system is closely related to macro-economic stability, another major objective to which tax reform is pertinent. How would a shift towards LVT affect this? Present automatic stabilisers, such as unemployment benefits, would be supplemented by a tax levied on inflated rents of land in periods of rising output and prices and a reduction of LVT yield when these decline. No change of tax rates would be required. There is a strong correlation between fluctuations in land rents and cycles in the nominal GDP. Indeed speculative motives probably make such rents a leading indicator of GDP movements. There can be little doubt that the crisis of 2008-9 would have been greatly moderated had there been a substantial annual tax on such rents in the preceding years. The introduction of LVT now would help to ensure no repetition of the same disastrous hyperinflation of land values and its accompanying financial crisis.

**How much account should be taken of the ease and efficiency with which a particular tax can be imposed and collected?**

18. LVT is virtually impossible to evade or avoid. The land remains through good and bad times, and cannot be moved, unlike all other assets: even buildings, which can be destroyed or not erected at all, if taxed heavily. Land value registers, necessary for LVT, would improve the transparency and efficiency of the property market. Recent research (Vickers, 2009) indicates that the entire LVT administration system could be financed by the private sector (primarily insurance and investment sectors).

19. Initially self-assessment could be used to establish taxable land values. The landowner would have an incentive not to overvalue the land, nor to undervalue it if sanctions were attached, such as the testing of doubtful valuations by a public valuation or even the compulsory sale at the market price of seriously undervalued land.

20. This compares very favourably with the present tax regime with its thousands of special provisions for a host of taxes imposed on wages, pensions, dividends, interest, company profits, capital gains, value added, etc.

**Are there aspects of the current tax system which are particularly distorting?**

21. Distortion of the productive capacity of the economy and of land use have been mentioned. There are, however, other serious distortions, arising from the unsound principle of taxing labour and capital rather than economic rent.

22. The idea that income is a measure of the ability to pay tax has become deeply embedded in the national consciousness. But income leaves out of account the wealth of the taxpayer, which may differ greatly from his or her standing as a recipient of taxable income. Wealth, in general, may be

concealed, held abroad or otherwise used to avoid the generation of taxable income. Its owner can borrow against its value, enjoy tax-free beneficial occupation of property, and afford expert advice as to how to minimise the taxable income derived from it. Increases in the capital value of assets are a greater source of wealth creation than is saving out of income, as every successful entrepreneur, bank director or speculator knows.

23. A wealth tax would be a complicated and probably inefficient exercise. All real capital (i.e. buildings, equipment, machinery etc.) has a limited life span. Land values alone provide a permanent foundation for most private wealth accumulation in the long run, often in the form of real estate directly owned, but also through shares in companies that own valuable land, mineral rights, and other natural resources. Much land value is hidden in various kinds of such claims. Hence a tax on land values would encapsulate most of the benefits that a wealth tax might aspire to, without the serious drawbacks of trying to tax such an amorphous thing as wealth.

24. Income is an especially poor measure of the ability to pay, in a society where homes – their values largely comprised of inflated land values - are bought through mortgages unless they are inherited. One person may have inherited a family house, free of a mortgage; another may be struggling to save a deposit and then make mortgage payments for twenty-five years. If they both have the same income, where is the fairness in the tax system?

25. A more technical point about distortions caused by the present tax system concerns the ‘second best theorem’. This refers to the way in which indirect taxes like VAT change the final prices of goods and services, so that a Pareto optimum obtainable without those taxes is frustrated. Taxes on land values have no effect at all on a Pareto optimum, since collecting economic rent does not affect final prices (except, of course, the capital price of land). Ricardo’s famous adage that price does not enter into rent is the general principle behind this.

26. Finally there is the enormous distortion in the whole economy arising from rent-seeking activity, rather than production of goods and services. Firms of all kinds are drawn into a search for available economic rent in the form of capital appreciation of land – often leading to unnecessary takeovers and asset stripping – investment in land rather than in productive capital, lending by banks for land speculation, and the siting of businesses in areas of high rent, rather than in the most efficient location.

<u>Reference</u>

Vickers A.J.M. (2009). *Visualising Landvaluescape: Developing the case for Britain.* Doctoral thesis published online only http://www.landvaluescape.org/archives/2009/12/visualising-landvaluescape-for-britian-thesis-published.html