

# CLASS SUICIDE

## How property owners bite the hand that feeds them



Proz Oz's Communications Officer, **Gavin Putland** (now promoted to full-time — onya, Gav!) here argues that, by opposing taxes on unearned increases in land values, property owners are blocking the financing of infrastructure that would increase their wealth and income.

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## 1. The miracle of the land market

If you are to share in the benefit of a public infrastructure project, such as a new freeway or bus route or state school, you must reside or do business in the area served by the project. For this purpose you need access to the *real estate* in the area. Hence the benefit of the project, as measured by the market, is the ensuing **uplift** in property values in the affected area.

If the infrastructure project is worthy of funding, the benefit exceeds the cost; so the cost can be covered by reclaiming only *part* of the benefit through the tax system, leaving the rest of the benefit is a *net windfall* for the owners of property in the affected area, but *without burdening other taxpayers*. If the reclaimed part of the benefit is *greater* than the cost of the project (but still less than the total benefit), the project is a net source of public revenue. This not only ensures that the project goes ahead — so that the property owners get the ensuing windfalls — but also

allows cuts in other taxes for the benefit of *all* taxpayers whether they own property or not.

*N.B.* The implementation of this funding mechanism does *not* require any initial increase in tax receipts, and any *subsequent* increases in tax receipts are due solely to expansion of the tax base — not increases in tax rates.

## 2. Five loaves and two fishes

The funding of a public project through increases in property values is attractive to property owners provided that the additional tax payable on each property due to the project is *less* than the benefit for the property owner due to the project. This requirement is met by a form of site value taxation.

A **site** is a piece of ground or airspace, including any *attached rights* to construct buildings on that ground or into that airspace, but *excluding* any actual buildings. The value of a site reflects the value of its location even if no buildings (yet) occupy the site. So, to the extent that infrastructure increases "property values" in a certain area, it actually increases **site values** in that area.

The simplest site value tax or "land tax" is a per-annum percentage of the (lump-sum) site value, payable by the owner of the site. If the land tax has a **threshold**, the taxable value is not the entire site value, but the margin by which the site value exceeds the threshold. If the threshold is the site value at the time of introduction of the tax (i.e. the "initial" site value), adjusted for inflation, the result is a tax on the subsequent *real increase* in the site value. If the threshold is reduced below the inflation-adjusted initial site value, the additional revenue from the land tax allows other taxes to be reduced or abolished on introduction of the land tax. In particular, one can abolish existing recurrent property taxes and set the threshold on *each* site so that the new land tax initially replaces the recurrent property taxes previously paid by the owner of *that* site; the threshold is then called a **site threshold** because it varies from site to site. Let's call this last arrangement an **incremental land tax (ILT)**.

the site value does not increase unless, in the judgment of the market, the owner is better off in spite of the tax

An ILT reclaims only *part* of the benefit of an infrastructure project, because the tax on a property does not increase unless the site value does, and the site value does not increase unless, in the judgment of the market, the owner is better off in spite of the tax implication. While the same is true of any holding tax on lump-sum site values, the ILT has the added feature that *property owners do not suffer any change in total tax liabilities when the ILT is introduced*.

As implied above, the ILT should replace all *recurrent* property taxes hitherto imposed by the same government. These include not only "land tax", but also any so-called fire levies or ambulance levies that amount to *de facto* recurrent taxes on property. The ILT should be allowed to be negative, so that it gives some compensation to that minority of property owners whose sites are devalued by planning decisions.

Very conveniently, property owners also have an interest in increasing the number of projects that proceed and the number of old taxes that can be reduced or abolished

### 3. Twelve baskets

If the ILT is to be attractive to politicians, it must turn a comprehensive range of infrastructure projects into net revenue earners. Rational property owners will concur with this requirement, because projects that earn more revenue than they cost are likely to proceed, so that property owners are likely to get the associated uplifts in land values. For property owners, the fact that *some* of these projects could have been funded by other taxes is a red herring for three reasons. First, the ILT allows *more* projects to be funded. Second, a project that could have been funded by other taxes still represents a net gain to property owners if it is funded by the ILT. Third, when projects that would have been funded by other taxes are instead funded by the ILT, those "other taxes" can be reduced, and property owners in their capacity as general taxpayers can expect to share in the benefit of that reduction.

### 4. A mutually profitable investment

From the viewpoint of property owners, the ILT is an investment, and the uplift in property values is the return on the investment. This return is already "net of tax" because the market takes the ILT into account when valuing each site. So the ILT cannot render the investment unprofitable.

From the viewpoint of the government, the cost of a public project is an investment and the consequent increase in ILT assessments is the return on the investment. The higher the marginal ILT rate (or the fraction of sites subject to ILT), the greater the number of projects that will pay for themselves through uplifts in site values, hence the greater the number of projects that will actually proceed — and the faster the rate at which old taxes can be reduced or abolished, thanks to the surplus revenue caused by projects whose benefit/cost ratios are higher than the minimum for a self-funding project.

there was no academic tenure: professors who failed to do the bidding of their paymasters could be fired without process or redress

Very conveniently, property owners also have an interest in increasing the number of projects that proceed and the number of old taxes that can be reduced or abolished. Of course there are only so many projects that would pass a cost-benefit test, and only so many old taxes to abolish. So, as the ILT rate is increased, there comes a point beyond which property owners are losing more through higher ILT than they are gaining through infrastructure and tax cuts. This confirms that from the viewpoint of property owners, the taxation of uplifts in land values *can* be too high. *But it can also be too low*, as the current infrastructure crisis clearly shows. Somewhere in between there is an optimum — for which every rational property owner should be campaigning.

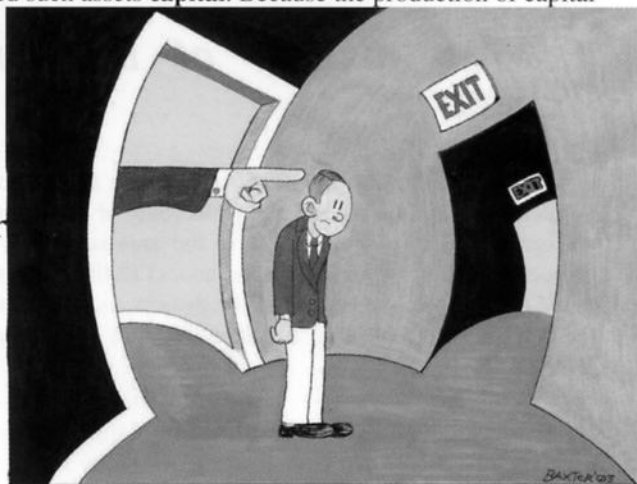
Unfortunately the behavior of property owners to date has been less than rational. But before we can tell that story, we must explain a bit of theory.

### 5. Assets ain't assets

Rivers of blood have been spilled over the ownership of the "means of production" because these "means of production" are spoken of as a single category, whereas in fact they fall into *two* categories:

- *Assets that taxpayers can neither create nor destroy nor move out of the taxing jurisdiction are land-like assets.*
- *The rest — that is, assets that taxpayers can move and/or destroy and/or refrain from creating — may be called (for want of a better analogy) house-like assets.*

By this terminology, *house-like* assets used as means of production include not only fixed structures, but also industrial and commercial equipment (fixed or movable) and stock in trade. The great classical economists from Adam Smith (1723–1790) to Max Hirsch (1853–1909) called such assets **capital**. Because the production of capital



adds to the total wealth of humanity, and because the **profits** from capital are an *incentive* to produce it, humanity gains from the private ownership of house-like assets and the private retention of profits derived therefrom.

Land-like assets include *sites* (not buildings), other natural resources (which cannot be created by human effort), and statutory monopolies and limited licenses (which can be created only by governments, not by taxpayers). Returns on land-like assets, net of the demands of labor and capital, are known as **economic rent** [1]. From the viewpoint of taxpayers, land-like assets cannot be *produced*, but can only be *acquired*. Acquiring an asset that cannot be produced adds nothing to the total assets of humanity. While the economic rent received from a land-like asset may be partly contingent on the application of labor and capital, it cannot be justified as an "incentive" to apply that labor and capital, because it accrues to the owner *as owner* even if the labor and capital are applied by other parties. So the standard argument justifying the private retention of returns on house-like assets is *not applicable* to land-like assets.

## 6. Taxes ain't taxes

A **holding tax** is a periodic tax on ownership of an asset — in contrast to a **transaction tax**, which applies to (e.g.) *changes* of ownership.

All transaction taxes impede commerce. All taxes on house-like assets reduce the incentive to produce capital. These effects hinder production and therefore raise prices and feed inflation, increasing the so-called **natural rate** of unemployment, which is defined as the minimum unemployment rate that causes sufficient downward pressure on wages to yield stable inflation. Central banks fight the inflationary tendency by raising interest rates (or otherwise restricting credit) in order to discourage consumption and hiring, thus maintaining unemployment at the dimly-named natural rate. So when the government decides to raise revenue from transaction taxes or taxes on house-like assets, the central bank responds by creating



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unemployment!

But *holding taxes on land-like assets* have none of these ill effects provided that the taxes take no more than the economic rent, which is *not* an incentive for production. Such taxes do not impede commerce by penalizing transactions. And they cannot impede production of assets, because they apply only to assets that cannot be produced by the taxpayers. If the government raises revenue exclusively from *holding taxes on land-like assets*, it minimizes inflationary tendencies, allowing the central bank to minimize unemployment.

Needless to say, *the ILT is a holding tax on land-like assets.*

## 7. Quick! Hide the loaves and fishes!

The campaign for holding taxes on land-like assets reached its zenith in the writings and speeches of the American classical economist Henry George (1839–1897), who advocated the public appropriation of almost the entire rental value of land in lieu of taxes on labor and capital [2]. When George rose to prominence, economics was just becoming established as a separate academic discipline. Landowners were well represented on the trustee boards of prestigious American universities, whose endowments, moreover, consisted chiefly of land grants. And there was no academic tenure: professors who failed to do the bidding of their paymasters could be fired without process or redress.

The counter-attack was swift, massive, decisive, and ridiculously indiscriminate. *The language of economics was deliberately corrupted so as to conflate land with capital, economic rent with profit, and acquisition with production*, thus obscuring the advantages of a selective tax on land-like assets [3]. The **fallacy of composition** — that what is good for the part is good for the whole — was accepted as a valid argument whenever the part in question was a landowner. By calling itself **neo-classical economics**, the new pseudo-science masqueraded as the successor, though in fact it was the usurper, of the classical tradition. Within a generation it became the new orthodoxy.

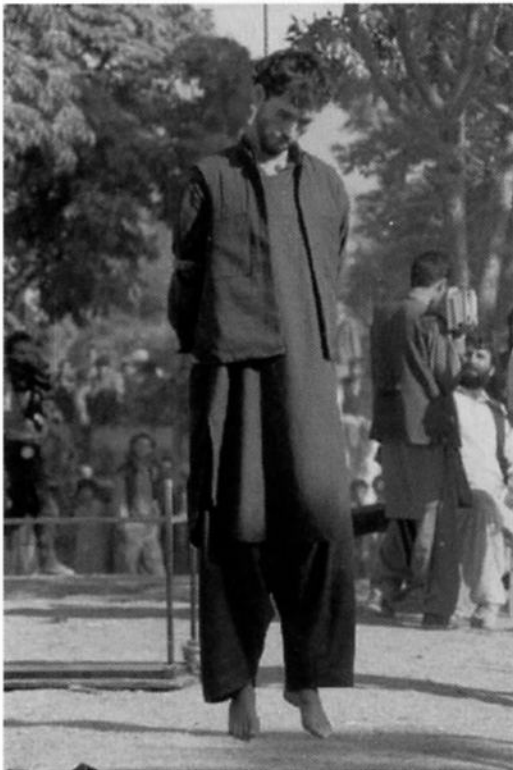
A consequence of the fallacy of composition was that **macro-economics**, in which profit is a cost of production and the rent of land is a surplus, was displaced by **micro-economics**, in which rent is a cost of production and profit is a surplus. Thereafter, those who wanted to reduce economic inequality by redistributing the "surplus" would attack private *profit*, not private economic rent; in other words, they would be *socialists* and *communists*, not mere "Georgists". The consequences for property owners in Russia, China, and eastern Europe were rather worse than those envisaged by Mr. George.

But even where the capitalist system of land ownership remained intact, property owners suffered because the neo-classicists opposed not only the full implementation of



George's system, but *all* reform in that direction, however modest it might be. In particular:

- They opposed Thomas Shearman's "Single Tax", which was a straightforward land tax calculated on "land price";



The consequences for property owners in Russia, China, and eastern Europe were rather worse than those envisaged by Mr. George

- They opposed the Ralston-Nolan Bill (U.S. House of Representatives, 1920), which would have imposed a federal tax of a mere 1% per annum on "the privilege of holding lands, natural resources and public franchises" with a threshold of \$10,000 (a princely sum in those days);
- They opposed the concentration of local property taxes on land values alone, preferring to tax the combined values of land and buildings, and sometimes even claiming that the separate valuation of land was not possible [4].

In each of these cases, the neo-classicists defeated a measure that would have enriched property owners by encouraging the provision of infrastructure. More generally, the neo-classical conflation of land with capital undermines *any* system of taxation that distinguishes between the two — including the ILT.

If property owners had known what was good for them, they would have concentrated their efforts on:

- making a moral-philosophical case, or even a practical case, for the sharing of publicly created value (e.g. uplifts in land values due to public infrastructure) between public and private partners, as opposed to the complete retention of publicly created value by the government; and

- ensuring that any system for financing infrastructure through uplifts in land values was implemented in such a way that taxpayers were protected against losses in the *transition* to the new system (as they are in the design of the ILT).

They might also have considered that, as owners of the most important class of economic assets, they had an interest in being able to get the right answers to economic questions, to which end it might help if the science of economics were allowed to remain a science.

But they were not that smart.

## 8. Seven plagues (and one remedy)

Two consequences of property owners' *unenlightened* self-interest have already been mentioned:

- **The infrastructure crisis:** Public projects and services of which the benefit would exceed the cost are stalled because of the alleged difficulty of meeting the cost.

If the benefit exceeds the cost, how can it be difficult to cover the cost? The excuse is absurd; but it is the "logical" consequence of the neo-classical dogma that land values, which capture the benefit of so much public *expenditure*, should not be a substantial source of public *revenue*.

- **Unemployment:** Failure to raise sufficient revenue from holding taxes on land-like assets necessitates other taxes that raise prices and feed inflation. Central banks counteract the inflationary tendency by raising interest rates in order to create unemployment, which exerts downward pressure on wages.

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Needless to say, those who are unemployed are not engaged in projects that enhance property values. Neither are they likely to be bidding up prices at property auctions. Low wages have a similarly depressing effect on spending power, hence property values.

Further consequences include the following:

- **The rat race:** Unemployment weakens the bargaining position of employees, driving down their wages and conditions. Poor prospects in one occupation drive some employees into other occupations, where they *increase the competitive pressure on employees* in those other occupations, driving down *their* wages and conditions, and so



To keep their employers afloat, salaried staff must work unpaid overtime, and those who cannot or will not do so are displaced by those who can and will

on. Some employees or would-be employees try to escape these pressures by starting businesses in competition with employers, some of whom are then forced into alternative lines of business, where they *increase the competitive pressure on employers* in those other lines of business, and so on. To keep their employers afloat, *salaried staff must work unpaid overtime*, and those who cannot or will not do so are displaced by those who can and will. Thus the unemployment rate sets a *benchmark level of stress* that propagates through the entire economy, affecting workers and bosses alike.

Only the recipients of economic rent are spared. Therefore everyone wants a slice of the economic rent, and the resulting competition for land-like assets *makes it harder to become a property owner*, even if the only property you want to own is your place of residence!

But if uplifts in site values are partly reclaimed through the tax system and spent on public projects and services and cuts in other taxes, everyone automatically gets a slice of the economic rent — and *not* at the expense of property owners, because the tax on uplifts takes only part of a benefit that accrues to property owners in consequence of the same tax.

- **Competing with speculators:** As land is a limited natural resource, an increase in total demand for land cannot be offset by an increase in total supply. And indeed the effective demand for land tends to increase due to population growth (which increases the need for sites) and economic growth (which increases capacity to pay for them). So sites tend to appreciate in real terms [5]. This causes **speculative demand** for sites as individuals and firms buy sites in the hope of reselling them for higher prices, or try to save

*in a falling market (if there were ever another falling market), the ILT would produce a falling tax liability counteracting the urge to "bail out"*

money by early acquisition of sites that they intend to use later. Speculation raises land prices because all buyers must compete with the speculators. Worse, sites held by speculators are likely to be unused or underused because the owners are not yet ready to use them, or because the owners wish to avoid commitments that would fetter their ability to sell at the most opportune times. This effect raises not only prices, but also rents, as the affected sites are withheld from both prospective buyers and prospective tenants.

An ILT on a site encourages the owner to cover the tax liability by generating revenue from the site — either by using it productively or by selling or letting it to someone who will. This makes rents and prices more affordable by strengthening the bargaining positions of potential tenants and buyers.

But such incentives are not always appropriate. An owner-occupied residence, for example, does not generate a cash flow with which to pay ILT. And because such a residence is already being used for its intended purpose, the owner should not be forced to sell or let it. Accordingly the ILT on an owner-occupied residential site should be deferred until the next transfer of title [6].

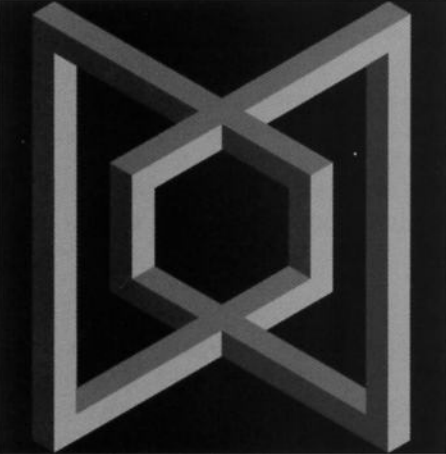
Deferred ILT would greatly improve the "affordability" of homes for first-time buyers. If owner-occupants can sell their old homes without paying any tax, they can spend the entire proceeds — including unearned capital gains — on new homes, and thereby outbid first-time buyers who have no capital gains to spend. A deferred ILT liability for sellers would strengthen the competitive position of first-time buyers. Meanwhile the sellers would benefit from the infrastructure funded by the ILT. To ensure that this benefit is preserved and seen to be preserved, the deferral of ILT should be interest-free, and the deferred ILT should be capped at some fraction of the real increase in the site value during the period of deferral.

*N.B.* Increases in land prices and rents due to infrastructure provision do *not* harm tenants and potential buyers, because such increases reflect genuine improvements in utility; they do *not* make it harder to buy or rent a site of *given utility*. But they certainly increase the income and wealth of the landlords and sellers. When these effects are combined with the improved bargaining position of renters and potential buyers, all the aforesaid parties become net winners; that is, the benefit of the infrastructure is shared among all parties.

- **Chasing our tails:** It is sometimes argued that ordinary home owners, who own no real estate apart from their homes, do not gain from a rise in

property values, because the higher selling prices of their present homes are cancelled by higher purchase prices of alternative accommodation — and they always need somewhere to live.

That argument, as far as it goes, is valid when the rise in values is due to general speculative demand [7]. But it is *not* valid when the rise is due to an infrastructure project serving the owners'



At some point the illusion becomes unsustainable and prices stop rising, taking away the alleged justification for current prices, and so on: the bubble bursts

locality, because in that case there is no matching rise in prices of alternative homes in other localities. Neither is it valid if prices in *all* localities rise due to infrastructure, because in that case the rise in prices of alternative homes is due to improved utility, and does not imply a rise in price for alternative homes of *given utility*. As ordinary home owners do not gain from general speculative demand, neither do they lose if that speculative demand is dampened by the tax system. But they still gain when the same tax system delivers improved infrastructure.

- **Bubbles and bursts:** In a *rational market*, the **capitalized** (or "lump-sum") value of a land-like asset is the **discounted present value** of the future rent stream. (That is, the capitalized value is the lump sum that would yield an interest stream equal to the rent for the same risk, or the sum of the future rental payments individually discounted for time and risk.) But speculation tends to make the market **irrational**. When people see prices rising, they want to buy into the market. In so doing, they accelerate the rise in prices, inducing more people to buy in, and so on, causing a speculative **bubble** — that is, a state in which prices are decoupled from

rents and are supported solely by the circular argument that prices will continue to rise. At some point the illusion becomes unsustainable and prices stop rising, taking away the alleged justification for current prices, and so on: the bubble **bursts**. This is obviously disastrous for investors who buy at or near the top of the bubble.

By inducing public investment in infrastructure, it would also help to lift the economy out of recessions — including the one that we're about to have, courtesy of the biggest global property bubble in history

But eventually the natural appreciation of land-like assets leads to a new bubble in the same asset class. So the market for any land-like asset class, including land itself, is **cyclic**.

The ILT would require property investors to earn income from their acquisitions in order to cover the tax, forcing them to consider the tax implications before bidding up prices, and making it less attractive to acquire land for speculation alone. These influences would impede the formation of bubbles. To avoid bubbles is to avoid bursts. Moreover, in a rising market, the ILT would produce a rising tax liability counteracting the urge to "buy in"; and in a falling market (if there were ever another falling market), the ILT would produce a falling tax liability counteracting the urge to "bail out". Thus the ILT would make property investment safer in the short term by smoothing out bubbles and bursts — but more lucrative in the long term by encouraging provision of infrastructure.

- **Recessions/depressions:** A bursting bubble in a particular asset market has two counteracting effects. On the one hand, it drives investors away from that asset class and, by default, towards some other asset class that may also be susceptible to bubbles. On the other hand, those who have invested heavily in the collapsed market must reduce their expenditure, and some (most likely those who have bought their assets with borrowed money) become insolvent. As one agent's expenditure is another's income, and as one agent's debt is another's asset, a **chain reaction** ensues, reducing the funds available for investment in other asset markets, possibly causing them to collapse, and so on. After an *isolated* bubble-burst, the former effect tends to dominate; thus the land burst of the mid 1920s led to a stock-market bubble [8], and the stock-market crash of 1987 led to a land bubble. But when that second bubble bursts, the cumulative belt-tightening and bad debt tend to cause a recession; thus the stock-market crash of 1929 led to the Great Depression, and the land burst of 1989 led to the recession of 1990–91. The exceptional size and unique importance of the land market mean that a bursting land bubble is the most reliable *single* predictor of a recession [9]; in particular, the global recessions of 1974–5, 1981–2, and 1990–91 were heralded by bursting "property" bubbles, i.e. land bubbles [10].

To the extent that the ILT would avoid property bubbles, it would avoid the ensuing bursts and recessions. By inducing public investment in infrastructure, it would also help to lift the economy out of recessions — including the one



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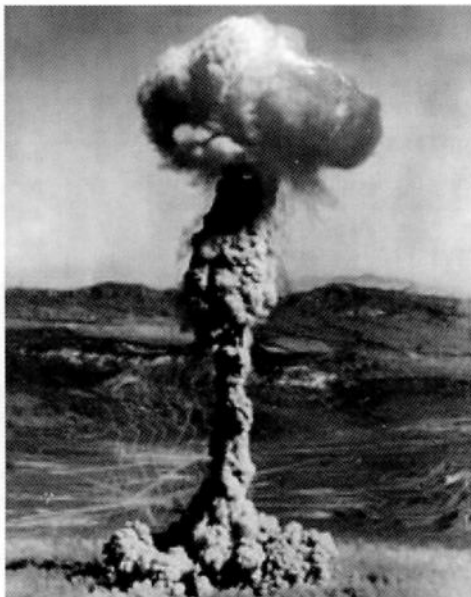
mathematical uncertainties in valuing land are minor compared with the legal uncertainties in classifying transactions as taxable or non-taxable under almost any other form of taxation.

## 9. Conclusion

The infrastructure funding problem can be solved by means of an incremental land tax (ILT) — that is, a site value tax with an inflation-adjusted site threshold, the threshold for each site being chosen so that the ILT payable on that site immediately replaces the recurrent property taxes previously payable to the same government in respect of the same site. By its nature, the ILT cannot raise more revenue from any particular property owner unless that owner receives a net benefit after tax.

The ILT on an owner-occupied residential site should be deferred interest-free until the next transfer of title, and capped to some fraction of the real increase in the site value during the period of deferral.

On introduction of the ILT, all recurrent property taxes hitherto imposed by the same government should be abolished. Other old taxes should be phased out as fiscal conditions permit.



**These multiplier effects work in reverse when the bubble bursts**

[5] While one may claim that sites on the city fringe remain affordable for first-time buyers on typical incomes, this claim does not refer to a fixed group of sites. As the city fringe moves outward while any given site remains stationary, that site tends to become less affordable.

[6] Similar arguments can be applied to sites owned and occupied by religious, charitable, or educational institutions that do not simply "charge what the market will bear" for their services. If such a site is nominally subject to deferred ILT, but is *never sold*, then the tax never becomes payable and never becomes a problem for the venerable user of the site.

[7] Indeed, the author has frequently used the argument in that context.

[8] Most corporate shares are *partly* backed by land-like assets. Moreover, the speed with which shares can be traded, relative to the speed with which they can be created and destroyed, makes their behavior land-like in the short term. So share prices are susceptible to bubbles and bursts.

[9] A land bubble tends to be accompanied by a construction boom (as buyers try to justify the exorbitant prices paid for sites) and a consumption binge (as owners borrow against inflated land values to buy goods and services). These **multiplier effects** work in reverse when the bubble bursts. Because of the long transaction times in the land market, a burst is initially manifested as slower sales rather than lower prices, allowing sellers and their agents to pretend that the market has "plateaued" when in fact it has crashed. This state of denial worsens the liquidity crisis that follows the crash.

[10] Concerning the theory that recessions are due to high oil prices, suffice it to say that: (i) there were recessions before there were oil shocks; (ii) the recession of 1990–91 started before the oil shock that allegedly caused it; and (iii) in the words of Alan Greenspan, "we create these elaborate models for policy responses and we put in oil prices [but] they don't create a recession in the models" [answer to a question from the International Monetary Conference (London, June 8, 2004), transcribed by Ashley Seager and quoted in Fred Harrison, *Boom Bust* (London: Shephard-Walwyn, 2005; 288pp.), p.65].

## Notes

[1] The so-called "rent" of real property comprises the rent of the land plus the hire of any building(s) attached to the land; only the former is economic rent. The so-called "rent" of a vehicle is not economic rent, but a return on capital.

[2] Henry George (abridged A.W. Madsen), *Progress and Poverty*, <http://www.henrygeorge.org/pplink.htm>. See also (e.g.) <http://schalkenbach.org/>, <http://hgclub.com.au/>, <http://hgfa.org.au/>, <http://prosper.org.au/>, <http://earthsharing.org.au/>, <http://lvrg.org.au/>.

[3] M. Gaffney, "Neo-classical Economics as a Stratagem against Henry George", in M. Gaffney, F. Harrison, and K. Feder, *The Corruption of Economics* (London: Shephard-Walwyn, 1994; 271pp.).

[4] Concerning this claim, note that: (i) land is valued separately from buildings in all Australian States; (ii) even in jurisdictions where governments do not separate land values from building values for the purpose of taxation, insurance companies manage to do the same thing for the purpose of setting premiums and assessing losses; (iii) the valuation of land, unlike that of buildings, is facilitated by **spatial continuity**, i.e. the requirement that in the absence of significant boundaries, the land value per unit area is a smoothly varying function of position; and (iv) the

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