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Settlers & the Land Tax

Settler Model I: Hong Kong & Public Finance

LORD PALMERSTON was scathing about the territory Britain acquired as a toehold on China – "a barren rock with nary a house upon it – it will never be a mart for trade". That was in 1841, after Palmerston had successfully waged the Opium War that secured Britain's right to sell narcotics to the Emperor's subjects. Today, Hong Kong is the freest, richest, most dynamic of entrepreneurial economies in the world. It is rated as No. 1 in the Index of Economic Freedom compiled by *The Wall Street Journal* and the Washington DC-based Heritage Foundation, a free market think tank.[1] All of this, and the land is not freehold, and never was.

But this key to Hong Kong's success is treated by Western diplomatic, economic and political commentators as if it were a shameful state secret. And it is true that Hong Kong's success does offend capitalism's most cherished belief, that land must be held as freehold if resources are to be efficiently allocated.

In 1843, Britain hoisted the Union flag and proclaimed that all land would remain with the Crown. Freehold would not feature in this colony. Instead, leases would be granted for 75 years, the period considered necessary to induce tenants to construct buildings. Other sites would be allocated on 21-year leases.[2]

Leasehold was not employed because it was the correct economic policy, however. Britain had acquired the rock from the Emperor on a lease that terminated on June 30, 1997. Therefore, it did not make legal sense to offer land as freehold, when such a right could not be enforced beyond the terms of the Crown's lease with China.

So Britain, the emerging epicentre of the global capitalist order, became landlord for anyone who wished to trade in the oriental markets. Leases were sold at public auctions or granted directly by the Crown, as landlord, in return for an annual rent. Subsequently, leasehold periods were altered, as were the terms for paying rent to the exchequer. But the principle was preserved: if you wanted to make money in Hong Kong, you had to pay rent to the British government which used the revenue to fund the infrastructure.[3] As a result of this financial formula, entrepreneurs were able to trade without carrying a heavy tax burden. This gave the value-adding producers a competitive edge in the global markets.

This was as close to a laboratory experiment as one could get to test the theory advanced by Adam Smith, that the rent of land was the "peculiarly suitable" source of revenue for a commercial society. The development of the economy proved so successful that, in 2006, it produced a

GDP (measured in purchasing power parity: PPP) of $30,822, compared with the UK's $30,821. Unlike the UK, however, Hong Kong could not draw on reserves of coal and oil to fuel her prosperity. Primary materials and food had to be imported. Even so, Hong Kong enjoyed one advantage over her colonial master: people-power, unburdened by the income tax.

Just before the colony was returned to Mao's successors in 1997, the Hong Kong government was providing 3m people with subsidised housing. The mass transit system was the envy of mayors who presided over cities in the West, its funding coming out of the value added to the land rents by the transport system itself.[4] Here was a classic case of the self-funding formula that fostered personal liberty in the open economy.

- Why, when politicians preach to governments of the neo-colonised world, do they fail to expound the lessons of Hong Kong?
- Why, when financial agencies offer development loans, do they attach strings that deliver the *opposite* results to those achieved by the tax-and-tenure policies of Hong Kong?

Hong Kong proves that institutions – combined with the enterprise of free people – are the keys to prosperity. Territory does not have to be richly endowed with natural resources. The key is the combination of property rights and public finance. *Once the rents that people produce together are ring-fenced as the revenue to be spent on the common good, the scope for corruption and bad governance is severely diminished, and the productive talents of people are liberated.*

Hong Kong's tax-and-tenure formula lays the foundation for the economics of material abundance.

Settler Model II: Argentina & Land Grabbing

IN THE history of colonialism, attempts were made to adopt policies similar to Hong Kong's. Their failures offer lessons to countries that wish to become prosperous. Argentina's history is illuminating. A sophisticated attempt was made to prevent land being grabbed to the detriment of future generations.

In 1824, Bernardino Rivadavia introduced a land law for the province of Buenos Aires. The law was extended to the rest of the country in 1826 when Rivadavia became Argentina's first president. The extensive lands – the *pampas*, the size of France – would be allocated to users who would pay rent to the community. The nation would retain dominion over the territory and would fund the public's services out of the rents that people were willing to pay to use the rich soils to grow wheat or as pasture for cattle.

The logic of this policy was explained to the British government by Dr. Ignacio Núñez, Rivadavia's diplomatic envoy, who said that "the spirit of the project is that publicly-owned land should never be held in any way other than by leaseholds...The present taxes bear harmfully upon the people and hinder [the country's] development...The rent of land is the most solid and definite source of revenue on which the State must count". Núñez argued that the collection of land rent would make it possible to abolish tariffs and all other taxes.[5]

Rent was payable at a yearly rate of 8% on the value of pasture lands and 4% on cultivated lands. Leases were on 20-year terms, with revision of rents at the end of 10 years after re-assessments by local juries. This would ensure that, as the economy grew, the rental surplus would be recycled back into the public purse for investment in the additional infrastructure that an expanding population needs.

It was an inspirational programme with the potential to lay the foundations of prosperity for future waves of settlers into this vast territory. The condition for securing this outcome was the willingness to enforce the terms of the land law. Unfortunately, the people who acquired estates found ways to avoid their obligations. This became possible as regional governors (*caudillos*, or bosses) resisted Rivadavia's approach to governance. Rivadavia was relying on a strong central government through which to implement progressive policies for the whole territory. The *caudillos* favoured a federal political structure, which would place the administration of property rights in their hands; giving them the power to undermine the land law. With the fall of Rivadavia, estate owners acquired the influence to evade their fiscal obligations: they manipulated their communities to secure the under-valuation of land. This deprived the public purse of revenue, and ranchers evolved a lifestyle based on the consumption of rents with the least effort possible directed towards the efficient use of their holdings.

Critics have blamed the land law, arguing that Rivadavia neglected to take account of the rapacity of human nature or heed that temporary concessions could be converted into permanent arrangements. These are not legitimate criticisms. As we have seen in the case of Hong Kong, which we may assume had its share of rapacious individuals, leaseholds were enforced to the financial benefit of both the government and the people who traded in the colony.

Argentina turned out to be another case in which sound institutions were sacrificed because the majority failed to defend their legal and moral rights. The predators were allowed to manipulate the law in a manner that would re-direct social evolution along a false path that was not sustainable. In 1914, thanks to the export of beef and wheat to Europe, Argentina was the fifth or sixth wealthiest nation in the world. A century later, in 2006, she was receiving aid from donor countries that once purchased her food.

An attempt was made to revive the rent-as-public-revenue policy in the 1970s when a lawyer, Fernando Scornik Gerstein, was appointed advisor on land taxation to the ministers of economics and agriculture. In 1975, he chaired the Special Commission on Land Taxation established by the Ministry of Agriculture. But then, anticipating the military coup of 1976, Gerstein departed for Spain, and "with the rightist military takeover, all ideas of tax reform were abandoned, and the Special Committee was dissolved".[6]

Argentina failed to seal her cultural foundations with the rents that could be produced by the people, so history shifted on to the path that was typical of the fate of Latin colonies. Once one of the abundant food larders of the world, in 1997 Argentina was shamed by the need to import cheaper Australian beef to keep near-bankrupt processing enterprises operating.

To derive insights from the past, economic historians compare Argentina and Australia because of their similarities. Tax-and-tenure policies proved to be the major difference, accounting for the striking dissimilarities in the prosperity of these two countries in the 20th century (see table below).

Argentina and Australia **Change of Fortune: Selected Vital Statistics (2006)**		
	Argentina	*Australia*
Population (million)	38.4	20.1
Territory (million km²)	2.7	7.6
Unemployment (%)	13.6	5.5
GDP (PPP) per capita ($)	13,298	30,331
Tax revenue (% of GDP)	14.2	24.1
Official development assistance ($m) – multilateral	27	none
Official development assistance ($m) – bilateral	94	none

Source: Kane, Holmes and O'Grady (2007)

Settler Model III: Australia & Public Rent Revenue

IN 1890, in *per capita* terms Australia was the richest nation on earth. She eclipsed income in the United States by a remarkable 41% (see table over). The frenetic land speculation that preceded the depression of 1890 was the turning point in her No.1 status. The severity of the crash is explained by "the magnitude and speculative nature of the preceding boom and the impact of a severe drought".[7] Drought was an act of nature, from which the settlers were able to recover. The real 'blight' which plagued the Australian continent throughout the 20th century was the propensity to abuse – and to speculate in – the rents of land.

Levels of per capita GDP 1820-1994 (relative to the US) (US = 100)			
	Australia	UK	Argentina
1820	119	136	n/a
1850	169	130	n/a
1870	155	133	53
1890	141	121	63
1900	105	113	67
1913	104	95	72
1929	74	76	63
1938	92	98	66
1950	75	72	52
1973	75	72	48
1994	76	73	37

Source: Maddison (1995) Appendix D

The Sachs thesis – that the abundance of nature's resources is a constraint on growth – was certainly false in the Australian case. Here, favourable institutional arrangements in the 19th century "ensured that resource abundance became a blessing rather than a curse". Ian McLean, an economic historian at the University of Adelaide, asked in one of his studies: *Why Was Australia so Rich?*

> Australia was born rich, attaining an income *per capita* higher than any other country after little more than half a century of European settlement. Further, for nearly two centuries Australia has remained (relatively) rich, despite some short-term slippages....Contrary to the view of many growth economists that it is a curse to be resource rich, natural resource abundance must figure prominently in any persuasive answer to the question posed in the title of this paper.[8]

A young, male settler population – partly due to the British policy of exporting convicts – made it possible to achieve high levels of productivity in the production of wool and gold. But there was more to the story than the resource endowment and the demographic profile. The institutional arrangements in the mining industry "helped ensure that the resources contributed to broader economic growth rather than rents accruing to just a limited segment of the population".[9]

But international comparisons of *per capita* GDP disguise the real story about living standards at the end of the 19th century. For Australians chose to reduce the hours they worked to improve the quality of their lives. Once this benefit was factored in, the "leisure-augmented income" rises from 9% to 18% above that achieved in the UK in 1913.[10] This was one benefit of ready access to land, which – in the second half of the 19th century – made it possible for labour to raise productivity and claim its rewards in cash and the quality-of-life free people chose for themselves.[11]

It was different at the beginning when settlement began with the scramble to grab as much land as possible. In due course, however, the British Crown secured the sub-division of land into family farms through land acts in the 1860s and 1870s. This resulted in a wide distribution of ownership.

> The contrast between Argentina and Australia is especially telling here, given the likely importance of these differing initial institutional arrangements to the later divergence in growth rates between these two economies.[12]

This is not a sufficient assessment. Although large holdings were allocated in Argentina, this was in conjunction with rental charges set at market levels. If those rents had been collected, and consistently reassessed as the economy grew, the owners would have had to put their holdings to best use. They would have had to achieve the same levels of productivity as was achieved by farmers on smaller holdings. This would have pressured the estate owners to employ many more people, thereby competing for labour and raising wages. If the owners failed to adopt these practices, they could not have met their rental obligations. That would have obliged them to relinquish some of their acres to others. So the fiscal policy, correctly administered, would have achieved results similar to those in Australia. It was to avoid this prospect that provincial governors resisted Rivadavia's policies. This left estate owners free to underuse their land without financial penalty. The costs were transferred to the pool of dependent workers, while increasing the political power of estate owners over the landless.

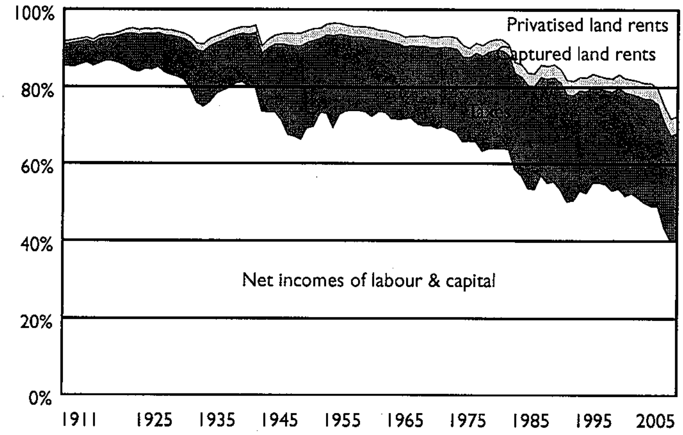
The leasehold system was put to better use in Australia. In 1847, New South Wales introduced regulations that based tenure on fixed-term leases. One consequence was "a more egalitarian distribution of land ownership, limiting in turn the political power of the pastoralists. The contrasting history of land disposal policies in Argentina, and of the political influence of large landowners there, is a salutary reminder of what might have been".[13]

One reason why Australia adopted public charges on rents was to break up large holdings. A second reason was that the settlers wanted to fund infrastructure to support the agricultural and mining industries.[14] In 1879, Queensland was the first colony to abandon the English property tax (imposed on both land and the improvements on it – ie the buildings, etc), to levy municipal charges on the capital value of land excluding improvements.[15]

Economists who emphasise institutions to explain economic growth stress the role played by the retention of European practices. In Australia, however, the settlers came to realise that the English property tax discouraged investment in improvements on the land. That was why "they quickly discarded it for a rate based not on total property income but on the market or selling price of raw land which became known as the system of rating on the 'Unimproved Capital Value'".[16] State governments switched to the land value-based charge beginning with Victoria (in 1877), Tasmania (1880), South Australia (1884), New South Wales (1895) and Queensland (1915). The new Federal Government enacted the Land Tax Act in 1911, which remained in place until it was abolished in 1952.

At the outbreak of World War I, Australian governments were raising a significant part of public revenue from rents. But with each passing decade – even as increasing prosperity brought a rising total rent – the fiscal philosophy was debased, with a lengthening catalogue of exemptions that reduced the share of rents collected to fund public goods. A seminal study by Terry Dwyer (see graph over) reported that total land and resource rents, *publicly collected and not*, were 8.85% of GDP in 1911. A century later, in 2005, they were 32%, but little of it was now collected fairly and directly for the public purse. (Although much of the rent was captured indirectly through the use of distortionary taxes.) Douglas Herps, a senior valuer and consultant to the Commonwealth Grants Commission, estimated that "the magnitude of Australia's economic rent is such that it could provide at least 50% of all the country's present inflated taxation".[17]

Classical Components of GDP – Australia 1911-2005



Source: Dwyer (2003), Kavanagh (2007)

Despite the policy retreats during the 20th century, however, Australia managed to cling on to the concept of rent as public revenue. This helped to secure the modernisation of the economy. Her territory was three times that of Argentina in size, but Argentina had the advantage of people-power: these people *could* have raised urban rents to levels at least equal to those in Australia. If those rents had been used to fund shared services, the GDP of Argentina could have matched Australia's (see tables on p. 143 & p. 144). But a similar remonstration can be levelled against Australia. Her GDP *per capita* was $30,331 in 2006. It could have been significantly higher (and greater than that achieved by the US) but for the cyclical booms and busts in the property market which repeatedly disrupted growth.[18]

We can only imagine how much more prosperous and environmentally secure Australia would be today if she had remained constant in the application of the rent-as-public-revenue policy. According to Bryan Kavanagh, adjusting for the lost investments and disruptions caused by real estate speculation just for the years since 1972, GDP in 2006 could have been AU$1 trillion higher than was actually achieved. Even with conservative estimates, the GDP lost due to the use of taxes that damaged the economy resulted in the deprivation of AU$35,000 per year for every man, woman and child.[19]

Implementing the tax reform agenda in the 21st century requires pioneers with the courage and imagination to lead the way from poverty to prosperity. We shall conclude this study by explaining why three countries of the redeveloping world could pioneer policies that would kick-start their societies on a path of growth that secured fair shares for everyone, immediately transforming the prospects for peace and prosperity around the globe.