Comments on Rent and Economic Reform in Estonia

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Introduction

The first priority for economic reform in Estonia, as in undisputed parts of the Soviet Union, must be the adoption of a functioning market economy employing a currency with a reliable value. This could occur either in the context of reform throughout the Soviet Union or as an initiative of an independent Estonia.

While even Gorbachev has acknowledged the justice of the claims of the Baltic republics for independence, it is not clear that they will be allowed to achieve their independence before the whole economy of the Soviet Union is reformed. But suppose that the people of Estonia have the chance to choose their own economic institutions. How should they proceed?

Currency Reform

To achieve a currency with a reliable value, the operation of the money supply must not be used as a source of revenue for the Government. I propose that a new currency be started, and that the same quantity of money be issued to each citizen over the age of 18. Each citizen who attains the age of 18 would be issued the same amount of currency, and when a citizen died or emigrated, he or she would be expected to return the amount of money that had been received.

Such a system makes it clear that the citizens are the joint beneficiaries of the monetary system, so it can be seen to be reasonable to make them jointly responsible for achieving stability in the value of money. Stability in the value of money is achieved by decreeing that the quantity in circulation will be adjusted in whatever way is necessary to achieve stability.

But first, a target for stable value must be chosen. The target could be either a value in relation to a foreign currency of recognized stable value such as the Deutschmark, an index of domestic prices, or a single commodity. I recommend the last of these.

Such a system would work as follows. Suppose it is decreed that a unit of currency is worth a kilogram of cement. Some quantity of cement would be kept as a reserve. Anyone would be allowed to receive currency in exchange for cement. If the Government received more cement than it needed for reserves, it would sell the excess and share the proceeds among all citizens as a monetary dividend. If the reserves of cement became too low, all citizens would be taxed equal amounts, and the proceeds would be used to buy additional cement. If people wished to turn in so much money at once that the reserve was exhausted, those who could not be given cement immediately would be paid a bonus of perhaps 1% per month for waiting while additional cement was manufactured to give them what was promised. Because all citizens would be accepting the obligation to return the currency that had been issued to them if people did not wish to continue holding currency, and because it is always possible to make more cement, it would be possible to guarantee that the money would always have the value in cement that had been promised.

Guaranteeing the value of money in terms of a single commodity is not the only way of achieving a reliable value of currency, but it is one way. So let it be supposed that in some way a currency with a reliable value is achieved. Then it is possible to address other elements of economic reform.

Economic Freedom

It is most important that people have economic freedom--freedom to live where they choose, to pursue the careers they choose, to open the businesses they choose, and to buy and sell what they choose with whomever they choose at whatever prices are mutually agreed. It is only through such freedom that a productive economy can be achieved.

The Need to Transfer Assets to Private Management

Getting to such a state from existing conditions is mainly a matter of decreeing that government will not interfere with citizens. But decisions must also be made regarding the disposition of assets that are now controlled by State enterprises. While it would not be unjust for State enterprises to continue to operate, it is notoriously difficult to achieve efficiency in the operation of State enterprises, so that the people of Estonia are likely to be better served if the State enterprises are in some manner turned over to private individuals for management. So there must be a mechanism for transfer of State enterprises. In designing the transfer mechanism, it is important to make a distinction between two kinds of assets currently controlled by State enterprises: capital and land.

Claims on Capital

The capital that State enterprises control is the product of the labor of the current and previous generations of Estonian workers. The current generation can claim the proceeds of selling the capital by virtue of being the ones, or being the heirs of the ones, who made it. An exception must be noted. To the extent that capital now controlled by State enterprises was seized unjustly from individuals following Soviet annexation of Estonia, those individuals or their heirs have claims on those particular items of capital. Note that general compensation is not proposed here. It is proposed only that when the Estonian population is not able to say, "The proceeds of disposing of that item of capital belong to us because we made it," then an effort should be made to discover who can properly claim that item of capital. If the item of capital in question is a house in which one or more other families are now living, then those who are living in the house should be allowed to continue to live there (provided that they buy the house or pay a market rent for its use), and the previous owners should be content with receiving a monetary payment.

Basing the claim to capital on having made it points to a further principle for allocating the proceeds from selling capital. Individuals should receive shares that are proportional to the number of years they have worked in Estonia. Individuals who have been on pensions can justly have their claims reduced by the value of the pensions they have received.

Claims on Land

Turn now to the disposition of the land that State enterprises now control. The current generation cannot claim the land by virtue of having made it. Neither did previous generations make the land. The land was seized from individuals after Soviet annexation, but they did not make it either. Some of them were granted land when Estonia was reconstituted after World War I; these persons did not make the land. Some persons bought land, but the persons from whom they bought it could not claim to own it by virtue of having made it, or by virtue of having bought it from anyone who did. No one can claim land by virtue of having made it. Justice with respect to land requires that the benefits from the use of land be shared equally among all persons alive at a given time. Ideally, this would be on a world-wide basis. However, at this time the people of Estonia are only in a position to arrange for the equal sharing of the benefits of using land in Estonia among the population of Estonia.

Equal sharing of benefits does not require management of land by the State. Nor does it require that all persons use land of the same value. It requires only that everyone who uses land pay into a common fund an amount equal to the rental value of the land that he or she uses.

Allocating the Rental Value of Land

But what is the proper disposition of the money that such a fund receives? It might be thought that the money should be shared equally among all citizens. However, a significant part of the rental value of land, particularly in urban areas, is the result of the provision of public services and the growth of communities. This value is properly appropriated by local governments to finance local public services. It is only the component of land value that is due to nature that must be shared equally among the population. Thus an effort must be made to identify the rental value of all land, apart from the value added by capital and human effort, and a separate effort must be made to identify the component of the value of all land that is due to nature.

Identifying the Rental Value of Land

First consider how full land rental value might be identified. If a plot of land is currently unimproved, then its rental value can be ascertained by offering it for rent through an auction, in which the terms are that the amount bid represents an offer of rent for the first year, with the amount of rent to be paid in future years to be determined by future auctions of similar land. The land would be placed under the control of the highest bidder, but the amount of money that he or she would be required to pay would be the second-highest bid. This use of the second-highest bid gives every bidder an incentive to bid the amount that the land is actually worth to him or her, rather than trying to bid strategically, just a bit more than the second-highest bidder is likely to bid. It also means that the person who can use land most valuably is not charged for the value that he is uniquely able to derive from the land, but only for the value that he prevents someone else from deriving from the land.

The highest bidder would be permitted to use the land in whatever way he or she wished, subject to concerns about public nuisances to be discussed below. He or she would be able to use the land for as long as desired, subject to payment in each year of the rental value in that year. He or she would also be permitted to transfer the right to use the land to anyone else, selling the improvements attached to the land, on any terms that were mutually agreed.

Renters or Owners?

Would the person who used the land be an owner or a renter? Not either one, actually. He or she would be like an owner, in being permitted to use the land as desired for as long as desired and to transfer it freely, but like a renter in being obliged to pay for the use of the land. It would probably be best to create a new term for this relationship to land. Perhaps a term like "land holder" or "entitled user" could be used to describe the new relationship.

Deposits for the Cost of Demolition

When improvements on land had come to the ends of their useful lives and needed to be demolished, they would have a negative value, reflecting the cost of demolition. Entitled users might be tempted to abandon the land and leave it to the State to demolish what had been improvements. To guard against such abandonment of worn-out improvements, it would be appropriate to require each entitled user to make a deposit from which the cost of demolition could be paid in the event that the entitled user disappeared. Entitled users would be given interest on their deposits, at a rate reflecting the cost to the local government of borrowing money. The interest on the deposit would be deducted from the payment that was due for use of the land. An entitled user would be permitted at any time to return the land to the local government, in a condition no worse than that of unimproved land, and demand the deposit back.

The Prices at Which Transfers in Assignments Would Occur

Because the entitled user would be required to pay the rental value of the land each year, land transfers would tend to occur at prices that reflected only the value of improvements to the land, plus the deposit. But no laws would restrict the prices at which land could be transferred or the persons to whom it could be transferred.

Determining All Rental Values from a Sample

It is not necessary to auction off all land to determine the value of all land. It is only necessary to auction off a scattered sample of sites. The value of the other sites can then be determined by a statistical analysis of the pattern of values of auctioned sites, combined with interpolation.

In each succeeding year, the local agency charged with determining the value of land would auction any land that had been returned for deposits, and where information was otherwise inadequate, it would acquire, through voluntary transactions, sites with relatively little in improvements, clear the improvements and auction these. It would then up-date the map of land value.

Unimproved Land Value in Agricultural Areas

In agricultural areas, improvements to land can take the form of sustained careful management that preserves the fertility of land. Since virtually all agricultural land has been used in one way or another, there is really no such thing as unimproved agricultural land. The only way to cut through this problem is to define a standard of minimally adequate land management. Land that is maintained to this standard will be declared to be unimproved, and the observed rental value of such land will be treated as the unimproved value of land with similar natural characteristics. If land were returned in a condition below that of the standard, the cost of restoring it to the standard condition would be deducted from the deposit.

Accounting for Consequences of Land Use on Surrounding Land

The manner in which land is used sometimes affects the rental value of surrounding land. Air pollution is the most obvious case. But such effects can also be positive. For example, the provision of a private parking garage can add to the commercial value of surrounding land. To motivate people to take account of such consequences of the way they use land, any effects that are significant enough to be detected in land value maps should be charged or credited to the people who generate them. Thus polluters should be charged for the reductions in surrounding land rents that result from their pollution, and those who provide private parking garages should be paid according to the increase in surrounding commercial rents.

Accounting for the Value of Regional Network Services

Part of the rental value of land arises from the provision of regional networks such as highways and rail lines. When these services are provided by higher levels of government, local governments can properly be billed for the contributions of these services to land values.

This concludes the discussion of the determination and allocation of the full rental value of land.

Estimating the Component of Rent Due to Nature

The component of rent due to nature is estimated by finding the lowest levels of agricultural rents, as far as possible from cities, roads, rail depots, and other signs of civilization. The manner in which such rents vary with natural characteristics of land is noted, and a natural value computed from such a pattern is applied to all land. An adjustment must be made for features such as harbors that make some sites particularly suitable for cities. In principle, the question to be asked is, "If there were no city here, how much would someone be willing to pay, annually, for the opportunity to develop one and rent out all the land?" I can offer no further guidance on this topic and can only commend it to others for inquiry.

Further Specification of the Rent Allocation Mechanism

With land rent divided into a component due to nature and a component due to cities and their services, it is possible to further specify the rent allocation mechanism. Each entitled user of land pays to the local government the full rental value land that he or she uses. When land is used by a government agency, the agency receives a bill for the rental value of the land. But this is not a drain on local government finances, because the knowledge that the rent will be paid permits the local government to increase the budget of the agency by a corresponding amount. The purpose of these circular payments is to clearly identify the full cost of the activities of each local government agency.

The local government is obliged to allocate to each citizen a per capita share of the part of rent due to nature. If the rent due to nature in a given locality is more than the per capita shares of its residents, then it has an obligation to pay the surplus into a fund from which payments would be made to localities that had less rent from nature than the per capita shares of their residents.

Any entitled user could have his or her per capita share applied to the rent of the land that he or she used. Thus anyone whose use of land was less than a per capita share of rent due to nature would have a negative net bill for using land, and would be due a monetary payment. People who used only small amounts of land would find that most of their rent could be paid by their shares of rent from nature.

With the rent identification and allocation mechanism specified, we turn now to issues of privatization.

Privatization

The first stage of reform of enterprises is that each enterprise receives a bill for the rental value of the land that it uses. If the enterprise is a collective farm, the shares of its members of rent from nature will be deducted from its rent bill. Billing for land use makes it possible to identify more accurately the true productivity of each enterprise. Judging the productivity of enterprises requires that they also be charged the full cost of the capital they use. Assigning value to old capital is more problematic, but the question to be asked, in principle, is, "How much money could be expected if the enterprise sold the capital to someone else?" The charge for using capital is then interest on this amount, plus the annual diminution in the sale value, along with whatever the enterprise spends on maintenance and repairs.

Managers of enterprises would be told that they would be judged according to the profits of their enterprises, taking account of the measured cost of land and capital. If these measurements are accurate, persistent losses are a sign that, unless its employees are willing to accept a reduction in their wages, the enterprise should be closed and its assets used by others. A rule would be instituted that something like 10% of the measured profit of the enterprise would be divided among the management according to their salaries, and something like 15% would be divided among the other workers according to their wages. The possibility that the enterprise would be closed if unprofitable and the possibility of receiving a share of the profits would provide incentives for greater efficiency in enterprises.

In the next stage of privatization, investors would be invited to purchase five or ten per cent of the value of all enterprises. Foreigners as well as Estonians would be invited to invest. The money received in this way would be allocated to citizens according to the number of years they have worked in Estonia, with downward adjustments for pensions received.

A board of directors would be formed for each enterprise, with the investors invited to elect one member of the board. The board of directors would meet only occasionally to review broad matters of policy and to decide whether to continue to employ the person with chief responsibility for running the enterprise. The board would be composed primarily of employees and successful managers of other enterprises. The managers of enterprises would have authority to dismiss from employment any individuals who they felt did not contribute adequately to the productivity of the enterprises.

Through the market for shares in enterprises, estimates would be made of the amounts that all citizens would receive from the privatization of all enterprises. Advances would be made to citizens of 75 or 80% of these amounts, so that they would be able to invest if they wished as enterprises were privatized.

Enterprises would then be picked, one by one at random, to have their shares auctioned. In each auction individuals would specify the number of shares they wanted and the price they were prepared to pay, or the total amount of money they wished to invest at whatever the share price turned out to be. Again, foreigners as well as Estonians would be invited to invest. The share price would be chosen to satisfy all the unconditional investors and all the conditional investors who were prepared to pay the chosen price. As the auctions proceeded, individuals would be given revised estimates of their total incomes from privatization, so that they could make better decisions about the amounts they wished to invest. As each auction was completed, its management would be turned over to a board of directors elected by its stockholders.

The Taxation of Enterprises

To achieve the highest possible price for enterprises, it would be important to guarantee investors that enterprises would not be taxed excessively. The best possible tax on profits is no tax at all. Even with no tax on the profits of enterprises, all Estonians would benefit from the profit opportunities of enterprises. The reason for this is that when there are no taxes to be paid on investments, international investors find it worthwhile to invest more, and when there is more investment the prices of goods are lower and wages are higher. Furthermore, land is worth more where there is no tax on profits, so that the money that Estonians receive from the rent of land rises. If Estonians want their Government to receive a share of the profits of enterprises, the best way to achieve this is to have the Government retain a share of the ownership of enterprises.