Using Tax Policy to Promote Urban Growth

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Urban growth is desired because it raises peoples' incomes. In a market economy, incomes can be divided into components derived from four factors of production:

- the rent of land,
- the wages of labor,
- the interest received from owning capital, and
- the profits of entrepreneurship (the activity of choosing investments and organizing production).

Thus a successful urban growth strategy in a market economy must either increase the amounts of land, labor, capital and entrepreneurship that are used in a city or increase the payments that are made per unit of each factor, or both.

The land that a city has is fixed (or if it changes, it does so at the expense of other administrative units). Therefore, with respect to land, socially productive urban growth means adopting policies that raise the productivity of land. Labor, on the other hand, is reasonably mobile, and capital is highly mobile. Entrepreneurship springs up and fades away with the rise and fall of opportunities. Therefore, in a market economy, the payments that must be made to attract these factors are substantially outside the control of a city. Thus the growth of a city with respect to labor, capital and entrepreneurship is achieved primarily by making the city a place that attracts more of these factors, taking the rates of wages, interest and profits that must be paid to attract them as given by market forces.

Tax policy is critical for urban growth because taxes on the earnings of labor, capital and entrepreneurship drive these factors away. A city that desires to grow should refrain from taxing wages, interest or profits and concentrate its taxes on land, which does not have the option of moving away.

Certain other sources of public revenue, in addition to the rent of land, have the characteristic of not discouraging growth. These sources of revenue involve either charging people for using scarce opportunities that no one created, as with land, or charging people for the costs that their actions impose on others.

A city that wishes to grow should confine its search for revenue to these sources. In this way it will attract more labor, capital and entrepreneurship, thereby raising the rent of land, which can be collected publicly without discouraging growth.

Additions to the stock of capital are extremely important for urban growth, because of the impact of abundant capital on wages and rents. When capital is abundant, labor and land are more productive, and the more productive they are, the higher wages and rents are.

There is virtually nothing a city can do to affect the rate of expected return that is needed to attract capital, because capital is highly mobile. Investment moves around the world, wherever expected returns are highest. To attract capital, St. Petersburg must offer the owners of capital prospects of returns comparable to those available elsewhere. Taxing the return to capital that foreigners invest in St. Petersburg is counter-productive. Additions to the stock of capital available to workers in St. Petersburg can also come from the savings of the residents of St. Petersburg. Here again, it is important not to tax returns, so that the residents of St. Petersburg will be induced to save rather than consume, and to invest in St. Petersburg rather than send their savings elsewhere.

In a market economy, the owners of capital are the principal entrepreneurs, the organizers of production whose incomes come from what is left after all contracted expenses of production have been paid. The return to entrepreneurship is not a matter of a rate of profits that is promised to investors by governments, but rather of how prospects, filled with risk and uncertainty, happen to turn out. In evaluating investment prospects, entrepreneurs are concerned with expected returns under existing conditions and with the consequences of potential future changes that would affect their returns.

Among the most important risks that entrepreneurs face is the risk that, after their investments have been made, governments will introduce policies that will ruin the possibility of achieving the returns that had been expected. Thus a substantial part of attracting investment is a matter of convincing potential investors that they need not worry about future government policies. How to do this is a key question of promoting growth.

A city that seeks foreign investment is like a man trying to persuade a woman he meets in foreign travel to marry him and go away to live in his country. The woman can be expected to ask herself, "Will he always treat me well, or is his current good behavior a ruse to put me in his power? How do I know he will not abuse me once I have left my friends and family?" The suitor must find a way to overcome her fears. In the same way, a city that seeks foreign investment must find a way to persuade potential investors that they will not be treated badly once their capital is committed.

Some examples of policies that would harm the interests of investors if they were implemented are:

1. New currency regulations that prohibit foreign investors from returning any profits they obtain.

2. New import restrictions that prevent enterprises from obtaining the materials they need.

3. New labor regulations that require enterprises to pay higher wages than were expected.

4. New environmental regulations that limit the production of enterprises.

5. New taxes.

A city that seeks foreign investment should do what it can to eliminate all such risks, so as not to acquire a reputation for exploiting the vulnerability of investors. Exploiting the vulnerability of investors would mean imposing conditions, after investors were committed, that cities would have been willing to forego to secure the investments. The effort to attract investment should begin by putting the finances on the public sector on a sound footing. This means limiting public expenditures to activities that are truly worthwhile and providing adequate financing for these activities. By managing its public budget prudently, a government can persuade potential investors that there is less need to worry that future governments will increase their taxes arbitrarily.

The financing of public activities does not necessarily have to be from current tax revenues--borrowing is appropriate for investments in facilities that last many years. But borrowing for current consumption undermines the confidence of potential investors.

For a city such as St. Petersburg, an implication of the importance of investor confidence is that much of the city's success in attracting investment will depend on investors' expectations about treatment from the national government. To attract investment, it will be important for St. Petersburg officials to do what they can to provide assurance that the Russian government will not make life difficult for those who invest in the city. This will not be easy. But St. Petersburg officials should at least exercise any influence they have to promote national policies that are encouraging rather than discouraging to foreign investors.

Ideally, St. Petersburg officials might negotiate an agreement with national officials that St. Petersburg would be a "free trade zone," with its own economic rules. Such an agreement might provide that taxation in St. Petersburg would be entirely at the discretion of the people and officials of St. Petersburg, as long as the region made an adequate payment to the National Treasury for services provided by the nation and did not impose uncompensated costs on the rest of the nation from such things as pollution or the migration of economic refugees. Whether or not permission for an independent tax policy can be secured, it will be in the interest of the people of St. Petersburg to avoid excessive spending at the national level, so that their taxes can be kept low.

Whatever arrangements are made for the financing of the national government, the people of St. Petersburg also need to finance their local government. For the activities of local government, the people of St. Petersburg have the option of reducing or eliminating activities if they are not worth their cost. Every activity that is continued should pass a test of providing adequate value for money. Most of the worthwhile activities of local governments raise the rental value of the land in the vicinity of the activity by enough to pay a substantial fraction if not all of the costs of the activity.

Thus the rental value of land is a natural first source of financing for local public expenditures.

Making the rental value of land a principal source of local public revenue has both an equity rationale and an efficiency rationale. The equity argument for social collection of the rent of land is founded on a recognition that the rental value of land has three sources. Part of the rental value of land is the gift of nature--the fertility of soil, the value of good rivers and harbors, the depletable value of minerals, and so on. This part of the rental value of land should be collected publicly because no individual has a just claim to more than a proportionate share of it. Public collection is just either if it is followed by an equal distribution to all citizens or by spending on activities that provide equal benefits to all.

A second part of the rental value of land comes from the provision of public services. The local agencies that provide these services can justly claim the increase in the rental value of land that results from their activities.

A third part of the rental value of any particular site arises from private activities that are conducted in the vicinity of that site. Social collection of this part of the rental value of land is particularly appropriate if this money is used to reward those private activities according to how much they increase the rental value of land.

The efficiency argument for social collection of the rent of land has two parts.

- First, the rental value of land has the rare quality of being a source of public revenue that does not discourage productive activity. If people are taxed according to their labor earnings, they can be expected to work less, and to tend to move from the places that tax them. If people are taxed on their investments and savings, they can be expected to save and invest less, and to find it attractive to put their savings and investments in other places where they will not be taxed as much. But when the rental value of land is collected, no one will reduce the amount of land in existence, and no one will move his land elsewhere. Thus social collection of the rent of land does not reduce the productivity of an economy in the way that most other sources of public revenue do.

- The second part of the efficiency argument is that social collection of the rent of land tends to make land more available to those who want to start new enterprises. When the rent of land is not collected publicly, those who have rights to land will tend to ignore the possibility of releasing it to someone who might make better use of it. On the other hand, if those who have rights to land are required to make annual payments equal to the market value of the rights they hold, then these continuing payments will induce people to ask themselves regularly whether they ought to release the land to someone who can make better use of it.

To achieve the potential efficiency of public revenue from land, it is important that people not be charged more for the use of land, just because they happen to be using it particularly productively. The rental value of land should be reassessed regularly, the values that are determined should vary smoothly with location, and they should be available for public inspection so that all users of land can see that they are being charged amounts commensurate with what their neighbors are being charged.

Social collection of the rent of land also facilitates the privatization of land. If every user of land is charged annually according to the rental value of the land that he or she holds, then it is possible to undertake a just privatization of land simply by passing out titles to the current users of land.

No one will be disadvantaged by not receiving land. Future generations will not be deprived by not having been awarded shares. And the community will have a continuing income from the rent of land.

The efficiency that is entailed in using the rent of land to finance public activities applies to certain other sources of public revenue as well:

1. Charges on any publicly granted privileges, such as the exclusive right to use a portion of the frequency spectrum for radio and TV broadcasts.

2. Payments for extractions of natural resources. Such payments should be set at levels that yield the greatest possible revenue of the resources, in present value terms.

3. Taxes on pollution. Every individual or enterprise that pollutes the air, water or ground should be required to pay the estimated cost of the pollution it generates. The effect of pollution on the rental value of surrounding land is one possible measure of its cost.

4. Taxes on any other activities that reduce the rental value of surrounding land.

5. Taxes on activities such as driving or parking in crowded streets, where one person's activities reduce opportunities for others. The administration of such

charges may be so expensive that it is not worth implementing them, but if the administration can be handled sufficiently cheaply, these charges are efficient to the extent that they only charge people for costs imposed on others.

6. Taxes on activities, such as the consumption of alcohol, which impose costs on others (e.g., higher traffic fatalities).

7. Charges for local public services, such as water, electricity, sewer connections, etc. It is not generally desirable to make every service completely self-financing. Rather, what is desirable is that each user be required to pay the marginal cost of the service he receives. Extensions of service networks are efficient when they increase publicly collected land rents by enough to cover the costs not covered by user charges.

8. A self-assessed tax on permanent improvements to land, at a very low rate (perhaps 1/10 of 1% per year). With a self-assessed tax, each possessor of land names a price at which he would be willing to part with the land he possesses (and any immovable improvements). He pays a tax proportional to the value he names, and anyone who wishes to may take over possession at that price. The value of such a tax is that it makes it much easier to assemble land for redevelopment, and to identify appropriate compensation when land is taken for public purposes.

All of the above taxes are positively beneficial and should be collected even if the revenue is not needed for public purposes. Any excess can be returned to the population on an equal per capita basis. If these attractive sources of revenue do not suffice to finance necessary public expenditures, then the least damaging additional tax would probably be a "poll tax," a uniform charge on all residents. If some residents are regarded to be incapable of paying such a tax, then the next most efficient tax is a proportional tax on income up to some specified amount. Then there is no disincentive effect for all persons who reach the tax limit. The next most efficient tax is a proportional tax on all income.

It is important not to tax the profits of corporations. Capital moves from where it is taxed to where it is not, until the same rate of return is earned everywhere. If the city refrains from taxing corporations they will invest more in St. Petersburg. Wages will be higher, and the rent of land, collected by the government, will be higher. The least damaging tax on corporations is one that provides a complete write-off of investments, with a carry-over of tax credits to future years. Such a tax has the effect of making the government a partner in all new investments. With such a tax the government provides, through tax credits, the same share of costs that it later receives in revenues. However, the tax does diminish the incentive for entrepreneurial activity, and it raises no revenue when investment is expanding rapidly. Furthermore, the efficiency of such a tax requires that everyone believe that the tax rate will never change. Thus it is best not to tax the profits of corporations at all. If the people of St. Petersburg want to share in the profits of corporations, then they should invest directly in the corporations, either privately or publicly. The residents of St. Petersburg would be best served by refraining from taxing the profits of corporations. Creating a place where profits are not taxed can be expected to attract so much capital that the resulting rises in wages and in government-collected rents will more than offset what might have been collected by taxing profits.

The taxes that promote urban growth have at least one of two features. The first feature that a growth-promoting tax can have is that it can serve to allocate a naturally occurring resource among competing potential users. Charges for the use of land, for the use of the frequency spectrum and for depleting natural resources share this feature. The second feature that a growth-promoting tax can have is that of being a charge for the costs imposed on the city by the person who pays the tax. This feature is shared by taxes on pollution, taxes on other activities that reduce the value of surrounding land, taxes on imposing congestion and other costs on other residents of the city, charges for the marginal cost of publicly provided services, and a self-assessed tax on property, reflecting the hindrance to future growth represented by existing development. A city that confines itself to these taxes can expect to attract capital rapidly, and therefore to experience rapid growth, raising the wages of its citizens and the publicly-collected rent of its land.

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