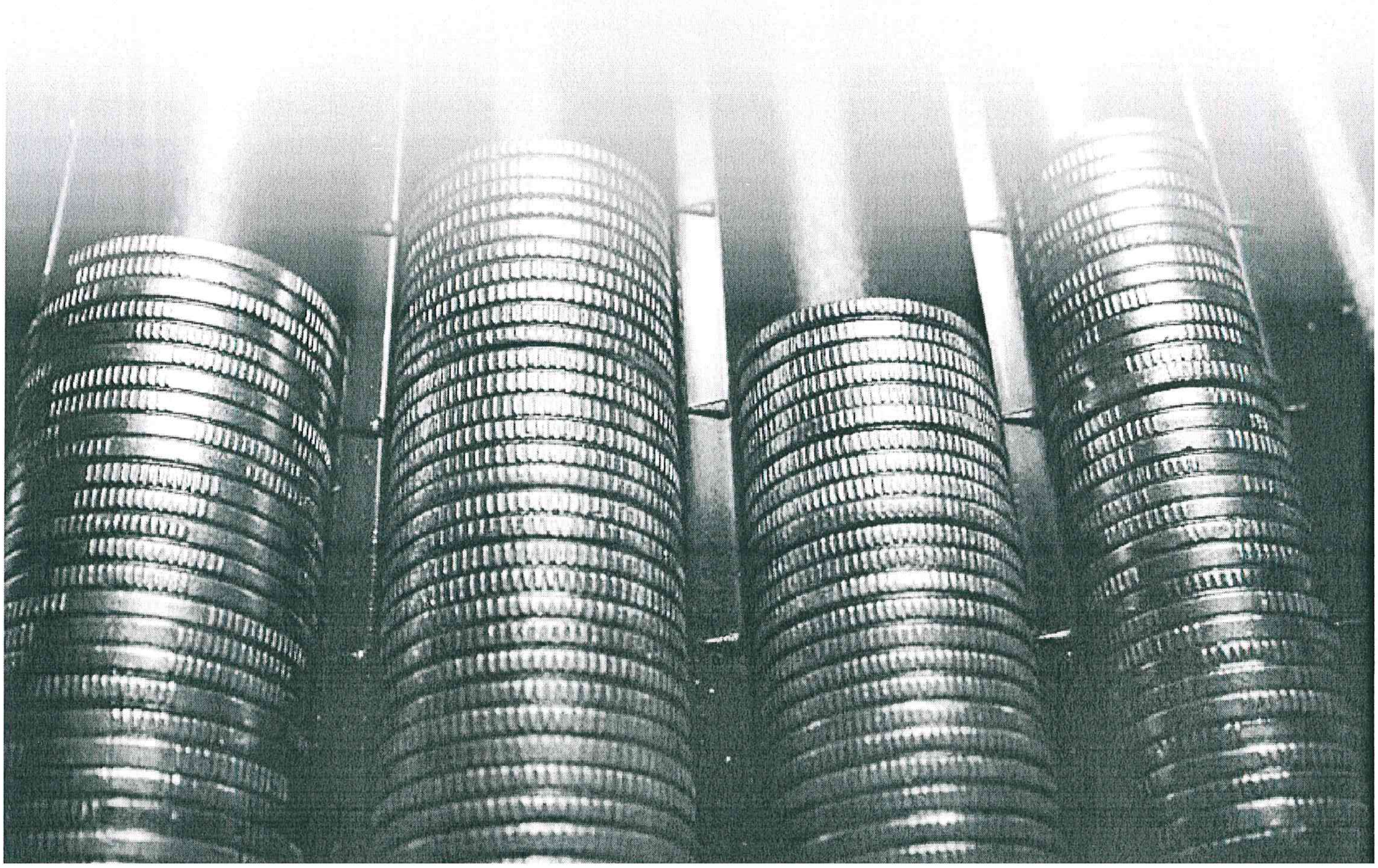
DAVID TRIGGS

Euro crisis: Cutting the Gordian knot*



cover story

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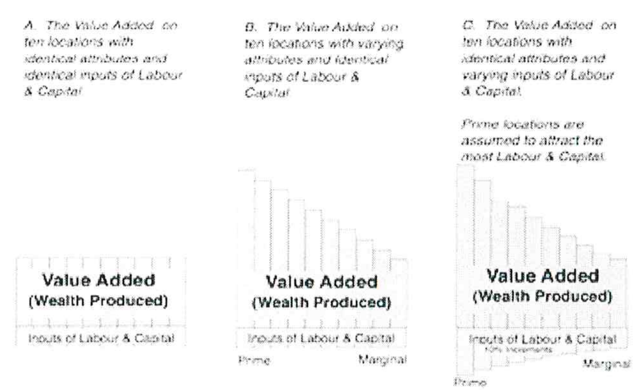
**Cut the Gordian knot: Solve or remove a problem in a direct or forceful way, rejecting gentler or more indirect methods.*

Origin mid 16th century: From the legend that Gordius, king of Gordium, tied an intricate knot and prophesied that whoever untied it would become the ruler of Asia. It was cut through with a sword by Alexander the Great.

The current eurozone crisis has served to illustrate the link that necessarily exists between the monetary, fiscal and political policies of nations that join together in order to form a unified economic community. Where the economic community consists of a sovereign state such as the United Kingdom a common fiscal regime alongside a common currency has a long tradition and is taken for granted, but in the EU this has not been the case and the dilemma members now face is whether or not more fiscal and political union is a price they are prepared to pay to save the monetary union embodied in the euro.

A problem for producers in the least economically productive locations within the eurozone is that their ability to sell the wealth they produce to customers abroad is restricted by the high and inflexible value that attaches to the currency they are obliged to use (the euro).

At the same time, their ability to sell to domestic customers is undermined by the relative cheapness of overseas products for those customers using the euro. Likewise producers in the more economically productive locations enjoy an advantage by being able to use a currency that, being determined by the overall economic performance of all eurozone countries, is for them undervalued. The advantages and disadvantages that are naturally enjoyed or suffered by producers in different locations, regions, or countries are thus amplified by their use of a common currency. They would however be amplified still further if they adopt a common tax system that taxes producers and products on the basis of their inputs or value added. Such taxes damage economic activity everywhere, but more so where productivity is least, i.e. at the margins of viable economic production. Consideration of some history and basic economic theory illustrates why this is so.



Diagrams A - C show how the value added at each of ten locations within a single economic community varies according the attributes of those locations (B), and the amount (quality and quantity) of labour and capital applied at each location (C).

Neither A, B, or C reflect a realistic situation i.e. neither locations nor inputs are ever identical. Both tend to vary as shown in D. (overleaf)

Europe is not alone in having adopted an economic system that both inhibits the production of wealth and prevents those that produce wealth from receiving their due rewards. The same problem exists throughout the world as more and more countries have adopted economic practices first developed in europe alongside the agricultural, industrial and social revolutions of recent centuries. The process began as the holding of land on condition of feudal service gave way to money payments. Over time these payments became fixed and negligible. Three developments were then critical in setting the economic environment that continues to operate today. First, the practice of duty free land enclosure became common. Second, governments introduced taxes on products, production and trade. Thirdly, finding the revenue from such taxes to be insufficient, governments resorted to borrowing. Today the tax systems and methods of borrowing that operate have become extraordinarily complex rendering them highly susceptible to abuse as few understand all their intricate details. Whilst neither are responsible for the production of any new wealth both profoundly distort the economy and how wealth is distributed throughout the community.

All wealth arises from the work of people working somewhere. People and locations vary giving rise to varying amounts of wealth (Diagrams A-D) and any rent payments come from people's earnings (Diagram E). This division varies very considerably between economic communities. In a sparsely populated rural community where there is little specialisation or competition for locations with special features, only a small proportion of the wealth produced will go in rent whilst most will be due, as earnings, to the suppliers of labour and capital (See pie chart). In a densely populated community however competition for the best sites becomes intense which, coupled with highly efficient and specialised forms of wealth production, enables people to pay an increasing fraction of the wealth produced in rent, leaving a smaller proportion retained as earnings.

If marginal locations are freely available, but attract no competition or rent, an occupier's earnings there will equal all that they produce. This then establishes a basic level of earnings for that community and other occupiers will only engage in competition for a better location, if it will enable them to equal, or better, that basic level of earnings (See Diagram E).

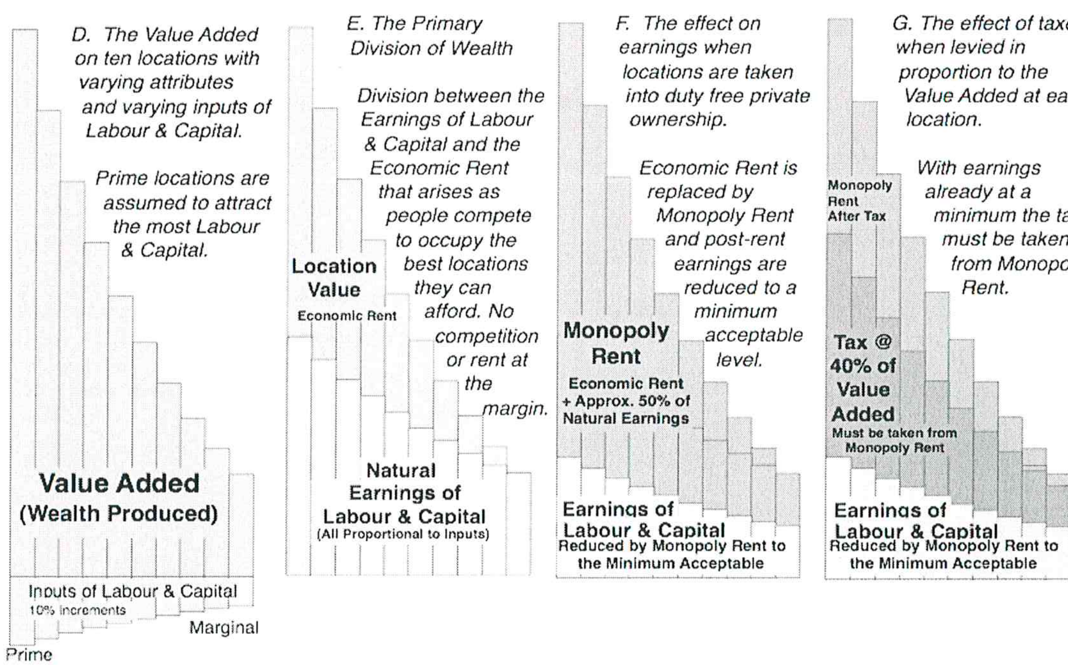
However, in a situation where no viable locations for living or earning a living may be had without charge, (e.g. where all land is enclosed, and duty free private property in land is recognised in law), the situation changes radically. Land at the margin now acquires a value that derives from the absolute necessity that every human being must have access to land in order to live and earn a living. The suppliers of labour and capital are then obliged to accept a level of earnings that does not so much reflect the value of what they produce as what they can survive on i.e. the least they will accept. (See Diagram F).

The Monopoly Rent payable at the margin may still be termed rent in everyday parlance but it has a quite different character and effect compared with the Economic Rent referred to earlier. Most significantly it skews the primary distribution of wealth against the interests of those who actually produce wealth.

The basic level of earnings will not now refer to the wealth which a person can produce by their enterprise and exertions but, in the extreme, it will be mere subsistence. Custom, tradition, culture, statute law, monopoly powers, closed shops, etc. may raise what some people will receive in return for the employment of their labour and capital - but it will remain the least they will accept.

These are the conditions that prevail in the UK, Europe, and generally throughout the world today and upon which governments superimpose their tax systems for raising public revenue. Governments must chose whether or not they take these locational considerations into account when they raise public revenue. Unfortunately, generally they do not, as they tax value added, employment, income, sales and profits etc. (See Diagram G).

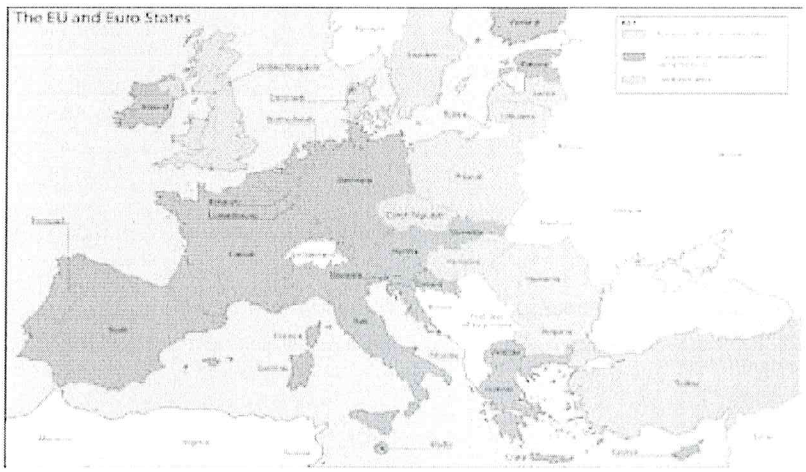
The consequence of this approach is that the amount of public revenue that can be collected is limited by the effect of the tax on marginal locations because they have the least ability to pay. Also, under current arrangements, where locations can acquire a capital and speculative value, in addition to their current rental value, the owners of marginal locations prefer to see their land unused rather than used by a tenant who cannot afford to pay both the tax and their monopoly rent. Sadly, this combination of factors has rendered many industries, trades, businesses and whole communities, unviable at marginal locations throughout the world giving rise to lost production, unemployment and poverty.



Diagrams E-G show how the distribution of wealth produced within a community (as shown in D) varies according to systems of land tenure and public revenue. The Primary Division between Rent and Earnings is shown on E & F. Diagram G shows the distribution between 'earned' and 'unearned' income that arises when taxes are levied at all locations in proportion to the Value Added at each location.

At the same time a tax on production set at a rate that can be accommodated at marginal sites, will increase income differentials as non-producing beneficiaries of rent at supra-marginal locations are left with progressively more of the value added by producers. We thus see the common situation where governments are unable to raise sufficient public revenue whilst the need for public expenditure expands as unemployed, underemployed and poorly paid people need to be provided with benefit payments of all kinds. The social stresses and costs of exchequer finance are thus enormous.

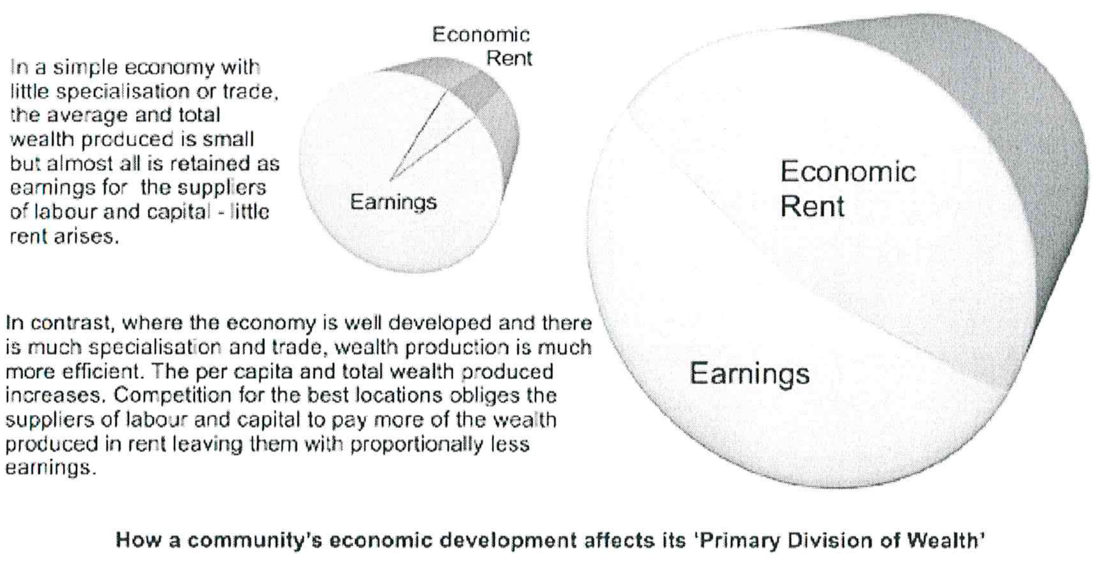
If in contrast all taxes on production, producers, and trade, were abolished but land owners were obliged to pay to the community the community created value of the locations they claim to own, i.e. its periodic rent, the speculative incentive would be replaced by one encouraging beneficial use. Owners would then either use the location, in accordance with its best permitted use, or allow someone else to do so. If, the combined monopoly and economic rent where collected as public revenue on the basis of the land's best permitted use it would not affect the economic viability of any location and would yield more in public revenue, and less social distress and expense, than the value added approach.



On its own however it would not restore the basis of earnings to their natural level i.e. the full added value at the margin. To achieve this in the UK, producers would need to receive an earned income benefit approximately equal to the value that their earnings currently enable them to purchase. This is because, under current arrangements the value of goods and services that an employee can get from their earnings represent around 50% of what it costs their employer to employ them, i.e. after income tax, national insurance contributions, and indirect taxes on expenditure. With UK taxes at around 40% of the value added at even marginal locations the residue monopoly rent there is likely to be around 10% of the value added.

This basic review of simple economic theory illustrates how current tax arrangements discourage economic activity everywhere, but damages most where productivity is least, i.e. at the margins of viable economic production. In the UK this amplifies the differences in wealth production that are possible between regions, cities, towns, and districts as well as the different forms of economic activity. Bad tax arrangements may thus be seen to undermine the unity that still exists within a culturally diverse nation.

Throughout the European Union the cultural differences are much wider and the threat to peace would be much greater if a common, and inherently unjust, inefficient and ineffective tax system were to be imposed on all countries. If the reality of location differences, with all their associated national, social, cultural, and historical traditions are ignored, we should not be surprised if attempts to homogenise them lead to distress and disintegration, rather than integration. The prospects for implementing a solution to established economic injustice on a continental scale would be improved if a working example could be provided. It may be that now is the time for the UK, and/or another independent economy to set such an example.



How a community's economic development affects its 'Primary Division of Wealth'