

CENTRE FOR ECONOMIC POLICY RESEARCH

Australian National University

DISCUSSION PAPERS

**Land Value Taxation:
A Critique Of
'Tax Reform, A Rational Solution'**

Julie P. Smith*

**Economics Program
Research School of Social Sciences
Australian National University**

DISCUSSION PAPER NO. 417

June 2000

ISSN: 1442-8636

ISBN: 0 7315 2281 8

*** The author was joint winner of the 1998 International Tax Reform Challenge Prize of \$25,000, sponsored by the Land Values Research Group.**

CONTENTS

	Page
Abstract	iii
Introduction	1
Are Governments Moral and Rational?	1
What Really Drives Tax Policy?	2
Do Governments Have Integrity to Sustain Ethical and Rational Revenue Policies?	3
Previous Australian Experience	4
Land Taxes	5
Public Leasehold	7
Betterment Taxes	9
Resource Taxes	9
Capital Gains Taxes	10
Summary and Conclusions	10

ABSTRACT

It has been argued by advocates of land value taxation that the centrepiece of tax reform should be land taxation, because of the efficiency, equity, simplicity and ethical advantages of taxation of the unearned increment in land values. This paper critiques these arguments. It is shown, by historical reference to the fate of land value taxation in the Australian states, to the ACT public leasehold system, and to the Commonwealth capital gains tax, that such tax reform will never succeed precisely because of its advantages, which adversely impinge on the interests of politically powerful landowners.

LAND VALUE TAXATION

Introduction

Land value taxation is an attractive revenue raising tool. However, its rationality is its defect. The paramount rule of taxation is *'plucking the goose so as to obtain the largest amount of feathers with the least amount of hissing'*.¹ Taxing unearned increments in land values threatens Australia's most powerful interest groups, offending this primary rule. History demonstrates Australia's governments lack the qualities needed to sustain land value taxation against attack by powerful vested interests.

*'Tax Reform: a Rational Solution'*² proposes a *'community charge'* of 100 per cent on land rental values to reduce income taxes. The authors say this is *'logically and morally unassailable'*. The only barrier is cultural - *'private appropriation of land values has been taken for granted and institutionalised'*. As *'recouping the whole of the annual rental value would reduce the price [of land] to zero'*, they propose introducing the charge gradually. With compensation for *'unconscionable'* equity effects, the system would be *'transparent, simple and cost effective, equitable, efficient, and incapable of avoidance'*. It would also *'provide free market economics with a universally applicable moral base'*, by distinguishing between land, and commodities and services which are the fruits of human labour.

However, this perfectly ethical and rational revenue instrument contains the seeds of its own destruction. Another rule of taxation is *'the only good tax is an old tax'*. A *'good'* tax - which raises revenue - is the one left after the most powerful groups in society have had their say. In our imperfect world, democratic political institutions are flawed and mobile capital exercises significant economic power. The inevitable, if unethical and irrational consequence is that tax burdens are shifted onto the fruits of labour. Taxes on unearned increments in land values never become old and 'good', because powerful landholder opposition nobbles them, if not at conception, then soon after birth.

Are Governments Moral And Rational?

'Tax Reform' presumes government revenue raising policy is motivated by ethics, to achieve rational, stated objectives.

Although taxation policy is a *'values-added'* issue, prevailing political ideologies discount social or ethical concerns and Governments defer to values generated and revealed in *'The Market'* by those with economic influence.

¹ Jean Baptiste Colbert, 1619-83.

² Day, P., R. Else-Mitchell, et al. (1996). Tax reform: a rational solution.

Public debate is in objective terms such as achieving efficient, equitable, simple, easy to enforce and comply with, and transparent taxes. However, governments do not make policy by rational consideration of all relevant issues; economic policy is 'the science of muddling through'.³ In the historical 'March of Folly' - '*the persistent pursuit by governments of policies contrary to their own interests*'⁴- neither logic nor morality have predominated.

Governments' stated objectives are rarely their real ones. Their real tax objectives are identified by Colbert - minimising hissing, while plucking maximum revenue from the goose.

On traditional public finance criteria, appropriating unearned increments in land values is an exemplary source of revenue. The merits of land value taxation have been known for a long time and are widely accepted. Over a century ago, reformers argued compellingly for public appropriation of the unearned increment in land.⁵ Modern town planning has strengthened the original rationale -

'Recent international discussions have served to underline the widespread conviction that these surplus values should accrue to the public, since they are produced mainly by public or community efforts and are unearned by the private holders'.⁶

Yet, governments have largely ignored its revenue potential. Indeed, successive governments have eroded or abolished existing levies of this kind at every opportunity.

What Really Drives Tax Policy?

Tax policy is about raising revenue. As governments seek revenue, the privileged and powerful try shifting the tax burden by threatening to take their capital, and sometimes their labour, elsewhere.

A 'global economy' and capital mobility challenges governments' ability to tax according to ability to pay, indeed to tax capital⁷ at all. The tax burden is shifting from capital, which is more, to labour, which is much less mobile.⁸ Meanwhile, governments' increasing revenue needs foreshadow 'a fiscal crisis of the state'.⁹

³ Lindblom, C. (1959). "The science of muddling through." *Public administration* **19**(2 Spring): 79-88.

⁴ Tuchman, B. (1984). *The March of Folly*. Great Britain, Michael Joseph Ltd.

⁵ Brennan, F. (1971). *Canberra In Crisis*. Canberra, Dalton.

⁶ Dunkerley, H. B., Ed. (1983). *Urban Land Policy, Issues and Opportunities*. Oxford, Oxford University Press: 23.'

⁷ Some skilled labour is also highly mobile.

⁸ Graetz, M. J. (1985). "Reform of Australian business taxation." *Australian Tax Forum* **2**(4).

⁹ O'Connor, J. (1973). *The Fiscal Crisis Of The State*. New York, St Martin's Press.

Immobile factors - labour and land - must ultimately bear the burden of all taxation as globalisation bypasses national revenue systems.¹⁰ For two decades, Australian governments have seen a GST as a panacea for their taxing problems. Worshipping mythical advantages of taxing labour income when spent, rather than taxing it when earned, they have left taxes on land, that other immobile factor, to languish or wither away.

Do Governments Have Integrity to Sustain Ethical and Rational Revenue Policies?

Changing economic conditions make levies on land rental values vulnerable to erosion by vested interests groups.

Public appropriation of development rights, the major element in the value of land, is politically difficult. It also requires very large, high-level administrative skills beyond the current capability of many governments. Since urban land is so valuable, and particular locations command semimonopolistic prices, public efforts to capture full land rental values are compromised by corruption and favouritism.¹¹ Indeed, early Australian land policy was,

'a dispiriting story of the lack of foresight, faulty legislation, poor administration, political corruption, dishonest practices, moral cowardice and human greed'.¹²

The influence and capabilities of democratic political institutions such as those in Australia are crumbling under the force of vested corporate interests and the increasing integration of the world economy. Modern governments cannot cope effectively with the problems our society confronts because:¹³

- Governments are unresponsive to the needs of disadvantaged groups, yet responsive to demands by strong private interests which they helped entrench;
- Political parties are powerless to resist pluralist and corporatist influences;
- Distinctive public interests are not articulated or are applied by ineffective or irresponsible bureaucracies beholden to powerful interests.

One can only conclude that even if the rational and ethical community charge were introduced, governments do not have the integrity and sophistication to sustain it.

¹⁰ Courchene, T. (1993). *Globalisation, Institutional Evolution And The Australian Federation*. Federalism Research Centre, Australian National University.

¹¹ Doeble, W. (1983). Concepts of urban land tenure. *Urban Land Policy, Issues And Opportunities*, Dunkerley, ed. *op cit*: 63-107.

¹² Brennan, F. (1971), *op cit*.

¹³ Self, P. (1985). *Political Theories Of Modern Government*. UK, George Allen & Unwin Pty Ltd. See also Hutton, W. (1995). *The State We're In*. Great Britain, Jonathon Cape Ltd; Martin, H. (1997). *The Global Trap*; Saul, J. R. (1997). *The Unconscious Civilisation*. Victoria, Penguin.

Previous Australian Experience

Weakened by its assumptions in conception, the 'perfect tax' could also be flawed in execution. The 'community charge' invites political attack and erosion because in practice it may generate inequity, economic damage, and other problems. Its revenue yield might be minimal.

The unearned increment in land values comprises several elements. The most important are: 'development gains' due to permitted changes in land use or shifts in locational advantage; public spending on infrastructure provision, associated with 'betterment' taxes or 'special assessments'; and 'land gains', arising from the general progress of an economy.

Each element must be dealt with differently to fully capture unearned increments. A levy on annual rental value differs from levying changes in value. A fixed annual charge on land rental value would not fully capture development gains or value increments due to public infrastructure spending.

Land prices also rise for reasons other than unearned increments in land value. As prices reflect capitalised values of anticipated income flows, values vary with high interest rates or rising prices, as well as fluctuations in profitability of land use.

Hence, the proposed community value charge might overtax or undertax true land rental values.

A 'comprehensive', and 'ethical' approach may not generate revenue from taxing development gain. Without affecting underlying demand or supply of land, planning decisions can not affect overall land values.¹⁴ Avoiding 'confiscation' by compensating planning 'wipeouts' means little revenue, as losses at one location will offset gains in value elsewhere. Equitable compensation for recent land purchasers and the 'asset-rich, income-poor' would open costly loopholes.

Careless administration of land levies also produces inequities and damaging economic effects.¹⁵ Valuation remains an art not a science; practices vary. Problems arise in assessing unimproved values without an active local market in raw land.

These practical flaws turn 'hissing' by vested interests at a 'perfect' tax into plausible complaints of 'confiscation' and 'theft'.

It is not feasible in practice to tax imputed rental income at 100 per cent. Historically, governments have been unable to charge more than 30-40 per cent tax rates on land or mineral resource rents, even where the public has legal title. The ethical

¹⁴ Prest, A. R. (1983), *op cit*.

¹⁵ Mathews, R. L. (1992). Land taxation in Australia revisited, the historical development of Australian land taxes. *Real Property And Land As A Tax Base For Development*. Taoyuan, Land Reform Training Institute.

argument of 'community rights' over land will not silence the voice of historical fact — private ownership and appropriation of value increments. Gradual introduction is no remedy. A 10-year transition to levying 100 per cent of land rents is akin to announcing all land value will be confiscated by the end of the period. If the threat was credible, current market prices of land would quickly fall, to little more than the discounted value of the revenue payments for the ten year period.¹⁶

Converting freehold land into long leases with reversionary rights to the state,¹⁷ or capturing future development values¹⁸ may achieve similar ends. However, as Prest points out,

'the fact that the first approach was outlined by Marshall in England in the 1880s and the second by J S Mill in the 1840s without any action being taken should be a warning to enthusiasts about there being a very stony furrow to plough'.¹⁹

Experience with Australia's land taxes, ACT public leasehold, development rights charges, and taxation of Crown minerals proves the point. So too does capital gains taxation.

Land Taxes

Australia levies unearned land value increments through land taxes and rates on unimproved values.²⁰ Legislators' primary motive for such levies was revenue during fiscal crisis. These land levies captured only a fraction of unearned value increments because of landholders influence in the legislatures.²¹

The spectre of capital flight frightened legislators. '*Capital*', they heard, was a beneficent genius. '*But she is shy, and can easily take wings and fly from land to lan*'.²²

¹⁶ See Walters, A. (1983). *The Value of Land. Urban Land Policy, Issues And Opportunities*. Dunkerley. ed. Oxford, Oxford University Press: 40-62.

¹⁷ (Else-Mitchell) Royal Commission of Inquiry into Rating, Valuation and Local Government Finance (1967). *Report*. Sydney, NSW Government Printer.

¹⁸ (Else-Mitchell), Commission of Inquiry into Land Tenures. (1974). *Interim Report*. Canberra., AGPS; and (1976). *Final Report*. Canberra., AGPS.

¹⁹ Prest, A. R. (1983), *op cit*: 10-11.

²⁰ For the history of these land taxes see for example, Garland, J. M. (1934). *Economic Aspects Of Land Taxation In Australia*. Melbourne, University Press, Melbourne; Else-Mitchell, R. (1974). *Legacies Of The Nineteenth Century Land Reformers From Melville To George*. John Murtagh Macrossan Lecture, University of Queensland Press; Mathews, R. L. (1992). *op cit*; Groenewegen, P. D. (1979). "*Progress And Poverty*" *In Historical Perspective*. Commemoration of the centenary of publication of '*Progress and Poverty*' by Henry George, Australian School of Social Sciences.

²¹ Smith, J. P. (1993). *Taxing Popularity*. Canberra, Federalism Research Centre, ANU.

²² Catherine Spence, quoted in Goodwin, C. D. W. (1966). *Economic Enquiry In Australia*. Durham NC., Duke University Press, p125.

Few distinguished investing in speculative asset holding from investing in productive capacity.

Because of the political clout of landowners, farmers and pastoralists received generous exemptions. Although combined federal and state land taxes were heavy at first,²³ even the highest rates were far below 100 per cent of rental value. And though the 1910 federal land tax levied crown leases, organised landholders and pastoral interests soon overturned it. Reimposition in 1914 produced such sustained hue and cry from pastoral lessees that their legislative representatives overturned it a decade later — also trying to make the change retrospective! Governments' slow reaction to double taxation and low farm prices in the late 1920s meant some land taxes were paid out of capital. This fuelled taxpayer discontent. By 1933-34, rates were half wartime levels.²⁴

In 1952 the Menzies government abolished the federal land tax, so states could replace lost income tax revenues. The states did no such thing. By the 1950s states' land taxes were already substantially eroded. Reflecting the political power of the farm lobby, and in response to political pressures from homeowners, land used for primary production had generally been exempted, as had land used for the principal place of residence.²⁵

This occurred because inflation and misuse as a 'progressive' land tax damaged political viability of the tax and weakened its rationale as a tax on unearned increments. Changing economic conditions made it increasingly unlikely that such taxes would fall only on pure 'land rents'. Land values were rising not just from population pressures, but because farm prices and profits rose. Variations in land fertility, and the effect of changing farming technology on land productivity meant careless valuation could penalise improvements. Changes in inflation or interest rates also altered the rate of return for those 'investing' in landownership. Higher interest rates made the land taxes into taxes on capital.

As more of Australia's wealth took the form of assets other than land, strong pressures emerged to exempt rural and residential land from 'discriminatory wealth taxes'. Exemption of various landowner categories during the severe inflation of the 1970s made it inequitable. Inflation pushed more taxpayers into higher tax rate categories, causing politically embarrassing cases of hardship. Intense criticism by urban landowners forced changes in the basis of rating as urban land prices accelerated in the 1980s.²⁶ Substantially a tax on urban land, land taxes became highly volatile. Boosting revenues meant lifting already high rates on a small, influential group of taxpayers.

²³ Mathews, R. L. (1992), *op cit*.

²⁴ *Ibid*: 5

²⁵ *Ibid*: 16, 7.

²⁶ *Ibid*: 18.

Archaic administration and the variety of valuation procedures produced inequities and anomalies, arbitrary jumps in land valuations, and tax assessments unmatched by taxable capacity.²⁷ The result:

'No political party now seems anxious to allow the land tax to operate as a means of taking from the landowner any part of the value of land as an unearned increment or for that tax to produce the effect of compelling owners of large or valuable holdings to dispose of or subdivide them'.²⁸

The largest state tax loopholes are now found in land taxes, which have only ever accounted for around 5 per cent of state taxes. In NSW, concessions are five times greater than revenue collected.²⁹

As land-owners are one of the main identifiable political groupings on which state politicians depend on to get elected, there is little scope to increase revenue from taxes on land. Land and property interests make important contributions to political party finances. Despite the merits of reforming land taxes to make them more comprehensive,³⁰ state governments prefer higher taxes on payrolls and business franchises. As George Bernard Shaw pointed out,

'A government which robs Peter to pay Paul can always count on the support of Paul'.

Public Leasehold

Under the 'Tax Reform' proposal, land tenure arrangements would be unchanged. However, what matters is not land tenure but how economic equity in the land is allocated between public and private 'stakeholders'.³¹ A charge equal to full market land rental amounts to public capture of all existing private financial equity in land value. If the public cannot even collect the full value of unearned land value increments in the ACT, where it has full legal ownership, then capturing it on land held under private title is a pipe dream.

Canberra's public leasehold system is rooted in the arguments made in the same era as land value taxation. There was unparalleled unanimity of public opinion at federation

²⁷ *Ibid.*

²⁸ Else-Mitchell). (1974): 19.

²⁹ Walsh, C. (1990). State Taxation and Vertical Financial Imbalance. *Issues in State Taxation*. C. Walsh: 67.

³⁰ Albon, R. (1990). The Impact of State Taxation: The Case of Housing. *Issues in State Taxation*. C. Walsh:43-52.

³¹ (Else-Mitchell). (1974), and (1976), *op cit.*

that land in the national capital should be publicly owned.³² A key objective was to avoid unproductive land speculation and unrequited public expense or inequitable wealth accumulation, by public capture of increments in national capital land values.

Long delays in adjusting rents had already eroded the public's equity in Canberra land values by the late 1960s. Irregular revaluations produced arbitrary rises in land rents during 1960 inflation. Rents on residential leases were abolished as a political gesture from 1 January 1971.

Public capture of land value increments was still feasible on non-residential leases, or when residential lease values rose due to planning changes. However, these were only half-heartedly pursued. Pressure from local land and property interests, combined with weak and inept administration, allowed private appropriation of most remaining public equity.

- lessees were never levied the full increment in value on lease purpose changes;
- commercial and rural lessees were permitted to increase their economic equity by 'paying out' leases.
- the ACT government bestowed 'a gift to sitting owners of commercial and industrial leases'³³ by waiving lease renewal fees.

There was, it is said, 'no ethical or economic reasons why such a gift of a national asset should be made'. Yet local land and property owners have persuaded the federal government to glue the national land grab into place by authorising perpetual leasehold, drawing spurious arguments for equity, 'freehold rights', and investment incentive.³⁴

Despite unwavering community support for the public leasehold system, non residential lessees have exercised political power to change the rules in their favour.³⁵ They were aided and abetted by government and the bureaucracy:

'Administrators, and on occasions politicians, have been markedly impervious to criticism and persisted in pursuing practices which have jeopardised the integrity of the leasehold system'.³⁶

Lack of political integrity, bureaucratic incompetence and indifference, combined with powerful local land and property interests and threats of capital flight defeated

³² Brennan, F. (1971). *op cit*

³³ Stein, P., P. Troy, et al. (1995). *Report Into The Administration Of ACT Leasehold*. Canberra, ACT government: 218

³⁴ ACT (Planning and Land Management) Amendment Bill 1997.

³⁵ Neutze M 1995, 'Is there a Future for Leasehold Tenure in Urban Areas', URP Newsletter no 23, June, ANU.

³⁶ Stein, P., P. Troy, et al. (1995), *op cit*: 47.

effective capture of land values in Australia's national capital, even under public land ownership.³⁷

Betterment Taxes

An alternative approach to capturing unearned land value increments is to levy development gains from public planning changes. NSW introduced such a charge in 1970 following recommendations by a Royal Commission of Inquiry.³⁸ However, the scheme was short-lived, being abolished within a few years. Those who stood to profit from rezoning decisions convinced decisionmakers the measure was pushing up land prices.³⁹

Unless backed by the threat of compulsory public acquisition, landowners have shown they will undermine such a policy by raising prices. However, as Prest comments

*'that is a policy which most governments are more willing to talk about than implement'.*⁴⁰

Similar issues arose from recommendations by the Land Tenures Inquiry in 1976.⁴¹ But pleas for ethics and rationality fell on deaf ears. Threats the tax would raise land prices won the day.

Resource Taxes

Taxes on land value are conceptually similar to mineral 'resource rent taxes'.⁴² Like land value taxes, properly designed levies on these mineral 'rents' can produce substantial revenues without undermining returns to genuine enterprise.⁴³ They too can conserve scarce resources and prevent premature exploitation and dissipation of value.⁴⁴

³⁷ Brennan, F. (1971). *op cit*; Neutze, M. (1987). "Planning and Land Tenure in Canberra after 60 Years." *Town Planning Review* **58**: 147-64; Smith, J. P. (1997), *op cit*; Stein, P., P. Troy, et al. (1995) *op cit*.

³⁸ Else-Mitchell 1967 *op cit*.

³⁹ Neutze, M. (1977). State and Local Property Taxes. *State and Local Taxation*. Mathews: 167; Prest, A. R. (1983), *op cit*. If developers or landowners expected the charge would be removed, they had an incentive to delay development.

⁴⁰ *Ibid*: 15

⁴¹ Else-Mitchell 1976, *op cit*.

⁴² Reece, B. F. (1986). "Could land betterment be taxed using resource rent tax concepts?" *Australian Economic Papers* **5**(3): 39-52.

⁴³ See Smith, B. and A. Ulph (1979). *Economic Principles And Taxation Of The Mining Industry*. Taxation of the mining industry, ANU Canberra, Centre for Resource and Environmental Studies; Swan, P. (1984), *ibid*.

⁴⁴ Swan, P. (1984). "Resources rent tax: the issues." *Australian Economic Papers* **3**(3): 1-10

Australian governments own all minerals. However, the political power wielded by mining capital, and the ever present threat of flight has meant the community's resource rents on minerals have not been captured for public profit.

In a rare burst of reformist zeal, the Commonwealth government introduced a 40% Resources Rent Tax in 1984 within its limited jurisdiction over offshore resources. However, backed by the mining industry, state governments refused to replace inequitable and economically wasteful existing mining taxes and royalties⁴⁵ with the Resource Rental Tax.⁴⁶

Capital Gains Taxes

The case for taxing 'land gains' is '*part and parcel of the case for taxing capital gains*'.⁴⁷ However, for nearly a century Australian parliaments proved incapable of taxing capital gains at all.

Most capital gains remain untaxed. The present levy falls only on realised gains, and has major loopholes through rollover into other assets. All assets acquired before 1985 and owner-occupied homes are exempt. Rural pressure resulted in assets being deemed unrealised on death, emasculating the tax as a partial levy on land value gains. As a US property millionairess Leona Helmsley says, '*only the little people pay taxes*'.

SUMMARY AND CONCLUSIONS

*'There are grounds for believing that many of those responsible for public policy view the taxation system merely as a symbol, which can be used to defuse complex and controversial issues of social and economic policy so long as it gives the appearance of contributing to stated goals. Whether or not this is so, it is time that we began to evaluate the tax system by reference to the effects which it actually achieves and not the effects which governments say they intend to achieve.'*⁴⁸

Raising public revenue by taxing unearned increments in land values has produced disappointing results. Weak or inept administration combined with practical flaws in 'the perfect tax', leaves the way open for plausible protest at public capture of unearned increments. Government inability to distinguish genuine concerns from the squeals for

⁴⁵ Livingstone, D. F. (1979). State mineral royalties in the Federal system. B. Smith and A. Ulph. *op cit*: 62-86.

⁴⁶ Lloyd, P. J. (1984). "Summary." *Australian Economic Papers* 3(3): 32-37.

⁴⁷ Prest, A. R. (1983), *op cit*: 12

⁴⁸ Mathews, R. L. 1983. *The Case for Indirect Taxation*, Reprint Series No. 54, CRFFR, ANU: 24.

abolition, undermines land levies' political viability. Tax policies are not rational if judged by stated objectives. They are rational if viewed as rhetoric, hiding the reality that the public are the 'gooses' who should be hissing.

Modern governments have proved unable to defend 'the public interest' against coalitions of private vested interests profiting from community-owned land value increments. It is not surprising, as Seligman commented a century ago, that,

*'the constitutional history of England is to a large extent a history of the struggle of the people to gain control of the Treasury'*⁴⁹

⁴⁹ Seligman, E. R. A. (1900). *Essays in Taxation*. London., McMillan & Co: 76.