

©Peter Meakin
Professional Registered Valuer
Cape Town
021 6834349
Nov/Dec 2009

Words 2515

Are neo-classical economists South Africa's Trojan horse?

It is satisfactorily proven that the fundamental reason for high rates of unemployment and poverty is a flawed fiscal policy. This is also the cause of credit crunches.

South Africa's taxes are modelled on the neo-classical tax system which targets labour, capital, trade and land so as not to discriminate between owners of these factors of production. Neo-classicists acknowledge that although all these taxes raise the prices of whatever is taxed and diminish their supply that is the price one pays for free enterprise. Here are three local examples of this thinking:

Richard Grant* a disciple of Frank H. Knight the father of neo-classicism: *"the distinction between man-made and natural factors of production that is, between capital and land ... is irrelevant when discussing intervention and taxation: the consequences will be the same for any asset."*
*previously Director of Research at the Free Market Foundation of Southern Africa in his book "Nationalisation: How Governments Control You." Sourced from the "Corruption of Economics" by F. Harris and T M Gaffney

Similarly Leon Louw Director Free Market Foundation: *"The legitimacy and sense of taxing one activity, not taxing another, and subsidising a third is hardly questioned. Yet it is only common sense that you get less of what you tax and more of what you subsidise."* in the FMF's "A Neutral Tax Structure Shows Respect for the Consumer"

And Manya Mooya at UCT:** *"The second criticism of land taxes arises from the fundamental premise that land is different from other factors of production"* letter to the SA Valuer July 2009
**Senior Lecturer in Property Studies, UCT.

In fact land taxes have entirely contrary results: the supply of land actually increases and its price falls when taxed. This can be quickly verified by imagining a vacant, unimproved urban stand or farm where the entire rent is taxed. This land has a zero purchase price because there are no revenues to capitalise. Who would pay for an asset whose holding cost equals its entire income?

Nor will the land area of South Africa be diminished by one square metre through land taxes.

If the four factors of production are compared to a quartet then three of them are clearly out of tune. It would be better for the South African economy if its taxes were sung solo; as a single land tax.

That will mean that personal taxes on work, profit, interest and trade can all gradually give way to land taxes. This is known as a *free-land, tax haven* which will ring in significant improvements in job creation and poverty levels.

So how are land taxes calculated? They are a percentage of land rents which Ricardo defined in 1809: *as the excess of production over that which the same application can secure from the least productive land in use.*

This rent is illustrated in the story of twin farmers, Abe and Bert, who own identical marginal and neighbouring farms. Marginal means that they just break even after paying market related wages and salaries as well as interest, profit and depreciation but there is nothing left over, no surplus (excess) or rent.

One day a spring gushes out of a field owned by Abe and increases his turnover by R100K pa after paying the extra annual costs of managing the water including labour, pumps, pipes and dams. Abe's land rent or excess therefore increases from zero to R100K. His farm is no longer marginal.

Next year Bert gets permission to build a farm stall. This increases his turnover by R100K after paying the extra annual costs of managing the stall including labour, stock, building rent and insurance. Bert's rent or excess becomes R100K too.

[At a p/e ratio of 20 years that means the unimproved land value of each farm has risen from zero to R2M.]

Similar excesses occur when one of two identical houses has a panoramic sea-view but not the other, or when two identical shops are situated in the same street but with different pedestrian volumes, or that one of two identical office blocks is ten minutes walk closer to a railway station than the other.

However, by limiting the tax on land rent to less than 100% and so having to rely on private wealth to fund the budget short-fall, as the neo classic tax formula, land owners enjoy a perpetual rent annuity.

This is a State subsidy because raw land prices are unearned: they rely entirely on outside factors such as nature's endowment (Abe), locality, government services, population increase, governance and zoning (Bert). Owners cannot raise land prices on their own except by adding improvements such as a house. But then the asset

is no longer land but a mixture of land and building.

It shows that if the fisc decides to under tax land and relies on work, capital and trade for part of their budget then prices will rise and supply is diminished.

Employers then have to pay the employees wages plus PAYE and so employ fewer than they might. Or consider windows which were boarded up in England when they were taxed in the 18th century. Or think of a tax on profits or interest which raises the cost of capital and investment. And VAT which increases the price at the tills.

Neo classical economists dominate South African universities, media and Parliament, whether government or opposition but their theory about taxes is tattered. They choose "bad" private taxes when there is a "good" land alternative.

The classical economists like Hume, Quesnay, Smith and Ricardo through to George and many Nobel Prize winners were in favour of only taxing land, like the perpetual quitrent tenures which Britain introduced to the Cape colony in 1813. Raw land then had no purchase price because its entire rent was captured to pay for infrastructure and services and governance.

We need to revisit these dysfunctional neo-classic policies. A land tax debate was last conducted by the Katz Commission in the 1990's. In their interim 1994 report the Katz Commissioners voted in favour of the neo-classical option stating, that *"there are more effective ways of addressing poverty than through the tax system"*. Those ways came to mean welfare payments which now consume 25% of the national budget and rising whilst able bodied men and women are shut out of land by its high price, now more than R400 000 per plot according to ABSA.

It is ironic that if Katz and his fellow tax advisers and academics had decided in favour of the classic single land tax then millions of South Africans would by now have built themselves decent homes from materials gathered from or grown on their small holdings. They would be rich not poor.

In the eighth (Land Tax) Katz Report of August 1998, chaired by neo-classicist and now Judge Dennis Davis the single land tax was raised in submissions: *"At one extreme Georgists held to the view that a site value tax on all land should be introduced, while all or most other taxes should be abolished. Alternatively, some respondents fiercely resisted the prospect of a land tax as an unjust impost on only one form of wealth that would discriminate against certain sectors of the economy."*

One would expect that in view of the terms of reference of the tax Commission *"to inquire into the appropriateness and efficiency of the present tax system and make recommendations on its improvement"* that the Commissioners would have

welcomed the opportunity of studying the effect of replacing all existing taxes with a single land tax and of testing the claims whether such taxes were unjust and discriminatory.

They did not and so condemned the poor to more poverty because an unemployed man without land is more useless, from a livelihood point of view, than a duck without a pond. Ducks can survive without ponds but man has to work the land to survive as an employee of someone else who has access or for himself when jobs are short.

This is all common cause but a new dimension in neo-classical fiscal irrelevance occurred recently when the London School of Economics [LSE] could not answer Queen Elizabeth's questions about the credit crunch? Their full reply read *"Your Majesty, the failure to foresee the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole. (Observer 31st July 2009)*

Such gibberish from this temple of learning will end any claim that neo-classical ideas on tax have any relevance today. One does not have to be able to count to ten to understand that the reasons for a dearth in credit is that government supported land prices drained the banks of cash. Who would sensibly lend to a bank when the real money lay in buying into land subsidy schemes with borrowed funds?

As Greenspan put it in the Spectator of 19th September 2009 *"the actual trigger was securitised American sub-prime mortgages"* and *"unless someone can find a way to change human nature we will have more crises."* Greenspan blames greed here but forgets that if the speculative element is removed from house prices by land taxes then greed cannot be satiated there.

The risky element of houses is the land price. In South Africa that now averages 40% of house prices according to ABSA. In the past twelve years South African and USA house prices rose by 13%pa. [The Economist 19th September 2009 and the CIA].

The little known fact is that house prices have grown in real terms in spite of the fact that building values fall by $\pm 3\%$ each year due to depreciation and obsolescence. This means that for every 13%pa that average house prices escalate the land value must rise by 30%pa, doubling every thirty months.

A 100% tax on land rents will inoculate all the greed and speculation because the security for house mortgages can then only rely on depreciating house values much as other man-made goods such as cars or white goods and equipment. There has never been speculation in these.

Land and house prices, however, play no part in economic growth except apparently to slow it. Between 1997 and 2009 house prices in Hong Kong actually declined by 2%pa yet annual per capita GDP there is now USA\$ 29K, nearly six times South Africa's USA\$5K.

Hong Kong's success is partly because land rent appropriations amount to 35% of its budget. By loading up on land taxes, the costs of employment and working capital are lowered. This means that more employment opportunities emerge.

Keynes obliquely recognised the vital component of land in his book *The General Theory of Employment, Interest, and Money* (1936) where, one supposes tongue in cheek, he advised "*If the (UK) Treasury were to fill old bottles with bank notes, bury them at suitable depths in disused coal mines which are then filled up with town rubbish, and leave them to private enterprise on the well-tryed principles of laissez faire to dig them up again there need be no more unemployment.*"

What he missed was that the treasure is already in place if only people could get to work it for themselves. The fertility, flora and fauna as well the ores, precious metals, oils, are all in the ground so there is no need to bury bottles full of bank notes to create jobs but just remove the entry cost.

In conclusion therefore land prices are a State subsidy where conventional taxes are required to bridge the shortfall from under taxed land and resources. Logically then homeowners hardly pay taxes but merely advance funds to the State and wait for higher land prices. That is not something which will last much longer.

Footnote: here are the main advantages which will jolt the South African economy once the Treasury retires its neo-classical assumptions:

1. Access to unimproved land becomes free, excluding rates and taxes. Using standard welfare-to-work methods and in concert with private sector developers this would mean that any able-bodied family would be able to own an unbonded two hectare farm in a rural village comprising a sturdy three bed-roomed house, fields, orchards, vineyards, barns, cellars and stables. This will take thirteen thousand and five hundred hours, [five years] of work in cooperation with neighbours.

Such an estate will be worth at least one million rands, today, whether it is near Butterworth or Stellenbosch. That is more than the total earnings of a domestic worker for forty five years at the current minimum (half day) statutory wage.

Self sufficiency in food during construction will add an average of one hour of work per day using low-input agriculture. Once the estate is completed the scope for labour intensive work is real. One of the highest earners is in the production of very fine mohair which can sell for R17 000 per kilo.

2. The repeal of private taxes, excluding excise and import duties, will reduce the cost of employment, capital and trade and will boost GDP by an estimated 30% in a few years because of the removal of burdensome taxes and high collection costs and the bringing into production of millions of hectares of land under the "use it or loose it" tax impact. *Twenty eight million hectares of potential arable land are not currently being cultivated according to Frost and Sullivan in Business Report July 7 2008.*
3. Infrastructure projects become virtually self-funding as the value that they add to land is captured by the taxes.
4. The constitutional obligation of the State to take *reasonable legislative and other measures, within its available resources, to foster conditions which enable citizens to gain access to land on an equitable basis* becomes satisfied.
5. No expropriations are required for a change in tax rates. It is unlikely that the State will pay compensation to landowners for repealing their subsidies. Nor will the State expect to be compensated for revoking personal taxes. It is a straight swap.

The diminution of house prices because of the loss of land value is by no means certain because house rents, whether imputed or not, become free of tax. Also the existing property taxes on estates, inheritances, gifts, donations, estate duties, and transfer duties which now weigh on prices will be repealed.

6. Vacant land speculators may loose out but they are familiar with such bets and need only improve the land, or let it, to avoid the tax.
7. Living in the country becomes more attractive because of lower taxes. A shirt maker in Butterworth can make the same number of shirts per day as his competitor in Stellenbosch but the transport costs of cotton and other supplies as well as the delivery charges to Cape Town favour the town dweller. Land taxes precisely reflect such disadvantages making it possible for country dwellers to compete on an equal footing with town dwellers.