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Professional Registered Valuer
Cape Town
021 6834349
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Are neo-classical economists South Africa's Trojan horse?

It has been shown 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 as if they will all have the same result when land acts differently when taxed. Here are three local examples of this thinking:

Richard Grant¹ a disciple of Frank H. Knight, the father of neo-classicism, states: "*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.*"

According to 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.*"²

According to Manya Mooya, Senior Lecturer in Property Studies at UCT, "*The second criticism of land taxes arises from the fundamental premise that land is different from other factors of production*".³

In fact the price of land will fall when taxed and its area (supply) will not alter. 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?

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.

If personal taxes on work, profit, interest and trade were all gradually replaced by land taxes, this would create a *free-land tax haven* which will result in significant improvement in job creation and poverty relief.

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 can be illustrated by the story of twin farmers, Abe and Bert, who own identical neighbouring farms; they barely break even after paying market-related wages and salaries. After taking interest, profit and depreciation into account there is nothing left over; that is, there is no surplus (excess) or rent.

One day a spring gushes out of a field owned by Abe and increases his turnover by R100K p.a. - 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.

In the following 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 also becomes R100K.

[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 when one of two identical office blocks is a ten-minute-walk closer to a railway station than the other.

¹ Previously Director of Research at the Free Market Foundation of Southern Africa, "Nationalisation: How Governments Control You"; Sourced from the "Corruption of Economics" by F. Harris and T M Gaffney.

² In the FMF's "A Neutral Tax Structure Shows Respect for the Consumer".

³ Letter to the S.A. Valuer, July 2009.

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, according to the neo classic tax formula), land owners enjoy a perpetual rent annuity.

This is in effect 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 by themselves except by adding improvements such as a house. However, in this case the asset is no longer land but a combination of land and building.

This shows that if the fiscus were to decide to under- tax land and rely instead on work, capital and trade to raise revenue, then prices will rise and supply will be diminished.

Employers then have to pay the employees wages plus PAYE, which means that they will employ as few people as possible. One is reminded of the case of windows which were boarded up in England when they were taxed in the 18th century. One might consider the effect of a tax on profits or interest, which would raise the cost of capital and investment. In addition to this, VAT which increases the price at the tills.

Neo-classical economists dominate South African universities, media and Parliament, whether in government or in opposition, but their theory regarding taxation does not stand up to scrutiny. Simply put, they choose "bad" private taxes when there is a "good" land alternative.

Classical economists like Hume, Quesnay, Smith and Ricardo through to George (and including many Nobel Prize winners) were in favour of only taxing land, as in the perpetual quitrent tenures which Britain introduced to the Cape Colony in 1813. Raw land at that time 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-classical policies. A land tax debate was last conducted by the Katz Commission in the 1990s. 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"*. This has resulted in welfare payments, which now consume 25% of the national budget (and rising). At the same time able-bodied men and women are excluded

from land ownership because of its cost, which according to ABSA is now more than R450 000 per plot.

Ironically, 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 smallholdings. 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 issue of a 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 imposition 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, which were *"to inquire into the appropriateness and efficiency of the present tax system and make recommendations on its improvement"*, the Commissioners would have welcomed the opportunity of studying the effect of replacing all existing taxes with a single land tax and testing claims that such taxes were unjust and discriminatory.

They did not do so, thereby condemning the poor to increased levels of poverty. An unemployed man without land is even more useless, from point of view of sustaining a livelihood, than a duck without a pond. Ducks can survive without ponds but man has to work the land to survive, either as an employee or on his own behalf (if other employment is not available).

This is now common cause. However, a new extreme of neo-classical fiscal irrelevance occurred recently when the London School of Economics 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)*

This egregious statement suggests that neo-classical ideas on tax are no longer relevant

today. It should be obvious that the reason for a dearth in credit is that government-supported land prices have drained the banks of cash. Does it make sense to lend to a bank when the real money is to be made by 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 but forgets that this would not apply if the speculative element were removed from house prices by land taxes.

The risk factor of property ownership is the price of land. In South Africa this is now on average 40% of the price of a house, according to ABSA. In the past twelve years the price of houses in South Africa and USA rose by 13% p.a. (*The Economist*, 19 September 2009 and the CIA 2009 Economics Report).

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

A 100% tax on land rents will remove the risk of greed and speculation because security for house mortgages will have to rely on depreciating house values, much as is the case with other man-made goods such as cars or “white goods”. These have never been subject to speculation.

Land and house prices, however, play no part in stimulating economic growth; if anything, they slow it down. Between 1997 and 2009 house prices in Hong Kong actually declined by 2% p.a., yet their annual per capita GDP is now US\$ 29K, nearly six times that of South Africa (US\$5K).

Hong Kong’s success is partly a result of land rent appropriations, which 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 are generated.

Keynes obliquely recognised the vital component of land in his book, *The General Theory of Employment, Interest, and Money* (1936), where (perhaps 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*

rubish, and leave them to private enterprise on the well-tried 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 of the soil (which supports flora and fauna) as well mineral and oil wealth are already in the ground, so there is no need to bury bottles full of bank notes to create jobs! All one has to do is remove the entry cost.

In conclusion, land prices are a state subsidy; this means that conventional taxes are required to bridge the shortfall from under-taxed land and resources. Logically, then, homeowners should hardly pay taxes; they should simply advance funds to the State and wait for higher land prices. This situation cannot last.

Finally, in summary form, this is what could happen if the Treasury were to abandon its neo-classical assumptions:

1. Access to unimproved land would become free (apart from 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. This would consist of a sturdy three bed-roomed house, fields, orchards, vineyards, barns, cellars and stables. This would require take five years of work in cooperation with neighbours.

Such an estate would be worth at least R1 million today, whether it is situated near Butterworth or Stellenbosch. This is more than the total earnings of a domestic worker for 45 years at the current minimum (half-day) statutory wage.

Self-sufficiency in food requires one hour of work per day using low-input agriculture. Once the estate is completed the scope for labour-intensive work is considerable. One of the highest potential earners is the production of very fine mohair which could 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 with their high collection costs. Millions of hectares of land will be brought into production under the “use it or lose it”

principle. *Twenty eight million hectares of potential arable land are not currently being cultivated*, according to Frost and Sullivan (*Business Report*, July 7 2008).

3. Infrastructure projects would become virtually self-funding as the value that they add to land is captured by 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”* would be satisfied.
5. No expropriations would be 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 tax-free. The existing property taxes on estates, inheritances, gifts, donations, estate duties, and transfer duties will be repealed.

6. Speculators in unused land will suffer, but they have the option of improving or letting the land, if they wish to avoid being taxed.
7. Living in the country would become 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. At present the transport costs of cotton and other supplies, as well as the delivery charges to Cape Town, favour the town dweller. Land taxes reflect such disadvantages, making it possible for country dwellers to compete on an equal footing with town dwellers.