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Tax Policy for Economic Progress:

Developing Countries as Well as Developed Ones Should Tax to Promote Production and Jobs

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ABSTRACT. *Developing countries,* in constructing modern *tax systems,* would do well to adopt policies based on proven *economic* principles so that *fiscal instruments* do not perpetuate stagnant economies and *underemployment* of *labor* and *resources.* To achieve *growth* and *jobs* and ever higher *levels of living,* they should avoid the mistakes of the *United States* and many other *industrially developed countries* in burdening *business*—enterprise *production*—with heavy and obstrusive *taxes.* They, and developed countries as well which are committed to progressive change based on tax reform, like the United States, should use *land values* where possible to finance *local governments* so as to avoid taxing the other factors of production. And where necessary taxes should be levied on *consumption,* for taxes on business income misallocate *resources* and hamper *market discipline* in promoting *output* and *efficiency.*

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I

Introduction

FINANCING GOVERNMENT presents problems with similarities and also differences all over the world. An American, even one who has traveled widely and studied for many decades, must be humble in venturing observations about policies for other countries. Yet there *are* lessons to be learned from experience. Avoidable mistakes have been made, followed by needless waste, distress, and obstruction of development. Successes have been recorded.

Two topics of commanding significance can well occupy all the space available in a journal article. The first—avoid the mistakes of the United States and many other countries in burdening business (enterprise production) with heavy and obtrusive taxes. The second—utilize land values where possible to finance local governments, perhaps especially in urban areas.

II

Business Taxation and Economic Development

"TAXATION OF BUSINESS" as a topic offers endless opportunity for suggesting how mankind might run its affairs better—in lands like the well developed United States and in others still in the earlier stages of development. Not all policies of economies which have generally developed well can serve as best for others. "Avoid the mistakes of others" should in itself be valuable advice. Other general considerations call for attention:

Need for Large Revenues. Some of us, if free to fashion our ideal economy, might try to develop one in which the need for taxes would be much less than is the case today. Realism, however, leaves no doubt that the "tax take" must be high to pay for the expenditures of "modern" governments.

Danger of High Tax Rates. High tax rates do more than bring in revenue. They alter human actions, and in ways different from the effects of prices. In the market one pays for what one gets. In competitive markets we generally get about as much as we pay for. But the services of government which a member of society receives are largely independent of the taxes he pays. He has incentive, therefore, to try to avoid a tax.

If tax rates are low, it will not often be worthwhile to sacrifice what is essentially one's best interest in order to save tax. But purely tax considerations can be decisive when *tax rates are high*—and when the *differences* in the tax consequences of different actions are large. What is basically a less efficient alternative will sometimes seem best when taxes are taken into account. Private benefit then conflicts with the general welfare. (1) The part of the cost of government which one person saves must be borne by others. (2) Resources are not used as productively as possible. Capital investment flows to take account of taxes as well as of productivity; skilled effort is devoted to saving taxes rather than to creating goods and services of positive value. The "underground economy" flourishes.

Differences Between Taxes and Prices: Role of Self-Interest. Tax laws take from the individual (or prevent him from getting) what would otherwise be his without a specific *quid pro quo.* In the free market, in contrast, what a person gives up is presumably matched in worth by what he gets. To get what one wants, one must provide equal value for others. The vigorous pursuit of self-interest in a competitive market economy will generally serve the public interest. The pursuit of self-interest through the political process (in government), however, often tends to conflict with the interest of others—dramatically so when taxes are concerned. A person who gets his own taxes reduced will benefit by just that much. He can expect no less of governmental service, but he pays less.

Even if everyone did feel that government services are worth their cost, many of these services could not be sold as are the products of the market place. No mechanism exists to make the individual share in the cost of government except by the use of compulsion. Here we face the fundamental issue of the relative roles of government and business. The larger the proportion of economic activity carried on by a government, the greater the role of taxes relative to prices.[1]

The total of taxes will be higher, and the role of prices smaller, the larger the governmental sector. Consequently, taxes as they *directly* affect business will tend to be more burdensome.

Environment as Affecting Tax Policy. Some "requirements" for a "good" system of taxation are applicable generally, while others which are suitable in one place will be inappropriate in another. Institutional and structural conditions vary from country to country. Legal systems differ, and the law inevitably affects the kind of taxes an economy may impose effectively.

Size of the Taxing Jurisdiction. The size of the taxing jurisdiction affects the range of possibility. When the benefits received by a taxpayer—an individual acting for himself or the manager of a giant business acting for the whole company—are not clearly associated with the taxes *he* pays, then the power of government to coerce him into paying tax depends to some extent upon his ability to escape to the jurisdiction of other governments. Some businesses are more firmly localized than others.[2]

Small taxing jurisdictions face more rivalry than do larger ones. Although tax laws are generally much less important than other determinants of location, no foresighted (by definition!) government will ignore the influence of the tax outlook it offers to business, relative to its "competition." No large fraction of total economic activity will ordinarily be sensitive to differences in taxes in various jurisdictions, domestic and foreign. But some companies, actual and potential, will find tax factors significant at the margin.

If lawmakers believe that such considerations are influential, the general result ought to be moderation in taxes on business as such, compared with what would otherwise seem politically attractive. The larger the tax jurisdiction, the less is the restraint which the tax officials experience in taxing business.

People, Not Things, Bear the Burdens of Taxation. Taxes are paid by people. One may speak of taxes falling on business, corporations, cigarettes, property, inheritances, income, or some other tax base. Yet it is not things, but people, who are deprived.

Hidden Versus Evident Burdens. In some cases it is much easier than in others to judge which individuals will be affected by a tax—by how much. In choosing to use hidden taxes, those which "conceal" the costs of government from the persons who pay, society sacrifices one instrument for helping make better rather than poorer decisions.

Justice in the Distribution of Tax Burdens. Taxes, whether borne directly or indirectly, will be not only heavy but also unequal in the sense that some people will pay much more than will others. Being heavy, unequal, and the result of the use of government's power of coercion, should taxes not seem to be fair, just, and equitable?

Two points seem worth making in this connection: (1) Business taxes can be inequitable by *any* reasonable standard, and (2) one basis for condemning present American taxes on business (and those in other countries if my impressions are not unduly imperfect) is that these levies run counter to reasonable standards of fairness.

III

Business Taxation—Some Basic Issues

SOME TAXES COLLECTED from business firms are intended to fall on the consumer (or perhaps the employee) and probably do, more or less as intended. Other taxes, however, such as those on business net income, are presumably intended to "burden the company"—whatever this term may mean. Still other taxes, such as those on purchases by business firms, on the property they own, or on payrolls, are less easily classified as to either the intent of the lawmaker or the actual result.

The Wisdom of Taxing "Business." Businesses are the organizations upon which the Western World relies to produce most of its output. Although the efforts of teachers, judges, military personnel, and other employees of government yield valuable results, most real income consists of what people accomplish through business firms.

Business, at least in America, is the public's major agency for organizing labor and capital to produce—and to produce more, rather than less, efficiently. Businesses are groups of people seeking to benefit themselves by serving others. It is this service, whether in producing and distributing things or in rendering services directly, which people want. The process of rendering service can be more or less efficient in terms of inputs per unit of desired output. A market economy relies primarily upon competition in markets to induce efficiency—and to stimulate growth. For it is in business organizations that we find, not only the source of more of the old, but also most of the venturesomeness which leads to the innovations that contribute so much to rising living standards.

The public interest calls for each business to: (1) Turn out products or services which are wanted more than something else, as reflected in freely made consumer decisions expressed in the market, or through government agencies. Part of this task of business is to anticipate, identifying wants which will be satisfied by new types of goods and services. (2) Produce by methods which economize on labor, materials, capital, and other "inputs" according to their relative scarcity and productivity.

The total accomplishment of people working as business organizations will depend upon many things: the training, inherent ability, and acquired skill of workers; their willingness to exert effort; the amount of capital—in the physical sense of buildings, equipment, and inventory, and also in the financial sense of money, without which transactions as we know them would rarely be possible; the degree of competition, the state of technology and speed of scientific advance; the competence of management; and other things. Among the "other" things are some services produced by government. The system of law and order is one. The tax structure is another.

Taxes are obstacles in the sense that they take from the taxpayer without directly giving him an equivalent. Taxes on business do not improve the process by which consumers indicate the relative importance of their desires. Taxes on business income do not help indicate to managers the relative scarcities and productiveness of inputs. But taxes do affect the alternatives, the incentives which a business must consider. One is to save on taxes. In adopting methods which reduce the tax bill, however, a business does not economize on the "input" of government nor reduce in any perceptible way government's use of resources. Nor does the firm increase its operating efficiency in the sense of using less input per unit of output.

A business, in fact, may wisely adopt methods which are inherently "second best" because the artificial factor of taxes makes such methods the best under the circumstances. Taxes thus give rise to an element of conflict between private and public interest as they induce the manager to redirect the firm's activities, away from what is fundamentally most efficient. Taxes lead to results which are less than optimal when judged on the basis of economic productivity.

Productive capacity is not allocated to the uses, and in the proportions, which are fundamentally best. Too much investment goes into forms with less burdensome tax consequences; too little where taxes will be high. The loss of real income is a burden—but one which is concealed.

Reasons Advanced for Taxing Business Income. How, then, can we account for the heavy taxation of business as such? Each country's history will have its unique features. But at least in the United States, accident and temporizing to meet emergencies, notably war, have played a larger role than has any rational evaluation of alternatives.

From time to time "business," especially big business, has drawn sharp criticism from persuasive writers and fighting "reformers". Whatever the bases for the criticisms, school books have tended to perpetuate attitudes which contain no small hostility to business. There is also a deep-seated public belief that "business" somehow has taxpaying capacity—"business" or "corporations" as distinguished from people as stockholders, consumers, or employees.

High U.S. corporation tax rates went into effect during time of war and the postwar boom when employees, owners, and government could all increase their "take." Concurrently, the rise in rates of tax on personal income appeared, quite illogically, to justify substantial increases in the rates on corporations.

Some economists contributed another argument: A tax on pure economic profit, they said, is a tax on a true surplus, not a payment for an essential cost of production. Whatever the theoretical merit of this concept, it is not the one used for tax purposes. Lawmakers framing income taxes have come up with definitions of taxable income very much broader indeed than the notion of pure profit as a true surplus.

Legal systems do permit the establishment of organizations such as corporations which to some extent *are* separate from their owners—and in ways which can have tax significance. Two aspects demand mention: (1) the equality of tax burden on incorporated and unincorporated activity; (2) the possibility of tax avoidance. Let me first say a few words about the second.

Not all corporate earnings are paid out in dividends. Those kept in the business are not subject to personal income tax. The owners are not so well off, presumably, as if they had received the income in cash free of tax; but at least those in control must expect to be better off than if they had gotten the earnings in cash and paid the personal income tax. The ownership interest in the business becomes more valuable because of the growth of assets. Another problem is the capital gains. Conversion into capital gains of what would be dividends obviously has tax significance.

For logical solutions to the problem of retained earnings, however, one will hardly look to a tax on *all* corporate earnings. Whatever is paid out to shareholders gets into their taxable income. (1) One "solution", a crude one, is to tax (only) undistributed profit. (2) Another possibility is to require the individual eventually to make a complete accounting for tax purposes. (3) A third approach allows the dividend recipient a credit for tax paid by the corporation. None of these approaches can be fully satisfactory. The guides of the market would not operate free from tax considerations to determine the amount of saving and the direction of investment.

IV

Uncertainty about "Who Really Pays"

ONE PROBLEM IN LEARNING about who actually bears the tax is to distinguish between the effect in the short run and those over the longer run.

Supplying business with equity capital (ownership as contrasted with debt) costs something. The stockholder sacrifices the opportunity to use his wealth in some other way. This sacrifice is an economic cost. Income tax law and traditional accounting, however, do not recognize this cost as a deductible expense of doing business. Consumers will not get equity capital to work *for* them—and employees will not get equity capital to work *with*—unless the people who can provide ownership capital expect total net benefits which will equal those obtainable elsewhere.

Suppliers of capital, whether in debt or equity (ownership) form, expect to be rewarded. The reward that counts is the reward *after tax.* A "normal" return on equity capital is an *essential economic cost.* The net after-tax return which a supplier of equity capital will insist upon will be as high a yield (total net benefit) as he could obtain from any alternative use of his funds.

The equity capital already in a business, of course, is largely sunk; it will remain there for a time, regardless of actual returns. To get new capital, however, the business must offer attractions which are equal to those otherwise available to the suppliers of funds. In turn, the company must look to customers for funds to reward those who provide capital. If the corporation tax rate is 50 percent, and if potential suppliers of new equity capital insist upon an *expected* return of 15 percent, then the corporation must expect to get a price from customers which yields 30 percent before tax. Only new projects offering a 30 percent gross return get equity financing.

The corporation will not succeed in selling new shares of stock unless the prices which it expects from its customers will bring an adequate *after-tax* yield. The growth of output (in a growing economy) will lag until prices *are* high enough to give profits which satisfy investors. Over the long run, then, some or much of the corporation income tax will tend to be shifted to consumers. The indirectness of the process conceals it. The result, however, is a tax on consumption, but one falling capriciously, unevenly, and not in line with any concept of fairness familiar to me. Corporations which are not growing, and which do not seek new capital, may never be able to shift an increase in a tax rate.

The actual shifting to the consumer will depend to some extent upon what happens to the *total supply* of, and *total demand* for, capital. The amount of capital available for new investment in business is not fixed. The amount available for investment in corporations is certainly not fixed.

Let us assume that the tax on corporate earnings makes the prospective yield on those earnings less than otherwise. The potential supply out of a given total of funds for investment will decline. Meanwhile, more of the total of savings will move to seek investment in debt form; the rate of return on new debt will fall. The tax on corporate income, therefore, tends to reduce not only the after-tax yield on equity capital for a time but also the yield for suppliers of debt capital. The corporate tax thus becomes a more generalized burden on the *suppliers of capital.* The magnitude and the distribution of this burden, however, cannot be measured nor compared with the amount passed on to consumers. And who will be able to learn for sure how the amount and type of capital formation will change?

Any process of shifting operates in an environment in which conditions constantly change. Lags and frictions will inevitably slow the process. Some corporations will be more successful than others in getting a satisfactory after-tax return. Competitive factors differ widely.

Difficulties of Defining the Tax Base and the Taxable Unit. "Income" or "profit" or "earnings" may seem reasonably clear concepts—until one tries to define them for purposes of taxation. Then difficulties appear. They multiply, and they grow. The same applies when trying to prescribe just what is the business unit to be taxed as a single entity, *e.g.*, a corporation or a group of related corporations.

Today, considerable tax may depend upon even apparently minor details of definition. And some matters become major determinants of business actions—treatment of depreciation, for example, or the variation of tax rates according to either the amount of earnings or the percentage distributed. The tax paid by the individual business, especially over a decade or so, may be appreciably different from what a casual look at the tax law would suggest.

The complexity of income taxation has become worse than baffling. In itself it is an impediment to progress. Specialists on one or a few features of tax law will be the first to admit doubts about what most other provisions really mean and the fruits they produce.

One detailed provision breeds another—to try to plug a loophole or to create another with no more, or less, merit. The conduct of business becomes ever more complicated for reasons inherently unnecessary.

V

"Tax Incentives"

THE EXISTENCE OF HIGH TAX RATES in a sense creates an opportunity. The high tax barriers can be reduced for those who do something especially desired. Provisions which lower the tax obstacle here and there are sometimes called "tax incentives." This term does not appeal to me.

In several countries objectives have been advanced by the offer of opportunity to escape from the impact of very high tax rates. Some of the objectives have unquestionably been worthy, but not necessarily the most worthy; some by reasonable standards may have been unimportant relative to others receiving no favoritism. With any level of revenue loss possible, I believe, broad, general reduction in tax rates on business seems better for the long run than concentrated reductions here and there. Specific adverse discriminations, for revenue or other purposes, are generally subject to criticism on the same grounds.

Such provisions introduce an element of coercion rather than free-choice to influence decisions—about what to produce, how, and for whom. Opportunities are altered for reasons which reflect votes in the ballot box (and at best very indirectly) or executive decision rather than economic choices expressed by economic means. Anyone, of course, can propose ways to improve any allocation of resources. Good intentions, however, are not enough. In using taxation, both *ends* and *means* must be selected by the political process. This process inevitably brings into the decision-making persons with no special competence and persons whose interests differ widely. Results are reached only with compromise, desirable for some things but not in operating an economy. Correction can be exceedingly difficult.

The cost of "tax incentives" tends to be high. Lawmakers have no way to limit tax concessions to those actions which would not be taken without the tax favor. For the marginal (incremental) benefit obtained, the public may pay dearly when it grants tax favors to *all* in the class. Meanwhile, other objectives more desirable at the margin get no tax stimulus.

Nevertheless, the results of special tax incentives may be dramatically impressive. The alternatives sacrificed rarely if ever appear. And if I were a manager trying to serve the owners, employees, and customers of a corporation, how could I justify not working industriously for special tax provisions to aid my company? The incentive structure for getting tax burdens reduced has elements which encourage the proliferation of special features with their distorting, complicating, and deceiving consequences.

VI

Taxation of Unincorporated Business

Personal income tax as a Business Tax. Though not labeled as a business tax, the personal income tax (in the tax systems with which I am familiar) applies to the earnings of unincorporated businesses. When rate schedules are high and progressive, high personal income tax rates take a bite out of business income more often than the "man in the street" would probably expect. Supporters of steeply graduated personal income tax rates characteristically give little attention to the fact that the tax in effect falls directly on business income.

Three kinds of results may be noted: (1) Some business decisions are influenced by marginal tax rates which are high enough to be distorting. (2) The tax applies to earnings which are, or would be, used, not for consumption by the owner's family, but for building up the business. (3) Proprietors who are free to use an alternative form of legal organization will tend to do so when there is a prospect of reducing the tax bill.

Unincorporated Business in the Economy. In the United States unincorporated producers account for perhaps one-fourth of business done (as measured by receipts). One fourth or so of the business economy is in itself important. For at least two reasons, however, the relative significance of these firms is greater.

(1) Some of those companies *provide competition* which helps keep the market economy, including much bigger firms, operating more competitively.

(2) In the future, as in the past, much *economic growth* will start, and much will take place, in unincorporated businesses. Enterprising men and women will try to start *new* businesses. Owners will work and save to *enlarge* companies already operating, to *improve efficiency* by reducing costs, to provide *more and better products* and services. The variety and the opportunity of an economy

will lie more extensively than often recognized in widely decentralized economic undertakings. People seeking new jobs will often look to the businesses nearby. Useful employment for an expanding population will depend upon the availability of new jobs, not only in the big factories—which cannot be everywhere—but also in the small, and often new, businesses scattered over the country.

Some of the goods, and many of the services, people seek as part of a rising standard of living can be supplied only from business sources close at hand. New sources of supply, as well as the competition which keeps everyone under pressure to do better, will frequently depend upon new firms. True entrepreneurship is not confined to big businesses. New and small companies contribute to economic growth of the most creative and the most progressive type.

Growth of new firms, among other things, results from both capital and the prospect of profit. High income taxes, unfortunately, can make capital accumulation out of earnings exceptionally difficult. Yet if a company is to compete effectively, if it is to be able to pay prevailing wage rates for labor of good quality, it must have good equipment and ample working capital. Both leasing and borrowing will often meet some needs, but as a rule only if equity funds are available to provide security that protects lenders.

Progressive tax rates frequently add another obstacle to growth. Risk will usually be present. Often the chances of loss are large. If things do turn out successfully, a large fraction of the reward can be taken away in taxes. But if results are unfavorable, losses can be deducted, if at all, only from lower brackets than those in which the profit would be taxed. Progressive tax rates can reduce the net after-tax return from risky undertakings. Small firms cannot have wide and well established diversification which provides a form of "insurance."

Finally, high personal income tax rates influence personal incentive to effort. The quality of management does make a difference to business, and taxation of management rewards will affect the supply of effort. High tax rates on money income certainly make leisure relatively more attractive.

VII

Directions of Progress in Taxing Business

GETTING RID of existing defects in business taxation requires action affecting the revenue structure at many points.

1. Resource allocation will be most efficient if taxes impede as little as possible the operation of the market process. Choices, in other words, will reflect more accurately the alternatives which are at issue when taxes do not influence the results.

2. To this end, taxes should be neutral or impartial in their effects on resource allocation—among industries (including private and governmentally owned), occupations, regions (internally and domestic versus foreign), methods of operation and finance, forms of legal organization, present versus future, and so on. In general, the economy will operate most productively if taxes exert a minimum of influence upon decisions about what to produce, how, and for whom.

3. Major reliance for revenue should be taxes which draw from the flow of income at the *personal level*—by taxes on personal income received and on the use of income and wealth in consumption expenditure.

Use of both income and consumption (expenditure) for the tax base will generally be preferable to exclusive reliance upon one or the other. (a) For reasons of fairness and equity in the distribution of burdens, the use of two bases has one great advantage over the reliance upon one or the other. In the real world, each base will have defects, but they will not be the same. Some crude averaging and compensating will result if both are used. (b) When tax rests upon both income and consumption, the tax rate on each can be materially lower than if all the revenue must be obtained from a single base. Consequently, the evils of high tax rates as such will be less.

4. Assuming that the personal income tax has a prominent, perhaps predominant, place in an ideal revenue system, it should be reexamined in the light of its bearing upon unincorporated business. In this connection the chief consideration in the United States would be the reduction of high (marginal) rates.

5. For the taxation of consumption as such, *retail sales taxes* more or less as used in most American states seem to me clearly superior per unit of revenue to selective excise taxes or to general turnover taxes. A tax on *value added*, however, would probably be my first choice—in part because as a matter of expediency it offers a realistic alternative to the taxation of corporate income at high rates. Application of the tax to the output of governmentally owned business-type activities, and to cooperatives, would seem desirable in principle.

6. Tax rates on corporation income would be reduced. Both the speed of reduction and the level conceived as the eventual goal would depend upon revenue needs (in the light of alternative changes to raise revenue) and such other factors as personal income tax rates and opportunities for avoidance.

7. Simplification, though highly desirable, seems difficult to achieve. But progress is possible.

8. The effects of inflation must be recognized—and adjustments made. (The lower the tax rates, of course, the smaller the distorting results of the business tax system in an inflationary economy.)

VIII

Land Taxation in Cities of a Developing World

PEOPLE'S opportunities typically exceed their success in utilizing them. Always at hand are challenges to utilize favorable potentialities more fully. The use of land values to finance local government constitutes an example. High and rising land prices in cities over the world ought to provide more funds than they yet do for much needed services of local government.

Urbanization—Costs of Space and Land Prices. City populations grow by leaps and bounds. The desire for governmental services outstrips those which can be supplied with the funds available. The quality of life for the hundreds of millions who live in cities around the world suffers because funds are not adequate for the facilities which governments are expected to provide. Yet people often pay "heavily" (per square meter) for living and working space in the city. Their demand for room sends land prices up. And in much of the world the increasing amounts which urban residents pay for the use of city land go primarily to private owners. Little, apparently, helps to meet the costs of government and to provide better services.

The congestion in cities multiplies the need for governmental services and also creates a potential source of funds for meeting some of the costs (1) without making the user of land as such worse off and (2) without endangering the supply of land. Moreover, a tax which brings about this result can also exert powerful pressure to put land to best use. And, in and around cities, such incentives would often have constructive results.

Similarity of Problems All Over the World. Obviously, the need to use land is universal. And almost as obvious is the fact that nature rather than the owner created the land. These two points combine to make a condition with elements of similarity in cities which differ widely in most respects.

From one country to another the responsibilities of city governments—for street, water, and other capital facilities and for such current services as policing, education, and garbage collection—vary widely. Both the national government and the private sector have different obligations.

Attitudes and traditions about land ownership and use differ, sometimes in subtle ways, and exert influences which outsiders have trouble taking into account. Systems of land titles and ownership, methods of financing and leasing, governmental use of zoning and eminent domain, all these bear upon the potential use of land as a tax base.

Just as one is correct in generalizing that cities need more money, one is also correct in the sweeping assertion that for the most part urban land prices are much higher than in the past and in general go up from one year to the next. Exceptions doubtless exist—presumably so where there is little or no free market in land (the communist world) and where such special factors as political uncertainty, threats of confiscation, and strict rent controls outweigh more normal economic forces. Yet as more people with more purchasing power seek to utilize the limited space of cities; the amount they are able and willing to pay per square yard or square meter rises. And it goes up by more, as a rule, than prices generally where inflation prevails.

Land as a Product of Nature. Land as a productive resource resembles labor and capital in some respects but is crucially different in others. The similarities include the fact that parcels of land differ greatly in desirability as do human skills and machines. An outstanding difference is the source, the way they come into existence. Labor and capital are man-made. The quantity and quality of training, the vigor of human endeavor, the amount of machinery and structures, all these depend in part upon what individuals expect to get in compensation—and the actual payments. To get such productive capacity, society must pay. Moreover, attempts of society to take back through taxes what it has paid for the services of capital and labor will affect the future supply.

Not so, land. Nature created it. In the sense of space (though not of all usable qualities, such as fertility) the amount of land in existence will depend scarcely at all upon the amount paid. The payment, however, does make a difference in what is available. Occasionally, payment will determine whether land is used at all or held essentially idle. Much more often, the amount paid will govern the particular use to be made of a parcel, its allocation among alternative uses.

Because parcels of land, especially in their characteristics as space and location, do differ immensely, something to help allocate use efficiently is of utmost importance. Payments for the use of land do perform a function of outstanding significance—allocation—but not, as for man-made productive capacity, also the function of inducing the creation of the productive resource.

Land is fixed. Tax it heavily, and it will not move to some other place, or decide to take a vacation, or leave the inventory of productive resources by going out of existence. Tax land lightly, and the favorable tax situation will not create more space on the surface of the earth.

The ethos which ties economic justice to rewards based on accomplishment does not lead to justification for large rewards because of ownership of land. Differences, perhaps very big ones, in payments for human services or for the use of capital can rest on what the recipient has done. But for the owner of urban land the same kind of justification cannot be found.

Private Ownership of Land. The institutions of ownership of land reflect history and a large variety of conditions. Outside communist countries, individuals and private groups own most of the "bundles of rights" which go with space on the earth's surface, and less often the things below and the air rights above. Outright public ownership, administered by government, may consist of little more than the areas of streets, governmental buildings, parks, and so on. Sometimes, however, the public owns considerably more, especially underground and underwater rights, including mineral and potable water rights.

Private owners have much control over how land is to be used, the space in a crowded city. They can insist upon being paid for the use of this land, at a rate that may be inflated by speculation and expectations. The private owner may do nothing, or very little, to affect the usability of land and yet from year to year get more occupants.

Land price increases in and around cities have made rich men out of owners of farm land, vegetable plots, and waste areas. Private enrichment has come to the passive owner of land who has done little or nothing to enlarge its worth as part of the city whose growth has brought his good fortune. In fact he may have paid no more than an infinitesimal fraction of the taxes which have paid for the streets and other governmental facilities which have helped to elevate the value of his land.

The moral justification of private ownership of property gets a bit thin and tenuous when related to such increments in land prices. The owner's contribution to production may have been somewhat positive in getting land into somewhat better use from time to time. But compared with labor and capital, land offers much greater possibilities of enhancement of private wealth without regard to the creative contribution of the person benefiting.

Private ownership of land—mere space in cities—does, however, serve a purpose of great importance. The owner has incentive to allocate and direct use into better rather than poorer alternatives. The scarcer the land and the greater the price it can command, then the more important for the community that it be used well. As congestion grows, the need for efficient use of space multiplies.

Failures to make best use do occur, however. They are more likely to result when the owner is free from great pressure to search out the best opportunity and then to exploit it.

Rent and Price. Land as a physical thing yields services associated with periods of time. Payment for these services may consist of an amount each period, say each month—of the rental. Or the payment may be a lump-sum in advance as one acquired the land by purchase, paying a capital amount.

The relation between periodic payments (rentals) and a price for rights into perpetuity will depend heavily upon market rates of interest. These rates indicate what one can get by using his funds to purchase other forms of property (or to lend). The total income stream from land as well as one can judge it into the future—say $100 a month, though the future will be uncertain—must be compared with the yields obtainable from alternative investment opportunities. The greater the yields from bonds, as indicated by rates of interest, the less one will pay for a monthly income stream of $100 or any other fixed amount. Suppose that taxes are imposed and reduce the amount which will remain for the owner, perhaps from $1,200 to $800 a year. Then the price which anyone will pay for the land will drop, in this case by one-third. The services produced by the land do not change. But government through taxes preempts more of their worth.

In this way property taxes are "capitalized". They reduce the price which a buyer will pay for land. Thereafter, the user (buyer) of the land turns over, in effect, a part of the yield or produce to government. But the person who has purchased after the tax became effective does not suffer from it. The owner of land at the time "paid" the tax increase in perpetuity.

Age-Old Arrangements and the New Conditions in Cities. Land ownership in much of the world has been concentrated in relatively few hands. Often the user has paid a fraction of the crop and may have given some service on the landlord's own fields. He may have gotten precious little in return, or he may have received services, perhaps protection more or less as from government plus some season-to-season financing of agriculture. For an imperfect world, the arrangements may or may not have become reasonably satisfactory, but criticisms abound. In one country after another age-old equilibria have been attacked as part of rural land reform.

Conditions in cities necessarily developed along other lines. Use of money took the place of rental payments in the form of shares of a crop. The product of city land does not have the tangible form of farm crops, and money rental payments are not subject to a limit imposed by nature's output of crops. Owners of urban land can get periodic rentals, or prices from sale, which exceed anything obtainable from land used for agricultural purposes. No sort of natural limit applies.

As rising population and purchasing power have raised the demand for urban land, owners have gotten more, sometimes fabulously more. Whatever the origin of a person's ownership of land, perhaps inheritance, community growth has enabled him or her to siphon off a growing amount from the stream of production and income. Is it not both logical and just to rechannel some of this flow to finance public services?

Taxing Urban Land. Henry George was only one of a group who over many decades has urged the heavy taxation of land. Whatever the reasons for not doing so in the past, conditions today call for new efforts. The propriety of drastic new burdens on present land prices may be debated. As to the future, however, the principle has convincing appeal.

The taxation of land (more accurately, the taxation of people on the basis of their ownership and use of land) can take somewhat different forms. The objectives can also differ somewhat.

1. Getting funds to pay for governmental services will stand as perhaps the prime objective. There may be some question about whether to use this as a source for local governments only or perhaps for national finances. Generally, local use would seem preferable, but conditions will differ from one country to another. Where the choice is for financing local government expenditures, there can be important questions about the size of each separate taxing jurisdiction—considerations of administrative feasibility, competition among neighboring communities, and other elements.
2. There will be question about how much the method of imposing tax should seek to influence land use and in what ways.
3. The relation of tax to benefit from specific local expenditures must be considered. On grounds of fairness and also for inducing efficiency in use there will be reason for attempting differentiation.

As a practical matter can such a tax be administered with rates high enough to bring substantial revenue? Space limits preclude discussion here of taxes on *sale or land turnover* and on *increments in land value.* The greatest promise lies in an annual tax on value.

Annual Tax on Value. The system used in the British Isles and adopted to some extent by several members of the Commonwealth uses as the tax base the annual income or rental value. The tax may be a modest, or a large, fraction of the annual rental value; when the tax is an obligation of the user (whether or not the owner), the tax can be much more than 100 percent of the annual flow, leaving one-third to the owner.

If this method is to serve the function of inducing the best use of land (and, of course, if revenue yield is to be the optimum), the tax base must be not the actual rental but the amount which could be obtained from best use. Underused land bringing rather little income, less than it could, should occasion tax on a base which may seem unreasonably and unfairly high.

One practical problem of administration would arise from the fact that the typical urban rental agreement will include the payment for the use of both land and structures. Making reasonably accurate separation to get the pure land portion is not insuperably difficult, but success requires considerable effort, especially when a relatively great amount of tax hinges on the division between the two portions. A problem, of course, is to keep assessments abreast of changing conditions, especially to take account of rising values (as well, perhaps, of recognizing declines).

The other system of property taxation using value—applied in the United States and Canada, among others—relies on capital value (of land and structures). The annual tax is a percentage of an assessment, presumably of what the property would sell for in an arm's length transaction. Actual market values, however, are almost never the tax base used; instead, some fraction of the estimated market value serves. The reasons for this practice of undervaluation need not be adopted elsewhere; hopefully, other countries could avoid what is certainly a deficiency in the United States.

Actual tax rates in American cities may be 3 or 4 percent (occasionally even more but often around 2 percent) of full current market value. The higher the tax rate, the lower the market price as the process of capitalization operates. Therefore, after time for adjustment, tax rates very much higher, 10 percent or even more, could be imposed—on *land* values. Structures, however, could hardly bear such tax burdens, assuming that investors had alternative uses of funds. The supply of new capital for buildings would decline. But if, as I would urge, the tax rate on structures were much lower than the rate on land, building would find financing easier.

In any case, land would not move away. Price of land would be less. The buyer would pay a lower price but then more each year to the tax collector.

Annual Tax: Area or Other Physical Basis. Another basis has merit as a supplement to one resting on value. Tax could be related to the size of plots of land with adjustment for location and perhaps other *objective* factors. Such a tax would be relatively easy to assess. It could adjust the tax somewhat according to costs of some services. Values growing out of governmental spending would be recaptured to some extent. Per amount of area—*e.g.,* per square meter—some services, such as streets, sewers, and fire protection may cost less in the center of cities, and more far out, because of the investment needed to extend the service to the distant location. Intensity of use could perhaps be measured and used to some extent.

Such an objectively based tax would not serve the full needs being discussed in this paper. Something substantial would remain for value as a base. But lower tax rates on value would then be adequate to bring the total revenue.

Administration. To administer a land value tax at rates high enough to yield substantial revenue requires more staff, with high skills, than are generally available. There are other requirements. The total cannot be achieved easily. But reasonable success is possible. No results in a world with the human limitations we know so well can be fully satisfactory. But much experience has been accumulated in many places, lessons about what to do and what not to do.

IX

Concluding Comments

A HIGH TAX WILL DO one thing, reduce the quantity of that thing—with one exception, a high tax on land. Land in its natural state, especially as space, has not come into existence because someone paid to get it produced. Yet we pay a very high price for the use of some land. When we do so, the payment does not go to someone for creating the land. Perhaps the person who gets the payment, and certainly prior owners through history, will have invested money and effort in making the parcel and the neighborhood more desirable. Something of what present users pay will represent compensation for such investment. Most urban land, however, brings prices which are vastly greater than the worth of such inputs.

The amount paid will generally exceed whatever was needed to get the land (broadly defined) in its present state. What city today has more land because the average price which people must now pay is three or four times that of a generation ago? If more of the payments for land had been channeled into the local government treasury, the land as space would still be available. For the future is not such action sensible?

Price has an economic function other than getting things produced. That other function consists of guiding the use, of preventing waste in consumption, of allocating resources according to their relative productivities and scarcities. As noted earlier, a "high" price for some land is essential for guiding it to the best available uses. A good market in land, one built around prices, is important for inducing the most productive use of this resource.

To assure efficient allocation of land, the user may pay; but the owner need not receive all that is paid. Therefore, government can take much of what the user pays, while keeping pressures and incentives for efficiency in use. But not take all. Present owners have made outlays in good faith and ought not to be deprived of investment made in accordance with established rules, except as noted below. Moreover, an owner must feel confident that his effort in finding a use yielding more return will bring *him* benefit.

As private owners get less and the public treasury obtains more, the price system would still allocate land use. The effective supply of land would go up in the sense that more would be offered on the market. And the tax rate on buildings and machinery could be kept much lower than perhaps otherwise—as in the United States where much man-made capital is taxed more heavily than seems to me desirable.

Investment by owner (or tenant)—or by a land developer—in improving land ought to be treated as the input of capital. To the extent practicable, such inputs deserve the same tax consideration as investment in structures.

Over the longer run, landowners would get less of the increment in land values. The general public would get more. On this score, the equity results commend themselves. The community can capture in taxes some of the values which it has created—including values resulting from local government spending on streets, schools, and other facilities. Localities can get funds to pay for local government by absorbing part of the values created by society.

Socially created values would go for governmental rather than private uses—and locally, relating government financing to a benefit basis geographically. The localities doing most to make themselves attractive would have most of this revenue source.

As for the future, the tax on land value above the present levels would be almost burdenless except as owners of land and their heirs get less "unearned increment" from rising values. Where land values drop, the annual tax at the higher rate would decline. The necessity of paying higher tax on land would put pressure on the owner to get the best income possible—"higher and better use."

Notes

1. Government enterprise-type activities financed partly or entirely by charges constitute an intermediate case. Even when prices or something close to them are used instead of taxation, how often do they result from the forces which determine prices in the market? Rarely, if ever. Consequently, they cannot do the full allocative job expected of prices in free (or even monopolistic?) markets.
2. Agriculture and other land-oriented economic activity decline in relation to the total. This tendency appears increasingly important as one thinks of the longer run in which retailing, housing, finance, and utility services serving business and consumers locate where other factors draw population. Manufacturing stands out as a type of activity which has choice about where to settle and which, in making its selections, influences other decisions about location.

Liberals and Liberalism

YET, UNATTRACTIVE and shallow as one may feel so many liberals to be, how rarely on any concrete social issue does one find the liberal position the wrong one.

W. H. AUDEN