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PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

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The President's Advisory Panel on Federal Tax Reform
1440 New York Ave., NW, Suite 2100
Washington, DC 20220

Dear Advisory Panel:

Although I am also emailing an electronic version of the attached essay separately, it is appropriate that I rely on the failsafe US Postal Service for this printed version.

Everything I have said in that essay is fairly self-explanatory, but perhaps it would be well that I should say something about myself. I am a former university professor of political science, who left teaching to join the New York State Legislative Tax Study Commission in 1982, where I worked for a decade before retiring in 1992. Since that time I have continued to write, to do research on my own, and to serve on non-profit boards reflecting commitment to the reforms I subscribe to. Two such organizations are the Center for the Study of Economics, based in Philadelphia, and the Robert Schalkenbach Foundation, which has its office in New York City. Both subscribe to the social philosophy first outlined by Henry George and both have substantial material on their websites, some of it my own writing. You can find the sites at www.urbantools.net and www.schalkenbach.org.

Should you wish to explore further some of the ideas I have outlined, or otherwise have any questions, I would naturally only be too delighted to help. I am by nature a social reformer, ever since being one of the earlier Peace Corps Volunteers, and my activism has continued on various themes since that time.

I urge you to explore revenue designs beyond the conventional frame of thinking; you should know that the Georgist philosophy cuts totally across conventional party lines – from William Buckley and Steve Moore on the Right to Michael Kinsley and Molly Ivins on the Left. No doubt you are aware of some of the classic figures on the world stage that have also endorsed Georgist ideas.

Very sincerely,

H William Batt

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Encl: Painless Taxation

Painless Taxation

H. William Batt, Ph.D April, 2005

Abstract

Real tax reform could do away with those taxes that are resented by the large proportion of our population. We could replace all taxes on wages and on interest by instead taxing economic rent. Rent is windfall income; it is income that arises not from the efforts of any person or corporation; it comes about as a surplus gain from common social enterprise. There is ample moral warrant for society to lay claim to that which it has created, as well as to that which no individual or party has earned. Analysis increasingly makes clear that economic rent in all its forms is far larger than official government figures indicate; in fact it is likely sufficient to supplant all current taxes on labor and capital (wages and interest) which are acknowledged to have so many negative effects. Recovering economic rent in all its manifestations by taxing its various bases actually can foster economic performance and yield other benefits that make it the natural source of revenue for governments. Such a tax is essentially painless.

Introduction

Under current tax regimes, some people get hit with onerous bills while others get windfall gains.[1] If taxes only on windfalls were collected, we could eliminate those burdens that fall unfairly upon people who have rightfully earned their income and wealth, and the total would likely remain revenue neutral. This is my thesis here, one which should compel the attention of those who would redesign our tax system.

It is astounding how shameful our tax system has become; one might guess that its designers – legislatures at all levels of government –deliberately conceived it just so that they might score cheap points by taking aim at it.[2] But perhaps this time some chosen leader, some deliberative body, or some civic constituency will rise to the challenge of

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[1] A windfall, usually defined, is "an unexpected financial gain, or a stroke of luck." But, as one exhaustive study makes clear, it is typically the consequence of some public policy decision. Donald Hagman & Dean Misczynski, *Windfalls for Wipeouts: Land Value Capture and Compensation*, (Chicago: APA Planners Press, 1978). This is illustrated in one widely read story in William L. Riordan's *Plunkitt of Tammany Hall*, (New York: Dutton, 1905): "Honest Graft and Dishonest Graft."

> There's an honest graft, and I'm an example of how it works. I might sum up the whole thing by sayin': "I seen my opportunities and I took 'em."
>
> Just let me explain by examples. My party's in power in the city, and it's goin' to undertake a lot of public improvements. Well, I'm tipped off, say, that they're going to lay out a new park at a certain place.
>
> I see my opportunity and I take it. I go to that place and I buy up all the land I can in the neighborhood. Then the board of this or that makes its plan public, and there's a rush to get my land, which nobody cared particular for before.
>
> Ain't it perfectly honest to charge a good price and make a profit on my investment and foresight? Of course, it is. Well, that's honest graft.

[2] Presidential candidate Jimmy Carter called the American tax system, "a disgrace to the human race." A recent estimate is that one-third to half of all Americans cheat in some way on their federal tax returns, and far more feel it would be all right to do so if they could get away with it. Donald L. Bartlett & James B. Steele, *The Great American Tax Dodge* (Boston: Little, Brown, Inc., 2000).

making clear some basic starting points rather than pandering to prejudice and low motives. Perhaps. It leads me to write this.

Tax Principles

The starting points should be the lessons that have been learned over the course of the past three hundred and more years about what is a good tax. Most basic textbooks in public finance enumerate them in very clear form, and they constitute benchmarks against which to measure the soundness of any particular tax. They are listed as few as three or as many as eight such principles but little disagreement exists as to their substance, regardless of ideology or government. Most commonly enumerated are neutrality, efficiency, equity, administrability, simplicity, stability, sufficiency.[3] Tax theorists typically measure revenue structures according to any or all of these criteria:

Tax neutrality refers to the influence (or absence of such) that any particular design has on economic behavior. Typically taxes are perceived as a damp on economic activity-- taxing income reduces the incentive to work, taxing sales discourages retail transactions, and taxing savings reduces the propensity to save. The more a tax is perceived to be neutral the less the identifiable distortions it imposes on the economy. The common assumption of most tax theorists is that all taxes impose distortions; it's simply a matter of which ones are least burdensome to economic health. A tax which imposes no distortions is ideally best.

Tax efficiency is much like tax neutrality, and is the measure of how much shifting of behavior it imposes, resulting in what is called "excess burden," or "deadweight loss" on the economy. Tax economists usually hold that the best taxes are those that are shifted little if at all. Because the elasticities (a technical word for the slope of supply and demand curves) of each are very different, a tax on land values and a tax on improvement values have very contrastive effects on economic choices. Using a tax base that has little or zero elasticity is the best way of assuring that taxes are not shifted. Zero elasticity is another way of saying fixed supply.

The principle of equity is central to any discussion of tax design. Tax design requires concern with both what is fair and the extent to which it must sometimes be compromised to satisfy the other principal criteria. Fairness can be evaluated according to what is termed "horizontal equity" -- the extent to which those in similar circumstances will pay similar tax burdens, and "vertical equity" -- how well those in different classes bear different burdens in the tax structure. It is this latter perspective that leads to the use

[3] For a discussion of what students of tax policy regard as the principles which should guide their design, see, for example, George Break, "Taxation," *Encarta Encyclopedia by Microsoft*, 1993; "Principles of Taxation, in Light of Modern Developments," Washington: Federal Tax Policy Memo, The Tax Foundation; "Principles of a High Quality Revenue System," *Tax Notes*, March 21, 1988; David G. Davies, *United States Taxes and Tax Policy*, (New York: Cambridge University Press, 1986), pp. 17-19; and David Brunori, *State Tax Policy. A Political Perspective*. Washington: Urban Institute Press, 2001, Ch. 2. State studies cited above also typically list any or all of these criteria. I have seen accountability, balance, certainty, competitiveness, and complementary included as well.

of terms like "proportional," "progressive," and "regressive" in referring to tax structures A tax is progressive with respect to income if the ratio of tax revenue to income rises when moving up the income scale, proportional if the ratio is constant, and regressive if the ratio declines. There is an ancillary question of whether taxing to reach greater equity should employ measures of income or of wealth, difficult as this is to measure. Such questions of equity are a matter particularly central when discussing the property tax.

Administrability refers to the ease with which a tax can be administered and collected. Taxes which distort the economy are inefficient but so are taxes that cost lots to administer. This is measured not only in the direct costs of tax avoidance and accounting expenses, but in the level of evasion and cheating, and by the cost of government auditing and policing. When the taxpaying public perceives that a tax is easily evaded, cumbersome, and unfair, it loses its legitimacy and calls government itself into question.

This is why the principle of simplicity is important: the more complex the tax design, the more lawyers and accountants will find loopholes, encourage the appearance of unfairness, and drive up the cost of its administration. People know that with simple taxes other parties are also paying their fair share, and all this enhances the legitimacy and therefore the compliance of the tax system.

Stability refers to the ability of a tax to produce revenue in the face of changing economic circumstances. Income and sales taxes, for example, vary greatly according to phases in the economic cycle; the property tax, in contrast, is highly stable regardless of the state of the economy. This is one reason why school administrators have typically been supportive of using the property tax base rather than some other tax to support school services.

The certainty of a tax's collection ensures that the number and types of tax changes be kept to a minimum. Frequent changes in tax rates and bases interfere with business decisions and the ability to make long-term financial plans. This concept reinforces the need for stability because an unstable revenue system is more likely to require continual adjustments.

In assessing the value of a tax it is also important, of course, to understand its potential to bring in revenue for the purposes of government, usually deemed revenue sufficiency. Income, sales and property taxes, along with corporation taxes to a lesser extent, have come to be regarded as the workhorses of the American revenue structure. But, as anti-tax politicians are quick to note, the higher these taxes are, the more they impose a drag on the economy. This is why one should ponder whether to consider raising taxes which have demonstrable distorting effects.

The Tax Base

The next concern should be upon what base to impose a tax – not about taxing whom but taxing what. There are only three possibilities, as all revenue streams necessarily come from one of three factors of economic production – 1) upon resources found raw in nature (what was classically called land), 2) upon our labor, or 3) upon things created by human hands or minds (capital). No other source exists; every possible tax must be on one or some combination of these parts. Each of these factors has its price: the price of land is counted in economic rent; the price of labor is in wages, and the price of capital (its liquid form) is in interest.

Any tax on capital has its downside effects, so that taxing savings causes people to save less, taxing consumption causes people to buy less, and taxing buildings causes people to build less. The result is that economists as well as businessmen usually frown upon taxing capital. Another alternative is to tax labor, but it is even more widely understood that taxing labor normally discourages people from working as much as they would in the absence of a tax. From this comes sentiment against taxing labor, even though for want of any alternative, people have today commonly come to accept it as a necessity. But electing to tax labor, just as for taxing capital, forecloses a discussion of the virtues of taxing land – not necessarily land as earth, but rather land as location. Yet land rent is the most attractive tax base of all, as rent is not earned; it is windfall income, entirely the result of being well situated in any market of scarce natural resources and where community demand (rather than one's own efforts) leads to an appreciation of that land's price. To be sure many people have learned to position themselves in situations where a land's market value is likely to rise – indeed these people come to think of themselves as astute investors. But the fact is that that market gain is not of their own doing at all; it is the result of common enterprise creating a surplus that comes to settle on land sites. An investment in land, in any form it might take, is speculation in greater or lesser degree.

Land in all its forms is a tax base that also conforms well to all the classic principles of sound tax theory as enumerated above. Land is classically taken to mean not just surfaces of the earth but places in time, in space, in any medium whether it be solid, liquid or gas, and even as a form of light, in the electromagnetic spectrum, and in life forms. One needs to return to 19th century classical economic definitions of the factors of production to appreciate the separate significance of land as it was understood in its manifold forms. One should ask how it is that land, so important to 19th century classical economic theory, has been given so little attention today in neoclassical economics. This is a story only now recovered from the dusty archives of academic economic history. Once understood and appreciated, it may be one of the greatest, if very silent, political revolutions of world history.[4]

The conventional wisdom of most contemporary tax designers, despite lip service to the enumerated principles above, is that the best tax regime relies essentially upon three tax bases – property, sales, and income -- perhaps ideally in equal weight.[5] But it is very

[4] For an extensive discussion of this shift in direction from the three-factor economics of land, labor and capital, to the more recent framing of economics largely in terms of labor and capital, see Mason Gaffney, *The Corruption of Economics* (London: Shepheard-Walwyn, 1995) Some of its implications are explored in H. William Batt, "How the Railroads Got Us on the Wrong Economic Track," *The Torch*, Winter, 98. Online at http://www.cooperativeindividualism.org/batt_railroad_1.html

[5] For a discussion of this, see this author's The Fallacy of the "Three-Legged Stool" Metaphor, published in *State Tax Notes*, Vol. 35, No. 6 (February 7, 2005), pp. 377-381; and printed online (unofficially) at http://www.cooperativeindividualism.org/batt_on-tax-policy.html

that when pressed even conventional (neoclassical) economists are often willing to concede that the best possible tax of all is one placed on land rent.[9]

Although one can infer innumerable instances where economic rent inheres in land factors, the econometric data maintained by public agencies has not been compiled in a way that makes it easily identifiable. In fact the US Census of Housing ceased to keep records on the assessed value of land in 1987, reasoning that the quality was so poor that it was more misleading than it was helpful. The actual account of the "rental income of persons" in the US government National Income and Product Accounts is estimated at less than 2%,[10] yet this figure is widely acknowledged to be so unrealistic an estimate that it is ludicrous by itself. What studies have been performed to calculate economic rent suggest that the amount for real property alone is in the neighborhood of 30 percent of a nation's GDP.[11] This realm of research begs for attention, but it will not likely be more than approximate as long as government statistics are so lacking and unreliable.

The growing availability of data, and of computer power, increasingly offers the promise that researchers will be able to "back into" some estimates, even if they are suggestive more than they are conclusive. With such inviting questions, there may well arise the prospect of better data collection, and which will allow for even better analysis.

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[9] To confirm this notion, here are some quotes from prominent American Nobel Prize winners in Economics. See www.urbantools.net. Their political philosophies run the gamut from Right to Left:
Milton Friedman: "I share your view that taxes would be best placed on the land, and not on improvements."
Paul Samuelson: "Pure land rent is in the nature of a 'surplus', which can be taxed heavily without distorting production incentives or efficiency." A site value tax can be called "the useful tax on measured land surplus."
Franco Modigilani: "It is important that the rent of land be retained as a source of government revenue. Some persons who could make excellent use of land would be unable to raise money for the purchase price. Collecting rent annually provides access to land for persons with limited access to credit."
Robert Solow: "Users of land should not be allowed to acquire rights of indefinite duration for single payments. For efficiency, for adequate revenue and for justice, every user of land should be required to make an annual payment to the local government equal to the current rental value of the land that he or she prevents others from using."
William Vickrey, "It guarantees that no one dispossesses fellow citizens by obtaining a disproportionate share of what nature provides for humanity."
James Tobin: "I think in principle it's a good idea to tax unimproved land, and particularly capital gains (windfalls) on it. Theory says we should try to tax items with zero or low elasticity, and those include sites."
James Buchanan: "The landowner who withdraws land from productive use to a purely private use should be required to pay higher, not lower, taxes."

[10] Fred Harrison, et al., The Losses of Nations (London: Othila Press, 1988, pp. 64-75; and http://members.aol.com/_ht_a/tma68/losses.htm;

[11] See, for example, Terry Dwyer, "The Taxable Capacity of Australian Land Resources," in *Australian Tax Forum*, January, 2003. www.prosper.org.au/Documents/TaxableCapacity.pdf; and *infra*. See also Steven Cord, "How Much Revenue Would a Full Land Value Tax Yield? Analysis of Census and Federal Reserve Data," *American Journal of Economics and Sociology*, Vol 44, No 3 (July, 1985), pp 279-293. More work is forthcoming on this question, and much greater documentation will be available shortly

It should also be noted that a transition to a tax on land rent would not be not difficult. In lieu of the conventional real property tax, it is already widely used,[12] and many localities are presently phasing in such a shift, downtaxing improvements and uptaxing land.[13] As for taxes at other levels of government, it is already conceded, for example, that "The Public Owns the Airwaves," a statement that is belied by the fact that the media and communications industry treats its rights to the use of frequency licenses as private property and whose market value is typically reflected when such corporations are sold.[14] One should also note as another example the case of the Alaska Permanent Fund, which provides a reliable citizen's dividend every year to everyone in that state, derived from oil revenue.[15] Development Administrator Paul Bremer proposed such a design for the new government of Iraq in 2003, a design idea that was also endorsed by the United Nations Association.[16] Many other instances could be cited where already land rent is recovered as a surplus to support public services.

A New Tax Ethic

Beyond the greater conformity to sound tax principles as noted earlier, the taxation of economic rent that accretes as a surplus upon land can offer two additional advantages. The first of these is the removal of the distortions wrought upon urban land use configurations and the negative environmental impacts which are presently apparent. The greatest of these affects is in the form of suburban sprawl, a phenomenon viewed with increasing alarm not only by its degradation of life quality but in the increased expenditures of time and resources (especially energy). Land use patterns, as intractable as they tend to be, will have to modify simply on account of the evolving limitations of future life. There are likely to be changes also in the way by which air, water, and other public goods are exploited. Treatment of these resources as "free goods" or as captive property of private parties will end if it is realized how generous the rental flow to public treasuries can be.

The second benefit to be obtained by the recovery of socially created economic rent is the restoration of a moral dimension to taxation and to economics generally. Taxation policy today is faced with a loss of legitimacy, and it is not sufficient to rely on totems that have sustained its design until now. A groundswell of resentment has occurred in all realms of tax policy – for income taxes, for sales taxes, and for real property taxes. All levels of

[12] Robert V. Andelson, *Land-Value Taxation Around the World. American Journal of Economics and Sociology*, Vol 59. No. 5 (Supplement, 2000), and Blackwell Publishers, 2000.

[13] For a record of cities in the United States that are either currently or intending to phase in a tax on land value to replace the conventional real property tax, see the website of the Center for the Study of Economics, in Philadelphia, PA: www.urbantools.net

[14] Although clearly a low estimate, one new research organization based in Washington has been exploring the potential rental value of the spectrum. See the work of the New America Foundation, http://www.newamerica.net/, particularly the work of Michael Calabrese, Program Director, and as referenced in *The Real State of the Union*, New America Foundation, 2003.

[15] See The Alaska Permanent Fund corporation: http://www.apfc.org/, and Alanna Hartzok, "Alaska Permanent Fund: A Model of Resource Rents for Public Investment and Citizen Dividends," http://www.earthrights.net/docs/alaska.html.

[16] http://www.unausa.org/site/pp.asp?c=fvKRI8MPJpF&b=345991