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

It has been satisfactorily shown that the fundamental reason for high rates of unemployment and poverty as well as credit crunches is due to flawed fiscal policies.

South Africa's tax system is a neo-classical canon which erroneously treats both man-made capital and land as if they were one and the same thing. Here are three local examples of this thinking:

Firstly, Richard Grant<sup>1</sup> 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."*

Mr Grant's mistake is illustrated in the case of improved properties which yield both building and land rents. Higher taxes on the former will reduce the future supply of buildings whilst higher land taxes will neither increase nor decrease the total 1.2 million square kilometres of South Africa.

In fact, vacant land holders who are faced with higher tax claims will become more willing sellers and so land prices will fall as land taxes rise. Some reasons for this include the fact that land and other natural endowments had no production cost, cannot be reproduced and do not normally depreciate. This cannot be said of plant and machinery.

In a like manner Many Mooya, Senior Lecturer in Property Studies at UCT posits that *"The second criticism of land taxes arises from the fundamental premise that land is different from other factors of production"*.<sup>2</sup>

His mistake is repeated by 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."*<sup>3</sup>

In this case imagine a vacant, unimproved erf or farm where the entire rent is taxed. This land has a zero purchase price because there is no income to capitalise whilst the extent of the farm does not lessen when taxed.

If all personal taxes on work, profit, interest and trade were gradually replaced by land taxes, South Africa will become a free-land tax haven. That is a similar situation to Hong Kong and Singapore whose GDPs rank amongst the highest in the world.

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How are land taxes calculated? They are a portion of land rents which Ricardo's law defined as *"the excess of production over that which the same application can secure from the least productive land in use"*.

This is illustrated by the story of twin farmers, Moses and Amos, who own identical neighbouring farms. They barely break even. After paying market-related wages and salaries and taking off interest, profit and depreciation there is no excess or rent.

One day a spring gushes up in a field owned by Moses and increases his turnover by R100K p.a. after paying the extra annual costs of managing the water (including labour, pumps, pipes and dams). Moses land rent or excess therefore increases from zero to R100K. His farm is no longer marginal.

In the following year Amos 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).

At a price earnings 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, or when two

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<sup>1</sup> 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.  
<sup>2</sup> Letter to the S.A. Valuer, July 2009.

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<sup>3</sup> In the FMF's "A Neutral Tax Structure Shows Respect for the Consumer"

identical shops are situated in the same street but with different pedestrian counts, or when one of two identical office blocks is nearer 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), land owners enjoy an unearned rent. This is what gives land its price.

These land prices are a State subsidy because they rely entirely on outside factors such as nature's endowment (Moses), locality, government services, population increase, governance and zoning (Amos). Owners are unable to raise raw land prices by themselves.

Under-taxing land causes unearned prices to rise. Getting on to the property ladder yields profits without work. That is why land is called *real estate*

When personal taxes prevail job opportunities will decrease as employers have to pay wages plus the tax. The effect of a tax on profits and interest is likewise to raise the cost of capital and investment. In addition to this there is VAT which increases prices at the tills.

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

Classical economists like Hume, Quesnay, Smith and Ricardo through to George (and including many Nobel Prize winners) were in favour of only taxing land. The perpetual quitrent tenures which Britain introduced to the Cape Colony in 1813 were pure land taxes. Raw land at that time had no purchase price because its entire rent was captured to pay for infrastructure, services and governance.

We need to revisit dysfunctional neo-classical policies. A land tax debate was last conducted by the Katz Commission in the 1990s. In their interim 1994 report the 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 having to pay for the welfare of millions of landless. These welfare payments now consume 25% of the national budget. At the same time able-bodied men and women are excluded from land ownership

because of its cost. According to ABSA this 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 and independent.

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, landless man without more useless 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.

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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 confirms that neo-classical ideas on tax are irrelevant. It is 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 borrowing money to buy land? And how tempting must it be for a bank to ditch its business and consumer customers, those who generate wealth by work and investment, when house mortgages offer better security because of the subsidy.

Let's get it from the horse's mouth. Allan Greenspan wrote in the *Spectator* of 19<sup>th</sup> 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 ignores the fact that unearned land price gains can be eliminated by land taxes.

The risk factor of property ownership is the price of land. In South Africa this is now some 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).

It is not widely understood that house prices have grown in spite of the natural fall in building values of  $\pm 3\%$  a year due to depreciation and obsolescence of bricks and mortar. 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 then 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.

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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 taxes which account for 35% of its budget. By loading up on land taxes, the costs of employment and working capital are lowered and 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*

*rubbish, 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 as well as mineral and oil wealth are already in the ground, so there is no need to bury bottles full of bank notes to create wealth! All one has to do is remove the entry cost.

In conclusion, land prices are a state subsidy and conventional taxes are required to bridge the shortfall from under-taxed land and resources. Logically, then, homeowners hardly pay taxes; they simply advance funds to the State and wait for higher land prices to pay them back.

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In summary here are the benefits which will flow if the Treasury were to abandon its neo-classical fixations:

1. Access to unimproved land will become free except for the annual charges. Using standard welfare-to-work methods and in concert with private-sector developers this will mean that any able-bodied person will be able to develop an unbonded two hectare farm in a country village.
2. This might consist of a sturdy four bedroomed house, fields, orchards, vineyards, barns, cellars and stables. According to a professional quantity surveyor it will require five years of labour to complete using materials which are collected or grown on the estate and are therefore free.
3. Such an estate would be worth some 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.
4. Once the estate is completed the scope for labour intensive work is wide open. An angora goat produces up to 8 kilos a year of very fine mohair when hand-raised. This sells for up to R17 000 per kilo or R136 000 pa per goat.
5. The reproductive power of nature also generates enormous surpluses. A giant squid produces three million babies a year. A single pumpkin has 250 seeds. A pair of rabbits can produce ten babies a month.

One can easily rear a hundred thousand a year. They sell for R30 each.

6. 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 70% in the time it takes to replace personal taxes with land taxes.
7. Millions of hectares of land will be brought into production under the “use it or lose it” principle which land taxes instil. *Twenty eight million hectares of potential arable land are not currently being cultivated*, according to Frost and Sullivan (*Business Report*, July 7 2008).
8. Infrastructure projects would become virtually self-funding as the value that they add to land is captured by taxes.
9. 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.
10. 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.

11. 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 also be repealed.
12. Speculators in unused land will suffer, but they have the option of improving or letting the land, if they wish to avoid being taxed.
13. 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.