FREE MARKET FOUNDATION

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Submission to the Davis Tax Committee on wealth taxes for South Africa

General introduction

The immediate reaction of most South Africans to the invitation to make submissions on the desirability and feasibility of introducing additional taxes in the form of 1. A land tax 2. A national tax on the value of property (over and above municipal rates), and 3. An annual wealth tax, is likely to be, "Surely not. Are taxpayers not already too heavily taxed?"

The invitation to make submissions does not state whether the three listed tax forms are to be considered as additional taxes or to replace or reduce existing taxes. Experience suggests that the taxes, if introduced, would be added to existing taxes.

The first and most important comment on the matter must be that instead of looking for additional taxes to cover government expenditure, the first focus should be on reducing that expenditure. Seeking additional sources of tax from already over-burdened taxpayers at a time when the economy is in recession reveals a lack of concern for the economic consequences. Placing increasing burdens on the producers of wealth at such a time will reduce investment in production of goods and services, deepen the recession, and cause further job losses.

We have been advised that it is not part of the responsibility of the Davis Tax Committee to examine the expenditure side of the national budget. It is required to focus exclusively on taxation in its various forms, and fundamentally, to find ways and means of increasing the transfer of resources from taxpayers to the government, without there being any formal mechanism, other than seriously harmful outcomes, to halt or reverse the amount of government spending.

In the call for submissions, the Davis Tax Committee says that it was established, "to inquire into the role of the tax system in the promotion of inclusive growth, employment creation, development and fiscal sustainability. In doing so, the committee will take into account recent domestic and international developments and, particularly, the long term objectives of the National Development Plan.

Given its mandate, the committee must seriously consider resisting the implementation of a proliferation of tax forms in various areas of the economy, each one of which will have a retarding effect on investment in the area of economic activity that is being taxed. If it wishes to promote inclusive growth, employment creation and development, the committee would do well to consider the benefit to be derived from the low tax regimes followed by Hong Kong (when it had mass unemployment) and Mauritius (when it decided to go for growth).

1. Land tax

Henry George (1839-1897) still has followers today, generally known as Georgists, who put forward his idea of a single tax on land and the repeal of all other taxes. The idea of a land tax has been shown to be unworkable for a variety of reasons. A critique of this land tax is contained in the attached research paper ***A Search-Theoretic Critique of Georgism*** by Zachary Gochenour and Bryan Caplan at George Mason University, USA.

The following is a brief comment on the issue by co-author Bryan Caplan:

A Search-Theoretic Critique of Georgism

Bryan Caplan

Economist **Henry George** famously advocated a 100% (or near 100%) "**Single Tax**" on the unimproved value of land. Many modern tax economists, most notably Joseph Stiglitz, conclude that George's logic was sound: Since the unimproved value of land is perfectly inelastic, even an expropriatory tax is non-distortionary. Economists' main objections to Georgism are merely that (a) it is difficult to implement in practice, and (b) politically impossible.

My co-author **Zachary Gochenour** and I have a **new working paper** arguing that the Single Tax suffers from a much more fundamental flaw. Namely: A tax on the unimproved value of land distorts the incentive to *search for new land and better uses of existing land*. If we actually imposed a 100% tax on the unimproved value of land, any incentive to search would disappear. This is no trivial problem: Imagine the long-run effect on the world's oil supply if companies stopped looking for new sources of oil.

I can explain our argument with a simple example. Clever Georgists propose a regime where property owners self-assess the value of their property, subject to the constraint that owners *must* sell their property to anyone who offers that self-assessed value. Now suppose you own a vacant lot with oil underneath; the present value of the oil minus the cost of extraction equals $1M. How will you self-assess? As long as the value of your land is public information, you cannot safely self-assess at anything less than its full value of $1M. So you self-assess at $1M, pay the Georgist tax (say 99%), and pump the oil anyway, right?

There's just one problem: While the Georgist tax has no effect on the incentive to pump discovered oil, it has a devastating effect on the incentive to discover oil in the first place. Suppose you could find a $1M well by spending $900k on exploration. With a 99% Georgist tax, your expected profits are *negative* $890k. (.01*$1M-$900k=-$890k)

You might think that this is merely a problem for a handful of industries. But that's probably false. All firms engage in search, whether or not they explicitly account for it. Take a real estate developer. One of his main functions is to find valuable new ways to use existing land. "This would be a great place for a new housing development." "This would be a perfect location for a Chinese restaurant." And so on. As Gochenour and I explain:

Note we have not complicated the models by differentiating between improvements and the land's "unimproved" value. Information about the land can be considered an improvement in its own right. Some of the land's qualities have very low search costs to discover: is it arable, will it support any type of building, is it in the middle of a city or rural area, etc. Discovery of other potential uses may require significant search and/or investment in other technologies. An entrepreneur brings these qualities to market - they do not bring themselves. Until he does so, the value of the land is undefined.

Georgists might be tempted to reply: "Fine. We'll limit the Single Tax to *existing* real estate, and exempt new development entirely." But in the real world, such offers lack credibility. Past expropriation is a strong signal of future expropriation:

Previous attempts at land reform have more often failed than not, sometimes with terrible consequences. Consider the case of Uganda, where in 1971 dictator Idi Amin expelled approximately 60,000 Indian immigrants and expropriated their land (Jorgensen 1981). The idea was simple: expel the immigrants and redistribute their holdings among the native population to curry favor without affecting future output. In years to come, lack of foreign investment crippled the country, and even non-Indians mistrusted the government. In 1998, when the expelled citizens and their heirs were offered the opportunity to return and take back their businesses, (understandably) very few accepted the offer. Once a government shows a willingness to drastically alter their respect for certain types of property rights for certain types of citizens, everyone updates their expectations to account for this change.

The big puzzle for me: Why do tax economists spend so much time discussing mere curiosities like lump-sum taxation, excess profit taxation, and land taxation, when the completely realistic option of **taxes on negative externalities** is right in front of their noses?

2. A national tax on the value of property (over and above municipal rates)

The notion of a national tax on the value of property is unrealistic. It cannot fail to impinge on the revenue raising capabilities of local governments. If it does, the local governments will be turning to central government for assistance and the tax collection will be back to square one. Local governments are likely to be at constant loggerheads with central government over every aspect of taxes and rates on property.

If anything will convince South Africans that they are over-taxed it would be a national property tax added on top of the local government rates they are already paying. Another consideration that should be borne in mind is that black South Africans, who were prohibited from owning property in land for a period of 78 years are now becoming property owners. It would be unjust to heavily tax property just when black South Africans are, on a large scale, becoming first time home owners.

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