

RAISING REVENUE: A better way for Vanuatu

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About the author

Dr Terry Dwyer did his Honours Arts degree at Sydney University majoring in Latin Pure Mathematics and his Honours Economics degree majoring in Economic Theory and Economic Statistics. He did his PhD in Economics at Harvard University on a Harkness Fellowship where noted public finance scholars Professors Richard Musgrave, Martin Feldstein and Arthur Smithies were his thesis supervisors and examiners. Professor Feldstein later served as Chairman of the President's Council of Economic Advisers. While at Harvard University he was awarded the Joseph A Schumpeter Fellowship in 1979 and taught a Public Finance class for a fellow student, Mr Larry Summers, later Secretary of the United States Treasury.

On returning to Australia he served as a Senior Finance Officer in the Tax Policy Branch of the Australian Federal Treasury and later Senior Adviser in charge of the Taxation and Income Security Section of the Department of the Prime Minister and Cabinet. His duties in the latter role included writing Cabinet briefing notes on taxation and social security measures. He also served as an adviser and notetaker during the National Tax Reform Summit of 1985 and the accompanying Cabinet discussions. Dr Dwyer later transferred as a Principal Researcher to the Office to the Economic Planning Advisory Council where he co-authored papers on taxation and incentives and the economics of an ageing population.

Upon leaving public service, Dr Dwyer advised various government and private corporations as to taxation matters and wrote on taxation and economic regulation issues for a variety of clients including the Business Council of Australia and its Tax Committee on tax policy, international competitiveness, comparative living standards and infrastructure financing, as well as the Rural Industries Research and Development Corporation. Dr Dwyer and his firm also advised the ACT Government on legislation for the introduction of limited liability partnerships and advised the New South Wales Government on the potential uses and tax treatment of such partnerships.

Dr Dwyer also served as Private Secretary and economic adviser to independent Tasmanian Senator Brian Harradine in the Australian Senate, in which capacity he provided advice on a wide range of economic issues including tax policy, general economic and competition policy and privatization of public utilities, such as Telstra. As well as managing meetings and correspondence with Departmental officials, as private secretary, he had to direct the drafting of amendments to Government legislation and prepare Parliamentary speeches.

He has been a Visiting Fellow at the National Centre for Development Studies at the Australian National University and in that capacity visited the Pacific Islands, Malaysia, Brunei, Singapore and Hong Kong in the course of researching and lecturing on domestic and international tax issues. Since 2008 he has practised as a lawyer in his own firm specialising in tax matters.

He has written critically on the OECD and international tax issues since the 1998 publication of *Harmful Tax Competition: An Emerging Global Issue* and was invited by the Government of Samoa to attend the OECD Tokyo consultation with the Pacific Islands in February 2001 as a member of the Samoan delegation.

The views expressed in this paper are his own and not necessarily, but hopefully, shared by others.

Overview – Tax Policy in a Nutshell

All economic activity is just people producing and exchanging goods and services. It can be as simple as a man exchanging fish in return for a pig. It can be as complex as a multinational buying rare metals in Australia to fabricate mobile phones in China to sell in Europe. All economic activity is the result of Man acting with Nature. All goods and services are the product of Land, the Labour of Man and the Capital that Man has created to help him produce things. Economists talk of Land, Labour and Capital as the three factors of production, where Capital is a factor of production produced by Man. By Land, economics means all natural resources, town sites, agricultural or mineral lands, fishing grounds, electromagnetic spectrum et cetera.

The value of everything produced by land, labour and capital and which is shared between them by exchange becomes the rent of land, the wages of the labour and the profits on the capital used to produce these goods and services. The whole national output of an economy necessarily is made up of the rent of land, the wages of labour and the profits of capital.

If a government is to derive a revenue, it must derive that revenue by claiming a part of the rent of land, of the wages of labour or the profits of capital. Fundamentally, there are only three things you can tax - land, labour or capital.

But two of these – labour and capital – only are put to production because of the voluntary actions of human beings. Only land exists and is available for use in production independently of the will of Man.

Therefore, over 250 years ago, the French Physiocrats, like John Locke, the English political philosopher, realised that a tax on the rent of land was uniquely efficient and could not be shifted by the landholder through any actions of his own. That is why they gave a tax on land rent the name *l'impôt unique* - the unique tax. Indeed, the theorem that a tax on land rent cannot be shifted was the first theorem ever discovered in economics and remains the oft-forgotten key to sensible tax policy.

All taxes are necessarily attempts by the State to claim a share of the rent of land, the wages of labour or the profits of capital. The secret of tax policy is therefore simple and can be summarised in one sentence -

There are only three things you can tax – land, labour or capital - and only one of them cannot demand higher wages, stop breeding, run away, emigrate, slack off, rust out, be hidden or taken elsewhere, so tax what you can, not what you cannot.

PART I

The principles of tax policy

Economics first became a scientific study in the 18th-century when the French Physiocrats, led by François Quesnay, discovered the concept of an economic circulation of goods and services, a discovery compared to Harvey's discovery of the circulation of the blood in the human body. Quesnay, being physician to Louis XV of France, was not slow to appreciate the similarity.

The Physiocrats realised that the circulation of all economic exchanges resulted in returns to the three factors of production, land, labour, and capital. Adam Smith, who visited Paris and met the Physiocrats, used their ideas in preparing his monumental *Inquiry into the Nature and Causes of the Wealth of Nations*, published in 1776, which still yields gems for the attentive reader.

All economic output reflects the cooperation of Man with Nature, the gift of the Creator to all men, as John Locke put it. The two original factors of production are thus Man, using his brawn and brain, and Land, comprising all natural resources, such as town sites, agricultural or mineral lands, fishing or water rights, the electromagnetic spectrum et cetera.

Man quickly discovers that production, the process of drawing out (*pro ducere* in Latin) goods and services from Nature becomes easier with tools. Catching fish is easier with spears or nets than bare hands. The third factor of production is thus Capital, the man-made tools of production, such as tools, plant, machinery, equipment or buildings. Capital is thus physical capital, that is, any produced thing which is used in further production of other things.

Accordingly, Adam Smith, and the economists after him described land, labour, and capital as the three factors of production. The total value of everything that is produced in a country in any year is distributed by exchange as the returns to these three factors of land labour and capital, described as the rent of land, the wages of labour and the profits of capital. They create the value and the value is returned to them. By "rent" is meant all forms of returns to use of natural resources, by "wages" all returns to labour of any kind, mental or physical, skilled or unskilled, by "profits" in this context is meant returns to physical capital of all kinds, not profits in an accounting sense.

It is important to note that rent, wages and profits are conceptual categories and often not easily observed in isolation. For example, the "profits" of a one-man business include a return to the owner's labour, a return to the tools he has used in the business and a rent to the land he has used, whether he holds the land as freehold or has leased it from someone else. Similarly, even a man living in his own home is producing a composite income in terms of accommodation services, representing a return to his labour and his family's in maintaining and keeping the building which is his house in good order, plus a return for the capital represented by the building along with a rent to the land upon which the building sits.

This simple observation leads to profound conclusions, which, unfortunately, are almost universally ignored by modern economists who are more versed in mathematical models than in the history of their subject and, in particular, the history of tax theory.

Principle One

There is no such thing as an “income tax” or a “value added tax” or a “business tax” or any other tax. An income tax is just three taxes rolled into one - a tax on the rent of land, a tax on the wages of labour and tax on the profits of capital. All taxes are, in the end, just taxes on one or more of rent, wages or profits.

One cannot analyse the economic effect of an income tax, without analysing its effects as its three constituent taxes.

For example, a high income tax may thoroughly discourage capital investment in turning over trading stock or maintenance of buildings. It may discourage work effort and, if no allowances are made for family subsistence, children or the cost of living, an income tax, being a wage tax, may even result in population decline, as has been happening in Europe.

By contrast, the oldest theorem in economics is that a tax on land rent cannot be shifted. The intuitive reason for this conclusion is that, as Adam Smith observed, land has no cost of production. The rent of land is thus a “demanded determined” price. A tax on land rent, such as a tax on land values, has no effect on the supply of land, which is the gift of Nature. Unlike manufactured goods, whose price must reflect the cost of production in the long run, (e.g. getting workers to come and make things) the rent for using a plot of land simply reflects demand for that land. In an urban area, that price will usually depend on amenity and location. In a rural area, the value of agricultural land in its raw state will depend on its inherent fertility as well as location to markets and, likewise, the rent of mineral lands will reflect the quality of ore bodies.

Because an income tax is not a tax on one single homogeneous factor of production, that is, something of the same type and nature, it is a *naïve economic fallacy to assert*, as poorly trained economists often assert, that –

“A broad-based income tax is necessarily more efficient than a narrowly based income tax.”

The truth is that it depends on what income producing factor of production is being taxed. An income tax narrowly based on land values, such as a rent or land value tax, may have little or no disincentive effects. By contrast, a tax at the same rate levied on profits will drive down the return to physical capital investment, thereby lowering productivity and hence reducing the wages of labour and consequently the living standards of working people. An income tax on wages may lead to fewer work hours being done or people not bothering to learn more skills.

In algebraic terms, a tax on income, tY , is the same as a tax on the returns to land labour and capital, that is,

$tY = tR+tW+tP$ because national income, $Y=R+W+P$

where R is the rent of land, W the wages of labour and P the profits of capital.

Interest

The profits of capital are often described in the literature as the “interest on capital” or “quasi-rents on capital”. This is because money is often borrowed to finance the creation of physical capital and will not be sunk into investing in physical capital if the money lent does not yield the going rate of interest. Once built, the return to a building or a stock of goods is what you can get for it, given the state of demand, not what it cost to produce and in that sense is like a rent.

However, rent, wages and profits can all be partly paid out as interest. A worker may borrow for a car and pay out part of his wages as interest; a landholder may borrow to furnish his home and pay out part of his rent as interest; a shopkeeper may borrow to the stock on his shelves and pay out some of his profits on selling it as interest.

Interest is not an original income but a sharing in rent, wages or profits, as the original parts of national income. A tax on interest income is therefore a reduction in the rent, wages or profits flowing to land, labour or capital or to the share of those original incomes flowing back to the lender.

Value-added tax or consumption taxes

As noted above, there is no such thing as an income tax. An income tax is in reality three taxes, a tax on the rent of land, the wages of labour and the profits of capital.

It is often stated that a value-added tax or a consumption tax is a different tax to an income tax. This is not correct. Income equals consumption plus savings. Therefore, a consumption tax of $x\%$ is just a tax on income with an exemption for saved income. To add an income tax to a value-added tax is just a backdoor way of increasing the value-added tax. Thus the rise in value-added taxes in Europe has seen a rise in the total tax take out of national incomes.

Turnover taxes

Turnover or general sales taxes were resorted to in Europe as governments sought to raise revenue to pay off debts from World War I. These taxes, unlike the value-added taxes which replace them, did not allow any deduction for purchases by businesses. That resulted in inefficiencies since tax was imposed at every stage of production. Tax would be imposed on the farmer selling his wool to a broker, upon the broker selling the wool to a manufacturer, upon the manufacturer selling the wool as cloth to the clothing manufacturer and upon the clothing manufacturer selling the garment to a retail store, and upon the retail store selling it to the consumer. If the consumer later sold the clothes to a second-hand store, that store would be taxed again on the re-sale of the clothes. This kind of cascading of taxes was condemned in 1776 by Adam Smith when he described the Spanish turnover tax as causing the decline of Spain and its Empire as an economic power. Effectively, the turnover tax with its cascading amounted to multiple impositions of income tax in a random fashion.

The obvious deficiencies of turnover taxes were what led France in 1954 to invent the value-added tax to eliminate the cascading problem by giving credit to businesses for tax on their business inputs. One of the arguments very strongly pressed for introduction of

value-added tax (goods and services tax) in Australia was to replace sales taxes which could operate on businesses as turnover taxes, pushing up the price of exported goods to Australia's competitive disadvantage. The disadvantages of turnover taxes are so obvious that it is now rare to see any economist seek to defend them.

If a country already has a value-added tax, it would be more logical to increase that tax rather than introduce a turnover tax on business. Of course, as has been argued above, both income taxes and value-added taxes are much inferior to a land rent charge, such as a land value tax or land value rate.

History of income tax

The first income tax was introduced by Pitt the Younger in 1798 in the United Kingdom in order to fight Napoleon Bonaparte and was made up of several schedules of different classes of income. Unlike modern income tax systems, Pitt the Younger wisely sought to exempt the wages of common labour from the taxation system by giving liberal subsistence exemptions for workers and their dependants.

Similarly, the Hong Kong income tax system was based on separate taxes on salaries, profits and land. What is not generally realised about Hong Kong was the extent to which its land revenues did not come solely from taxes on land but from leasing land. This situation arose from a suggestion made by Lord Aberdeen to Sir Henry Pottinger that, given the Crown had spent a large amount creating a free-trade colony, the merchants occupying it should pay a decent rent to the Crown for the use of the colony for their trading.

This leads us to a paradox -

When is a tax not a tax?

A tax is generally described as a compulsory exaction of money from the subject or citizen, being money not paid in return for the supply of a resource, goods or services.

By contrast, a royalty for fishing rights, for pumping out oil, for mining ore or cutting down trees for timber is not a tax. A royalty is a non-tax source of revenue to the sovereign.

Adam Smith observed that many societies had functioned without much taxation, if any, by the sovereign relying on his non-tax revenues to meet the public expenses.

This was the scheme adopted in England by William the Conqueror. The lands of England were parcelled out to his followers who became his Lords and his tenants. In turn, they were expected to pay for the costs of running the kingdom by paying the King rent in the form of knight service and cash payments, with other obligations annexed. This was encapsulated in the maxim of both English and French law that "the King should live off His own." The phrase, "real estate" originally seems to have come from "royal estate" and English law drew a sharp distinction between the hereditary revenues of the Crown, such as its land rents, from taxes voted as grants, aids, subsidies or benevolences to the Crown by the representatives of the common people. That usage is still reflected in the Norman French words by which the Queen acknowledges the grant of supply by the Commons to Her Ministers. The granting of

Royal Assent to a supply bill is indicated with the words “*La Reyne remercie ses bons sujets, accepte leur benevolence, et ainsi le vault*”, translated as “The Queen thanks her good subjects, accepts their bounty, and so wills it.” The giving away of Crown lands by foolish sovereigns to favourites, without reserving rent, weakened the English and French governments. Indeed, the French Revolution was largely triggered by the nobility refusing to be taxed on their estates or pay rent driving the Crown to burden the common people.

These observations are not of mere antiquarian interest. If one looks around the world, one sees some of the fastest developing economies in the Middle East, in places such as Dubai et cetera. During the 1960s and 70s, the Arab States, seeing how much the Seven Sisters of the oil industry and European Governments had made by way of profits and taxes from their oil moved to raise posted prices for royalties and started to limit oil concessions and reclaim equity, thus reversing the effects of concessions granted in the 1930s and earlier and restoring great revenues to their treasuries from oil rents. Because the Oil States have collected land rents in the form of oil royalties, they have been able to minimise reliance on income taxes. This, as with Hong Kong raising public revenue from land, has allowed them to offer low-tax regimes for foreign investors as well as local investors. The obvious point is that if the royalties on just one form of natural resource (oil alone) can fund a government, why cannot governments be funded from the land rents of their sovereign territory?

This question was put by the author to Christopher Heady, then a leading researcher in tax policy for the OECD, at a conference in Canberra some years ago. Why was the OECD busy pursuing other countries, such small Pacific island states, to collect revenue extra-territorially when the land values of London, Paris or Berlin would far exceed anything to be found in the Pacific or Caribbean Islands and when the OECD itself had publicly stated that taxes on immobile factors of production such as land were superior to taxes on mobile activities such as mobile capital or labour? The answer was disarmingly frank. It was that “It was politically difficult” to get support for such a tax. To which the author of this paper replied that OECD domestic political problems should not be the problems of other countries and economic advice should not be driven by political considerations.

When a government imposes a land value tax, what it is really doing is reasserting its sovereign rights over its territory and demanding the merchants, manufacturers, miners, plantation owners and others who use its lands or live on them, and are given by the State the opportunity to use them to the exclusion of their fellow citizens, should pay a decent rent for the exclusive land tenure which the State is conferring upon the landholders. Hence, John Stuart Mill, the 19th-century economist and philosopher, observed that the introduction of a land tax was really a re-appropriation of rent by the sovereign as owner rather than truly a tax.

It is because a land value tax is fundamentally a demand by the State for rent to be paid by landholders which represents value being given to them, it is not really a tax and has none of the distorting effects of taxes on labour or capital.

A “no public revenue” society is impossible. Governments need money to provide the essential public services and infrastructure needed by a civilised community. Where these do not exist, as in a failed state such as Somalia, production, wages and living standards collapse and land values also collapse since few people wish to live, work or invest in a conflict zone,

By contrast, a “no tax revenue” society is not only possible but highly desirable.

A State can fund its essential public services and infrastructure from the rents of the lands which are made more productive by those expenditures. Such a State has a great advantage in terms of economic development over other countries where labour and capital are taxed. A “no tax revenue” society is achievable because all useful public expenditures and the benefits therefrom are reflected in rising productivity of land, labour and capital and thereby ultimately reflected in land rents and land values. For this reason, Adam Smith observed that a land tax was particularly justified, given that land values are created so much by the good government of a sovereign.

Income tax as three taxes

To understand the impact of any tax, whether an income tax, a business turnover or licensing tax, or a value-added tax, it is necessary to strip things down to basics.

It is obvious that land, labour and capital are different things. To understand the impact of any tax you must ask yourself how it affects the supply of land, labour or capital - how does the tax affect their productivity – their output of the goods and services everybody wants. The real question for a government or a sovereign is how will the supply of land, labour or capital react to a tax?

It is obvious that land, labour and capital react differently to taxes. Land is the passive factor of production. Land exists, it lies waiting to be used. Labour and capital are the *active* factors of production. Unlike land, the supply of labour and capital depend on human decisions and human activity. By contrast, there is no fixed or automatic supply of willing workers or investment in plant machinery equipment and buildings.

The supply of labour when a tax is imposed

Everyone understands that if you deprive a worker of a proportion of what he gets from working, he may decide to work less. The worker may try to see if he can pass the tax on to his employer by demanding higher wages. If he is a professional, such as a lawyer or a doctor, he may pass the cost on to his clients or patients. But that, in the end, may reduce the effective earnings of the patients and clients whose incomes can no longer so easily afford legal or medical costs.

In short, whether or not a tax on labour is passed on, whether or not it leads to a withdrawal of labour, it diminishes the net return to working, either the work of the taxed supplier or the work of the buyer to whom the tax is passed on. In a country such as Vanuatu, a worker may even decide to quit the market economy and go back to his village and enjoy a subsistence living by the ocean, fishing and tending his pigs and vegetables to supply himself with necessities of life, rather than working for a low-wage in Port Vila or Luganville.

The availability of the alternative of a subsistence living on customary or common lands fortunately gives unskilled labour some bargaining power against low wages. Curiously, in some colonies, such as Ceylon, South Africa and Rhodesia, and Uganda, colonial administrations imposed poll or hut taxes, that is head taxes of so much per year per person or per family, to make so-called “lazy natives” go to work in the mines and farms to earn the money to pay the head tax. Some text books still foolishly describe a poll tax or head tax as

an efficient tax, because it is claimed the worker has no choice but to pay it and it will not affect the reduce the extra return from extra work . Yet there is nothing efficient about lowering a person's standard of living by forcing him to work in circumstances where his preference would be not to work in the market economy but to provide for himself and his family on his tribal lands. A poll or hut tax actually introduces a distortion to the labour market - and one heavily weighted in favour of employers. Taking a longer run perspective, it is even possible that a poll tax could reduce the number of children people are willing to have and thereby diminish the long run supply of useful labour for the nation's growth and productivity. Thus, Adam Smith on the 18th century warned against taxes on subsistence or taxes on the earnings of unskilled labour. Both he and William Pitt the Younger did not wish to see the working classes forced into starvation or into reducing the size of their families so as to diminish the total workforce of the United Kingdom.

The simple fact is that a tax on labour, one way or another, diminishes the supply of useful labour and therefore necessarily diminishes the national output of goods and services. There is no avoiding this fact. Because an income tax is a tax on labour income, it necessarily has all the evil effects of a tax on the earnings of labour. It is nonsense to pretend that a graduated tax with increasing tax rates on higher incomes from labour does not have these effects. Indeed the higher the tax rate on extra labour income from higher earning workers, the greater the distorting effects.

The supply of capital

What is true of labour is equally true of capital. No one is obliged to invest in creating productive physical capital if the return he gets for his investment is reduced below what he will accept - you cannot force people to invest their money. Assuming that people invest to the extent it is profitable to do so, once a tax on the earnings from capital is introduced, it is inevitable that investments with small margins of profitability will be abandoned. As they are abandoned, workers employed in those businesses will lose their jobs, depressing wage levels and the lack of capital will reduce the productivity of other workers.

The simplest way of seeing what a tax on capital does is to ask yourself what would a tax on buildings do? You can see a live demonstration if you take the train from Chicago to New York and look at the abandoned factories of the old industrial heartland of the United States. In the United States there is often heavy local property tax which is imposed, not on the land value alone, but on the value of the land and buildings. As a result, as the train passes through the old industrial cities of Ohio, Pennsylvania and New York State you will see many dilapidated buildings. It suits the owners to leave them abandoned and producing nothing and not being recycled for a better use because the derelict building reduces the value of the so-called "improved" site, thereby reducing the property owner's annual tax bill. Meanwhile, cities are deprived of acre upon acre of valuable industrial land which could be recycled for other uses or for apartments for people to live in. When you see in the newspapers stories of rioters coming from the derelict neighbourhoods of great American cities, you are seeing in part the effects of taxing capital improvements over decades and its effects in depriving people of meaningful employment and decent places to live.

What is true of buildings is equally true of investment in plant equipment or stock in trade. Any diminution in the profits of capital through taxation leads to a withdrawal of physical capital. That withdrawal may take place by abandonment, non-repair, usage past

obsolescence and non-replacement. As the United States, Australia and other so-called advanced Western economies are discovering, it can also take place by capital replacing itself overseas in lower tax and lower cost jurisdictions such as China, Vietnam or Malaysia, just as it used to go to Singapore and Hong Kong before they rose to riches on their attractiveness to foreign capital.

Any sensible country should try not to tax capital at all so as to become a haven for investment.

Occasionally some economists have suggested taxing “passive” capital as opposed to “active” capital, that is taxing dividends and interest on financial investments rather than taxing plant, machinery, equipment and buildings. This is a mistake. “Passive” or “financial capital” is not capital in the economic sense of a produced factor of production. The only truly passive asset is land. It is therefore an illusion to think that there is such a thing as “passive capital” which can be taxed like land values. Dividends and interest are paid out of the profits of businesses, not just out of land rents. Those profits include the returns on physical capital investment. A tax on dividends and interest is therefore a tax to a greater or lesser extent upon the returns of physical investment.

Further, interest on “passive capital” or “financial capital” does not only get paid by businesses. Governments and consumers also borrow and pay interest, just like businesses. In those cases, a tax on interest from “passive capital” raises the cost of money to governments and consumers. As for governments, a tax on interest becomes a case of government taxing itself (a rather silly thing to do) by pushing up the interest cost demanded by lenders. As for consumers, it is a case of taxing the earnings of workers who need to borrow to buy houses or finance consumption. As a hard practical matter-of-fact, taxes on interest almost invariably are passed on because interest rates are so internationally competitive. No country can force international lenders to accept a reduced after-tax rate of interest.

Strangely, the EU countries have come to realize this themselves. European countries often now no longer impose withholding taxes on interest paid to foreign lenders because they know interest taxes just raise the cost of borrowing for their governments, businesses, and consumers. Yet, paradoxically, they persist in the delusion that there are billions of dollars of passive capital lying in tax havens and able to be taxed by them.

The supply of land

Unlike labour or capital, land exists regardless of the will, blood sweat or tears or effort of the landholder. The landholder fundamentally has one choice only, to use the land (or let it be used) - or not.

In normal circumstances, a landholder will obviously want to see that his land is put to good use so that he can enjoy a rent from it, whether by using it himself in his own business of farming activities or by using it for his home or by letting someone else put it to use and pay him rent. In each case, the land is yielding an implied or imputed rent or an actual rent.

If one wishes to tax the economic concept of rent, it is very important that the tax not be just on rent actually paid by a tenant, because the owner may take over the land and use it himself

with no visible payment for rent. Yet, in such a case, he is getting the benefit of the use of the land and therefore deriving rent for himself from his own use.

To tax land rent, what one aims to do is to tax the rent a landholder *could get* from the market. Land's accruing rental value can easily be estimated from the market value of the land. If a block of land with no tax in existence is valued at \$10,000, assuming the general rate of return is 5%, the market rent for the land might be \$500.

Therefore, the easiest way to compute and tax the underlying land rent is simply to impose a rate on the land value. For example, if you impose a tax of 2% on a land value of \$10,000, the annual tax liability is \$200. That annual tax liability represents at first glance a 40% tax rate on the land rent. That is not, however, correct because once the 2% tax is imposed, the net rent from the land will be \$300 per year, so, at first glance, the market price would adjust downwards to \$6,000 to give the going rate of return of 5%. That would reduce the annual tax on market value to \$120 per annum, leaving a net rent of \$380, so the \$6,000 must be too low a market price. The market will adjust to an equilibrium which can be mathematically worked out as being equal to a new market value of $i/(i+t)$ of the previous market value, where i is the interest rate and t is the tax rate on the market price. Hence the new market price should be $5/(2+5)$ of \$10,000 that is \$7143. Checking, one sees 5% of that amount is \$357 per annum as privatised rent and 2% of that amount is \$143 per annum representing the amount of rent taken by government as tax. The total rent in economic terms (and the true value of the land) remains as before - \$500 - but the effect of the 2% land value tax is that the government is now taking a share of the gross \$500 rent. This was what the 19th century economist and political philosopher John Stuart Mill meant when he said that a land tax was not so much a tax as a reappropriation of rent by the sovereign, bearing in mind that all lands are ultimately owned by the Sovereign or the State.

The above formula is a long-term equilibrium formula and in practice will vary depending on circumstances but it makes the obvious point that only an infinite tax rate on land values could amount to an over taxation of rent. The mathematics of market price readjustment for taxes drives down the private market price of land even though its true economic value remains the same.

This brings us to the interesting question of what can the landholder do, if anything, to avoid a land value tax? Can he withdraw the land from use? Will he destroy it and diminish its value?

The short answer is: why should he? - half a loaf is better than none. It would be cutting off his nose to spite his face were he to withdraw the land from production. He would get absolutely nothing from it by doing so and would still be left with the obligation of paying the land tax (effectively a rent charge to the State).

If a landholder cannot sensibly avoid the tax by not letting the land be used or by not using it himself, can he avoid the tax by selling the land? In one sense yes, obviously, he will no longer be liable for the land tax. However, the tax will be taken into account by the buyer and the buyer will pay \$7143 reflecting the annual amount of net rent after allowing for the amount of rent taken by the government, instead of \$10,000 which would be the market price if the land were untaxed. In short, the landholder cannot avoid the economic burden of the tax. The buyer buys the land "free of tax" because he can allow for the tax. In that sense a land value tax is a perfect tax because it does not discourage land being put to best use. On

the contrary, it penalises a lazy landholder who withhold land from use and simply sit on the land, speculating on a rise in value from no effort of his own. In that sense, a land value tax is better than a “neutral” tax – it removes impediments to production.

There is a great deal of literature on taxation and land value taxation, much of which is surveyed in the author’s *Taxation: The Lost History* but all one needs to know is what everyone already knows from common observation.

Land, labour and capital behave differently in response to taxation. Land is unique in that it cannot be hidden, taken away, or left to rust away. The landholder can effectively do nothing to avoid a land value tax. That is because fundamentally a land value tax is not a tax at all – it is really a re-assertion of the underlying ownership of its territorial lands by the State demanding a return from the lands which it allows to be used exclusively by private landholders.

What happens when a land value tax replaces other taxes?

So far, we have talked about taxes in isolation as if we were starting from scratch with a blank sheet of paper. In the real world of tax reform, there are existing taxes.

This naturally raises the question of what happens when you abolish some taxes and make up the public revenue from a land value tax?

The answer is that you actually do get a “free lunch”. If you take taxes off labour and capital, the supply of labour and capital increases. Their willingness to engage in production in return for their now higher after-tax returns increases. That increased willingness to produce leads to a greater demand for the natural resources needed for production, thereby increasing the underlying economic demand for land.

You therefore get what Prof Martin Feldstein described as a surprising economic result. A tax on land values can actually increase the underlying demand for land and increase its total economic value. A similar thing was observed by Alfred Marshall in his *Principles of Economics* many years ago, when he commented on “beneficial” versus “onerous” rates on land values. The idea is simple. If a group of landholders are made to pay a rate on their land values by a government or province in order to build or maintain a highway or build canals for flood control, the benefits of that infrastructure will lead to an increase in the rents of the lands serviced by the infrastructure which have been made more productive by the infrastructure.

Financing public utility networks

For that reason, Australian land value rating was often used to pay for local services such as roads, electricity and water networks. The principle is of broader application and could equally apply to railroads, gas works and any other form of physical infrastructure which raises the productivity of land. Infrastructure literally means structures sunk into land. When capital is sunk into land improvements, be they canals, roads, gas, electricity or water networks or mobile phone tower networks, all these physical capital expenditures add value to the land serviced. Even lands not directly serviced by the infrastructure may benefit. If a road extension means that what used to be half day trip from a distant block of land walking to the nearest road to get to market becomes a one-hour trip, the value of that land is

enhanced. Even intangible services such as the provision of police forces or fire brigades add value to land. No one wants to live or build or keep his possessions in an area which is physically unsafe from theft or fire. This simple observation illustrates what economists describe as a beneficial externality. The benefit of the building of a network does not accrue just to the builder of the network or to the users of the infrastructure but also to the passive landholders. It is therefore appropriate, as well as efficient, for the fixed costs of creating and maintaining the infrastructure to be met by land rates on the value of the lands benefited by the infrastructure or services which add value to land. Provincial or municipal land rates may therefore be added to a national land rate to finance local, as well as national, public works.

Excess burden (deadweight loss)

It has long been understood that taxes may cause economic damage. There are extreme cases as when Arab taxes on date trees in Egypt led to peasants chopping down the trees. This is the concept of “excess burden” (deadweight loss). This loss occurs where a tax has the effect of not just taking money from the taxpayer but also leads to him behaving such a way as to reduce or destroy his economic output.

In extreme cases, a tax on labour or capital at very high rate may have an infinite deadweight loss: it may destroy the economic activity completely and provide no revenue to the State because the taxed activity ceases to exist. Famous examples of this include the notorious British window tax. The tax was imposed on windows as a sign of wealth. Homeowners boarded up windows depriving themselves of healthy light and the Inland Revenue of the tax.

Oppressive regulations can be seen as infinite taxes with massive excess burdens (deadweight losses). EU and OECD demands that offshore financial centres enforce so-called “business substance” rules or impose onerous reporting requirements may lead to many small offshore businesses closing up, depriving States such as Vanuatu of any economic benefit. This is exactly what such rules are designed to do, to pressure offshore financial centres to inflict economic losses on themselves so that business activity will be driven back to the EU. Whether it will, is uncertain, but one thing is certain. The EU will not compensate offshore financial centres for the losses it has pressured them to inflict on themselves by oppressive regulatory requirements.

Tax incidence and shifting of taxation

Most taxes are shifted. The person who is the apparent taxpayer does not pay the tax or some of it. Sometimes this is intended by the legislature. For example, it is intended that merchants who must pay value-added tax will shift the tax to their customers. While this may be the intention of the legislature, there is no guarantee that tax can always be shifted, as hoped or expected. For example, a value-added tax on food sold in supermarkets may lead to households growing more fruit and vegetables at home. In such case, shopkeepers will not be able to raise their prices by the full amount of the tax lest they lose too much trade. Effectively, consumer resistance shifts part of the tax back onto the profits accruing to the capital of the shopkeeper.

After a tax is introduced, a whole process of shifting and readjustment takes place in economic activity so that factors of production earn the same after-tax rates of return, which

will be less than the previous tax-free rate of return on their labour and capital. Some of the costs of this adjustment will be “once for all” as systems are put in place or businesses restructured. That is why it is sometimes said that “an old tax is a good tax”. People have had a chance to adapt to it and to learn to live with it, just as a body attacked by a virus can learn to live with it after the initial shock. As Adam Smith remarked, the natural vigour of most economic societies is strong enough to withstand more misguided taxes and regulations than one might reasonably expect, like a strong and vigorous body.

However, it is only a partial truth that “an old tax is a good tax”. If the tax creates an ongoing distortion in economic choices, it continues to inflict economic damage. All shifting of taxes necessarily creates inefficiencies. Deadweight loss or excess burden is the necessary result of tax shifting and tax readjustment by businesses and consumers. To say that an economic system continues to function after the introduction of a tax and therefore the distortions introduced by the tax are not so bad is rather like saying the administration of a drug has only left a man crippled instead of killing him.

Tax shifting might be described as the “economic avoidance” of taxation. To illustrate, consider a small island economy such as Kiribati where most of the income tax payers are public servants employed by the government plus a few merchants while the rest of the population is largely engaged in subsistence agriculture or fishing. If income tax is increased on their wages, one might expect that, in due course, pay rises will be sought by the public servants. The public servants may avoid much of the tax by passing it back to the government as the employer. It would be more efficient to simply abolish the income tax, reduce public servants’ wages accordingly, and just collect a rent charge from the merchants on the value of the lands they use, as this will reflect the profitability of their businesses.

Another example of economic avoidance occurs when, for example, a doctor faced with an increased tax burden, say a 15% tax on his income, decides to put up his fees and work four days a week instead of five. His real contribution to the economy is reduced by 20% but if he puts his fees up by 10% and is able to pass that on to his patients or the hospital which employs him, then his income declines by 12%, (110% wage rate on 80% of former work hours is 88% of his former income of 100% wages on 100% work hours). The government may collect tax of 13.2 units on 88% of his former income (15% tax on 88% of former income) but the community suffers a loss of 20% of his contribution. The 20% reduction of his economic contribution is a pure deadweight loss. It represents no gain to the doctor or the government but represents a loss of 20% of his former labour to the community whose health may suffer. It is gone and lost for ever. It is called deadweight loss or excess burden of taxation because it is a cost inflicted by taxation which is a pure loss and no gain to the government or to any other person. In this case the amount of tax collected by the government is 13.2 units but the lost output is 20 units.

The lost output of 20 units divided by the 13.2 units of tax revenue collected represents a deadweight loss of 152% of the tax revenue actually collected. For every 100 Vatu collected as income tax the community has lost 152 Vatu.

Economic avoidance of taxation by tax shifting and reduction of supply of labour or capital to the economy is extremely damaging to the economic prosperity of a country. Tax shifting or economic avoidance of taxation is only possible where the taxpayer is able to change his behaviour and refuse to supply labour or capital as a reaction to a decline in his net earnings caused by taxation.

This leads us to observe a second principle of taxation, namely, that if the taxpayer can do anything to shift the tax, there will be invariably more or less deadweight loss. The very process of readjustment in response to a tax means that output is not what it could have been.

Principle Two

The imposition of any tax or burden on a factor of production which is not in fixed supply, such as labour or capital, will trigger supply or pricing readjustments which will result in deadweight loss. That is, there will be an excess burden to the economy in lost output over and above the revenue collected by the government.

Because the rent of land, and therefore its value, depends upon the demand for land, and that demand is determined by the willingness of labour and capital to bid for the use of land production, anything that either reduces or makes more costly the supply of labour or capital, will reduce the rent of land.

This leads to another principle of taxation, first put forward by English political philosopher John Locke.

Principle Three

All taxes come out of rent, in the sense that all taxes diminish rent and land values. However, if the tax is not directly levied upon rental land values, it will not only lead to reduced rents, but also create deadweight loss by diminishing the supply of labour and capital.

One can see how this occurs through a simple thought experiment. Consider two islands located next to each other where both islands have identical resources and people the same skills, capital et cetera.

Suppose one island imposes a 20% tax on wages and profits of capital but no tax on rent or land values. Suppose the other island seeks to raise the same revenue by just taxing land values. People will cross to the other island, take their business there, paradoxically increasing land values of the second island, the one which is taxing land values, while the island which is taxing its labour and capital instead of land values will see them emigrate and the value of its lands fall to nothing because nobody wants to live and work there.

This is of course a very simple thought experiment. However, one can see real-life examples of this happening. For example, when Australia had State-based financial institutions duties but Queensland did not have them, banks started to shift their processing activities to Brisbane, the capital of Queensland. They have ceased to rent land in Sydney or Melbourne or pay workers there and created jobs and increased land values in Brisbane. Vanuatu is only too well aware that, in the Pacific, there is competition between itself and places such as Samoa, the Cook Islands and others to attract business.

Tax avoidance and evasion

Tax avoidance and evasion are other examples of behavioural readjustments by taxpayers in response to a tax.

Tax shifting and tax readjustment of the behaviour of businesses and consumers is “economic avoidance” of taxation by changing economic behaviour. Businesses and consumers may also attempt to cope with or resist taxation by avoiding taxation legally or evading taxation illegally.

In contrast to “economic avoidance” of taxation by alteration of real economic output, some taxpayers may engage in “legal avoidance” of tax to minimize the economic impact and protect the net earnings of their labour or capital. For example, a doctor may employ his wife as a nurse or receptionist and split his income with her to get a reduced tax rate. If he can so reduce the burden of taxation upon the earnings available from his labour to support his family, he may not reduce his hours by a full day of week. If by splitting his income and avoiding tax, he reduces his tax burden but continues to work more as before, then the economic damage done by the tax in the form of deadweight loss to the community is less.

Legal tax avoidance may paradoxically help the economy by limiting the deadweight loss which would otherwise be caused by taxation through withdrawal of labour or capital from active production in the economy. Like a body fighting an infection with a fever to neutralise bacteria, tax avoidance is not desirable but may be less undesirable than activities being entirely killed off. The loss of revenue from the doctor rearranging his affairs legally to reduce his tax may more than compensated for by the continued productivity and well-being of his healthier patients.

Simplistic calculations by OECD and other Revenue authorities of “losses” from tax avoidance cannot - and do not - attempt to measure total economic costs and benefits of taxation. It is very difficult to do so. Nonetheless, ignoring the mitigating benefit of legal tax avoidance in preventing deadweight loss to the economy means official reports on “losses” from tax avoidance are often grossly misleading and deceptive. It is not intellectually honest to use the excuse of an inability to quantify the full adverse implications of a tax to ignore inconvenient questions about the wisdom of a proposed tax policy, such as the introduction of an income tax or business turnover tax, and the deadweight costs such taxes may create to everyone’s detriment.

Legal avoidance of taxation consists of finding loopholes in the taxing laws which enable a business to do what it wanted to do first place without paying so much tax. Although often denounced, especially by the OECD tax administrators, there is nothing morally or legally wrong, by definition, with tax avoidance. No man is obliged to stand in front of a firing squad if he can step out of the way. If lawyers can find a way for business to operate pretty much as usual, they may in fact be doing the economy and the government a service by keeping some economic activities going which would otherwise be abandoned together with deadweight loss to the whole community.

This was why the late Professor Wheatcroft remarked that “a tax system breathes through its loopholes.” For example, virtually every legislature has found it necessary to provide loopholes for capital gains taxes. If capital gains taxes are imposed on every large transaction, many workers will not move homes to go and work where they are needed and

many businesses will never be sold or restructured, even if the assets be put to better use by a new owner. That is why most tax systems provide exemptions from capital gains tax on sales of homes or business reorganisations – to mitigate the economic damage otherwise necessarily caused by the tax. The obvious question, namely, “Why bother to introduce a tax which is necessarily so damaging you have to provide exemptions from it?” is rarely asked and so-called tax experts from international organisations continue to tell other countries to imitate the follies of their own OECD tax systems by copying OECD tax legislation.

Tax evasion

Some taxpayers cannot or will not look for legal ways of minimising or avoiding tax and resort to self-help through tax evasion. It is a fact of life that most taxpayers do not like paying tax and, if they cannot legally avoid the tax, some taxpayers will engage in tax evasion to a greater or lesser degree. Indeed, it has sometimes been said that tax evasion is the poor man’s tax avoidance.

As Vanuatu is well aware, reluctant taxpayers from the European Union or other countries may rather like an income tax-free jurisdiction such as Vanuatu and not feel particularly inclined to tell their OECD or other tax authorities about their assets in offshore centres. It should be obvious, and it is a rule of international law, that no sovereign State has a moral or legal obligation to assist another sovereign State in the collection of taxes. There is no morality about taxation law. As British judges have remarked “there is no equity about a tax”. Taxes are not creatures of common law or equity. They are not mandated by natural law but by a country’s particular laws. If you do not levy an income tax, why should you assist another country collect its income taxes, especially if it is claiming tax on income generated within your country? You are only helping another country destroy your economy.

Unfortunately, as Adam Smith pointed out, bad taxes which incite evasion, such as the very heavy British customs duties of the 18th century, encourage otherwise law abiding men to become the most hardened of criminals. They lead to an attitude of contempt for the law generally and corrupt public morals. Tax evasion is more dangerous than tax avoidance since those who are seeking reduce or eliminate their taxes within the law are “playing by the rules” and not undermining respect for the laws.

Land value taxation, avoidance and evasion

A land value charge, rate or tax is uniquely immune to avoidance or evasion. A landholder cannot avoid a land charge, such as land tax or rate on its market value. The land rate can be easily made a legally enforceable charge upon the land. If the registered landholder fails to pay it, the land can be put up for sale to discharge the tax debt. The purchaser will pay the tax debt to get the property transferred and will adjust the price he pays to the former landholder to allow for future land rates or taxes. The landholder can neither shift the tax nor avoid it.

As for evasion, how can a landholder evade the land charge? He cannot hide the land, he cannot say he does not own the land. If he does, the State can simply claim it as vacant and transfer it to another landholder willing to pay for it and to pay the land taxes or rates. If the landholder tries to put the land in another name, it does him no good: that person must pay the land tax or rate or he, too, will forfeit the land. A worker may control the amount of labour he

is willing to supply or work for cash and hide his income; an owner of capital may conceal his earnings or invest his money elsewhere - but a landholder has nowhere to hide or move his land.

Ease of administration

Of all taxes, a tax on land values is one of the easiest to implement. The starting point is a geographical map where all land parcels are plotted. From this can be constructed a land registry, which exists already in many countries. The only real work involved is in finding and updating the land values of each parcel, ignoring all structures or other human improvements having any remaining usefulness. This is not particularly difficult, because real estate sales, especially sales of vacant land or land where structures are being demolished and replaced provide good benchmark values which can be used to extrapolate per square metre valuations to other sites. It is also possible to allow landholders to self-assess their land values but on condition that they can be bought out by the State at their own declared valuations with compensation for any improvements as determined by a Court of arbitration. Neither Australian nor New Zealand have experienced much difficulty in administering land value charges or rates or determining valuations.

Licensing for public revenue

Licensing is sometimes used as a source of government revenue. There are four sorts of licenses.

1. Licences to use scarce natural resources
2. Licences to ensure that those who practice an occupation are qualified
3. Licences to regulate a perceived but tolerated social evil, such as gambling, drinking or prostitution
4. Licences to establish a monopoly, for example patents, for private or public revenue

The first type of license is really a form of rent collection. If a natural resource, such as a fishery or the electromagnetic spectrum, is limited by nature then a licence is really an exclusive right to use land in the economic sense. Any licence fee is really a form of rent collection and the value of any such resource should be included in a land value tax. If a natural resource is not limited, e.g. the air we breathe, then there is no rent naturally arising. Sometimes a resource which was not limited becomes limited. For example, a river might be able to cope with so many tons of waste being washed into it from a few small farms but not able to cope with the amount of waste from lots of large farms if it is to remain suitable for other uses such as drinking or fishing. In these cases licensing has to be imposed to protect the value of the resource for everybody by collecting a rent through a licensing system to prevent degradation of the resource from over-use.

The second form of licensing, occupational licensing, for example, of doctors or lawyers, is designed to protect the public from unscrupulous, dishonest or incompetent practitioners. Such licensing should *never* be used for revenue or to limit the number of practitioners. Anyone who qualifies as a fit and proper person should be entitled *as of right* to get a licence. The only licensing charge made should be simply to cover the costs of administration.

Anything in excess of this is fundamentally a tax on the supply of the restricted service - which will be passed on to consumers, reducing their real incomes.

The starting principle should be any person should be entitled to practice any trade and it is the job of the purchaser to check the supplier's competence or credentials. Consenting adults should be free to make their own lawful choices. In reality, of course, such freedom can be, and has been, abused. The job of occupational licensing is then to *do no more than is absolutely required* to protect the public from serious injury.

To do more can be injurious to the public. For example, drug and medical licensing can be, and has been, used to create monopoly cartels which can exploit the consumer. Over restrictive occupational licensing in some OECD countries has gone so far in some cases that developing countries have been able to find a niche market. For example, Australians sometimes have cosmetic dentistry done in Thailand because Australian occupational restrictions have reduced the supply and raised the price of cosmetic dentistry in Australia. Similarly, some medical treatments available in other countries are not available in Australia because doctors fear being struck off if they adopt new treatments which are not officially approved. Such restrictions are not to the benefit of patients but to their detriment and limited medical innovation. Thus, Mexico has some clinics which provide experimental or innovative medical treatments which are not necessarily wrong but rare - because they have not been tested in mass trials. Every new medical treatment has to start somewhere. Again, over-restrictive regulation in OECD countries could create a market in Vanuatu for what is described as medical tourism where innovative or semi-experimental treatments can be tried without innovation being restricted by undue fears of litigation. In short, occupational licensing should not do more than is necessary to let informed adults make their own choices. Anything else creates monopoly profits.

The third form of licensing related to "sin taxes" is designed to limit or control what is seen as either a social evil in itself or an activity which may be indulged in too freely for the health of the public. Thus, alcohol and tobacco have often been licensed in many countries. In these cases, governments are faced with a dilemma - if alcohol and tobacco are so bad, why not prohibit them absolutely? The experience of the United States during Prohibition shows why not.

Economists generally say that it is better to license and tax such activities to recover the costs of regulation and the costs of making good the social damage, the costs being thereby charged against the sale of the products. There is merit in this argument but it can be pushed too far. Why should a moderate drinker be taxed to pay for violent drunkards? In Australia, the taxes raised from tobacco exceed the costs of medical treatment provided by government for tobacco related diseases. Further, very high tobacco taxes do encourage illegal production and underground sale. Furthermore, there are some drugs which one might never consider licensing, such as heroin or cocaine. The arguments for these forms of licensing should not be made in such ways as to treat the underlying activities as routine sources of public revenue. Rather, they should be based on what works best to limit or eliminate abuse or usage. By definition, no government should ever become dependent for revenue from an activity it really wants to see suppressed.

The fourth type of licensing really relates to the creation of an artificial monopoly by statute. The law prohibits an otherwise lawful activity and then gives permission to a particular person by way of a licence to undertake that activity to the exclusion of others. The creation

of monopolies was the subject of great abuse in Elizabethan England and the public reaction led to the Statute of Monopolies and Queen Elizabeth's "Golden Speech" in which she apologised to the Parliament for the abuses of the patents of monopoly which she had granted.

Fundamentally, where natural monopoly exists, the State should collect the rent. Where the monopoly is not a natural monopoly but something created by an Act of Parliament it should be abolished so that no one is restricted in exercising his talents for the benefit of the community.

User charges as quasi-taxes

Before leaving the subject of monopoly, one should sound a note of warning against the abuse of user charges to raise public revenue. Since the 1980s many Western countries have privatised or corporatised natural monopolies such as water supply, electricity and gas networks and toll roads.

While payments by users of these networks are not shown as taxes and are not formally taxes in legal terms, they can be seen in economic terms as a form of privatised taxation similar in effect to the farming out of taxes practised in France before the Revolution.

This is a large subject and the literature can be traced back to the French engineer Jules Dupuit in 1844 with major contributions by Professors Harold Hotelling and William Vickrey. Some of the issues can perhaps be best illustrated by a simple example. Suppose the landholders of a region have contributed by way of rates on their lands to build a dam and a water supply system. The capital costs of the infrastructure have all been met and paid for long ago. Water users, both consumers and industry, are only charged the operating costs to maintain the system and purify the water delivered.

Suppose the Treasury now decides to privatise the water system and sell it on the stock market. The Treasury estimates the replacement cost of the system at x billion dollars. The terms of the sale permit the purchaser of the water system to charge a price which gives the "investor" a rate of return of 10% on the "investment" of x billion dollars.

The result is that water users now have to pay again to get the benefit of the dam they have already paid for. The purchasing company is actually investing nothing in terms of creating new productive physical capital: rather than creating a new dam, the purchasing company is buying a dam and water supply system already built and paid for while the water users now have their water prices greatly increased to give an income to the stock market investors in the company who have paid a large amount of money to the Treasury for the privilege of charging the public higher prices for the water supply built and paid for long ago. In truth, there has been no new investment, merely the sale of a monopoly with a licence to exploit it.

The situation just described is a fair description of what has essentially happened with the water supply systems of London and Sydney. Dirty privatisations or corporatisations have effectively been disguised indirect tax schemes, whereby large lump sums are paid upfront to public treasuries in return for letting private companies impose higher user charges on the public for essential services than what are either economically necessary or warranted.

Needless to say, a developing country such as Vanuatu should not follow such pernicious examples. One of the reasons manufacturing industry has left countries such as Australia has been the steady rise of input costs in the form of energy, water and transport costs. The last thing any country should do is permit user charges for essential infrastructure be abused as quasi-taxing systems.

PART II

From Principles to Practice

Like any self-respecting nation, the people and the Republic of Vanuatu do not wish to be dictated to, or under any obligation to foreign powers, other than as freely decided to be in the national interest. To be independent means being financially self-sufficient and not reliant on grants or subsidies from other countries.

The superiority of a land value tax against guiding principles

The Report of the 2017 Revenue Review in its first chapter set out what it regarded as guiding principles for a good revenue system. The Terms of Reference for the 2020 Revenue Governance Committee repeated much the same principles which are as follows:

- Equity and Fairness
- Certainty
- Convenience of Payment
- Economy of Collection
- Simplicity
- Neutrality
- Economic Growth and Efficiency
- Transparency and Visibility
- Minimum Tax Gap
- Appropriate Government Revenues

Some comment now needs to be made on those principles, the extent to which they are valid and, if so, the extent to which a land value tax satisfies those principles better than any alternative.

In particular, this author would place a high premium on another guiding principle which needs to be always remembered above all: -

- Justice

Is a proposed revenue raising measure consistent with normal legal principles and the dictum, going back beyond the Code of Justinian, Cicero and Plato and recognised in every human society that “Justice consists of rendering unto each his due?”

Equity and Fairness

Many economic discussions of equity and fairness conflict with basic principles of law and justice. Economists commonly talk about equity and fairness in terms of increasingly higher taxation of higher incomes. Many take it for granted, without rational examination, that it is “fair” for somebody with twice as much income as someone else to pay more than twice as much tax.

To make such an assumption is to beg or avoid the question of defining “fairness”. It is to assume the answer before enquiry. Why is it fair to tax income? Why is it fair to have a rising tax rate as income rises? If it is, why does it stop at less than 100%?

Defining “fairness” as requiring a graduated tax on incomes confuses fairness in terms of equality of outcome with fairness in terms of equality of opportunity.

The obvious question which even a child will see is - why should it be fair to tax a man more who has worked twice as hard as his neighbour? If he has fairly earned his income, why should the law, on the one hand, say “It is his” and, on the other hand, take any of it away? And why more from any man than another? Free men are not slaves: their labour and its fruits are not the property of government. On the contrary, they are citizens to whom the government owes a duty to protect in their rights to enjoy what they have produced.

Sometimes it is said, as with Oliver Wendell Holmes, the American Judge, that taxation is the price we pay for a civilised society or, to put it another way, we part with some of our money to be protected in the rest. This might be seen as the “insurance premium theory” of taxation. But, if it were true, then what is the justification for charging one man $x\%$ of his income or wealth and another with double more than twice $x\%$ or for exempting anyone with a small income or wealth?

Fairness is often misunderstood. The obligation to contribute to the public revenue should reflect the benefits a person receives from the State. The landholder is protected by the law of the State in the exclusive enjoyment of a natural resource which fundamentally belongs to the nation. Other citizens are excluded for his benefit. It is reasonable to expect him to contribute to the common expenses in proportion to that benefit. Adam Smith likened the government of the great nation to the management of a large estate where each of the tenants contributes, in proportion to his interest in the estate, to a common fund to meet the common expenses of the estate. As Adam Smith observed, the value of a sovereign’s lands is largely attributable to his good government and it is therefore just that landholders contribute for those common expenses.

Rather than thinking of fairness in terms of equality of income or of wealth or of happiness or of anything else, the truest test of fairness is equality of opportunity. Given that land resources are naturally limited, it is fair for governments to insist that those citizens who are confirmed in their right to use natural resources to the exclusion of their fellow citizens pay a contribution, based on the value of those resources enjoyed by them, towards the common expenses of the State.

Certainty

Nothing could be more simple, certain or convenient than the collection of a land tax or rate. The real estate market from day-to-day provides information which enables land values to be ascertained from year to year.

The land value tax or rate can be based on last year’s valuation which is updated each year. The amount to be paid is immediately certain.

Convenience of Payment

As for convenience, rather than collecting a large annual charge in a lump sum, it is easy to offer the landholder the option of paying by quarterly, monthly, fortnightly or weekly instalments, just like any other rent payment. Direct debits can be set up and used so that, like other regular payments, the land charge is paid routinely without fuss.

Economy of Collection

Income tax and value-added tax systems used in OECD and other countries impose enormous compliance obligations upon taxpayers and become increasingly onerous every year. Tax agencies not only force taxpayers to fill in forms and declare their incomes, turnovers et cetera but they then take it upon themselves to harass taxpayers through tax audits, backed by horrendous penalties of 100% or more for any shortfall. The burden of proving that the tax assessment is excessive is usually placed upon the taxpayer, who then has to incur accounting, auditing and legal costs to defend himself in a Tribunal or Court. These “vexatious inquisitions”, as Adam Smith called them, are now being extended by OECD countries (through threats against small countries such as Vanuatu) to the affairs of taxpayers in other countries. OECD countries have since the 1980s enacted increasingly severe legislation requiring more and more compliance resources be devoted by both taxpayers and their national tax offices to information gathering from third countries. Vanuatu is only too well aware of the costs being inflicted upon itself and its own business community by the unwarranted demands of OECD and other countries trying to enforce their fundamentally flawed tax systems outside their own borders.

By contrast, if Vanuatu raises revenue simply from land taxes and rates, it needs no international cooperation to enforce compliance with Vanuatu law, it has no need to harass its own people, businesses, or foreign investors. The government can simply collect its land revenues and leave people free to get on with their lives and their businesses to their own satisfaction without any of the odious obligations imposed by OECD countries on their poor unfortunate citizens. Freedom from burdensome compliance obligations could be a major attraction for investors coming to do business in Vanuatu.

In terms of economy of collection, both for citizens and revenue collectors, and achieving the lowest possible cost of collection, a land value charge is trivially easy compared to an income tax or a value-added tax or a turnover tax. A State just needs to have a record of its natural resources. Land titles (for all natural resources) have to be issued and recorded in a public land register of natural resources. If the State is leasing land, it needs to keep records in such a register in any case. A system of land registration and valuation makes land use planning and public infrastructure provision much easier.

The cost of collecting a land value charge is minimal. Each year, an annual assessment may be issued to the landholder at the registered address of the landholder and it can be made payable in monthly or fortnightly instalments, including by direct bank transfer.

If the landholder defaults in paying, it is easy to have a process of serving notice so that if the tax is not paid within a given time, the outstanding land value taxes will be paid by selling the land at public auction to the highest bidder, with compensation to be paid for improvements as agreed or fixed by a Court of Arbitration in which each side bears its own costs.

Simplicity

There is no need for any process of disclosure by the taxpayer of his income or private wealth. There is no need to audit his bank accounts or his books of account or ever investigate the taxpayer's affairs. His privacy is completely respected and, indeed, there is no need to require the taxpayer to keep any records or books of account. The land rate is assessed on publicly available information as to the value of his lands which can be seen by anyone who looks at the land register.

Neutrality

This is an extremely important guiding requirement. By neutrality is meant that the tax should not distort economic choices – it should be economically efficient. When it comes to neutrality, a land value tax or rate is unique. It is the *only* neutral, non-distorting, tax which can exist. All other taxes are necessarily distorting because they are imposed on the returns to the active factors of production, namely the wages of labour or the profits of capital. When the returns to work or capital investment are reduced, it is inevitable that the supply of each will diminish or cost more. As noted in Principle Two, such reactions inevitably cause deadweight loss.

A land value tax of $x\%$ of the value, regardless of use or non-use, is superior to every other form of taxation in this respect.

Economic Growth and Efficiency

In terms of supporting economic growth, efficiency and higher living standards, a land value tax or rate is clearly superior to any alternative. By not taxing labour or capital, it removes disincentives to productive activity. By ensuring landholders must pay a rate or charge to the State for the use of land, a land value tax or rate discourages squatting or neglect of land and encourages landholders to put land to good use to generate income from the land being made productive. The market mechanism of assessing land value means that, if other people think land can be put to better use, their views will show up in valuations and push the existing landholder to think about putting the land to better use as his land rates rise with higher valuations.

By contrast, every other tax lowers the return to human effort or ingenuity, discourages trade, the creation of productive physical capital, the acquisition of skills and the specialisation which makes economic progress possible.

Transparency and Visibility

Other taxes, such as an income tax or a turnover tax, require prying into the private affairs of taxpayers. The details of such taxes can never be made a matter of public disclosure, save in litigation. Private businesses and companies cannot have their business affairs in the public domain for perfectly valid reasons. First of all, they are private not public affairs. Second, the disclosure of private commercial activities can seriously damage the competitive position and

businesses of private companies. Third, the public disclosure of the income and wealth of individuals can expose them and their families to threats and unwanted public attention. Most income tax systems and taxes on wealth therefore require that the affairs of taxpayers are secret and not to be disclosed.

One of the inherent difficulties of income tax systems or wealth tax systems where such privacy and secrecy requirements are necessarily imposed is that any corruption will never be visible.

By contrast, the amount of tax payable on the value of a block of land can be easily ascertained from the land register. Land is a public asset and its value and public revenue contribution a matter of public knowledge, as much as the rent being charged for office space in a city or town.

Minimum Tax Gap

The concept of the “tax gap” is the supposed lack of tax revenue from non-compliance. Clearly, an income or wealth tax system which relies on voluntary compliance or compliance induced by fear of penalties, is heavily dependent upon that compliance. If tax rates are high or people think the chances of penalties are remote, compliance may decline and a gap may emerge between what tax is theoretically legally due and what tax is actually paid.

By contrast, no tax gap can emerge with a land value tax or rating system. The amount of tax is visible to all. No voluntary compliance is required by way of private disclosure to tax collectors. It is all a matter of public record. The only way a tax gap can emerge is not from any failure to disclose by taxpayers but rather failure by the revenue office to issue and collect assessments. In short, no tax should ever exist, if public officials are doing their duty and collecting the land value assessments.

There is nothing a landholder can do other than comply by paying the land value tax or rate. He cannot hide the land. He cannot conceal its value. He cannot hide behind someone else being registered as the landholder. If the tax or rate charge on the land is not paid, he is thrown off the land by the State, just as any tenant who does not pay rent is thrown out of the tenancy. In effect, as John Stuart Mill observed, a land value tax or a tax on rent is really just the State asserting its right to rent as the paramount and ultimate landowner in the nation.

Appropriate Government revenues

The requirement of “appropriate” government revenues is vague. Clearly, no tax system can finance buying the Moon. Governments, like everyone else, are constrained by what they can collect as income. What is relevant is whether a land value taxes or rates can raise as much revenue as any other contender.

In that regard, statistics are often hard to come by, since most national statistical offices do not attempt to compute land revenues in any systematic way. It is however worth noting that Australian land values have been estimated to be such that leaving a rate upon them could finance abolition of many taxes and large reductions in others. Even casual studies of land values indicate that they are a very large proportion of national wealth.

The revenue system must meet the needs of the Vanuatu community.

Vanuatu, like many other Pacific nations, has a large part of the community which engages in subsistence fishing and agriculture. Traditional lifestyles should not be interfered with by oppressive taxation. In some African colonies in the past, colonial administrators, under the influence of economists, thought that imposing head taxes (so many pounds sterling per person per year) upon native inhabitants would force them not to subsist on reservations of tribal lands but to go and work in mines, factories and farms and contribute to gross domestic product and “development”. Just like the IMF and World Bank today, these colonial administrators and economists confused true actual output with measured monetary output. That is a gross fallacy. Why should it be part of Vanuatu’s GDP if a tourist pays hundreds of dollars to sit on a beach and fish but not part of GDP if a ni-Vanuatu does so on his customary lands without paying anyone?

A tax system should not discriminate for - or against - subsistence agriculture or traditional lifestyles. It should not force people off their lands into urban slums. A land value tax need only charge a land rate upon the value of alienated or commercially used lands, such as urban land or commercial agricultural plantations. There is no need to impose a land value charge on communal or customary land which is available to all members of the group for common use. Such communal or customary lands perform a valuable service by ensuring that every member of the Vanuatu community can always provide a subsistence for himself and not become a charge upon the State or a beggar or member of a lawless dispossessed proletariat living in slums. Port Moresby is not an example to follow.

This is in fact a great economic advantage of many Pacific islands: communal land tenure systems provide a natural social security safety net so that taxes do not have to be imposed in order to keep people from destitution. To the extent that lands are alienated away from communal use for individual commercial use it is appropriate that the exclusive users of those lands make a contribution to the common Treasury in return for the exclusive landholding rights granted by the Republic.

Just as no tax system should discriminate against non-market activity, a tax system should equally not discriminate against market activity. By contrast, an income tax or a business tax discriminates against market activity by labour and punishes those who wish to gain employable skills or to set up businesses to provide goods and services in the market economy. Vanuatu needs people who wish to develop modern skilled occupations to supply the goods and services its people needs. It needs professionals, tradesmen et cetera ranging the whole gamut of modern activity. People developing such skills should not be discouraged by taxation.

Compatibility of land value rating with Vanuatu Constitution and custom

Section 5 of the Constitution includes as fundamental rights and freedoms of the individual –

(1)

(b) liberty;

.....

(d) protection of the law;

(e) freedom from inhuman treatment and forced labour;

.....

(j) protection for the privacy of the home and other property and from unjust deprivation of property;

(k) equal treatment under the law

An income tax taking a part of the earnings of a person's labour may be seen as depriving him of what he has lawfully acquired by his labour and if it forces him to work more to achieve what he needs, may even be seen as a form of forced labour. In contrast, a land value rate can be seen as merely asking a person who enjoys a privilege from the State for the exclusive use of its resources to contribute to the upkeep of the State in meeting the common expenses. A graduated income tax system which increases the rate of tax as income increases seems to violate the concept of "equal treatment under the law".

There is a fundamental paradox in "modern" Western legal systems. On the one hand, the law declares a person's right to the earnings of his labour and punishes another man for stealing those earnings from him; on the other hand, OECD countries routinely authorise tax authorities to take part of his earnings from the person. By basing its revenue system on the rating of the value of alienated or commercially used lands, the Republic of Vanuatu can avoid this paradox by having a revenue system where the contribution is proportional to the benefit conferred by the Republic in securing a person's use of alienated land to the exclusion of his fellows.

In terms of fundamental duties of citizens set out in section 7 of the Constitution, it is provided that every person "has a duty –

.....

(d) to protect the Republic of Vanuatu and to safeguard the national wealth, resources and environment in the interests of the present generation and of future generations;

(e) to work according to his talents in socially useful employment and, if necessary, to create for himself legitimate opportunities for such employment;

A land value tax or rate works helps prevent the natural resource wealth of the Republic from being locked up forever in the hands of a few private individuals to the exclusion of the descendants of people. The landholder is constantly being nudged by the obligation to pay a fair charge for the use of land, based on its value, to ensure that the land is being put to good use or to sell it to someone else who is willing to put it to good use.

By contrast, an income tax or a business tax or a turnover tax punishes a person for creating

socially useful employment for himself and others. A land value tax or rate in no way adversely affects employment or business activity.

Avoiding the creation of monopolies, including patent monopolies, is in keeping with the principles set out in section 7 of the Constitution of Vanuatu declaring that every person is entitled to exercise his talents.

In practice, the ability of Vanuatu to abolish monopolies or limit copyrights is restricted by the World Trade Organisation treaties and so-called trade-related intellectual property protection. However, this need not restrict Vanuatu from doing the next best thing to abolishing legislated monopoly – taxing it. Nothing restricts Vanuatu from requiring companies, whether foreign or domestic, to declare the value of their patents protected by Vanuatu law and paying a tax of 10, 20 or 50% per annum on the declared value of the patent - with forfeiture to the State if the tax is not paid and the State having the right to buy the patent at the declared value. The OECD can hardly complain since the OECD has been urging tax authorities to act against profit shifting by use of patents and intellectual property.

Either way Vanuatu wins. Foreign companies either start paying for patent protection and the public revenue is increased or the patent is abandoned in which case businesses in Vanuatu can save on intellectual property costs and new businesses start up in Vanuatu, freely using the intellectual property that is now in the public domain. The delivery of services now made possible over the Internet means that even the smallest country can compete in the digital economy and anything which reduces the cost of doing business from Vanuatu will feed through into enhanced land values.

As an alternative, Vanuatu could reserve the right to exempt, from a tax on patent values, any company incorporated in a country which guarantees Vanuatu trade and financial services access to its markets. This could assist Vanuatu in negotiating a treaty with the United States which would protect the Vanuatu financial sector from EU or OECD sanctions. In short, Vanuatu could say “We will protect Silicon Valley technology companies and Hollywood studios if you ensure that no sanctions can be effectively imposed on our economy as regards financial services, tariffs or anything else”.

In terms of consistency with the provisions of the Constitution in chapter 12 relating to land, a land value rate which is applied to alienated or commercially used land but not to customary land, respects traditional usages and retains for the people of Vanuatu their “natural social security system”, namely, access to customary land to live on and support themselves regardless of their means. Section 76 of the Constitution expressly permits Republic to make different provision for different categories of land, including incidence of revenue raising such as a land value rate.

Section 79 of the Constitution is sensibly aimed at preventing the land inheritance of future generations from being sold off without any benefit to future generations. Land hunger and the greedy grabbing of land in new countries by Europeans in the 19th century meant that millions upon millions of acres of fertile land were grabbed by a fortunate few over a few generations, leaving less and less for those generations who followed. A system of land value rating makes sure that those who are given exclusive title to land are not allowed to sit up forever, free of rent, to the detriment of future descendants of themselves and others. Land value rating means that alienated land will always be contributing forever to the common expenses of the services necessary for all the people.

Revenue sharing between levels of government and public authorities

Section 82 of the Constitution wisely understands that government cannot be totally centralised and that functions should be carried out at the local level as much as possible.

A land value rating system across the whole country can be shared between the national government, provincial and public authorities.

Once a national land registry and valuation system has been established, it is a relatively easy task to allow each level of government and public utility authorities to set its own level of land rate for its own district and for its needed revenues. These rates and a Republic rate can be collected and distributed to each authority by a common collection agency.

Thus, a local road or electricity board in an area may wish to build a road or put in an electricity transmission line. It can set a rate to cover the cost over a period to repay any loans required and get the landholders to contribute through the same revenue collection agency as the national government. Each provincial or local authority can have its own autonomy in raising and spending its own money but, by doing it on a common base through a common authority, people are not subjected to multiple encounters with tax gatherers. In a country such as Vanuatu, economy and simplicity in reducing the number of civil servants required for tax collection is highly desirable. It is far better for a country to collect public revenue from one source competently and efficiently than to try to import a multitude of oppressive and ill administered income or business taxes from the uninspiring examples of so-called developed countries.

Conclusion

A government must draw its public revenue from the earnings of land, labour or capital. No matter how any tax or charge is described it must be paid out of the incomes of one or more of the above.

Economics dictates what is intuitive common sense. Tax what you can, not what you can't. Land alone does not diminish its supply in response to a taking of its earnings. The land cares not for who takes its rent. Efficiency therefore dictates that land should be the fundamental source of public revenue. This has been recognised in economic theory for over 200 years. For that reason, at the time when the Soviet Union was abandoning Communism, many extremely eminent economists advised Mr Gorbachev, in an open letter ([https://en.wikisource.org/wiki/Open_letter_to_Mikhail_Gorbachev_\(1990\)](https://en.wikisource.org/wiki/Open_letter_to_Mikhail_Gorbachev_(1990))) , not to privatise land but to retain the rent of land as a source of government revenue.

Law has always seen land as different to other things. No man made it. It is peculiarly the sovereign territory of a nation. For that reason, many nations have over the centuries seen land as the primary source of public revenue. The most recent examples are the Oil States. Every country is blessed with natural resources which have a value in return for which the sovereign can claim a revenue.

Equality and fairness dictate that all should have equal access to opportunities and to use of natural resources. It is unfair to tax a man on what he has produced: it is fair to demand a payment in return for superior advantage in terms of exclusive use of productive land ahead of his fellows.

Good government dictates that administrators should not interfere with people going about their lawful business, producing things, exchanging them and making each other prosperous. The collection of the revenue from land does not require a vast number of administrators nor the harassment of taxpayers. It can be done cleanly, simply and with no more fuss than a landlord collecting rent. Vanuatu can achieve great prosperity by having a simple robust revenue system which does not impede business and prosperity and can be self-funding by paying for the infrastructure and services which will add value to its lands.

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