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Solid ground: Adopting land value taxation in Vanuatu

This is a summary of a more detailed essay by Terence Dwyer. [Click here to read it]

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Collecting Vanuatu's public revenue through a land value rate would empower the most productive among us, and protect the most vulnerable, raising money more equitably.

Citizens of OECD member countries are accustomed to equating government revenue with taxation of their income and purchases, among other things. But what if this kind of taxation, while accepted as a necessary evil in the West, was actually an impediment to the well-being of a community? What if we could do better, and raise more revenue more fairly from all segments of society? This is not a far-fetched notion. Economists long ago came to the conclusion that the only fair and efficient means of filling the public purse is not by taxing labour or capital, but by taxing land.

The explanation requires a few steps back.

Over two centuries ago, when the underpinnings of modern economics were taking shape, people like the French Physiocrats and the British John Locke and Adam Smith postulated that the total value of everything produced in a country comes from the returns on three factors of production:

- **Land** (all natural resources including agricultural or mineral lands, fishing or water rights, the electromagnetic spectrum, etc.)
- **Labour** (mental or physical, skilled or unskilled)
- **Capital** (the physical man-made tools of production including equipment, buildings, any product used in the further production of other things)

All governments need revenue to provide the essential public services and infrastructure needed by a civilised community. What most developed countries do today is collect, via taxation, on the returns of ***all three*** factors of production: the rent of the land, the wages of labour, and the profits of capital.

What may come as a surprise except to some economists is that all forms of taxation – whether on income, value-added, turnover, licensing – have one shortcoming in common: they reduce the supply of labour and capital. This bears looking at in more detail.

Firstly, labour. If one deprives workers of a proportion of what they get from working, they might decide to work less, or try to pass the tax on to their employers or clients by demanding higher wages or fees. This may reduce the effective earnings of the employer or clients who can no longer so easily afford the worker's output. Taxing the wages of labour diminishes the supply of useful labour and therefore necessarily diminishes the national output of goods and services.

As for capital, assuming that people invest to the extent it is profitable to do so, once a tax on the profits from capital is introduced, investments with smaller margins of profitability will be abandoned. Workers employed in the affected businesses will lose their jobs, depressing wage levels, while the lack of capital will reduce the productivity of other workers. Any diminution in the profits of capital through taxation leads to a withdrawal of physical capital, through abandonment, non-repair, usage past obsolescence and non-replacement.

Where there's tax there's shift

People around the world are used to these forms of taxation, and they've been levied for a long time by many governments. But their widespread use doesn't necessarily mean they are an optimal solution for raising public revenue. Because of the distortions they introduce in economic activity, they inevitably inflict some damage on the economy in the form of deadweight loss or excess burden.

Here's how that happens: All taxes end up being shifted by businesses and consumers. After a tax is introduced, a whole process of readjustment takes place in economic activity so that the factors of production maximize after-tax rates of return, which will be less than the previous tax-free rate of return on labour and capital.

A lose-lose situation

For example, a doctor faced with an increased tax burden can decide to put up his fees and work fewer hours; his real contribution to the economy is reduced but his income declines less because his fees are higher. The government may collect tax on a portion of his former income but the community still suffers a loss of his contribution. This is a pure deadweight loss – a revenue loss to government and a value loss to the community.

This doctor may also engage in tax avoidance. Instead of altering his real economic output, he'll seek legal loopholes to reduce his tax burden while continuing to work as much as before. 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.

Others opt for illegal tax evasion, which turns otherwise law abiding individuals into criminals, and leads to an attitude of contempt for the law generally and corrupts public morals.

Land doesn't budge

If taxing the wages of labour or the profits of capital ends in economic damage, then what about taxing the rent of the land?

As the forefathers of economics noted long ago, labour and capital are put to production because of the voluntary actions of human beings. Only land exists and is available for use in production *independently* of our will. While there is no fixed or automatic supply of willing workers or investment in plant machinery, equipment and buildings, the supply of land is indeed fixed. Land is the only passive, immobile factor of production: it lies, waiting to be used.

Hence early economists realized that public revenue collected from the rent of land (we'll call it a "land value rate") was uniquely efficient and could not be shifted by the landholder through any actions of his own. Indeed, the theorem that a tax on land cannot be shifted was the first theorem ever postulated in economics and remains an oft-forgotten key to crafting equitable tax policy.

"Land value rate" is different from property taxes, which are based on the value of the land as well as the buildings and other property located on it. Property taxes can have perverse effects, as can be seen in cities around the world where abandoned buildings are left to deteriorate by landlords in order to minimize their tax bills while they speculate on a future purchase offer. Valuable land is left unused, an eyesore to the community, when it could be recycled into some other industrial or residential use.

By contrast, a land value rate is a portion of the value of the land alone, and disregards the value of buildings, personal property or other improvements to real estate. The value of the land is determined by demand, supported by factors such as amenities and location in cities, fertility in rural areas, quality of ore bodies in mineral fields, etc.

A land value rate is fundamentally a demand by the State for rent to be paid by landholders which represents value being given to them. In this way it's not really a tax, and so has none of the distorting effects of taxes on labour or capital.

It can even be said it has an incentive effect on landholders to put the land to best use. Whether they conduct business or farming activities, use the land for their homes, or let someone else use it for a fee, they have to pay the same land value rate to the State. If they don't do anything, or withdraw the land from production, they still are left with the obligation of paying the rate – or letting someone more motivated use or hold the land.

Barring tectonic activity, land stays put. As opposed to labour and capital, 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 rate, which makes it uniquely immune to shifting, avoidance or evasion.

If the landholder fails to pay the rate, the land can be put up for sale to discharge the outstanding land value rate (the purchaser will pay the debt to get the property transferred). If he pretends that he doesn't hold the land, the State can simply claim it as vacant and transfer it to another landholder willing to pay for it and to pay the land value rate. Either way, the land value rate gets collected in full.

Tax isn't everything

When a government imposes a land value rate, what it is really doing is reasserting its sovereign rights over its territory. It is demanding that merchants, manufacturers, miners, plantation owners and others who use its lands or live on them, and are given by the State the right to use them to the exclusion of their fellow citizens, should pay for the privilege.

Many societies have functioned on this model, with the sovereign or the State relying on these non-tax revenues to meet the public expenses. In feudal England, Lords were assigned land in exchange for paying the costs of running the kingdom; the phrase "real estate" originally seems to have come from "royal estate".

More recently, the fast-developing economies of the Middle East have collected land rents in the form of oil royalties and have been able to minimise reliance on income taxes. If the royalties on just one natural resource (oil alone) can fund a government, why cannot governments be funded from all the land rents of their sovereign territory?

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 essential public services do not exist and there is, for example, no law and order, wages and living standards collapse along with land values. 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 essential expenditures, in a virtuous circle of value addition. 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.

Benefits for all Ni-Vanuatu

A land value rate would have benefits for all members of the Vanuatu community, by providing both an incentive for production and a social safety net.

Instead of being locked up forever in the hands of a few individuals and their descendants, the natural resource wealth of the Republic would be held by those willing to put it to good use. They would be constantly nudged by the obligation to pay a fair charge for the use of land, based on its value, thus encouraged to use it, or sell it to someone else who is willing to do so.

However, the rate would only apply to alienated or commercially used lands, such as urban land or commercial plantations, and would spare communal and customary lands which are available to everyone for common use. Many Ni-Vanuatu engage in subsistence fishing or agriculture, and communal land tenure ensures that every member of the community can always provide for himself and not become a charge upon the State. A revenue system should not force people off their lands into urban slums (see Port Moresby for a sad example). Only the exclusive users of lands that are alienated away from communal use would be asked to make a contribution to the common treasury in return for their landholding rights.

Not only is the implementation of a land value rate compatible with the Constitution of the Republic of Vanuatu, it would meet all "guiding principles" set out in the 2017 Revenue Review and in the Terms of Reference for the 2020 Revenue Governance Committee:

- 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

Easy to implement

A land value rate is much easier to collect than taxes. The starting point is to build a registry of all land parcels, then to find and regularly update their individual values, ignoring all structures or other human improvements. Real estate sales provide good benchmark values which can be used to extrapolate per square metre valuations. 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.

Once a national land registry and valuation system has been established, each level of government and public utility authority can be assigned its own level of land rate for its own district and for its needed revenues. Thus, a local road or electricity board in an area can set a rate to cover the cost of any required loans for building a new road 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, so that 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 based on the uninspiring examples of so-called developed countries.

Reaffirming Vanuatu's sovereignty

The idea of a tax land rate in Vanuatu comes at an auspicious time. The EU and the OECD have been increasingly pressuring Vanuatu to enforce onerous regulatory requirements and to adopt taxation policies inspired by their own. Their demands are pushing Vanuatu to inflict economic losses on itself in the hope that business activity will be driven away from Vanuatu back to the EU. Whether it will is uncertain, but one thing is certain: the EU will not compensate Vanuatu for the losses.

To be independent means being financially self-sufficient and not reliant on grants or subsidies from other countries. Vanuatu can achieve great prosperity by having a simple, robust revenue system which does not impede but rather propels business, one that can be self-funding by paying for the infrastructure and services which then add value to its lands.

Aid from foreign governments often comes with strings attached, whether stated or implicit. Advanced economies will have much less leeway to try and dictate Vanuatu policy if the nation doesn't need their generosity anymore. OECD domestic political problems should not be the problems of other countries and economic advice should not be driven by political considerations.

As demonstrated since the dawn of economics, everyone in Vanuatu will have more equal access to opportunities and to the use of natural resources if the nation solely collects revenue from the land. For a country that has been sovereign for 40 years, it would be an even more decisive step towards greater economic strength and independence.