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Executive Summary: I propose a radical tax shift from employment and consumption to the economic rent of land, in the interest of more efficient wealth creation, and a higher reward to enterprise and work, based on the recommendation of Adam Smith.

Should advocates of free market economics adopt the policies of Adam Smith?

I would suggest that they should. This is my novel suggestion. The man often described as the father of Capitalism and a powerful protagonist for the free market economy has been understood selectively. Perhaps it is the long sentences, and interminable paragraphs discussing the price of corn that puts the modern reader off; but it is only by fully understanding his analysis will we truly liberate the enterprise economy to fulfill the promise of *The Wealth of Nations*.

I will summarise what he said.

First, he divided the population into three groups, or agents for the creation of wealth: the Landlord, who by definition owned land, the Capitalist who brought money or investment in factories and machines to increase the productivity of us all, and finally the Labourer who would actually create the wealth by working. Each group, in turn could enjoy some return for their contribution. The landowner could collect his rent, the capitalist his profit, and the labourer his wages.

Smith’s analysis of the progress of humanity is instructive, relying as it does on specialisation and the division of labour as well as perhaps his most well known phrase: the concept of the “invisible hand” which through the medium of the free market would guide each person to pursue his own self interest, and almost by accident, serve the interest of the whole of society. This idea lies at the heart of the capitalist concept of production – to buy the raw materials as cheaply as possible, and sell the finished product as dearly as possible to ensure the greatest profit.

However, Smith sounds a warning: **"In that original state of things, which precedes both the appropriation of land and the accumulation of stock the whole produce of labour belongs to the labourer. He has neither landlord nor master to share with him."[1]**

We are no longer in that original state of things, quite the contrary, so how, when most of the land is held in private hands, or has, in the words of Adam Smith, been appropriated, and where a small number of people have accumulated a large proportion of the "stock" by which I take him to mean both the means of production whether of a physical nature or of an intangible financial claim, are we to ensure a fairer share of the produce to the labourer?

This is where we have now arrived, and perhaps not for the first time. One can see how the struggles of the nineteenth and early twentieth century led to the revolutions inspired by the idea that "property is theft" expressed by Karl Marx and the Communists. However, confiscation and collectivisation of property and land, did not resolve the problem, as people were no longer free to pursue their own self interest – they were corralled to serve the bigger idea of the State, and the planned economy with disastrous effects for productivity and human choice.

In reaction to this, a liberal philosophy emerged to ameliorate the worst impact of appropriation and accumulation of the means of creating wealth, whereby wealth would be redistributed by a benevolent or "welfare state". This worked for a short time, until perhaps the debilitating effect of dependency or the inefficiency inherent in scale, began to erode the wealth creating capacity of all concerned. The reaction to this failure was the promotion of the neo-liberal agenda of privatisation and trickle down economics, small government and deregulation.

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[1] *An Enquiry into the Nature and Causes of the Wealth of Nations,* Adam Smith, Book 1, chapter 8.

So we are back where we were – living with growing inequality, and with the labourer enjoying an ever diminishing share of the wealth created, whether in the more developed economies or across the developing nations who were persuaded after the fall of the Soviet Union to adopt the ideology of capitalism and neo-classical economics.

Let us return to Adam Smith, and discover his remedy.

Arising from the nature of living with others in Society, it is clear that some things have to be organised and paid for collectively. In the field of sanitation and provision of clean water, even if you could organize a private supply, the disease affecting your neighbours who might not be able to pay for a private supply would migrate to you and your family in time. So in the interests of all, sanitation is arranged for everyone in the community. Smith gives to the sovereign:

"…the duty of erecting and maintaining certain public works…which it can never be for the interest of any individual…to erect or maintain; because the profit could never repay the expense to any individual…"[2]

We can debate the scope of these so called public works, but the principle is clear.

So who should pay? And how is the money to be raised? Smith gave guidance not only in his four precepts for taxation, which I won't repeat here, but in general advice given repeatedly, for example:

"Both ground-rents and the ordinary rent of land are a species of revenue which the owner, in many cases, enjoys without any care or attention of his own. Though a part of this revenue should be taken from him in order to defray the expenses of the state, no discouragement will

[2] Smith, Book 4, chapter 9.

thereby be given to any sort of industry. The annual produce of the land and labour of the society, the real wealth of the great body of the people, might be the same after such a tax as before. Ground rents and the ordinary rent of land are, therefore, perhaps, the species of revenue which can best bear to have a peculiar tax upon them."[3]

Here is a summary of his essential teaching, and something that lies at the heart of the free market economy – that it is enterprise that should be rewarded, not the idle landlord who benefits from the hard work of the community whether he lifts a finger to help them or not. So the source of taxation should be the unearned income enjoyed by the rentier, it should not come from the labourer at all. In short, the public revenue to pay for public works should come from the economic rent of land.

In a recent article The Economist, a newspaper, agreed:

"Taxing land and property is one of the most efficient and least distorting ways for governments to raise money. A pure land tax, one without regard to how land is used or what is built on it, is the best sort. Since the amount of land is fixed, taxing it cannot distort supply in the way that taxing work or saving might discourage effort or thrift. Instead, a land tax encourages efficient land use."[4]

But what do we find in practice? Have economists and governments heeded this advice? In most western economies we find that on the contrary, enterprise is taxed most heavily. In the UK, employment taxes, in the form of income tax (PAYE), and national insurance (both employer and employee contributions) are forecast to raise 43.1% of the total revenue. Add consumption taxes, which again inhibit production and the creation of wealth, and the percentage of revenue raised from enterprise increases even further. Value Added Tax (VAT) alone contributes 16.8% of the total.[5]

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[3] Smith, Book 5, chapter 2.
[4] Free Exchange/Levying the land, *The Economist,* June 29th 2013
[5] HM government Budget forecast 2016/17. Viewed online 23/12/16

Not only are those members of the working population least able to pay taxed most heavily, but the growth of the economy is crippled by this unnecessary burden. So what can be done?

Fortunately, we can turn to two economies which have performed rather well over the last 60 years, and satisfy the criteria of success dictated to them by the neo-classical economists. They consistently appear at the head of the Index of Economic Freedom: Hong Kong and Singapore, number one and two respectively in the 2016 index, published by the Heritage Foundation, a think tank.[6] In terms of GDP per capita, depending which index is used, Singapore is in the top 5, and Hong Kong the top 15, both well ahead of the UK.[7] Their growth over the period has been spectacular, and both are very much considered as world class international city states, great places in which to create wealth.

So how has this been achieved? Not by following the herd mentality of the governments of western economies which tax in a way that cripples enterprise, but by collecting a significant percentage of their public revenue from land values and rents. In the case of Hong Kong, this came about for two reasons – a long history of leasehold landholding in China, but also a series of historical events and accidents, during the period of British rule, which has created a system of perpetual leasehold for much of the land area. Over 25% of their public revenue is collected from land values (in the form of stamp duties, land auction premiums, and lease modification premiums, as well as Government Rent). As a result, only 12% of public revenue in Hong Kong is collected from personal income taxes, and they have no taxes on consumption such as VAT.[8]

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[6] http://www.heritage.org/index/?ac=1 viewed on 23/12/16
[7] https://en.wikipedia.org/wiki/List_of_countries_by_GDP_(PPP)_per_capita viewed on 23/12/16. Indexes include those of the IMF, World Bank and CIA.
[8] Hong Kong government Budget estimates 2015/16 viewed online 23/12/16

In contrast, the Singapore government soon after independence deliberately went about acquiring land not already owned, and offered it to companies and individuals on a leasehold basis. The government now owns 90% of the land, although how this translates into public revenue is more nuanced. Looking at the Operating Revenue Accounts, personal income taxes account for only 14.2% of the total, slightly higher than in Hong Kong. There is a General Sales Tax (GST) in Singapore which accounts for 16.1% of the operating revenue, a similar level to the UK, while Assets taxes (various property taxes) raise 6.8% of the total, and stamp duties a further 4.3%. However, the operating revenue does not take account of all revenues arising from land values, as these are not recorded in the operating revenue budget.[9] Singapore interestingly also follows Smith's suggestion that some public expenditure should be borne directly by the user (often referred to as 'user pays') such as vehicle quota premiums for private cars (which raises 8.4% of total revenue) and comprehensive road pricing mechanisms. But it is not the purpose of this essay to examine the respective tax systems of Hong Kong or Singapore.

The purpose is, based on the recommendations of Adam Smith, to propose a grown up examination of what taxes will promote growth and enterprise in western economies. The experience of Hong Kong and Singapore suggest a helpful direction, even though their tax systems could not be said to be deliberate efforts to raise revenues from land rents in the way that Smith suggest they should be.

Having conducted this examination, I propose as a key policy taken from Adam Smith, that tax authorities around the world should implement a tax shift - away from taxes on employment, production and consumption - to taxes on land rents. This is not a new idea, as it lies at the heart of Smith's analysis. This would force a reappraisal of the special place of land in economic thinking. Land and capital would no longer be conflated, and individuals and

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9 http://www.singaporebudget.gov.sg/data/budget_2016/download/FY2016_Analysis_of_Revenue_and_Expenditure.pdf viewed 23/12/16

companies would be forced to earn their income from enterprise and wealth creation, rather than claims on rents and other income streams arising from control of financial instruments. Owning land (rather than using land) would become less attractive, and the price of land might fall, which would have a beneficial impact on a whole generation currently priced out of even the bottom rung of the so called housing ladder.

Let me be clear, the burden of taxation would shift to the site value only, excluding any building, machinery or other capital investment which might add to the overall value. Every site would have two values, as they do in Denmark for tax purposes: a site value, and a buildings value. The new tax (lets call it a site or land value tax) would be levied only on the site value. The owner or tenant of the site would continue to benefit from the enterprise being conducted on the site. There would be no exemptions for empty sites, although the government of the day could exempt places of worship, education, care homes for the elderly, hospitals or the homes of people beyond working age – so long as they agreed to pay the rolled-up site value tax with their death duties. This would take care of those who might be asset rich but cash or income poor, and allow them to continue living in their existing homes.

Returning to the UK, the income tax threshold could be gradually increased to lift the vast majority of people out of personal employment taxes until PAYE is abolished altogether. Businesses would rejoice at the removal of National Insurance, (both employer and employee contributions) which are not really about any kind of insurance at all – only a tax on employment. The next victim of this bonfire of the taxes would be VAT, whose rate could gradually be reduced – although from a legal perspective, it could not be abolished altogether until the UK leaves the EU.

In case you are thinking that there would be insufficient rent to collect to replace all the revenue gathered from the existing taxes, please bear in mind that the rent is already being collected (at least where there is a tenant to pay, and landlord to collect) only it is going to a private owner or shareholder, rather than the public purse. Where there is no landlord/tenant relationship, the rent arrives directly in the hands of the landowner, assuming he is using the land for some productive purpose; or is reflected in the value of his asset. Here, it is important to understand the nature of rent, how it is determined, and Smith helpfully provides an explanation:

"Rent, it is to be observed, therefore, enters into the composition of the price of commodities in a different way from wages and profit. High or low wages and profit are the causes of high or low price; high or low rent is the effect of it. It is because high or low wages and profit must be paid, in order to bring a particular commodity to market, that its price is high or low. But it is because its price is high or low; a great deal more, or very little more, or no more, than what is sufficient to pay those wages and profit, that it affords a high rent, or a low rent, or no rent at all."[10]

What this means in practice, is that where there is a strong demand for products in a large community, and turnover is high, rents will also be high. If a tax is introduced which bears on the owner of the land, he cannot pass it on to the tenant, as we assume that the landowner is already collecting the maximum rent that the tenant can afford. On the other hand, in more remote areas, where demand is lower, rents will also be lower, and therefore the corresponding tax would be lower, or non existent (where there is no economic rent), giving a great boost to the productive potential of all marginal sites.

No doubt all this would have to be carefully choreographed to avoid any unintended consequences, but the result would be a transformation not only of the Nation's finances, but also the fortunes of those "just about managing" who are currently relieved of a higher percentage of their income through the effect of taxation than those either on higher incomes, or who benefit from the various forms of unearned or property incomes.

[10] Smith, Book 1, chapter 11

Only then, would the vision of Adam Smith be realised:

"The natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle, that it is alone, and without any assistance, is not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often encumbers its operations…"[11]

Such a tax shift would also rescue the 1% of the population from their gated communities and tax havens to join the rest of us in the noble effort of work and the creation of some thing of lasting beauty – real and tangible wealth. They would be rescued from the position which Smith found they were in as a result of a miss-calibration of the economic system that was emerging around him:

"…what all the violence of the feudal institutions could never have effected, the silent and insensible operation of foreign commerce and manufactures gradually brought about. These gradually furnished the great proprietors with something for which they could exchange the whole surplus produce of their lands, and which they could consume themselves without sharing it either with tenants or retainers. All for ourselves, and nothing for other people, seems, in every age of the world to have been the vile maxim of the masters of mankind. As soon, therefore, as they could find a method of consuming the whole value of their rents themselves, they had no disposition to share them with any other persons."[12]

This proposal would surely transform the fortunes of millions of people whose lives are less rich than they should be.

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[11] Smith, Book 4, chapter 5

[12] Smith, Book 3, Chapter 4