RENT, TAXATION, DISSIPATION, AND FEDERALISM

Mason Gaffney, Working Paper

Outline

I. The issue

The question before us is, "How can we prevent the dissipation of resource rents?"

This cuts to the heart of ancient and modern issues of land tenure, growth management, fiscal federalism, tax methods, and spending priorities.

II. Sources of rent

I premise we understand "rent" to mean the income imputable to natural resources, and natural resources means gifts of nature, fixed and limited in quantity. We understand there are marginal resources yielding little or no rent, grading up to superior ones yielding much. We understand there is a dynamic secular tendency for rents to rise with rising population and more so with rising disposable income per capita. There is a tendency for marginal exhaustible resources to rise in value with the depletion of superior ones that are normally used up first.

Because land is not produced, rents may be zero or less, and rise without limit. There is no competition from new production.

I premise resource rents are the joint product of three distinguishable factors: nature; complementary private activity; and public works and services, publicly financed.

I premise rent is the most basic and general source of taxable surplus, especially in an open economy in which other input costs and product prices are set at world levels in world markets.

Triffin's epigram says "Surpluses are either competed away or imputed away." (Source?) Rent is what we call it when they are imputed away. He might have added, they may also be frittered away: that is what we seek to avoid.

Imputed rent is the foregone gain of withholding land from the market, i.e., from others. It is equal to the marginal product of land. I premise (some others differ) that rent is the prior distributive claim, not a "residual." Thus, unused valuable land costs the owner as much rent as though he were paying cash to a landlord. Failure to realize this rent is imputable to management, not land as such.

Rent is a levelized concept to give a unitary, commensurable expression to costs and yields that have variable time patterns. Selecting time patterns optimally is part of maximizing rent. That is *a fortiori* true of exhaustible resources.

III. Dissipation of rent before the fisc takes it: what and how?

A. Dissipation means waste and destruction or suppression. It means incurring needless costs, or aborting surplus-yielding activities. Redistribution is not, *per se*, dissipation. No incentive is required to produce land, or able to make more be created, so who collects rent is a distributive choice. However the manner of collection may twist incentives and interfere with efficient use; so may the method of tenure, or tenure-creation.

B. How rent is dissipated.

1. Open access, tragedy of commons. Arthur Young, Scott Gordon, Garrett Hardin, et al. Simple cases like open range, fisheries, public parks and beaches, freeways: a principle easily perceived (although not usually by undergraduates).

2. Open access followed by tenure: rent-seeking institutions. Rent is dissipated through prematurity of investments. Squatters' rights (Preemption Act of 1841) and residence requirement of Homestead Act (1862), traditional examples. Prior appropriation doctrine of water rights, simple example. Air routes; broadcast licenses; extending utility franchises; zoning; offset rights to pollute; other modern examples.

Offset rights to pollute are doubly effective in dissipating rent. By generating a nuisance and lowering the value of surrounding land, a polluter is rewarded by receiving a valuable vested right to continue the nuisance in perpetuity, or sell it.

Internationally, rent-seeking via warfare, or big-stick policies threatening warfare, may be seen to dissipate rent when we deduct the public cost from the private gain.

3. Open access to exploration, followed by claims, as in minerals act of 1872.

4. Noncompetitive leasing (free entry; first come, first served), as in Alaska until fairly recent times.

5. Open access for preliminary forms of exploration, followed by leases for exploratory drilling.

6. Leasing on demand ("nomination"), i.e., at the convenience of the first potential lessee, rather than the lessor.

In conjunction with the bonus bid system, leasing on demand puts a premium on financial or front-money power as the triggering force. It also puts a premium on sequestering information and treating it as proprietary, and forcing as much duplication of effort as there are competitors.

7. Subsidizing exploration. A subsidy, almost by definition, causes waste in the amount of the subsidy, by causing people to spend more to produce things than they are worth. With minerals, subsidies cause submarginal lands to be developed. Submarginal in this case generally means "premature," since rising scarcity probably means the submarginal will eventually become superior.

a. Direct subsidies.

b. Tax preferences (a long list). I premise the tax-subsidy concept, i.e., that those who pay less taxes on the supposed principle of taxation are being subsidized by others who pay more.

8. Unlimited license to acquire leaseholds. Gale Johnson, Stephen Cheung, and others have shown the rational landlord may make a system of share tenancy work only if he limits the land each tenant may have. State and federal lessors generally impose royalties and other charges on a unit-of-production basis, so their lessees are sharecroppers; but they put no upper limit on leasehold acquisition.

There are time limits on holding without producing, but these may be met by token compliance.

9. Leverage of private investment over public investment and public services.

10. Tolerating environmental damage without compensation. Minerals exploration, transportation, refining, and consumption all receive heavy subsidies of this kind. (However, cf. #14, gold-plating.)

11. Subsidizing consumption.

a. Providing highways below cost.

b. Underpricing gas and power at the margins, by melding and cross-subsidy.

c. Subsidizing energy-intensive water projects.

d. Etc., not quite *ad infinitum*.

12. Slowing down use and extraction of minerals once discovered. In tandem with incentives to premature exploration, this generates an unduly capital-freezing industry. It attracts capital too soon, and releases it too slowly. In the Austrian sense, it becomes too capital-intensive.

Freezing up capital is not free. To justify each year capital is frozen, interest must be paid. This wasted interest comes out of rent, in the form of lower bids for leaseholds.

a. Severance taxation.

b. MER-based regulation of production.

Other regulations that mandate low-grading of subeconomic residuals.

c. Cartel behavior.

13. Impact of extreme pro-development psychology.

a. One man's cost is another man's income, and they cancel out, so there are no social costs.

b. Gross product rather than net gain is the objective function a state should maximize.

c. Export industries are more basic, and have multipliers.

d. Small firms depend on large ones, rather than all activities are mutually supportive.

e. Discovery is the same as creating land.

f. Discovery creates value by itself; other activities are dependent.

g. Economies of scale are all that matter, and all activities are like newspaper publishing in this regard. This does tend to affect the attitude of editors who sway opinion.

14. Mandatory gold-plating to appease organized groups. Environmental protection, like other good things, may be carried to excess in specific cases like the Wilmington Basin. That is no basis for generalizing, however, and it is obviously underfinanced in other cases like tanker spillage.

15. Overextension of subeconomic feeder lines, cross-subsidized.

16. Selling at the wrong time. A good deal of early Alaska oil was sold, not that long ago, for $1/bbl netback to the wellhead.

17. Looting. Looting *per se* is only redistributive in the short run, but its destructive incentive effects are obvious.

Looting is sporadic, but the total ongoing cost of guarding against crime is an enormous drain.

18. Rent control in cities; price control at the wellhead. Both these are redistributive in intent and effect, but highly destructive of good incentives.

Wellhead price control of gas has been turned into a subsidy for exploring for new gas, via melding costs in gas rate regulation.

19. Taxes and lease provisions that twist incentives.

IV. Dissipating rent via public spending

A. Taxes and lease provisions need not twist incentives.

1. At worst taxes destroy incentives only at the margins: the "wedge effect."

2. Taxes may be structured to zero in on taxable surplus while sparing the margins. An obvious and well-discussed case is a tax based on land value, or putative rent, imposed as a flat charge unaffected by landowner production.

3. Taxes in excess of benefits received have positive incentive effects on landowners.

a. The wealth effect.

b. The liquidity or cash-drain effect.

c. The effect of offsetting credit discrimination and rationing. (Land is cheaper to buy, hence less credit is needed, and taxes are or may be nondiscriminatory among potential owners.)

So it is not taxation *per se* that dissipates rent, even though ill-structured taxes do destroy some rent.

B. Public spending of tax proceeds may dissipate rent.

Jurisdictions with higher rents/capita may support public services at a higher level, and so attract immigrants. This distorts locational decisions, attracting people to low-productivity, low-paying jobs where they may benefit from higher public services.

C. History of recognition of this spending effect.

We are not the first to have noticed!

1. James Madison. U.S. Constitution blocked direct taxes on land at federal level, allowed it at state and local. Also guaranteed free migration among and within states. Madison's rationale was the self-interest of local voters would then keep them from redistributing rents.

2. Edwin Cannan. Around 1900 the ideas of Henry George were powerful in the U.K., and adopted by the Liberal Party. George, of course, spoke and wrote in favor of rent-sharing via tax and spending policy. Cannan wrote in the *Economic Journal* that heavy local taxes on land rents, used to provide superior public services, would distort locational incentives and cause overpopulation in London.

This is a tragedy of commons once-removed. Land remains tenured, but schools, parks, welfare, streets, libraries, public restrooms, public ambiance, etc. are open to all.

Alfred Marshall seconded Cannan, shifting the argument however to the suburbs, which he thought would become overpopulated. Marshall, by the way, came around to favoring a national land tax, in spite of Stigler's resurrection of his acrimony with travelling agitator Henry George at Oxford.

Neither George, Cannan, nor Marshall got into exclusionary local zoning, a later and highly relevant development.[1]

3. Half-brothers Austen and Neville Chamberlain, arch-foes of land taxation, adopted the Madison principle of stifling it by relegating it to local jurisdictions only, letting forces of local particularism limit its use.

4. Upton Sinclair learned the force of this principle in 1933. In his *I, Candidate for Governor: And How I Got Licked*, he reports his EPIC campaign nearly won until the enemy found the formula of anti-Okie-ism.

5. B.C. offsets the magnet of Vancouver's location and public facilities by costly provincial efforts to subsidize less attractive cities at Vancouver's expense. Nationally, Canada does the same with Alberta oil revenues.

Ironically, Canada's effort is still too little to placate Quebec, giving a notion of the limits of purely fiscal measures to overpower cultural factors. While this may discourage the purely allocative economist, it contains a seed of hope for those interested in ethics and justice, indicating narrow pecuniary self-interest is not everything. There is some pleasure in contemplating a people who will not sell out so cheaply (and perhaps not at all).

6. Alaska, of course, lost out to the ghost of Madison when it gave a social dividend to all residents with five years in the state, and was successfully sued (Zobel v. Williams, 102 USSC 2309, 1982).

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[1]Ironically, *Euclid v. Ambler* was lost by attorney Newton D. Baker. Baker had been Tom Johnson's protégé and successor as mayor of Cleveland, and later secretary of war under Wilson. This was the highest political office attained by a single-taxer in the United States (unless we count Joseph Tumulty and Colonel Edward House, advisers to Wilson).

7. Etc. A universal principle has universal illustrations.

D. Successful compromises with the principle.

1. Barriers to immigration or sharing.

a. Ethnic political machines.

b. Theocracies with a religious test for entry.

c. Building up heritage funds to abate future taxes.

d. Excluding non-citizens from benefits, where relevant. This is what Kuwait does, e.g. California cannot exclude U.S. citizens directly, but can exclude them indirectly by using illegal Mexican labor for stoop and sweatshop labor, excluding Mexicans from public benefits while the Mexicans keep out eastern U.S. immigrants from California.

e. Racial discrimination and segregation, as in the old South.

f. Exclusionary zoning.

2. Selling voters on the benefits of immigration.

a. Henry George was apparently elected mayor of New York City in 1886 (but counted out by Tammany). He was not selling an ethnic machine (the Irish Catholic hierarchy opposed him.) He sold the benefits of growth. Immigrants would not dilute rents as much as they augmented them, a central point George underscores in his major work, *Progress and Poverty*.

George also brought out a countervailing point the critics have overlooked, in their exclusive concern with protecting high central rents from invasion. Taxes on the use and improvement of marginal land sterilize said land, "and tend to drive population and wealth from them to the great cities." That is not the last word on the subject either, but shows there is more to the subject than Cannan began to disclose. As George maintained, aborting rent on marginal land, not just rent-sharing on superior land, distorts locational decisions.

b. Chambers of commerce have generally followed the same tack as George, touting the gains of growth. They often support tax increases, just as the California establishment lined up for Prop. 111 this year. They recognize the role of infrastructure in promoting economic development. Chambers of commerce, however, put much more emphasis on attracting capital than George did, and emphasize capital-intensive and land-intensive, even land-raping, industries.

c. Public schools and universities have been a screening device attracting an especially desired form of immigrant.

E. Less successful compromises with the principle.

1. Public works. These enhance the value of specific private lands and so attract support from specific benefited landowners. At the same time, they link new lands with old markets and, in the aggregate, increase the amount of land that is usable in more intensive forms, e.g., for urban housing, and thus have some redistributive effect in favor of non-owners. This makes for a wide constituency.

Because they are durable capital they appear to represent real assets. However many are heavily subsidized or cross-subsidized and cost far more than their benefits to anyone. In the aggregate they freeze up too much of the nation's limited capital stock.

Services are not inherently wasteful, and capital is not inherently economical. Economy is the key in either case. (When debt-financed, however, there should be capital resulting.)

Capital is the more wasteful when we consider it is taken from the margins of alternative uses where it may be very scarce today. Labor, on the other hand, is in surplus.

Anti-growth movements burgeoning today manifest growing disbelief in the benefits of subeconomic extensions of infrastructure. A small but growing element is increasing awareness of the high degree of absentee and alien ownership, highly concentrated, of the benefited lands.[2]

Squandering the Alaska surplus is a splendid case in point. A social dividend would have been efficient, and respectful of consumer sovereignty. James Madison's dead hand stopped it (in part). (Zobel v. Williams.)

2. Subsidized public works in tandem with exclusionary zoning.

Through revenue-sharing with categorical grants, many localities have built expensive public works, e.g., sewer plants, designed to accommodate higher populations. Then they turn around and impose exclusionary zoning, to limit the benefits to a few.

In the B.C. ferry service, the main lines make a little money and the branch lines to small islands are heavily cross-subsidized, some making $1 of revenues for $12 of costs. Residents of those islands, having sought and secured the service, are now alarmed at the influx of population and are zoning it out.

Here we have public works turned into pure giveaways to a few landowners, with no tokens for any wider constituency.

3. Hocking the revenues.

Borrowing to spend worsens the public works problems. Worse yet is borrowing to pay for current services, with some admixture of graft, as the NYC bankruptcy illustrated, and much third-world borrowing illustrates today on a wider canvas.

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[2]One need not be xenophobic to recognize the anomaly of alien ownership of real estate. One need only recognize the political reality that landowners have more than their share of control over government. Shall aliens then have more political power here than citizens?

4. Other.

V. Solutions

A. Socialize rent at the national level.

B. Limit benefits to citizens *per se* (not to landowners *per se*).

C. A social dividend to citizens is the obvious route.

D. Return rents to local school districts in inverse proportion to local tax base per capita (the Colin Clark principle).

E. Promote James Madison and Neville Chamberlain to elder statesmen emeritus.[3]

[3]"Where is the merit in being emeritus? What is the etymology? Arduous research has now found the truth: it means 'retired, and deservedly so.'" -- Stephen Butler Leacock.