# Still on the mountaintop: Economically rational racism

By Gavin R. Putland | April 3, 2008

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Forty years ago, as Martin Luther King Jr. spoke of the Promised Land and prophesied "*I may not get there with you*," a quiet revolution in economic theory was beginning, which would ensure that Dr. King's hearers, except perhaps the occasional Caleb or Joshua, wouldn't get there either. The architects of the revolution didn't plan it that way, but that's the way it turned out.

The revolution concerned the relationship between unemployment and inflation. A paper by Milton Friedman, published in the month before Dr. King spoke, and another by Edmund Phelps, published a few months later, gave reason to believe that in the long term, if unemployment falls below a certain rate, inflation speeds up, whereas if unemployment rises above that rate, inflation slows down. That magic unemployment number became known as the **Non-Accelerating-Inflation Rate of Unemployment**, usually abbreviated by the acronym **NAIRU**.

By about 1980, during the term of Federal Reserve Chairman Paul Volcker, it was accepted that the aim of interest-rate policy was to create enough unemployment to exert enough downward pressure on wages to give stable (and low) inflation. That didn't mean that central bankers always aimed at a particular unemployment rate — the NAIRU — because they didn't always know what the magic rate was. But it did mean that the Fed concentrated on inflation and accepted whatever the unemployment outcome might be. And it did mean that the Fed would sometimes cite falling unemployment as a sign of rising inflationary pressure, which supposedly had to be checked by raising interest rates.

While central banks determined interest rates, governments still had a role in setting other policies so as to minimize the NAIRU. But eventually that role was limited to making life for the unemployed as unpleasant as possible, in order to maximize wage restraint for any given unemployment rate, and defining an unemployed person as narrowly as possible, so that official statistics understated the extent of unemployment. (Attacking workers' wages and conditions is also widely advocated, but harder to do in a democracy. That's one reason why some people prefer dictatorship.)

The NAIRU was more commonly called the **natural rate of unemployment**. Well, of course it's "natural" to define a problem out of existence when you have no intention of solving it. More recently, politicians and central bankers have started referring to the natural rate as **full employment**. Yes, folks: in Newspeak, "full employment" means enough unemployment to cause enough wage restraint to give stable inflation.

So we're living in a system of enforced failure. A percentage of people have to be unemployed, and therefore, at the boundaries of unemployment, another percentage of people have to be underemployed or intermittently employed or precariously employed. In other words, **the economy is being run in such a way that a certain percentage of people have to be losers**. And people know this is true, even if they don't know why. More than half the population are too young to remember a time of genuine full employment, and those who remember know that unemployment has been a continuous problem since the early '70s.

If a certain percentage of the population must be losers, two conclusions follow.

- First, **any attempt to equalize opportunity is a zero-sum game**, in which no one can be rescued from the pool of losers except by throwing someone else in.
- Second, and here's the rub: **if a certain racial or religious minority is large enough to contain all or most of the losers, the majority stands to gain by discriminating against that minority**, because if the pool of losers contains more members of the minority, it will contain fewer members of the majority, so that persons born into the majority face a lower risk of being among the losers. Such discrimination, although immoral, is economically rational. So members of the majority will discriminate, encourage their peers to discriminate, and vote for politicians who make it easy to discriminate.

Not every minority is a suitable target for economically rational discrimination. If a minority is very small, it can absorb only a small fraction of the losers, and in so doing will not greatly reduce the risk that a person born into the majority will be among the losers. That's why, from the majority's point of view, a minority needs to be at least a certain size before it's worth discriminating against. But there are other caveats. If a certain minority consists of recent immigrants and their descendants, they're the products of a favorable selection process. Immigrants come with big plans, on which they've already taken big actions. Immigrants are guaranteed to have some "get up and go," because they actually got up and went. Their children and grandchildren inherit some of these advantages, if not genetically then at least by example. In America, that's part of the Asian story and, to some extent, the Hispanic story. Employers know this. More obviously, if a certain minority has a very strong religious or cultural commitment to education, and especially if it can supply the teachers from among its own ranks, its members will be attractive to employers, and will be hired whether the majority of workers like it or not. In America that's the Jewish story and the Catholic story, and perhaps another part of the Asian story.

But none of these stories is the Black American story. The Black American minority is large enough to supply as many losers as the economy might need. The first Black Americans were immigrants, but only because they were brought in against their will, and any "get up and go" that they had was ruthlessly suppressed. To get ahead in their new country, they needed a Western education to which they were denied access, and which they couldn't supply for themselves. And what they didn't have, they could hardly bequeath to future generations. Therefore, **as unemployment became a permanent feature of the economic landscape, Black Americans became the perfect targets for economically rational discrimination**, which helped to keep them in the wilderness for another 40 years.

What then is to be done?

Clearly it's no use asking the majority not to engage in economically rational discrimination, because the majority rules, and because, in a zero-sum game, the majority can't help another group without harming itself.

**But what if this accursed "natural rate" of unemployment were somehow drastically reduced, without attacking wages and working conditions?** As the unemployment rate fell, all ethnic and religious groups could share the benefit. That part of the game would not be zero-sum. And when the unemployment rate stabilized at the new low level, there would be so few losers, and members of the majority would face such a low risk of being among the losers, that offloading the risk onto some minority group would no longer be worth the trouble. **The effort that is now spent on discrimination would then pay a bigger dividend if spent on self-improvement**. Discrimination would no longer be economically rational.

So the key to the Promised Land is to reduce the natural rate of unemployment without creating a new class of working losers. To see how to do that, we must revisit some basic economic principles.

For a century and a half, capitalists and socialists argued about ownership of the **means of production** as if the assets that make up the "eans of production" were all of the same kind. But they're not; they fall into two distinct categories.

- In one category are the assets can be produced by private, competitive effort. For convenience I'll call these <u>**house-like assets**</u>, although they include not only houses but also other buildings, as well as movable plant and equipment.
- In the other category are those assets that cannot be produced by human effort, or at least cannot be produced by private, competitive effort. For convenience I'll call them <u>**land-like assets**</u>, although they include not only land but also other natural resources, building rights attached to land, and monopolies and privileges of all kinds.

The returns on *house-like* assets include

- **interest**, which is the price of time-preference,
- **insurance**, which is the reward for bearing (quantifiable) risk, and
- **economic profit**, which is the reward for bearing (unquantifiable) uncertainty.

Those returns are an incentive to produce house-like assets. <u>Any tax on those returns, or on the assets themselves, reduces the incentive.</u> Conservatives repeat this argument *ad nauseam* but never acknowledge that it's valid only for house-like assets.

The net returns on *land-like* assets are usually called **economic rent**. Some people prefer to call them **usury**. But whatever you call them, they can't be an incentive to produce anything, because no private person or corporation can produce land-like assets, while the rental values of those assets are produced not by the owners, but by the demand from prospective users. It follows that any fraction of the rental value of a land-like asset can be diverted into the public treasury without discouraging any productive activity, and therefore without raising prices. In other words, **taxes on the values of land-like assets are not inflationary**.

**But instead of taxing values of land-like assets, governments — including conservative governments — impose punitive taxes on everything that they pretend to encourage**, such as work, employment, consumption (which creates demand), saving (which allows investment), and of course investment in house-like assets. Some of these taxes directly impede production. Some of them directly increase the cost of hiring a worker at a given standard of living. But one way or the other, **all such taxes feed inflation**. Because of this additional upward pressure on inflation, it takes more unemployment to supply the compensating downward pressure; in other words, **inflationary taxes raise the natural rate of unemployment**.

So the key to reducing the natural rate of unemployment

— the key to the Promised Land — is to reduce or eliminate income tax, payroll tax, sales tax, property taxes on values of buildings, and death taxes on *house-like* assets, and to replace the revenue, as far as that's necessary, with taxes on values of *land-like* assets. Those taxes can take the form of capital gains taxes, or property taxes on land values only (not including values of buildings), or holding taxes of so many tenths of a percent per year on values of other land-like assets. These **land-value taxes** and other holding taxes can have **tax-free thresholds**, so that only the portion of the value above the threshold is taxable. For taxpayers who are asset-rich but income- poor, the holding taxes can be deferred until the assets are sold or bequeathed, in which case the taxes may superficially resemble estate taxes on *land-like assets only*. It's even possible to set the thresholds on a case-by-case basis so that individual taxpayers are no worse off under the new system than under the old.

Which brings us to the question of political feasibility: Does the Promised Land have to come at the expense of the landowners? Paradoxically, the answer is "*No*," and not only because the increase in taxes on land-like assets would be offset by reductions in other taxes. Paradoxically, landowners as a class actually stand to gain by shifting the present tax burden off desirable activities and onto land values. To see why, we must revisit another old piece of economic theory.

The overall supply of land is fixed. From the viewpoint of the taxpayer, the supply of land legally usable for any particular purpose is also fixed, as is the supply of land within acceptable distance of any particular services, infrastructure, or markets. Yet access to suitably located land is essential to life and livelihood. Therefore **land rents and land prices are bid upward until they absorb the economy's capacity to pay**. All taxes are deductions from the capacity to pay for land. **If a tax is *only* a deduction from that capacity, it will take as much from landowners as it delivers to the Treasury. But most taxes do more than that**; most taxes (more precisely, all taxes except those on values of land-like assets) target productive transactions, causing otherwise viable transactions and enterprises to become unviable, thus reducing the capacity to pay for land even before the tax is taken out. This is called the **deadweight** effect. So under most taxes, the returns on land-like assets fall by more than the tax paid: the landowners are overcharged! But **direct taxation of land values avoids the overcharge** because there's no deadweight: the tax doesn't deter any productive transactions. Even if someone sells land to avoid the tax, the incentive to use the land is not reduced, but is merely transferred to the buyer.

The same logic applies even to landowners who are about to sell. Anticipated liability for land-value tax reduces buyers' capacity to pay and therefore reduces sale prices. But so does anticipated liability for any other tax — with the usual overcharge.

**So, while land-value taxation takes only as much from landowners as it delivers to the Treasury, almost every other tax takes more from landowners than it delivers to the Treasury. Therefore, under land-value taxation, landowners as a class would be better off.**

Does that mean everybody else would be worse off? No, because **the landowners' gain would be funded by overall economic growth, not by anyone else's loss**. Furthermore, not all of the benefit of that growth would go to landowners. (In other words, not all of the deadweight of existing taxes is converted into an overcharge on landowners.) A holding tax on land induces the landowner to cover the tax liability by attracting rent-paying tenants, or avoid the tax by selling the land. Thus it strengthens the bargaining positions of renters and prospective buyers. A capital gains tax on land increases the attractiveness of rental income relative to capital gains, giving more bargaining power to renters, and discourages speculative hoarding of land, giving more bargaining power to prospective buyers. In short, both kinds of tax ensure that **non-landowners get a slice of the growth**.

By the way, the idea that all taxes fall on landowners is indeed very old. In 1691, one of the great philosophers of freedom wrote, in part:

> *It is in vain in a country whose great fund is land to hope to lay the public charge of the Government on anything else; there at last it will terminate. The merchant (do what you can) will not bear it, the laborer cannot, and therefore the landholder must: and whether he were best to do it by laying it directly where it will at last settle, or by letting it come to him by the sinking of his rents,... let him consider.*

That was John Locke. And in 1787, one of America's founding fathers wrote:

> *Our Legislators are all Landholders; and they are not yet persuaded that all Taxes are finally paid by the Land...*

That was Benjamin Franklin, writing to Alexander Small eleven days after the signing of the Constitution.

So far, in explaining the advantages of moving the tax burden onto land values, I've only considered what happens when the taxes are collected — not what happens when they're spent. A core spending responsibility is infrastructure, including **network infrastructure** such as transport, waste disposal, water, sewerage, and drainage, and **community infrastructure** such as schools, libraries, and emergency services.

**The benefit of an infrastructure project (net of user charges such as fares and tolls) is location-specific, and therefore is reflected as an uplift in land values in the serviced locations** — not an uplift in *building* values, because the value of a building is limited by construction costs, but an uplift in *land* values, because land has location, and therefore locational value, even if no buildings yet stand on it.

**So, if the tax system claws back X% of every uplift in land value, any public infrastructure project with a cost/benefit ratio of X% is self-funding, and any public infrastructure project with a lower cost/-benefit ratio is better than self-funding, yielding a revenue surplus that can be used for other purposes. If you wish, those other purposes can include tax cuts. That should please conservatives.** Moreover, the untaxed portion of the uplift — the other (100-X)% — is a net windfall for the landowners, who therefore should enthusiastically support the tax because it would finance projects that would not otherwise proceed, yielding windfalls that the owners would not otherwise get. That should please conservatives even more.

Financing infrastructure out of income tax, sales tax, property taxes on buildings, or death taxes on house-like assets, is socialism for landowners — **welfare for landowners**. Financing infrastructure out of uplifts in land values is **self-help for landowners**. Which is more conservative?

I should note, for the sake of precision, that costs and benefits may have capitalized and annualized components, while uplifts in land values may be expressed in terms of (capitalized) sale prices or (annualized) rents. So for the purpose of the foregoing argument, all terms must be converted to the same basis: either capitalized or annualized. I should also note that an annual tax on the capitalized value of land, with or without a threshold, automatically takes less than 100% of the benefit of an infrastructure project, leaving a net windfall for the landowner, because your tax bill doesn't go up unless your land value does, and your land value doesn't go up unless, in the judgment of the market, you are better off in spite of the tax implication. And conservatives respect the judgment of the market, don't they?

Better infrastructure, especially better public education, has been a touchstone of progressive politics. Unfortunately it's also been a point of vulnerability, because it invites the question **"Where's the money going to come from?"** which conservatives have answered by accusing progressives of being **taxaholics**. But financing infrastructure out of uplifts in land values does not mean raising taxes in order to pay for infrastructure. It means redesigning the tax system so that future expenditure on infrastructure automatically pays for itself by expanding the tax *base* without any increase in tax *rates*. In other words, it means financing infrastructure out of the **growth dividend** — not the mythical growth dividend that supposedly comes from cutting taxes on the rich, although the tax cuts aren't conditional on the growth or on any behavior that contributes to it, but the real growth dividend that follows when the revenue of a government is conditional on spending decisions that add value to land. Mark my words: **Progressives will never shake off the "taxaholic" label until they move some of the present tax burden off productive activities and onto land values**, so that a subsequent increase in infrastructure investment doesn't require an increase in tax rates.

Now what about those crumbling **public schools** left over from the segregation era? Empirical studies have found that a satisfactory public school adds value to land within walking distance of the school, while a highly desirable public school adds value to land within its entire catchment area. (The effect of a merely "satisfactory" public school on land values within driving distance, as opposed to walking distance, would be hard to determine empirically because the presence of the school would be correlated with numerous other influences.) So a public school, like any other piece of infrastructure, raises land values in the serviced area. This implies that **so-called "free" schools aren't free at all; the admission charge is hidden in prices and rents of land** in locations serviced by the schools, and is payable to the incumbent landowners. The argument that property taxes shouldn't pay for schools, because schools aren't services to property, is baloney; **public schools are services to property because they add value to property**, and the property owners get the benefit whether they send their kids to those schools or not.

So land-value taxation is good for landowners, as well as the rest of us, because it induces investment in infrastructure that adds value to land, and because landowners don't pay back any part of their windfall unless and until they actually get it. Logically, landowners ought to support this policy. But I know from experience that logic isn't their strong suit. Some of them reject the argument not because they find any fault with it, but because they simply refuse to engage with it — they just don't want to know. Others point to infrastructure projects that allegedly didn't raise land values. Well, if a project didn't raise land values by at least the cost of the project, it failed the cost-benefit test and therefore shouldn't have gone ahead. If a funding method isn't capable of funding projects that shouldn't go ahead, that's not an argument against the method; that's an argument in its favor.

How then shall we overcome the non-thinkers and the land-windfall deniers? Dr. King gave an unintentional hint when he encouraged the Black community in Memphis to impose what amounted to human--rights-related trade sanctions. These involved not only boycotts of businesses that mistreated Blacks, but also what he called a "*bank-in*"" (keeping your money in Black financial institutions) and an "*insurance-in*" (dealing with Black insurance companies). That was then. Perhaps what we need now is a sort of *"infra-structure-in*." Although Black Americans are a minority in the country as a whole, there are many cities and counties with Black majorities, including Detroit, New Orleans, Baltimore, Atlanta, Washington DC, and of course Memphis. So, if we can't have land-value taxation in all American cities and counties because it's good for all Americans, then maybe we can have it in Black American cities and counties because it's good for Black Americans. Of course I shouldn't have to say that. But if the only way to get some action on infrastructure is to turn it into a Black Pride issue, let's turn it into a Black Pride issue, because action is needed. Then the other cities and counties can try to catch up.

If America is sliding into **recession**, as seems to be the case, then the necessity of moving to land-value taxation is amplified by, yes, "**the fierce urgency of Now**." As Dr. King said at the Lincoln Memorial, "*This is no time ... to take the tranquilizing drug of gradualism*." *Now is the time* to cut payroll taxes that discourage hiring. *Now is the time* to cut sales taxes that reduce demand. *Now is the time* to exempt the values of buildings from property taxes, so that construction is no longer discouraged. *Now is the time* to create wealth and jobs by investing in infrastructure. ***Now is the time* to move the tax burden onto land values so that great infrastructure projects can be financed without increasing already alarming budget deficits**. And those who hope that the present crisis can be overcome by yet another stimulus package or taxpayer-funded bailout "*will have a rude awakening if the nation returns to business as usual*," because the tax system that gave us this recession and the one before and the one before that, if left essentially intact, will give us the next recession and the one after and the one after that.

**The present recession, like the recessions of the early '90s, early '80s, and mid '70s, was preceded by a crash in the land market.** The recession of 2001 may seem different because it was preceded by crash in the *share* market. But shares are land-like in so far as the underlying assets are land-like. Shares are even more land-like *in the short term* because they can be bought and sold much faster than they can be issued. Now the crucial point is this: **Markets for land-like assets are susceptible to crashes under the present tax system, but would not be if the tax burden were moved onto values of land-like assets.**

As economic growth adds to the demand for land-like assets while private agents can't add to the supply, prices of land-like assets rise in the long term. When people see prices rising, they try to buy into the market, thereby reinforcing the price rise, inducing more people to buy in, and so on, so that prices become decoupled from rents and are supported solely by the circular argument that prices will continue to rise. This is a speculative **bubble**. But eventually the illusion becomes unsustainable and prices stop rising, taking away the alleged justification for current prices, and so on: the bubble "**bursts**." Those who have invested heavily in the collapsed market must reduce their expenditure. If they've invested with borrowed money, they may be bankrupt. As one agent's expenditure is another's income, and as one agent's debt is another's asset, a chain reaction begins. If the initial burst is big enough, the chain reaction leads to recession, which is made worse if the reduction in funds available for investment causes bursts in other asset markets.

Irresponsible lending inflates the bubble further, causing a bigger burst, hence a deeper recession. The recent practice of selling and reselling mortgage loans, packaging them into securities and selling them again, and so forth, makes it hard to know who is credit-worthy and who isn't, causing a broader chain reaction, hence a deeper recession. But these are secondary issues peculiar to the current recession. The basic problem, common to all recessions, is that **the present tax system encourages speculative bubbles by making capital gains more attractive than earned income**. However, a sufficiently heavy tax on values of land-like assets can prevent recessions by preventing bubbles. If it's a capital gains tax, it directly reduces the speculative motive that inflates bubbles. If it's a holding tax, it provides corrective feedback: when prices rise, the tax also rises, making the assets less attractive and opposing the price rise, whereas when prices fall, the tax also falls, making the assets more attractive and opposing the price fall. Thus a holding tax stabilizes prices around the long--term trend. That's how to prevent the next recession.

**In the Promised Land of the Old Testament, there was no land speculation and no possibility of speculative bubbles**, because you couldn't sell land in perpetuity. According to the 25th chapter of Leviticus, every 50th year was to be a Jubilee, and you could only sell a lease on the land up to the next Jubilee. As the time remaining on the lease was always getting shorter, the lease was always falling in value, so you couldn't make a capital gain on it. Nowadays, if we somehow don't consider ourselves bound by the commandment that "**The land shall not be sold for ever" (Leviticus 25:23)**, we need another method of preventing speculation. **Land-value taxation not only discourages speculation, but also reduces inflationary pressure, allowing a reduction in the natural rate of unemployment, so that members of the dominant ethnic group face little risk of unemployment and have little to gain by trying to offload that risk onto some minority.**

Alternatively, America can retain the present inflationary taxes, and the Fed can fight the inflationary pressure by creating unemployment, the burden of which will continue to fall disproportionately on Blacks. Meanwhile the opportunity to make capital gains on land, together with the lack of pressure to earn income from it, will maintain a permanent artificial demand for land, exacerbated by periodic speculative bubbles. The artificial demand will inflate rents and prices of residential land, which is a necessity of life, and for which workers will have to pay out of wages that have been depressed by the competition for scarce jobs, eroded by income tax, and devalued by indirect taxes. This is the **Ownership Society**, the caricature of the Promised Land offered by those who call themselves conservatives.

But let's conclude on a more conciliatory note. In the present recession, which has been triggered by a collapse in land prices, land-value taxation would reverse the collapse — not by re-inflating a temporary speculative bubble, but by inducing investment in infrastructure that permanently enhances the utility of the land. So maybe it takes a recession to induce a conservative appreciation of land-value taxation as a substitute for existing taxes. Maybe that's one way in which "*only when it is dark enough can you see the stars.*"

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