Would Exiting the EU be Disastrous for Britain?

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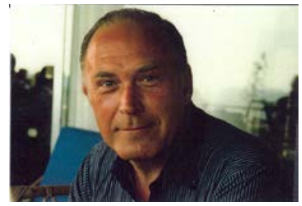

The future of Britain within the European Union hangs in the balance. According to those who wish the UK to remain a member, Britain would suffer from an exit from the world's biggest single market. Ronald Banks explains that, even if Britain did quit Europe, she could independently shift onto a new path of sustained prosperity. Far from rendering herself vulnerable, Britain could anchor her future in a win-win strategy and blaze the trail for nations that are struggling to survive the uncertain world of the 21st century.

BY NOW, there should be no controversy about what caused the financial crisis of 2008. Over the course of the last property cycle, bankers overloaded themselves with the toxic "sub-prime" mortgages they sold to low-income families. Those mortgages were then sold to institutions around the world, including regional governments in Germany and pension funds in Britain. When the crash came, they all suffered large losses and some were driven to the brink of bankruptcy. This state of affairs originated with the propensity to speculate in the capital gains that could be reaped from land. That propensity has now made a comeback, even before a full recovery from the depression that began in 2008.

The temptation to risk money by speculating in land is the result of a policy failure: governments fail to relate the funding of public services to the stream of rents which those services create. The reciprocal of this failure is the imposition of harmful taxes on earned incomes. Taxes reduce people's ability to generate the incomes they need to support their families, which consequently reduces national income and growth. As Winston Churchill said, when he was a Liberal Cabinet member in the early 1900s, "taxing yourself into prosperity is like standing in a bucket and trying to lift yourself up by the handle".

And so the global economy is once again exposed to the financial measures that will cause the next property boom/bust. But there is nothing inevitable about such an outcome. Even if the people of Britain choose to withdraw from the European Union at the referendum that is expected in 2017, the UK could deploy a strategy that would secure economic self-sufficiency. How can this be achieved? Parliament needs to *reform fiscal policy.*

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[1] Ronald Banks is the author of *Double-cross - Gordon Brown, the Treasury & The Hidden Cost of Taxe*s, Centre for Land Policy Studies, London, 2001.

If the proposals that I outline here had been implemented in the aftermath of the last major economic crisis (back in 1992), the British economy would by now be double the current GDP of £1.8 trillion. This tells us that, for generations, the UK has operated at levels far below the potential of her labour skills and technical know-how.

The Deadweight Losses

To understand how the UK potential has been curbed, we need to take account of how taxes on incomes, on earnings from savings and on the profits of productive enterprises burden the economy with what are called '*deadweight losses'*.

- *Income taxes* destroy jobs. They raise the cost of employing some people above the level of the value they can produce: so their jobs disappear.
- *Consumption taxes*, such as VAT, raise the price of goods in shops: this restricts sales and curbs the demand for production from manufacturers.
- *Taxes on profits* encourage entrepreneurs to wriggle every which way to try to keep their profits; in doing so, they shift away from serving their customers.

Taxes on economic activity encourage firms to secrete their profits so as to minimise their tax payments and maximise the returns to shareholders. Tax avoidance schemes would not exist if government raised its revenue from the optimal source – the rent of locations. Land cannot disappear into tax havens!

These are just a few of the constraints on efficiency in the private sector. They need to be addressed by reforms to public finance.

Towards the Post-tax State

If good governance is built on the twin pillars of justice and efficiency, the bulk of public revenue would come from the rents of land and natural resources. This, in turn, would make it possible to abolish the deadweight losses from taxes. Some taxes should be retained: those that relate to health and to the natural environment. It is in the public interest to discourage private activities that harm other people, including those activities that impose costs on others. I estimate that the revenue raised in the UK by "bad" taxes in 2015 was about £438bn. If we conservatively assume that £1 is lost for every £1 raised by those taxes, then GDP would be of the order of £2,238 billion instead of £1,800 billion (Box 1).

Box 1
Estimating the Deadweight Losses

The calculation of £438bn is based on two considerations.

First, of the revenue raised by taxes in 2015 (£515bn), 85% falls into the deadweight loss category. The other 15% is either drawn directly from rent (such as taxes on hydrocarbon oils and stamp taxes) or are taxes on tobacco and alcohol. I omit the revenue raised by local governments as if they did not impose losses. Strictly speaking, this is not correct: local property taxes permit the under-use of land, which imposes losses on communities.

Second, I have applied a 1:1 ratio loss, as recommended by Mason Gaffney, emeritus professor of economics at the University of California. Other US economists believe the losses to be as high as 2:1.

The step change towards the correct way to fund public services should begin by

- ✓ first, reducing income tax by 5p in the £, and
- ✓ concurrently, abolishing Council Tax and Business Rates, and
- ✓ replacing the lost revenue by levying a charge on land rentals.

The new public charge would NOT suffer from the characteristics of a tax! There is no room for the arbitrary, intrusive and discriminatory features that are embedded in the current fiscal regime. Rental payments would be symmetrically related to the value of the services that people freely choose to enjoy, by virtue of the decisions they make about where to live or work. And because rental payments are neutral in relation to people's decision-making, rental payments would rebalance the economy and stimulate growth. Property speculation, for example, would be discouraged. And the financial institutions would be encouraged to cooperate with productive enterprises that add value to the wealth of the nation, instead of offering to fund speculative property development.

What proportion of overall tax should be raised on business profits? In my monograph *Double Cross* I argue that business profits should not be taxed. The incremental reduction in taxes, phased in over an agreed period, would consist of repeated tax reductions and increases in the charges on land rentals. This triggers a virtuous circle!

What proportion of overall tax should be raised on individual earnings? The answer is much the same – continue the virtuous circle to its logical conclusion.

What proportion of overall tax should be raised on consumption? This is more difficult. The European Union has trapped the UK into VAT, but if the UK exited from the EU, it could phase out VAT in line with the rise in land rents.

Should Britain retain the contributions called "national insurance" to pay for the state pension and contribute to medical and unemployment costs? In terms of its negative impact, the national insurance contribution is like a tax on employment, which destroys a large number of jobs.

The State must provide services like defence, police, justice and highways which the private sector cannot sensibly deliver. The net income produced by the workforce – the economic rents in all their forms, from desirable urban locations to natural resources like oil from the North Sea and the wind power that drives the emerging infrastructure that produces clean energy – would be sufficient to pay for those essential public services. And, with a constantly growing economy, there would be every opportunity to fund any social requirements of the population.

But what would be the effect on rents? Landlords would lose the revenue from the land element of property. Their revenue from "bricks and mortar", however, would be exempt from taxation.

The Landlord Legacy

The foregoing financial reform would set the UK onto a new path of evolutionary growth. It does require a big shift in the collective imagination, and there would be an element of disruption in people's lives as they adapted to the exciting new opportunities. But there is no other way to address the greater disruptions that afflict society, such as poverty, inequality, unaffordable housing and all the other problems that successive governments have been unable to address.

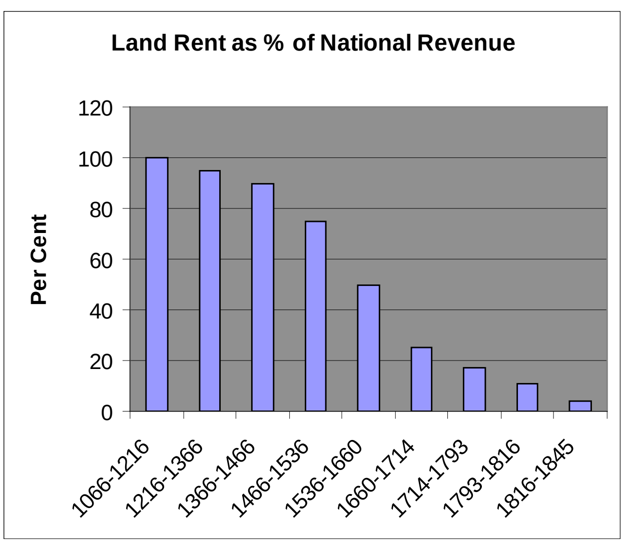
The root-and-branch approach to reform is unavoidable, because current defects in governance are not the result of idiosyncratic failures of recent generations of policy-makers. To appreciate how deeply embedded are the institutions and attitudes that favour the boom/bust economy and the under-production of income, we must place the flawed mechanisms for funding public services in their historical context.

The return of Charles II, after the Cromwell experiment in republicanism, ushered in a time when Parliament impoverished the people of Britain. Members of Parliament were the owners of land, as indeed were their voters. Parliament gained great power when it invited William of Orange to be King after the so-called Glorious Revolution of 1688. Parliament became even more powerful when George I was invited to be King. Parliament was rising to supreme power, and it made use of that power in a self-serving manner.

The holders of land had funded government since 1066, when the vast majority of public revenue was raised from rent. Half of public revenue was still raised from the rents of land by 1660. But Parliament was now under the sway of the land owning aristocracy and gentry! A gradual and consistent increase in taxes on the people was accompanied by a decrease in the revenue raised from land and landowners.

When Richard Cobden, who made his mark as a champion of Free Trade, spoke in 1845, only about 4% of revenue came from land (see graph[2]). Cobden told Parliament:

"Thus the land, which anciently paid the whole of taxation, paid now only a fraction or one twenty-fifth, notwithstanding the immense increase that had taken place in the value of the rentals. The people had fared better under the despotic monarchs than when the powers of the state had fallen into the hands of a landed oligarchy, who had first exempted themselves from taxation, and next claimed compensation for themselves by a Corn Law for their heavy and peculiar burdens."



This legacy of the landed aristocracy led the people of the UK to end up (in the 21st century) with a fixation on the ownership of land. Getting "on the property ladder" is everyone's primary aim in life. And instead of investing in the productive economy, most people

[2] Data from 'Richard Cobden and the Land Tax', *Land Values*, 1910, and Victor Saldji, "New Light on Richard Cobden and the Land Question", Paper delivered to the Ninth International Conference on Land-Value Taxation and Free Trade: St. Andrews, Scotland, 1955.

now pin their hopes for a secure future on the capital gains that they can reap by owning the land beneath bricks-and-mortar.[3]

The outcome is the seriously inefficient stewardship of the nation's land and natural resources. This is not a recent phenomenon, as an example from the 19th century illustrates (see Box 2).

Box 2
The Danger in Long Leases without Rent Reviews

Until 1914, Britain operated under the Gold Standard. A £1 note could be exchanged for one sovereign (1/4 ounce of gold, approximately). Inflation could therefore be ignored. Property owners would let their property on leases of 99 years with no review of rentals. Such was the confidence of Victorian property owners during the 19th century that they expected the value of their rents to be the same at the end of the 99 years as at the beginning.

But those property owners made one mistake: they took no account of the potential rise in land values over the 99 years as the economy expanded and *particular* areas and sites grew in importance and value. So despite the safeguard of the gold value in their rentals, those landlords failed to take into account that many of their leaseholders would, in time, gain asset value from their leases. Tenants would pocket some of the flow of rents. Those gains to leaseholders were at the expense of landlords.

After coming off the Gold Standard, inflation took hold. The real value of the 99-year leasehold rents went down rapidly. The value was transferred to the leases and leaseholders. One unintended consequence of this was that, during the depression of the 1930s, many businesses survived because their rents had been set perhaps 60 years earlier. Not only did they pay an unrealistically low rent, but inflation had reduced the real value of that figure to tiny proportions.

Local government land owners

To comprehend the scale of the losses to the nation, we need to take into account the ineffiencies associated with land that is owned by all tiers of governments. The harsh conclusion is that *taking land into public ownership is not the solution*. The history of local authority stewardship of their estates is chequered. The quality of locally provided services is, in part, dependent on the efficient use of publicly-owned land. Yet the evidence shows a patchy performance. In fact, historically, practices could be considered negligent, because significant portions of increases in land values were given away.

1. There is no common policy or practice adopted by local authorities. Because there is no national uniform land policy, financial institutions lay down the standards for leasing land to suit them. They *'pull the strings'*.

2. Although significant proportions of city centres are publicly owned, lease terms still leave large proportions of land values in private hands.

[3] Hugo Greenhalgh (2015), "Britons pin their pension hopes on property", *Financial Times*, November 11.

3. Where economic development is considered to be more important than land disposals, private investors and developers can obtain the land on very favourable terms, sometimes for nothing.

4. Local authorities have become more commercial in dealing with land resources. Even so, their practices leave much land value in private hands, to the disadvantage of taxpayers.

The public purse loses considerable revenue because of the failure to administer public land efficiently. We do not know how much revenue is lost, because HM Treasury and the National Audit Office do not value and disclose the current value of land in the UK. Back in 1988 the National Audit Commission castigated national and local authorities for not properly appraising the value of their property. In terms of valuation, there has been little improvement in the administration of the national estate since then. In a review of local authority practices in the 1990s, I identified how publicly owned land was not being used to attract the full benefits for local residents. The problems are illustrated by the city of Bath.

In addition to land and property holdings for social housing and its own administrative purposes, Bath owned considerable city centre property investments leased to private developers and businesses. The city then owned 65% of all central freeholds, just under one-half of which yielded a ground (land) rent only; the remainder was leased as a whole property (land and buildings together). Since 1988, their policy and practice has become more commercial. Even so, the private developer can negotiate very favourable terms for the release or re-development of Bath land.

Prior to the 1980s, Bath City Council commonly offered land on a 99-year lease with reviews of rent every 21 years. For instance, one major shopping development in Bath city centre was negotiated on the following terms:

a. Lease of city-owned land for 99 years, which commenced in 1971.
b. Rent reviews every 21 years.
c. Initial rent for 21 years – a 'peppercorn' (nothing)
d. After 21 years, the rent was calculated by a formula that left much of the land value with the investor.

A conservative estimate would be to put the increase in that site's value between 1971 and 1992 at seven or eight times. At the time of the review in 1992, the development as a whole was valued at £200m, with a land element of about £30m (which, in my view, was an under-estimate). And yet by a formula in the lease, the new rent for the next 21 years was to be £600,000 per annum! If we take 5% as a reasonable figure for interest and the £30m land value, then the rent should be £1.5 million for 1992 with regular reviews thereafter at short periods, preferably every 3 to 5 years.

The shortcomings in the way Bath administered its estate heralded a much more commercial attitude to its land and property holdings. Rent reviews are now, for new or re-negotiated leases, a maximum of 5 years.

Real "fiscal responsibility"

The Cameron Government has now enacted a Fiscal Responsibility law. This is supposed to oblige Parliament to oversee the balancing of the books over the long term. The law is little more than a gimmick. It relies on the Keynesian theory that budget deficits are necessary during times of recession. But real fiscal responsibility would be achieved by reforming taxes so that people kept what they earned, and paid for what they received. This would ensure balanced budgets from year-to-year, without the land-led crises that create recessions. To achieve this outcome, Parliament would have to return to what economists like Adam Smith regarded as the best source of public revenue: the rents of land and natural resources.

But that did not happen. Instead, Parliament continues to operate on the basis that the tax base should be broadened (or, to put it another way: the tax net cast wider). This doctrine is grounded in an anti-democratic proposition: *conceal the taxes that burden people*. But people are not fools. Whether taxes are highly visible or not, most of those taxes decrease the efficiency of the economy, lowering productive capacity and creating poverty. That is one of the lessons from the economic history of Hong Kong (Box 3).

Box 3
How Hong Kong grew to be the world's No.1 Economy

As a British territory, all land in Hong Kong was held by the government on a lease from China. So the British, in turn, sold or granted leasehold interests only until 1997, when the UK handed the colony back to China. What was the outcome of this arrangement, in which no-one was a freeholder? The economy of Hong Kong was so successful that leases entered into in the early 1980s, which terminated in 1997, i.e. for periods of only 12 to 17 years, were easily financed even for massive skyscraper structures. The developers expected full capital return after about eight years! A significant part of government revenue was derived from the rent of land.* This explains why taxes on earned incomes are very low, and why Hong Kong's economy is rated as the most efficient in the world.

* Andrew Purves (2015), *No Debt, High Growth, Low Tax: Hong Kong's Economic Miracle Explained*, London: Shepheard-Walwyn.

Prime Minister David Cameron, in seeking to revise the terms of membership with the EU, claims that exit would reduce Britain's voice on the world stage. But the certain way of retaining that voice is through the moral leadership of good governance. And that can be achieved only if the UK puts its own financial house in order.