Land-Backed Debt as a Revenue Base

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Abstract

In the case of land subject to a mortgage, Henry George favoured treating the mortgagee (lender) as a part-owner for the purpose of the single tax. From the viewpoint of the beneficial owner (the borrower), this provision is equivalent to compensation for the debt against the land at the time of introduction of the "tax", but is ineffectual if applied to debts incurred thereafter. The "compensation" is at the expense of the lender as co-owner, *not* at the expense of non-owners. It is unclear whether George would have given such compensation for *all* debt against the land, or only for debt incurred for the purpose of *acquiring* the land. Compensation for the actual *cost of acquisition* (incurred *before* the introduction of the single tax) suggests itself as being less generous to the buyer than the former option, but more generous than the latter.

Compensation for the cost of acquisition of land, as distinct from its current value, is supported by independent argument and is not explicitly condemned in George's writings. If compensation for the cost of acquisition is taken as the ideal, compensation for outstanding debt can be understood as an approximation thereto, with the advantage of avoiding inquiry into past events. But there is no case for compensating acquisition costs or debts incurred *after* the introduction of the single tax, not least because if the "tax" takes the entire rental value of the land, there is no acquisition cost to incur, and no land price to borrow against.

By treating the lender (or each lender, if there are more than one) as part-owner in respect of the pre-existing debt against the land at the time of introduction of the single tax, irrespective of the purpose of the debt, and by giving the beneficial owner a deduction for the greater of the said debt (or the sum of the said debts) and the verifiable cost of acquisition, one could err on the side of generosity to *beneficial owners* without conceding compensation to land owners (including mortgagees) *as a class*. The lenders, in order to remain solvent, would need a deduction for their own pre-existing indebtedness, which would be taxable in the hands of their creditors, and so on. As the pre-existing debts were paid off, the associated taxes and deductions would disappear. This arrangement would ease the transition to the single tax by ensuring that an indebted "owner" is *not* required to pay the same rent twice—once to the State and once to the bank.

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Contents

1 Introduction **2**
- 1.1 Note on terminology 4

2 George, Spencer, and the compensation question **4**
- 2.1 Levels of compensation 4
- 2.2 Spencer's "incongruous passage" 6
- 2.3 George's incongruous omission 8
- 2.4 From George to Leo XIII 11
- 2.5 Debt vs. cost of acquisition 11

3 Without jar or shock **12**
- 3.1 Solvency of lenders 12
- 3.2 Solvency of borrowers 13
- 3.3 Digression: Exemptions for owner-occupied residential sites? 13
- 3.4 Notes on gradual implementation 14

4 Conclusion **15**

1 Introduction

"Twelve political criticisms of [Henry] George were paramount after he formed his own political party in 1887," wrote Michael Hudson in 2008.[1] Among the milder accusations against George were:

> (2) his singular focus on ground rent to the exclusion of other forms of monopoly income. . . ;
>
> . . .
>
> (6) his refusal to acknowledge interest-bearing debt as the twin form of *rentier* income alongside ground rent. . .

All words quoted so far are from Hudson's abstract. His conclusion opines that "Georgism failed to achieve land-value taxation for three reasons", including:

> Third, Georgists have made no attempt to trace who ends up with land rent and other economic rent. This misses the symbiosis between mortgage banking and real estate that has developed over the past century. . . .

As Hudson was writing in a journal receptive to Georgist ideas, he must have expected a wide-ranging rejoinder. It came from Richard Giles, Secretary of the Association for Good Government (formerly the Henry George League) in New South Wales.[2] Giles defends many of George's positions, including "his singular focus on ground rent", as being not *political* positions but essential *theoretical* positions. But on Hudson's point (6), Giles remarks:

> Hudson complains a couple of times that George did not take up the issue of mortgages. Doubtless, had it been a popular issue in his day, he would have.

[1] Michael Hudson, "Henry George's Political Critics", *American J. of Economics and Sociology*, vol. 67, no. 1 (Jan. 2008), pp. 1–45.

[2] Richard Giles, "Henry George Under the Microscope: Comments on 'Henry George's Political Critics' ", *American J. of Economics and Sociology*, vol. 68, no. 5 (Nov. 2009), pp. 1153–1167.

Actually he did—in the following exchange with the jurist David Dudley Field in 1885:

> FIELD: Then supposing *A* to own twenty lots, with twenty buildings on them, the lots being, as vacant lots, worth each $1000, and the buildings being worth $49 000 each; and *B* to own twenty lots of the same value, as vacant lots, without any buildings; would you tax *A* and *B* alike?
>
> GEORGE: I would.
>
> FIELD: Suppose that *B*, to buy the twenty lots, had borrowed the price and mortgaged them for it; would you have the tax in that case apportioned?
>
> GEORGE: I would hold the land for it. *In cases in which it became necessary to consider the relations of mortgagee and mortgager, I would treat them as joint owners.*[3]

In so far as George's "focus" concerned *taxation* rather than nationalization, it was indeed on "ground rent to the exclusion of other forms of monopoly income," as Hudson says. And George indeed refused to acknowledge interest on debt as "*rentier* income alongside ground rent", if "alongside" means "in addition to". But in the exchange with Field, George implicitly acknowledged interest as rentier income in so far as it *absorbed* ground rent.

In *Protection or Free Trade*, in explaining the political alignment of capitalists with landowners, George again acknowledged that returns to land can appear in other guises:

> Even in England, where the division between the three economic orders—landholders, capitalists, and laborers—is clearer than anywhere else, the distinction between landholders and capitalists is more theoretical than real. That is to say, the landholder is generally a capitalist as well, and the capitalist is generally in actuality or expectation to some extent a landholder, or by the agency of leases and *mortgages* is interested in the profits of landholding.[4]

Further confirmation came in the open letter to Pope Leo XIII, where, in the course of denying that landowners should be compensated for the single tax, George referred to

> . . . the propertied class in general, among whom the profits of land-ownership are really divided through *mortgages*, rent charges, etc.[5]

While this letter does not explicitly identify the "propertied class in general" with the class to be taxed without compensation, George's answer to Field makes it sufficiently clear that the latter class includes mortgagees—that is, mortgage lenders.[6]

One cannot meaningfully debate compensation without specifying the parties to whom compensation is to be granted or denied. More generally, one cannot debate transitional arrangements without specifying the class of taxpayers to be affected by the transition. More fundamentally, one cannot impose a charge on land owners without specifying who the "owners" are! There were in George's time, and still are, some jurisdictions in which the mortgage lender is technically the owner of the property until the debt is paid; and property buyers in all jurisdictions are familiar with their "equity" in the property—the implication being that for practical purposes, the lender owns the rest. George could hardly ignore those jurisdictions in which the mortgagee was the legal owner. Neither could he ignore the treatment of mortgagees and mortgagers as joint owners for the purpose of "property"

[3] "Land and Taxation: A Conversation between David Dudley Field and Henry George", *North American Review*, July 1885; reprinted in (e.g.) *The Complete Works of Henry George* (New York: Doubleday Page & Co., 1904), vol. 8 ("*Our Land and Land Policy*, Speeches, Lectures and Miscellaneous Writings"), pp. 219–239. Emphasis added. [*N.B.:* **Footnotes in the PDF version of this paper contain clickable links**.]

[4] *Protection or Free Trade* (1886), Chapter XXVII, par. 14. Emphasis added.

[5] Henry George, *The Condition of Labor* (1891), Chapter II, Ans. 8. Emphasis added.

[6] The borrower is the mortgag*er* (also spelt "mortgag*or*"), as is clear when the word *mortgage* is used as a verb.

taxation under California's 1879 constitution,[7] with which he was undoubtedly familiar.[8] But after George's death, a century of Georgist campaigning was apparently silent on including mortgages in the revenue base,[9] even in the context of compensation. So Hudson's claim that "Georgists have made no attempt to trace who ends up with land rent" seems to true of Georgists "over the past century." That it is *not* true of George himself reinforces Hudson's criticism of "Georgists" in general, by making it harder for them to plead ignorance. In particular, those who profess to take George as their sole or final authority—apparently including Giles—must admit that later Georgists were at fault in neglecting mortgages as a revenue base, because George himself did not neglect them.

In this paper I take up Hudson's challenge by attempting to integrate mortgages into Georgist theory and policy. But I also hope to keep faith with Giles by retaining George as my final authority—with two minor qualifications. First, I pay attention not only to what George said, but also to what he conspicuously did not say. Second, I submit that George's authority does not extend to the interpretation of *non*-authorities such as Herbert Spencer. For the latter reason, I hope to be pardoned for disagreeing with George as to how Spencer contradicted himself on compensation, as long as I maintain (as I do) that he indeed contradicted himself.

1.1 Note on terminology

With respect to land encumbered by a mortgage, the word *owner* is ambiguous in that the mortgagee is the legal owner in some jurisdictions but not in all. This ambiguity (among others) is normally resolved by defining the **beneficial owner** as the party who stands to collect any "capital gain" on the land provided that the debt is serviced. In the simple case, that means the mortgag*er*; but "beneficial owner" is more precise and more evocative of the intended meaning.

For convenience, clarity, and sufficient precision for the present context, let us refer to the mortgagee simply as the **lender**.

2 George, Spencer, and the compensation question

2.1 Levels of compensation

From the viewpoint of the beneficial owners of land—not to be confused with the viewpoint of any wider class of owners who might be targeted by a public charge on land values—there are at least five possible levels of compensation (or lack thereof) for the introduction of such a charge:

0. No compensation (not even for debt);
1. Compensation for outstanding debt against the land, incurred for the purpose of acquiring the land;
2. Compensation for the past cost of acquiring the land;
3. Compensation for outstanding debt against the land, incurred for any purpose;
4. Compensation for the current value of the land.

[7] *Constitution of the State of California* (1879), Art. XIII, s. 4. The scope of "property" is very wide (Art. XIII, s. 1). The author is indebted to Prof. Mason Gaffney for pointing out this precedent.

[8] "In point of constructive statesmanship..., the Constitution of the United States, adopted a century ago, is greatly superior to the latest State Constitutions, the most recent of which is that of California—a piece of utter botchwork."— *Progress and Poverty*, Book X, Chapter 4, note 67.

[9] Mason Gaffney mentioned the idea in "The Great Crash of 2008", *GroundSwell*, Jul.–Aug. 2008.

Level 4, which George famously opposed, was the preference of J. S. Mill, who recommended taxing away only *future* increments in ground-rents, and of the various land-nationalizers who advocated buying back the land at market price, and (effectively) of Spencer in his later writings, in which he was anxious to demonstrate the impracticability of his earlier proposal to nationalize land. Level 0 is the preference of modern Georgists who consider themselves ultra-orthodox but have forgotten what George himself said about mortgages. So, having accepted George as my authority, I need not consider levels 0 and 4 any further.

George's preference was either level 1 or level 3. The difference has no effect on overall revenue, but concerns how much of that revenue comes from beneficial owners and how much from lenders; under level 3, less of it comes from beneficial owners. Levels 1 and 3 agree in providing no compensation for landowners *as a class*, but differ as to the definition of that class; level 3 imputes more ownership to lenders and less to beneficial owners. Only from the latter's viewpoint is level 3 more generous.

So, while George resolutely opposed compensation for land owners as *he* defined them, he not only permitted, but actually prescribed, compensation for *beneficial* owners—not at the expense of non-owners (which was anathema to him) but at the expense of other owners included in his definition.

From the statements quoted above, it is not clear whether George preferred level 1 or level 3. However, if the government suddenly introduces an annual charge on land values when the ubiquitous "**poor widow**" has just taken out a reverse mortgage on her home, it is perfectly clear which level is easier to defend!

If the beneficial owner has incurred a debt in order to acquire the land, the unpaid portion of that debt (level 1) is normally less than the cost of acquisition. If the beneficial owner then borrows against the risen land value for some other purpose, the new total debt against the land (level 3) can exceed the cost of acquisition, and can be made to do so at the option of the beneficial owner (although the option would not always be exercised). Hence, from the viewpoint of beneficial owners, level 1 is less generous than compensation for the cost of acquisition, while level 3 is (at least potentially) *more* generous, so that compensation for the cost of acquisition (**level 2**) is *within the range* of compensation levels that are compatible with George's statements.

The foregoing comparisons apply to the *introduction* of a charge on land values. If land is mortgaged when such a charge is *already in place*, then the incidence of the charge on the debt against the land is determined by the "higgling of the market" regardless of which party is legally liable to pay: if the charge is payable by the lender, the lender will want to add it to the interest (or lend less), whereas if it is payable by the borrower, the borrower will want to deduct it from the interest (or borrow less). But it is simpler to make it payable by the borrower, because then a buyer is responsible for the whole charge on the land value (the charge being capitalized in the price; hence, regardless of who is responsible for the charge on the debt component, the ultimate incidence is on the seller). The question of compensation for the cost of acquisition (level 2) does not arise in respect of acquisitions *after* the charge is introduced, because the implications of the charge are accepted and "priced in" before the cost is incurred. Moreover, if the charge is already in place *and* collects 100% of the rental value of the land, then the capitalized value of land is reduced to zero, so that no new debts or acquisition costs can be incurred in respect of land (as distinct from the improvements). Accordingly, from this point on, levels 1 to 3 are taken as referring only to debts and costs incurred *before* the introduction of the charge on land values.

To the extent that the charge on the beneficial owner of land is reduced on account of a loan against the land, George's proposal (level 1 or level 3) is that the forgone revenue be recovered from the *counterparty* to the loan. This is feasible because the debt, no less than the land title itself, is an income-bearing asset. The same cannot be said if the charge on the beneficial owner is reduced on account of the past cost of acquisition (level 2), because the counterparty, i.e. the party from whom

the land was acquired, may have spent the proceeds on consumption. So, if level 2 is adopted, from whom should the forgone revenue be recovered? One option is to abandon the strict "counterparty" logic and bill the lender as for level 1 or level 3. Another is to write off the forgone revenue on the following grounds:

- The abolition of existing taxes will automatically generate enough additional rent to replace the revenue from those taxes.[10]
- For the purpose of capturing the additional rent, the new charge on land values must collect 100% of *increments* in rental values, but need not collect all of the rental values as they are when the new charge is introduced, let alone the rental values as they *were* when the land was acquired; and only the last-mentioned are forgone by compensating beneficial owners for acquisition costs.
- Moreover, the "last-mentioned" are not *completely* forgone, because when the parties from whom the land was acquired spent the proceeds, they transfered spending power which contributed to subsequent increments in ground-rents.
- The concession granted to current land owners is not capitalized in transfer prices, because it is not transferable; there is no suggestion of compensation for acquisition costs incurred *after* the new charge is introduced.

A third option, with less leakage of revenue, is to bill the lender as for level 3, and bill the beneficial owner as for the more "generous" of levels 2 and 3 (that is, compensate the beneficial owner for the greater of the cost of acquisition and the total outstanding debt—the latter being "potentially" greater, but not necessarily greater in the individual case). If there is more than one lender against the same site, then obviously each lender is billed for its part of the debt at the time of introduction of the charge, and the "total outstanding debt" is the total for all lenders, regardless of the purpose for which each debt was incurred.

In the foregoing discussion, compensation for the past cost of acquisition is presented as a compromise between two possible interpretations of George's position. It what follows, the same level of compensation is suggested by independent reasoning, and by one of George's more conspicuous omissions.

2.2 Spencer's "incongruous passage"

In *A Perplexed Philosopher*, George compliments Herbert Spencer for demonstrating, in Chapter IX of *Social Statics*, that equity does not permit private property in land. Although dissatisfied with Spencer's "clumsy" remedy of "having the state formally resume land and let it out in lots",[11] George concedes that the argument is "clear and logical, except in one place." He then quotes the allegedly "weak and confusing" and "incongruous" passage:

> No doubt great difficulties must attend the resumption, by mankind at large, of their rights to the soil. The question of compensation to existing proprietors is a complicated one—one that perhaps cannot be settled in a strictly equitable manner. Had we to deal with the parties who originally robbed the human race of its heritage, we might make short work of the matter. But, unfortunately, most of our present landowners are men who have either mediately or immediately—either

[10] Cf. *Progress and Poverty*, Book VI, Chapter 1, s. I ("From Greater Economy in Government").

[11] Henry George, *A Perplexed Philosopher* (1892), Part I, Chapter II ("The Incongruous Passage").

> by their own acts, or by the acts of their ancestors—given for their estates equivalents of honestly-earned wealth, believing that they were investing their savings in a legitimate manner. To justly estimate and liquidate the claims of such, is one of the most intricate problems society will one day have to solve.[12]

On its face, this passage refers to compensation for the *cost of acquisition* of the land, *excluding* improvements. What the present owners have "given *for* their estates" is the cost of acquisition of their estates. While the word "estates" by itself can be taken to mean both land and improvements, the opening sentence announces that the passage is about resumption of "rights to the *soil*"—not rights to improvements. Moreover, the right to compensation for improvements (as if it were necessary to resume them) is unequivocally conceded earlier in the same chapter;[13] hence, if the "incongruous" passage were about compensation for improvements, there would be no need for the defensive words "believing that they were investing their savings in a legitimate manner," because the legitimacy of investing in improvements was never in dispute. Only by investing in the land itself does one deal "mediately or immediately" with "the parties who originally robbed the human race of its heritage". To estimate the acquisition cost for each present owner is indeed "intricate" because it requires evidence of the historical cost of acquisition of the *land*—as distinct from improvements which may no longer exist, and whose state at the time of acquisition may not be known—and converting that cost to a present value or annuity. If Spencer were here referring to compensation for the *current* value of the land and/or the improvements, the bill would normally be far higher but also far easier to estimate, in which case he would surely express concern about the size of the bill rather than the intricacy of the assessment.

But according to George, "this passage seems to admit that existing landowners should be compensated for the *land they hold*" (emphasis added), this being "diametrically opposed to all that has gone before and all that follows after," but nevertheless "the sense in which it has been generally understood" and "the sense in which I understood it when, in quoting from *Social Statics* in *Progress and Poverty*,[14] I spoke of it as a careless concession, which Mr. Spencer on reflection would undoubtedly reconsider."

The passage would indeed be "diametrically opposed to all that has gone before and all that follows after" if it referred to compensation for the *present value* of the land, but *not* if it referred to compensation only for the *cost of acquisition* of the land; under the latter interpretation, consistency alone would not require Spencer to "reconsider."

But George, not noticing that possibility, does some reconsidering of his own, asserting that Spencer really meant compensation for the *improvements*, and explaining the new interpretation by re-quoting the passage with some interpolated words. George duly acknowledges the added words (using italics), but fails to acknowledge that he has also *omitted* the first sentence, containing the crucial words "rights to the soil", which do not fit his preferred interpretation! He further supports that interpretation by noting:

> And that this was what Mr. Spencer had in mind is supported by his more recent utterances; for while he has allowed these sentences to be understood as meaning compensation to landowners for their land, yet in the only places where he has stated in terms what the compensation he has proposed is to be for, he has, as will hereafter be seen, spoken of it as "compensation for the artificial value given by cultivation," or by some similar phrase showed that what was in his mind was merely compensation for improvements.[15]

[12] Herbert Spencer, *Social Statics* (1851), Chapter IX, § 9.

[13] *Social Statics*, Chapter IX, § 4.

[14] Book VIII, Chapter 2, par. 7. (Footnote added.)

[15] The quoted phrase is from Spencer's letter in *The Times* (London), Nov. 7, 1889, reproduced in *A Perplexed Philosopher*, Part II, Chapter III.

That is true. But why should George, of all people, credit Spencer with consistency on this point? Spencer's "more recent utterances" dated from after *Progress and Poverty*, and were calculated to maximize the cost of the required compensation so that he could claim that nationalization of land, though imperative in theory, was impossible in practice—that is, so that he could back away from his youthful radicalism without admitting it. This he did by (among other devices) ignoring the locational component of the unimproved value, so that the unearned value conferred by the surrounding community would be wrongly counted as improvements requiring compensation.[16] In view of this agenda, the mature Spencer was never going to admit that the youthful Spencer's "incongruous passage" referred only to compensation for the past cost of acquisition, because that level of compensation would have been too feasible.

2.3 George's incongruous omission

George's first argument against compensation, namely that it would "give the land holders in another form a claim of the same kind and amount that their possession of land now gives them" and in particular "raise for them by taxation the same proportion of the earnings of labor and capital that they are now enabled to appropriate in rent",[17] assumes that the compensation is for the *present* value of the land—not for any lesser value at which the land might have been purchased in the past. Through the rest of his writings, George likewise considers "compensation" as compensation for the current value, and does not explicitly reject compensation for the cost of acquisition.

To one who recognizes property in the products of labour but not in land, the argument that some land "owners" have bought their land with the proceeds of their own labour is, on its face, an argument for compensation for the purchase price only—not for any higher value that the land may have subsequently attained. Yet even when addressing that argument, George does not distinguish between compensation for the purchase price and compensation for the current value, and does not make a separate case against the former. His answer is that those who bought their land "got no better title than the seller had to give".[18] This is later elaborated as follows:

> When a man exchanges property of one kind for property of another kind he gives up the one with all its incidents and takes in its stead the other with its incidents. He cannot sell bricks and buy hay, and then complain because the hay burned when the bricks would not. The greater liability of the hay to burn is one of the incidents he accepted in buying it. Nor can he exchange property having moral sanction for property having only legal sanction, and claim that the moral sanction of the thing he sold attaches now to the thing he bought. That has gone with the thing to the other party in the exchange.[19]

That is true of a valid exchange. But if the exchange was *invalid*, does not the *status quo ante*, in so far as it was valid, remain in force? (Note that this is a *moral* argument, not a legal one.) And in the case of a sale of land, does this not mean that the buyer can reclaim the purchase price?

Moreover, as taxes are paid by persons, not things, George's argument does not of itself tell us which (if any) party in the exchange of land for money is to be credited with the moral sanction. One might credit the seller by saying "*Caveat emptor!*" But the purpose of *caveat emptor*, in so far as modern consumer-protection laws have not abandoned it in favour of the reverse (***caveat venditor***), is to avoid interminable disputes of *fact*—not of law or morals. For the same reason, George goes on to reject two other legal doctrines as arguments for compensation:

[16] Cf. *A Perplexed Philosopher*, Part III, Chapter VIII.
[17] *Progress and Poverty*, Book VII, Chapter 3, par. 10.
[18] Henry George, *The Land Question* (1881), Chapter VI ("Landlords' Right is Labor's Wrong").
[19] *A Perplexed Philosopher*, Part III, Chapter XI.

> Innocent purchasers of what involves wrong to others! Is not the phrase absurd? If in our legal tribunals, "ignorance of the law excuseth no man," how much less can it do so in the tribunal of morals—and it is this to which compensationists appeal.
>
> And innocence can only shield from the punishment due to conscious wrong; it cannot give right. . . . Nor does the principle of **market overt**, which gives to the purchaser of certain things openly sold in certain places, possession even against the rightful owner unless he proves fraud; nor the principle of **statutes of limitation**, which refuses to question ownership after a certain lapse of time, deny this general principle.
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> The principle of "market overt" is not that passage from hand to hand gives ownership, but that there are certain things so constantly passing from hand to hand by simple transfer that the interests of commerce and the general convenience are best served by assuming possession to be conclusive of ownership where wrongful intent cannot be proved. The principle of statutes of limitation is not that mere length of possession gives ownership, but that past a certain point it becomes impossible certainly to adjudicate disputes between man and man. . . No scheme of religion and no theory of morals would hold him blameless who relied on a statute of limitations to keep what he knew belonged morally to another. But legal machinery . . . can inquire only into the *evidence*; and the evidence of things past is to human perceptions quickly dimmed and soon obliterated by the passage of time.[20]

Likewise, the evidence of a *factual* grievance held by a buyer against a seller may be obliterated as soon as the two part company—in which case, *caveat emptor*. But where such evidence exists, *caveat venditor* has been ascendant. Ironically, *caveat venditor* apparently began with the "market overt" rule, which Albert H. Putney explains thus:

> Sales in market overt in England, offer an exception to the general principle that the vendor can convey only such title as he himself possesses. As has been stated, the doctrine has no application in the United States. In London all shops in which goods are exposed subject to sale are markets overt, but in the country only such places are so considered, as are set apart by custom for the vending of certain goods, and all shops are not included. Even in London the shops are considered as markets overt, only for such goods as are usually sold in the shop. *The shop-keeper himself is not protected from liability by this rule of law;* it is for the benefit only of the innocent purchaser. A sale in market overt could not convey title to property of the kings, nor could a sale there made, protect the purchaser who does not buy in good faith. And the sale must not be made in a warehouse or where the shop windows are closed.[21]

The "market overt" rule has since disappeared from English common law, but its intent survives in consumer-protection laws and industry codes that require sellers in certain markets to guarantee title. Where the guarantee takes the form of a refund of the purchase price of any item that turns out to be stolen, it amounts to compensation for the cost of acquisition.

In view of the retreat of *caveat emptor*, which in any case concerns facts rather than morals, invoking *caveat emptor* to penalize the buyer and absolve the seller of a morally invalid land title would be, at best, arbitrary.

In his much-quoted chapter "The Great-Great-Grandson of Captain Kidd", George comes closest to rejecting compensation for the cost of acquisition:

> Or supposing it had happened that Mr. Kidd had sold out his piratical business to Smith, Jones, or Robinson, we will all agree that society ought to say that their purchase of the business gave them no greater right than Mr. Kidd had.[22]

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[20] *Loc. cit.* Emphasis added.

[21] Albert H. Putney, Popular Law Library, vol. V: *Sales, Personal Property, Bailments, Carriers, Patents, Copyrights* (Minneapolis: Cree Publishing Co., 1908), "Eleventh Subject — Sales", Section 63 ("Purchaser in Market Overt"). Emphasis added; punctuation original !

[22] *The Land Question*, Chapter VII.

As Mr. Kidd is assumed to have inherited the business, and as neither he nor any of his ancestors appears to have bought or built the business with the fruits of honest labour, George here implies—although he nowhere draws attention to it—that there should be no inclination to compensate the buyer of a piratical business for the cost of acquisition.

This in turn implies that there should be no inclination to compensate the buyer of land for the cost of acquisition, *if* the two cases are sufficiently analogous. But are they? And would George have claimed that they are? George goes on to say that property in land has done far more mischief than sea-piracy. Conceding that point, one is still confronted with an essential difference: that while no one is obliged to be a sea-pirate, everyone is absolutely obliged to use land.[23] Hence, while there is no sympathy for one who buys a piratical business and loses it, there is instinctive sympathy for one who is forced to pay *more than once* for the right to use a piece of land. The Georgist doctrine that the landholder has the duty to compensate society by paying the rental value of the land—no more and no less—should not diminish that sympathy, but rather reinforce it. With this in mind, consider the following scenarios.

Case 1: A tenant is renting land from a landlord, who owns it by inheritance, when the State suddenly starts collecting the full rental value of land (the "**Public Rent**") in lieu of taxes. Thereafter, the landlord forwards the rent to the State. The tenant still pays the rent for the use of the land, but the landlord no longer retains it, and neither party pays tax any more. This is the desired outcome.

Case 2: As for case 1, except that the tenant has prepaid 10 years' rent and is partway through the 10-year lease when the State suddenly starts collecting the Public Rent; moreover the State forbids the landlord to demand more rent for the prepaid period. If the assessed Public Rent has increased since the start of the lease, from which party shall the State demand the increase?

> **(a)** If the landlord, then in the absence of purely arbitrary line-drawing, the same answer must be given for a prepaid 20-year lease or 49-year lease or 99-year lease, or for a perpetual lease, whose price would hardly differ from that of a 99-year lease, or indeed for an outright purchase, whose price would hardly differ from that of a perpetual lease. So the outright purchaser would not only be compensated for the purchase price, but would escape the Public Rent in perpetuity! Clearly that is absurd.
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> **(b)** If the tenant, shall the State bill the tenant only for the *increase* in the Public Rent since the start of the lease, or for the whole Public Rent?
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> > **(i)** If the whole Public Rent, then the tenant pays ground-rent twice—once to the landlord and once to the State—and is presumably ruined, which is presumably unacceptable. Hence, if the prepaid period is extended until the lease becomes an outright purchase, it is likewise unacceptable that the buyer pays the purchase price to the seller plus the Public Rent to the State; that is, it is *un*acceptable that the buyer *not* be compensated for the purchase price.
> >
> > **(ii)** So the only remaining option is to bill the tenant for the *increase* in the Public Rent. Then, if the lease is extended into an outright purchase, the seller continues to pay the rent as at the time of sale, while the buyer pays the increase since that time. That is, the buyer is *compensated* for the *rental equivalent of the purchase price*, which is paid by the seller.

The resulting treatment of the buyer is *not* the proposal of J. S. Mill, but differs from it in two ways. First, the buyer pays the increase in the rental value since the time of acquisition, not since the time

[23] Even the sea is "land" in the economic sense, and even a Flying Dutchman *indirectly* uses "land" in the sense of terra firma.

of introduction of the Public Rent. Second, the rental value at the time of acquisition is taken from the seller. Consequently, there is *no compensation for landowners as a class*, provided that the sellers are included in that class. The practicalities of billing the sellers are considered at the end of subsection 2.1, above (p. 6).

Case 3: If, contrary to the conclusion in case 2(b)(i), it is acceptable that the buyer not be compensated for the purchase price, let the Public Rent be introduced immediately after the purchase (this being but a limiting case), and let the seller be the State (this being but a special case), and let the buyer be you. Then it is acceptable that the State sells you the land, then immediately repents of its evil ways and starts charging you the full rental value of the same land, although its repentance does not extend to refunding the purchase price!

If, in general, it is unacceptable that the buyer be compensated for the cost of acquisition, then, in case 3 above, it is unacceptable for the State to refund the purchase price, although this would be equivalent to not selling the land in the first place. Thus the rejection of compensation for the cost of acquisition is distilled to an absurdity.

2.4 From George to Leo XIII

Because George did not make the distinction between the cost of acquisition and the present value when attacking property in land or compensation for it, Pope Leo XIII was free to ignore that distinction when defending the same, and thence to gloss over the fact that land is usually worth more than the cost of acquisition, whereas anything else acquired by the same means is usually worth less:

> If one man hires out to another his strength or skill, he . . . expressly intends to acquire a right full and real, not only to the remuneration, but also to the disposal of such remuneration, just as he pleases. Thus, if he lives sparingly, saves money, and, for greater security, invests his savings in land, the land, in such case, is only his wages under another form; and, consequently, a working man's little estate thus purchased should be as completely at his full disposal as are the wages he receives for his labor. But it is precisely in such power of disposal that ownership obtains, whether the property consist of land or chattels.[24]

If George, in his earlier writings, had expressly and prominently approved compensation for the working man's cost of acquisition, that would have been far more clearly "only his wages in another form", so that Leo's statement above, had it been directed against George, would have needed to *defend speculative gains*. That, I submit, was and is an unlikely course for a Pope to take.

2.5 Debt vs. cost of acquisition

Compensation for the cost of acquisition requires evidence of the cost—that is, evidence of a *past* event. If there is a *current* debt outstanding against the land, evidence of that debt is likely to be more recent and voluminous, because the lender is interested in enforcing the debt and monitoring its performance. Similarly, the evidence of the *amount* of the debt is likely to be more recent and voluminous than the evidence of its *purpose*. So, if compensation for the cost of acquisition (level 2) is accepted as the ideal, compensation for the outstanding debt against the land regardless of purpose (level 3), can be understood as a sort of ultimate extension of the doctrine of statutes of limitations, to the point where one inquires as to the amount of the current debt, but not the history of it.

Alternatively, the State could consider any evidence of the cost of acquisition only if it is to the advantage of the beneficial owner. That is, the lender could be treated as part-owner to the extent of

[24] Leo XIII, *Rerum Novarum* (1891), English Ed. (Vatican Publishing House), par. 5.

the debt (level 3), and the beneficial owner could be compensated for the greater of the debt and the verifiable cost of acquisition. Apart from the obvious need for verifiability, this option has already been canvassed [subsection 2.1, p. 6].

3 Without jar or shock

3.1 Solvency of lenders

The "too big to fail" doctrine holds that large lenders are indispensable and must therefore be rescued from mass defaults—as if rescuing them would make them lend for productive purposes, and as if governments could not create credit for the same purposes. One can deny that doctrine while still admitting that, strictly speaking, a tax reform that bankrupted mortgagees would not be "without jar or shock".[25]

If a bank has a portfolio of loans yielding interest of 8% (per annum), against property with a rental yield of 5%, of which 2.5% (i.e. half of the yield) is due to the land component, and if the bank were suddenly required to pay the rental value of its claims on the land in lieu of taxes, then that rental value would amount to a little more than 30% of the interest. That would be similar to what the bank presently pays in income tax on the interest. If any change in the tax bill were shifted onto borrowers, the resulting change in interest rates would be well within the limits of experience, and in any case the central bank could make such compensating adjustments as it thought fit.

That considers only the lending side of the business. Banks not only lend but also borrow; and under the present system the interest on their borrowings is tax-deductible. To preserve that feature under a Georgist system, the borrowings would need to be deductible at 2.5% in the hand of the bank, but taxable at the same rate in the hands of the upstream lenders, who in turn could claim deductions for their borrowings; and so on. To prevent tax avoidance through securitization, the tax on securitized debt would be payable by the holders of the securities. There would be some leakage of revenue under this formula, because some lenders would be outside the taxing jurisdiction while others (especially individual depositors) would tend to attract exemptions. But one could tolerate such leakage for much the same reasons as one could write off the tax payable by "counterparties" under level 2.

The result is a general tax on *pre-existing* debt (that is, debt dating from before the introduction of the Public Rent) at the rate of 2.5%, except that a pre-existing debt backed by a claim against property is taxed at the rental value of the land component of the claim—the remainder of the rental value of the land being payable by the beneficial owner, subject to any concession that may apply where the historical cost of acquisition is greater than the outstanding debt.

Thus the tax on debt,[26] payable by lenders, would be a *transitional* provision. Initially there would be some political advantage in it, because of the role of lenders in financing property bubbles, leading to bursts, financial crises, and recessions. But as property bubbles would be impossible under the new Georgist system, the reputation of lenders would presumably improve, so that the gradual disappearance of the tax (due to repayment of old debt) would be readily accepted.

[25] "Nor to take rent for public uses is it necessary that the State should bother with the letting of lands... The machinery already exists. Instead of extending it, all we have to do is to simplify and reduce it. By ... making use of this existing machinery, we may, without jar or shock, assert the common right to land by taking rent for public uses." — *Progress and Poverty*, Book VIII, Chapter 2, par. 13.

[26] That is, the tax on debt as proposed here, and not necessarily as proposed in any past or future document by this author!

3.2 Solvency of borrowers

The same tax on pre-existing debt would give lenders an incentive to write down non-performing debts to serviceable levels, in order to avoid paying tax on debt that is not realistically recoverable. In managing such write-downs, creditors would be keen to minimize damage to the debtors' credit in order to maximize the debtors' chances of servicing the remaining debt. The maintenance of credit-worthiness would help to minimize "jar or shock" and accelerate recovery from any crisis that preceded the implementation of Public Rent. After the implementation, such crises would be unlikely to recur, so the lack of any similar tax on debt incurred *after* the implementation would be readily tolerated.

If the State starts collecting the entire rental value of a site, the sale price of the site falls to zero. If this happens suddenly while the site is subject to a mortgage, the beneficial owner is left with **negative equity**. Treating the lender as part-owner for the purpose of collecting the rent does *not* solve this problem, but *does* solve a more serious problem by ensuring that negative equity is not reflected as negative cash flow—that is, by ensuring that the beneficial owner does not pay both interest *and* rent on the same portion of the site value.

If the cash-flow issue is thus addressed, and if the insolvency laws are adjusted to ensure that beneficial owners are not deemed to be insolvent solely by reason of wipe-outs of land prices, then it becomes easier to argue that **home owners** are no worse off due to the disappearance of the sale prices of their sites, because the purchases prices of alternative home sites are likewise wiped out.

Treating lenders as part-owners does not address the difficulty of the retired home owner whose only asset is the home, and whose income is now insufficient to pay the Public Rent, and who can no longer get a reverse mortgage on the site, because it no longer has a capitalized value. Neither does it deal effectively with the investor who now has negative equity in *several* properties, and who may therefore be tempted to "walk away". Rather than propose specific solutions, I point out that if the State is to abolish existing taxes *and* collect enough site rent to reduce capitalized site values to zero, it will need to collect the rental values of sites not as they presently are, but *as they would be in the absence of the existing taxes*. To a first approximation, the amount of site rent collected will be the total of present site rents and present taxes, so that the present site rents will represent *additional* revenue, providing ample means with which to respond to any remaining transitional problems. If the responses can be characterized as middle-class welfare or upper-class welfare or unjustified bailouts, they will not be the first such abuses; but they can be the last.

If, on the contrary, the State were to collect only enough of the site rent to replace existing taxes, then the sale prices of sites would *not* be wiped out. Thus the issue of negative equity would not arise, while the "asset-rich, income-poor" home owner would remain asset-rich and would still be able to borrow against the site value. But George did not approve any such limited program, except "[f]or a beginning",[27] from which he thought the end would "follow as a matter of course".[28]

In cases where the State foreclosed on beneficial owners who failed to pay their shares of the site rent, the enabling legislation would need to specify the priorities of tax liens and mortgages. In this paper, however, the focus is on avoiding the need for such foreclosures.

3.3 Digression: Exemptions for owner-occupied residential sites?

George would not have exempted the site under the "family home" from the public collection of site rent, whether that collection were full or partial. However, it may be of interest to consider how the

[27] "Land and Taxation: A Conversation between David Dudley Field and Henry George"; see note 3.
[28] *Progress and Poverty*, Book VIII, Chapter 2, par. 18.

cost of such an exemption would be affected by the transitional tax on debt—especially in the case of Australia, where the "family home" is exempt from State and Territory land taxes.

At June 2009, according to the Australian Bureau of Statistics,[29] Australia's land was worth $3012 billion, of which $2215 bn was residential, $592 bn commercial or rural, and $205 bn "other", all figures being capitalized values in Australian dollars. Excluding the "other" as being probably unavailable for environmental or cultural reasons, we are left with a usable value of about $2800 bn, which, at an annual yield of 5%, would give an annual rent of about $140 bn, comprising about $110 bn residential, and $30 bn commercial or rural. Of the residential land, perhaps $80 bn by rental value would be owner-occupied. If that is exempt in the usual sense, the forgone revenue is about $80 bn, which is comparable to the combined revenue from GST (VAT), fuel excise and payroll tax. However, of the exempt value, probably a little more than a quarter is owed to lenders. Hence, if the corresponding rental value is taken from the lenders, the "clawback" of revenue is a little more than $20 bn, which is more than enough to replace the much-ridiculed payroll tax.

These figures are conservative in that they fail to account for the effect of abolition of existing taxes. If we accept the thesis, as George did, that taxes in the aggregate are deductions from site rent, then the figures just quoted can be "grossed up" by a factor of at least three, in which case the "clawback" would be at least equivalent to GST plus payroll tax.

The "clawback", however, would be temporary, because it would be reduced as pre-existing debts were paid off.

3.4 Notes on gradual implementation

In theory, one way to implement George's program "without jar or shock" is to implement it gradually—first moving property taxes from improvements to land, then gradually increasing the rate while phasing out other taxes—giving property owners ample time to avoid negative equity and negative cash flow. In practice, however, land speculators will use that time not to prepare for the reform, but to defeat it. That leads many modern Georgists to reject gradual implementation.

But if public collection of site rent is implemented in one step, how shall negative equity and negative cash flow be avoided? George himself hoped that the mere *expectation* of reform would gradually reduce capitalized values of land, and thereby gradually reduce the motive for opposing reform. He used this as an argument against compensation—and in the present context it is noteworthy that his argument would be weakened if the compensation were for a fixed historical cost of acquisition rather than the increasing present value:

> Take slavery. The confidence of American slave-holders, . . . that abolition would not come without compensation, kept up to the highest point the market value of slaves, . . . whereas if there had been no paltering with the idea of compensation the growth of the sentiment against slavery would by reducing the selling value of slaves have gradually lessened the pecuniary interests concerned in supporting it.
>
> Take private property in land. Where the expectation of future growth and improvement is in every advancing community a most important element in selling value, the effect of the idea of compensation will be to keep up speculation, and thus to prevent that lessening in the selling value of land, that **gradual accommodation** of individuals to the coming change, which is the natural effect of the growth of the demand for the recognition of equal rights to land.[30]

This is true even if the "coming change" is to happen in a single step—provided of course that the single step is sufficiently delayed. And this mechanism is relied upon by some modern Georgists who

[29] *Australian System of National Accounts*, ABS 5204.0, Table 61 ("Value of Land, by Land use by State/Territory").
[30] *A Perplexed Philosopher*, Part III, Chapter XI. Emphasis added.

propose full implementation in one step. The price of avoiding "jar or shock", according to them, is not gradual change but "gradual accommodation" to a long-delayed single-step change. It is the gradualism that one embraces when one does not admit being a gradualist. Meanwhile, landed interests use the delay to prevent the necessary "gradual accommodation". In so doing, they indefinitely prolong the delay.

A third option, which is a sort of political analog of the biologists' **punctuated gradualism**, is to move the tax burden onto land values not in small steps, but in *large steps*, each step being accompanied by the abolition of some existing taxes for all of the people, or of all existing taxes for some of the people, so that any politician who proposes to reverse the step has a veritable cliff-face to climb—a cliff-face made all the higher by the compliance costs that disappeared along with the taxes. Thus each step, like the click of a ratchet, is easier to do than to undo. If the first step is *intrinsically* free of "jar or shock", it can be implemented without delay.

A particularly attractive "first step" is the one that collects just enough of the site rent to abolish *all* existing taxes for *all* of the people. But if this much is to be done without forcing recent mortgagers into negative cash flow, the lenders will need to be treated as part-owners in proportion to debts incurred before the "first step".

4 Conclusion

Because a tax on debt incurred for the purpose of acquiring land is shifted onto the land, such debt is not a revenue base distinct from the land value unless the debt was incurred before the introduction of the public charge on the land value. Even then, a tax on the debt is only a means of collecting that part of the land rent which is no longer collectable from the beneficial owners (borrowers) because they have pledged it to the lenders in the form of interest.

In practice, however, if one wishes to collect the rent of land for public purposes, one must collect it from those who actually have it. In the case of the portion of the rent paid as interest under mortgages taken out *before* the introduction of public collection of land rent, those who have it are the lenders. And because lenders also borrow, they must be allowed a deduction for debt incurred before the introduction of public rent collection—that debt being taxable in the hands of their creditors, and so on.

These remarks apply to pre-existing debt owed against land or owed by those who have lent against land; the revenue potential of debt *in general* is not considered here.

From the viewpoint of the beneficial owner, treating the lender as part-owner for the purpose of the "single tax" would be equivalent to compensation for the debt. One could err on the side of generosity to the beneficial owner by stipulating that if compensation for the proven historical cost of acquisition is more generous than compensation for the debt, the former shall apply. Neither arrangement is condemned in the writings of Henry George, and neither would amount to compensation for land owners *as a class* if that class includes mortgage lenders.

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