SLAVERY/AFFORDABILITY

Exactly two hundred years after the abolition of the trans-Atlantic slave trade, is it possible that our taxation and landholding systems are evolving into a more subtle form of slavery?

The unfortunate English sociopath Edward Gibbon Wakefield, who abducted then married two young heiresses, dreamed up a theory of colonisation whilst in Newgate Prison for the second of these offences from 1827 to 1830. Wakefield espoused that new settlements required neither slaves nor convicts for cheap labour; a compliant workforce may be had simply by selling land at 'sufficient price' that only the wealthy would be able to afford it. Wakefield had stumbled upon the high-land price, high-taxing formula that Pliny the Elder said had been the ruin of Ancient Rome: "The great landed estates destroyed Italy" (*Latifundia perdidere Italiam)*. It is this selfsame socially damaging regime into which at the outset of the 21st century world economies have morphed.

Unlocking the Riches of Oz uses Australian data as a proxy for the economies of the world to confirm this thesis.

L V R G

SYNOPSIS

This report collates Australia's real estate sales since 1972 to create '*The Barometer of the Economy'.* As the *barometer* demonstrates a delayed inverse relationship between property bubbles and the economy, we investigate the extent of Australia's publicly-generated natural resource rent in order to assess the scope for '*Unlocking the Riches of Oz*' currently suppressed by the deadweight costs of taxation. Re-calculating GDP on the assumption of the notional public capture of one half of Australia's resource rent since 1972, we show the benefits that would flow to all Australians, the environment, housing affordability and industrial relations by reducing taxes in favour of greater reliance on resource rents to be substantial.

Pure rent is in the nature of a 'surplus' which can be taxed without affecting production incentives.

- **Economics** (Second Australian Edition) Samuelson, Hancock and Wallace, p. 623

UNLOCKING THE RICHES OF OZ: A CASE STUDY OF THE SOCIAL AND ECONOMIC COSTS OF REAL ESTATE BUBBLES 1972 TO 2006

Bryan Kavanagh

The Land Values Research Group
2007

The National Library of Australia Cataloguing-in-Publication

Kavanagh, Bryan, 1944-
Unlocking the Riches of Oz: a case study of the social and economic costs of real estate bubbles 1972 to 2006.

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ISBN 9780909946036 (pbk.).

1. Land speculation - Australia - Case studies.
2. Real estate investment - Australia - Case studies.
I. Land Values Research Group (Melbourne, Vic.).
II. Title.

333.33230994

The Land Values Research Group gratefully acknowledges a grant from the Henry George Foundation of Australia for publication of this report, and the assistance of Gavin Putland and Karl Fitzgerald in offering the author helpful suggestions. The use of Peter Nicholson's insightful cartoons does not imply that he supports the views of *The Land Values Research Group*.

The Print Press
EST. 1985
Printing and Artwork Services

Telephone: 9569 4412 ~ Fax: 95631005
Email: printpress@bigpond.com

INTRODUCING THE TAX SYSTEM

Revenues sourced from other than the capture of annual land and natural resource values all offend against *at least one* of the four classical canons of taxation, namely, that revenues should (1) bear lightly upon production, (2) be cheap and easy to collect, (3) be certain, and not able to be passed on and, (4) bear equally, giving advantage to none (*Progress and Poverty*, chapter 33). Therefore, the almost complete lack of interest in establishing a community claim to the land values generated by public infrastructure and the existence of community as the *primary* source of public revenue is curious. It is perhaps best understood in terms of a media bias thought to favour its real estate advertisers, even though they too can be shown to benefit from land-based revenues. Amazingly, the forces of both left and right have fallen under the spell of this blinkered mind-set, and the idea of extending land value capture has rated little discussion.

Poll-driven governments are therefore unlikely to be burdened by matters of principle in considering from whence they will draw their revenues. Considerations of the canons of taxation will go out the window in favour of cynicism such as *'The art of taxation consists of so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing'* (Jean Baptiste Colbert, 1619-1683), or the modern equivalent, the metaphorical 'three legged stool', ie. that *a mix* of taxes on incomes, sales and property provides the most 'stable' tax base. Politics being deemed to be the art of the possible, it appears that policy makers and politicians have decided to appease noisy landed interests by up-taxing productive activities and down-taxing resource rents, the canons of taxation and the axiom that 'taxes destroy' notwithstanding.

How does land price arise?

If residential returns in a particular locality are showing 4.0% after deduction of $1000 in municipal rates, and if vacant lots are selling for $200,000, the indicated annual value of sites is $8000 per lot net of rates [i.e. 4.0% of $200,000].

However, if half this imputed annual yield were captured for public revenue, the price of the sites would immediately *fall* from $200,000 to $100,000, as the $4000 annual value remaining uncaptured by government would be privately capitalised at 4.0%. That is, people would be prepared to pay a capital sum of $100,000 for a site on which they did *not* to have to pay the annual value of $4000 to government.

On the other hand, if the existing council rates of $1000 were abolished on the sites, their price would *increase* from $200,000 to $225,000 (i.e. $9000 annual value capitalised at 4.0%).

So, whether people realise it or not, land price is actually the private capitalisation of imputed site rent remaining on a site, developed or un-developed, after deduction of government charges.

Hence, as taxes in other areas of the economy act to *increase* prices, policymakers should consider greater land value capture as the most effective way to *reduce* land prices and improve ‘housing’ (read *land*) affordability, because there would remain less annual site value to be capitalised into land price.

[The analysis above deals with the effect on land prices due to annual charges *on land*. It does not allow for effects on land prices due to changes in spending power caused by other kinds of taxes or tax reductions. Neither does it allow for bubbles. These matters are addressed in the text.]

Given the lack of intellectual rigour concerning the equitable sourcing of revenue, it isn't surprising that tax systems have run amok and developed into a Mad Hatter's Tea Party. A welter of tax legislation is directed towards fining labour and capital for working, and rewarding property holders and speculators for inflating socially damaging property bubbles. Those who follow the imperatives of the tax system by turning to rent-seeking tend to do very well for themselves, while all others tend to do poorly. Taxes on productive transactions impede the supply of goods and services and therefore raise prices, feeding inflation and increasing the unemployment rate 'required' to lower wages sufficiently to stabilise inflation. This unemployment rate is accepted as 'natural', and even defined as 'full employment'. All these effects widen the gap between a minority of haves and the vast majority of have-nots, despite transfer payments nominally targeted to narrow the poverty gap. Paradoxically, those most disadvantaged by the tax system cling to the forlorn hope that it may be tinkered with in order to redistribute wealth more justly. It cannot - unless the three legged stool's extremely shortened 'property' leg is replaced. This conclusion will be tested by analysis of Australia's real estate sales, some 70% of which, including vacant land sales, is now represented by land price. Importantly, this compares with the far lesser figure of 25% in 1970.

To date, all discussion about declining housing affordability has ignored that in a rational market land price is simply the private capitalisation of publicly-generated annual land values, as explained in the inset on the opposite page. When the land market develops into a **bubble**, the rational price is inflated by a temporarily self-fulfilling expectation of capital gain.

Land price is now the greater part of residential property values in Australia, so it may be that greater public capture of annual land values has much to commend it on at least four fronts: (1) reducing land prices, or at least dampening speculative price increases by imposing a **holding cost** on speculators, (2) providing scope to redress a Mad Hatter's tax regime which penalises work and employment, (3) establishing a citizens' claim to Australia's natural resource values and, (4) assisting to foster a natural job-shift, away from further intensive urban agglomeration, towards cheaper and more decentralised locations.

A vast government workforce currently administers well-intentioned transfer payments which are categorised and distinguished unnecessarily and at great cost to the nation. It would be far cheaper were all Australians to claim their *equal* birthright to the annual surplus, national resource rents, in the form of a yearly citizen's dividend. Whilst a guaranteed annual income has remained a pipe dream, it need not, and there could be no sounder foundation than community-generated resource rents.

In order to make land more affordable, Alan Moran, head of the Institute for Public Affairs (IPA) Deregulation Unit has recently promoted greater release of broadacre lands for residential subdivision. However, this is an indirect and ineffective way of reducing land prices. In *The Tragedy of Planning: Losing the Great Australian Dream* (IPA, 2006), Moran makes a case against the 'regulatory morass' into which Australia's town planning has descended, showing it to be akin to California's. He fails, however, to mention the substantially higher than

LAND, n. *A part of the earth's surface, considered as property. The theory that land is property subject to private ownership and control is the foundation of modern society, and is eminently worthy of the superstructure. Carried to its logical conclusion, it means that some have the right to prevent others from living; for the right to own implies the right exclusively to occupy; and in fact laws of trespass are enacted wherever property in land is recognized. It follows that if the whole area of terra firma is owned by A, B and C, there will be no place for D, E, F and G to be born, or, born as trespassers, to exist.*

- Ambrose Bierce "The Devil's Dictionary", 1911 average crime rates in those US cities he approvingly cites as having a more relaxed attitude to zoning more land for residential development on the urban periphery. Ironically, the higher crime rates in those cities may have contributed to their lower land prices, therefore, greater 'housing' affordability, because increased rates of crime will *usually* prove to be the corollary of inadequate social infrastructure on the urban fringe. Perhaps those people living within Australia's 'urban sprawl', a term to which Moran objects, are not doing *as they wish*, as he suggests, but are following the dictates of job opportunities *as they must*. Under a tax code delivering enormously disproportionate benefits to Australia's capital cities, the cities are where jobs are most likely be found. The largest capital gains are also to be found in the *best* parts of our major cities, and whilst investors refer to this as 'location, location, location', economists know it as 'Ricardo's Law' - that is, those locations where supra-marginal rents are greatest.

It is quite natural that many young people will be attracted to the vibrancy of the big city, but how many might have eventually returned home had the benefits of 'location, location, location' been recognised by geo-spatially based revenue systems which acknowledge *relative* locational values? We witness instead the private plunder of vast slabs of *community* resource rents, whether by Russian oligarchs or Nigerian oil crooks abroad, or to a lesser extent by Macquarie Bank and leveraged buyouts of our natural resources at home. The cost to everybody but the proponents of these insidious rent-seeking techniques is an increasingly pernicious tax system, higher and higher land prices and declining levels of social welfare.

In a recent book *Ricardo's Law: House Prices and the Great Tax Clawback Scam,* British economist and journalist Fred Harrison takes his readers on a journey from the centre of London northwards along the ancient Roman road to Lincoln and onwards to Hadrian's wall. Harrison documents that wealth, property values, and the very length of life itself, all decrease as the trip proceeds north through England's six statistical divisions along the way. He notes London's parasitical dependence on these far-flung locations for its surplus tax funding, and that London redistributes only *part* of this ill-gotten gain back to the benefit of these lesser locations. In all likelihood, a study of the tax privileges dispensed to Australia's mainland capitals would disclose great similarity to Harrison's analysis.

SCOPE FOR REPLACING TAXES WITH RESOURCE RENT/LAND VALUE CAPTURE

In 2000, *The Land Values Research Group* (LVRG) commissioned Dr Terry Dwyer, then visiting Fellow, National Centre for Development Studies, Asia Pacific School of Economics and Management, Australian National University, to quantify Australia's natural resource rents. The result was a tabular time series analysis from 1911 to 1999 published as *The Taxable Capacity of Australian Land and Resources* in **Australian Tax Forum**, Volume 18, Number 1, 2003. Dr Dwyer found that smoothed land incomes in the financial year 1998/99 had reached 134.1% of Australia's total corporate and personal income tax. The LVRG has extended Dr Dwyer's analysis since 1999, using his technique of establishing the value of land and other natural resources and then adding their current and

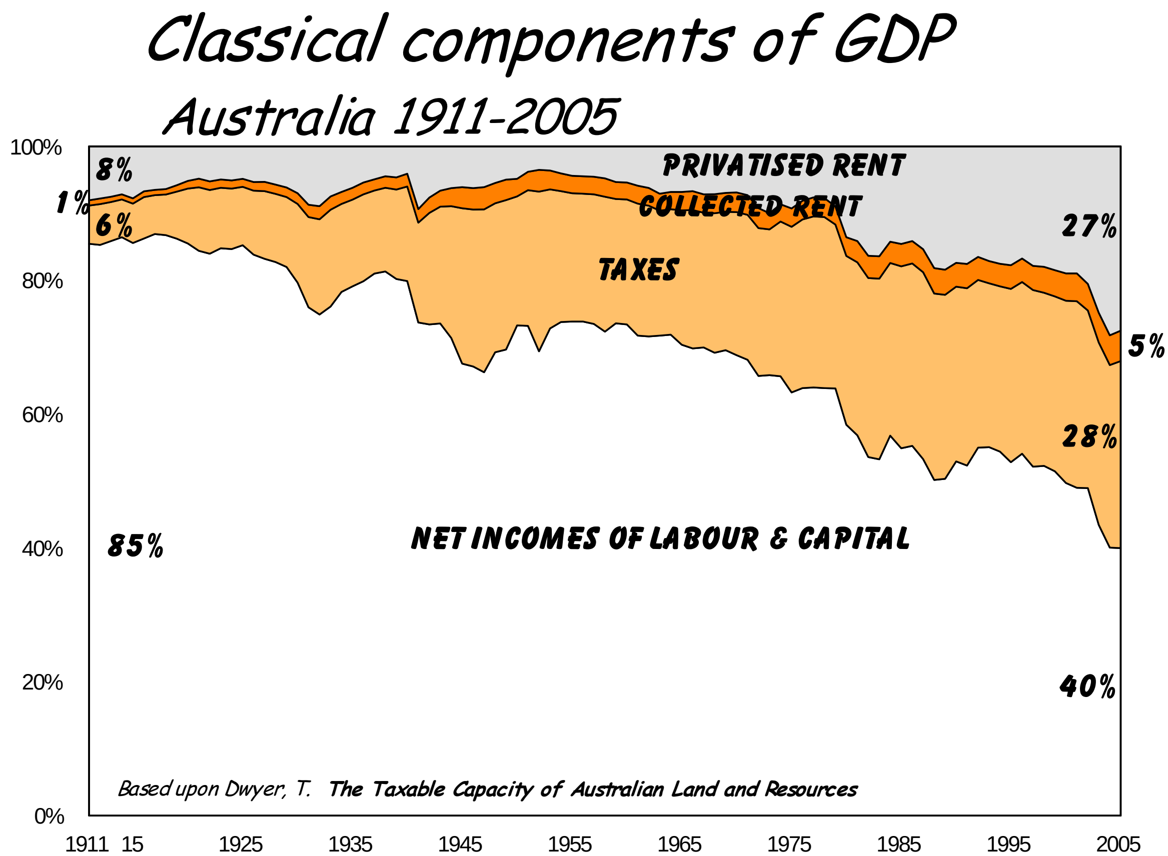

Classical components of GDP
Australia 1911-2005
100%
80%
60%
40%
20%
0%
1911
15
1925
1935
1945
1955
1965
1975
1985
1995
2005
PRIVATISED RENT
COLLECTED RENT
TAXES
NET INCOMES OF LABOUR & CAPITAL
8%
1%
6%
85%
27%
5%
28%
40%
Based upon Dwyer, T. The Taxable Capacity of Australian Land and Resources

FIGURE 1

accrued yields. Annual resource values proved to be 22.41% of GDP in 1999, but by 2005 they had grown to 32% of GDP, under the influence of what from 1996 to 2004 has been the greatest real estate bubble in Australia's history. This percentage of GDP was sufficient to have replaced taxation at *all three* levels of government in Australia.

It may be argued that 'economic rationalism' has amounted to little more than thirty years of government acquiescence to the private plunder of Australia's natural resources, and that the environment has suffered mightily as a consequence. As resource rents may be seen to *represent* community, the whittling away of the sense of community that has accompanied this quite *irrational* period of our economic history cannot be considered coincidental.

Whereas the national accounts simply roll Australia's *earned* incomes and *unearned* natural resource rents together as 'income', using Dwyer's study we have disaggregated rent and taxes from GDP to arrive at the net *earned* incomes of labour and capital in *classical* economic terms. These *non-speculative* incomes are shown at Figure 1, together with the relatively small percentage of resource rents which are currently collected for public revenue.

Economic rationalism is characterised in the chart by an upsurge in rent and rent-seeking from 1980, following the abolition of death duties, and the Whitlam government assuming responsibility for funding a large part of local government. The more extensively *privatised* capture of land rent and the concomitant increase in taxation from this time is readily observable.

IMPLICATIONS FOR INDUSTRIAL RELATIONS

Other than providing some idea of the scope for reducing land prices and rectifying a Mad Hatter's Tea Party of taxes, the most striking feature of the chart is its import for industrial relations reform. Under existing taxation arrangements, labour and capital fight over the 40% of GDP remaining from *earned* incomes *after* 28% of GDP has been taken from them by taxation and *after* 27% of the 32% of GDP comprising publicly generated resource rents has been creamed off by private interests - many of whose names will be found listed each year in *Business Review Weekly*'s "Australia's Richest 200".

Winning a greater share of land and resource rents is currently proving to be a soft target for speculative capital. Therefore, both labour and capital appear to have a *common* interest, not only in winning back some of the 28% of GDP taken from their earned incomes in taxes, but also in seeking greater public capture of Australia's annual land values. Further analysis discloses that net earned incomes have declined by 40% as a percentage of GDP since 1972, taxes have grown by 27%, and annual land values/resource rents or *unearned* incomes have *grown by 160%.* Whilst the earned incomes of many Australians may *indeed* have been supplemented by land values, it may also be seen that this rapidly appreciating natural resource fund has much to recommend it as the *natural* revenue base - and from which an *equal* dividend may be delivered to *all* Australian citizens.

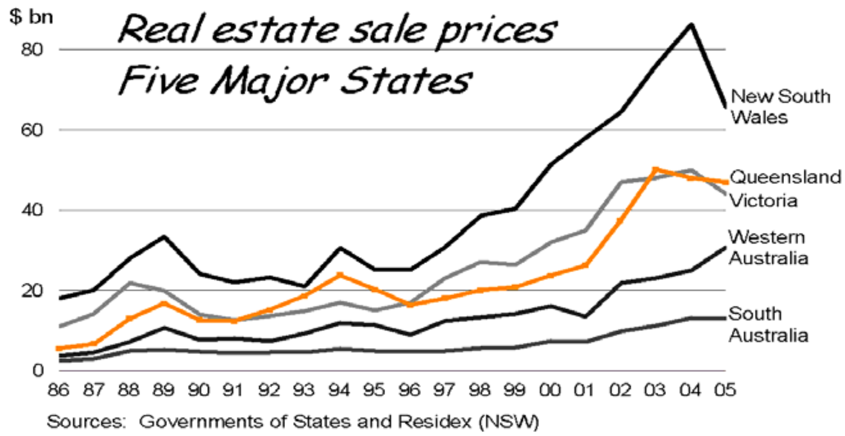


FIGURE 2

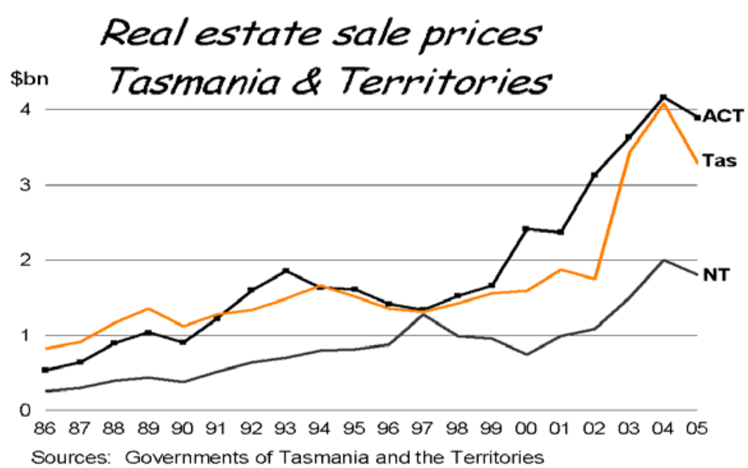


FIGURE 3

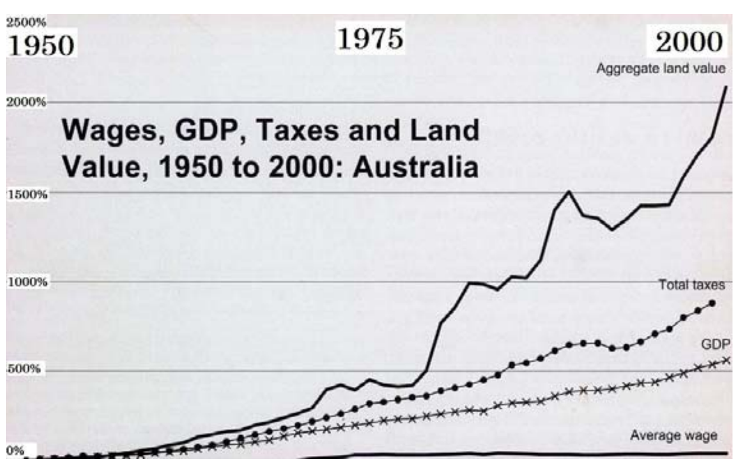


FIGURE 4

ASSESSING THE INFLUENCE OF THE PROPERTY MARKET ON THE AUSTRALIAN ECONOMY

Other than recording building commencements and borrowings for the purchase of real estate, the Australian Bureau of Statistics (ABS), the Reserve Bank of Australia (RBA) and federal Treasury have shown little interest in quantifying the overall Australian real estate market. The LVRG has therefore set out to fill this void by gathering real estate sales at current prices from Australia's six States and two Territories, each of which by the mid-1980s collected, analysed and published the details of its own real estate sales.

Figures 2 & 3 show that real estate sales turnover declined in the early 1990s after the bursting of the 1988/89 bubble. Although it may not *appear* to be the case, real estate sales actually proceeded quite sluggishly until 1996 - with the exception of Queensland. Figure 2 shows Queensland's sales prices surpassing those of Victoria between 1991 and 1995, and closely approaching the New South Wales juggernaut in 1993. Whilst Queensland *did* experience a strong real estate boom from that time, this was not the case elsewhere in Australia where the upward inflection in the sales graph includes major commercial and industrial sales by banks as mortgagee-in-possession. Properties of lesser defaulters from the late 1980s bubble had already been meted out onto extremely depressed markets, but these larger commercial and industrial properties had been held back whilst business bankers wrestled with their greater complexity.

In 2005, the volume of real estate activity in most states had either turned down or levelled out; but in Western Australia it continued to climb, underpinned by prosperity emanating from its extraordinary minerals boom. In Tasmania, the highest number of migrants in a decade in the 2004 financial year was part of the sharp increase evident in its real estate market between 2002 and 2004 in Figure 3. This included immigrants who 'sold down' into the Tasmanian market to realise capital gains and release funds on their higher valued mainland properties.

THE <u>AUSTRALIAN</u> REAL ESTATE MARKET

The values of states' and territories' property sales were next collated into a national total in order to remove local influences and to permit comparison with other national aggregates. This is shown in nominal and real terms at Figures 5 & 6. Figure 7, the total *number* of sales, confirms the price of real estate to be numbers-driven, sales in the troughs numbering from only 380,000 to 500,000, whereas numbers at the peaks range from 500,000 to 767,000.

But what drives the numbers? It is difficult to resist the conclusion that, apart from normal user demand, two pathologies are hard at work. One is the Mad Hatter's tax regime encouraging residential landlordism by granting deductions for interest on the land price on an equal footing with *productive* business investment, whilst the other is the herd mentality that arises, either when prices in the real estate market start to boom or when, more rarely, they begin to fall.

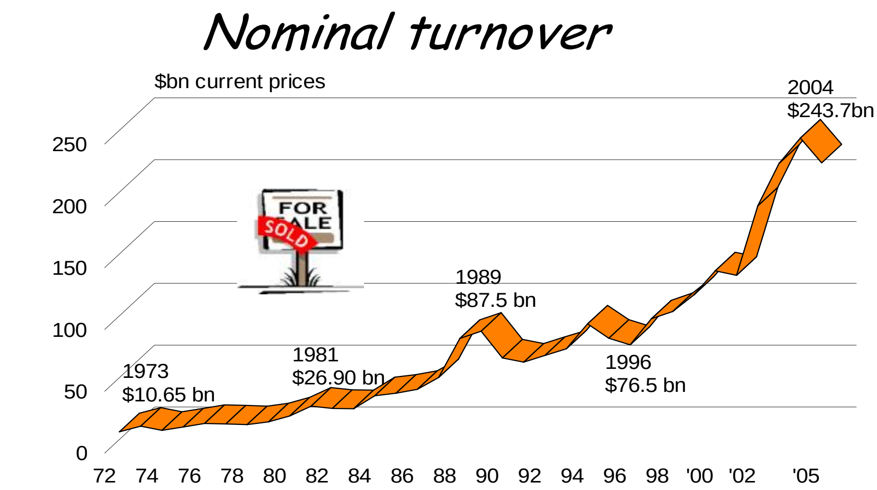


FIGURE 5

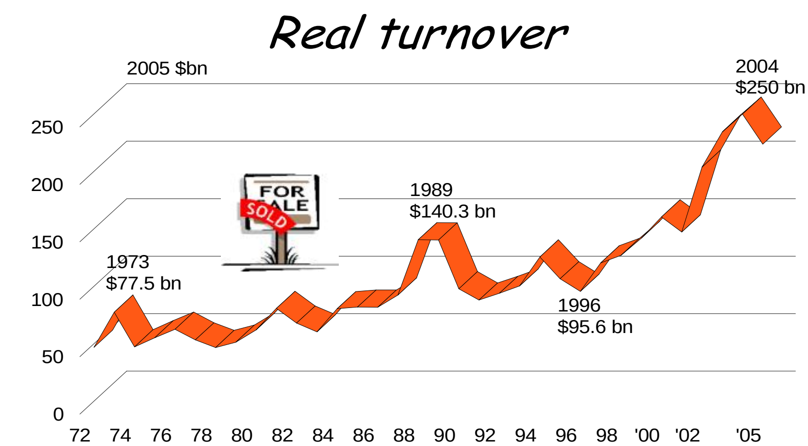


FIGURE 6

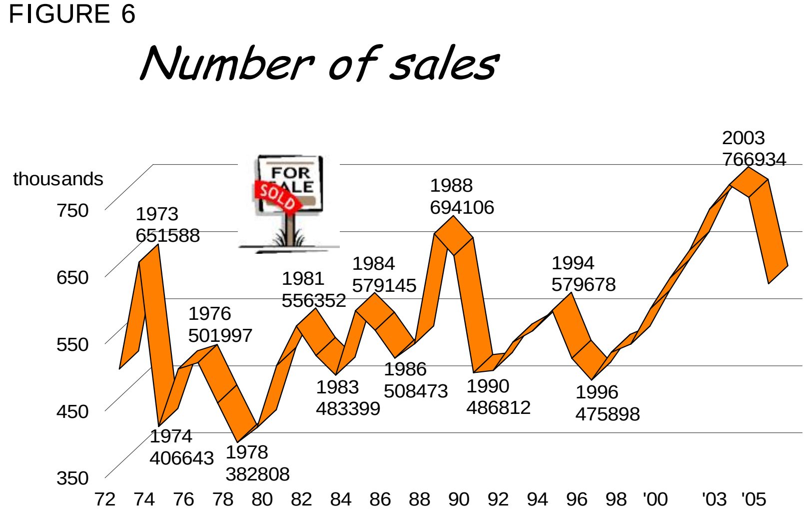


FIGURE 7

On the latter occasions, residential landlords will be heard demanding that land taxes be slashed, or seeking other government support to rectify their declining capital gains. “Otherwise, we will stop *providing* rental housing.” God forbid the creation of a *genuine* real estate market by deterring the private capture of publicly-created asset values! Such fiscal discouragement would pose the pointed question to those holding real estate assets: “*Am I really using this property, or simply seeking capital gain - thereby pricing future generations of Australians out of home ownership?*” In what market essential to human existence other than real estate may anything achieve the incredibly generous capitals gains shown at Figure 4 (from *Land Monopoly and Income Polarisation in Australia 1950 to 2000*), simply by holding it *off* the market until the blackmail price is met for it?

THE BAROMETER OF THE ECONOMY

Australia’s total real estate sale prices, extrapolated back to 1972, was then divided by gross domestic product (GDP) at current prices in order to provide an aggregate adjusted for population growth and national movements in consumer prices. The graph of the quotient at Figure 8 paints such an extraordinary picture that we have nominated it *The Barometer of the Economy*. Not only does it provide at a glance Australia’s socio-economic record over the last thirty years, but it may be employed to *forecast* periods of economic growth or decline. Upward inflections in the *barometer* signify that real estate sales prices are outperforming economic growth, so these may be seen as property booms. A downward deflection, on the other hand, shows the economy to be doing better than the real estate market, and this clearly does *not* represent a property boom.

As a response to the recessionary fallout from the bursting of a worldwide property bubble in the early 1970s, it became fashionable to reduce the incidence of property-based revenues. The 1970s real estate bubble has virtually been written out of history and blame for the resulting recession laid instead at the foot of the simultaneous OPEC oil crisis. However, amongst other remaining public records, the gigantic real estate bubble is well documented in a ten page special report in TIME magazine of 1 October 1973, entitled *The New American Land Rush*.

As with all recessions, the 1974/75 recession, heralded in Australia by the collapse of Cambridge Credit and Dick Baker’s Mainline Corporation, affected everyone badly, but the property investment lobby was successful in capturing the ear of western governments by claiming that not only had its property values fallen, but that property taxes had *created* the recession. Nothing could have been further from the truth, but the media reported the property tax revolt sympathetically. California’s Proposition 13, which put a ceiling on the property tax in 1978, represented the full flowering of this putsch in the USA. [*Pan the property lobby’s propaganda cameras to Whistler’s mother being evicted onto the sidewalk in her rocking chair.*]

In Australia, although local government had once funded itself, Prime Minister Gough Whitlam saw fit to support municipalities from federal taxation in order to slow the naturally increasing growth in municipal rates. Shortly afterwards,

The Barometer of the Economy

total real estate sales prices divided by GDP

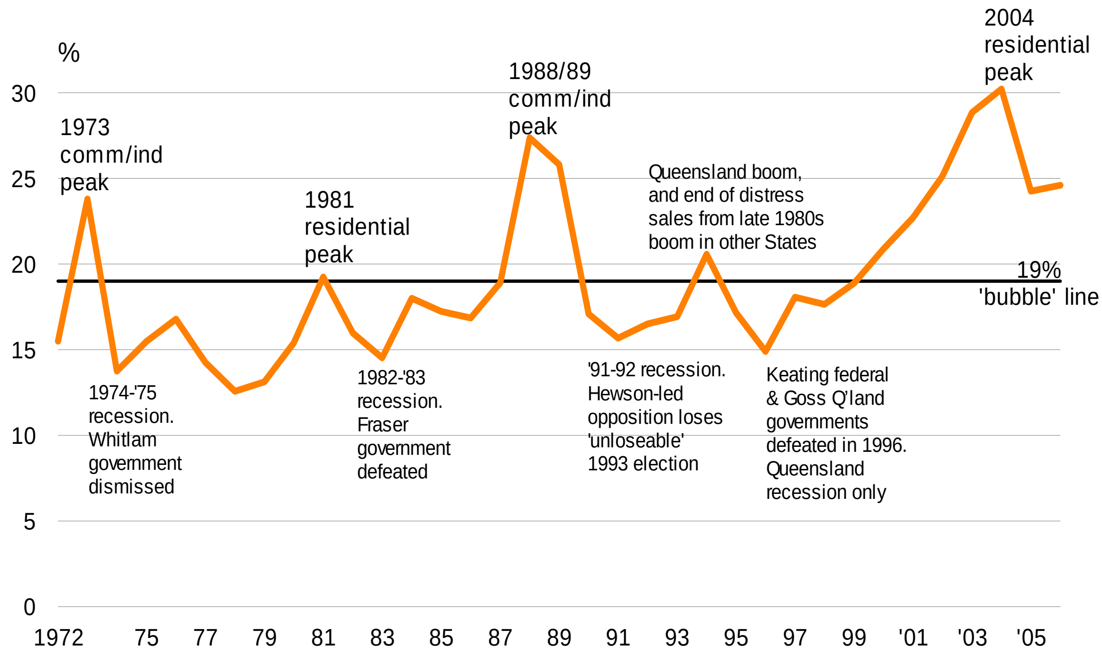


FIGURE 8

Premier Joh Bjelke-Petersen removed probate duty from the statute books of Queensland. Governments of the other states and territories followed suit, and the federal government then proceeded to scrap estate duty. By 1980, growth in local government rates had been constrained and the field of Australian death duties entirely vacated. The coast was now clear for the 1981 residential real estate bubble.

The Australian residential market grew from 64% to 80% as a proportion of the total property market between 1984 and 2004, whilst the commercial/industrial and rural categories both contracted to 10% (from 16% and 20%, respectively, in 1984). Whereas Australia's population grew by a factor of 1.36 between 1984 and 2004 (from 15 million to 20.4 million) and GDP increased in real terms by a factor of 1.86, real land values increased a remarkable *3.2* times.

The barometer's 'bubble line' has been pitched empirically at 19%, simply because the boom appears to transform into a socially devastating bubble from this point. For example, whereas no recession ensued in the decline of 1985/86 after the real estate market had peaked at a ratio of 18%, recession has followed on each occasion the relationship has exceeded 19% - even at 19.24% in 1981. So, while neo-classical economists seem unable to identify a bubble until it bursts, the LVRG offers the following definition: an Australian real estate bubble is any occasion when, in one financial year, total real estate sale prices exceed 19% of GDP.

The 1994 peak is an apparent exception in that real estate turnover exceeded the 'bubble line' but no national recession followed. The explanation in this case is that both the bubble and the ensuing recession were confined to Queensland. Elsewhere in Australia, the peak in *turnover* in 1994 did not coincide with any peak in *prices*, but was caused by banks divesting themselves of their remaining portfolios of 'distressed' commercial and industrial properties overhanging from the bursting of the property bubble in late 1989. The delay worked to the advantage of the banks as land prices gradually began to recover. Price escalation gained a momentum from 1996 which did not falter until the bubble peaked in 2004.

Whereas the earlier 1987 to 1989 bubble had been driven mainly by the commercial and industrial property markets in which the names Bond, Skase and Elliott loomed large, and terms such as 'the white shoe brigade' were featured, the recent eight-year land price phenomenon has notably been residentially inspired. So, whether as owners or tenants, *everyone* has been directly involved in this particular bubble.

The Barometer of the Economy indicates that, after the *whole* Australian real estate market escalates from boom into bubble conditions, a national economic recession may be expected to ensue within 24 months of the real estate sales to GDP relationship cutting back below the 19% bubble line again. Swinging voters, that is, those people not permanently committed to either one of the two major parties, will usually throw the government of the day out at the next election, influenced mainly by their 'hip-pocket nerve'. An exception occurred when the

Nominal real estate sales and GDP growth

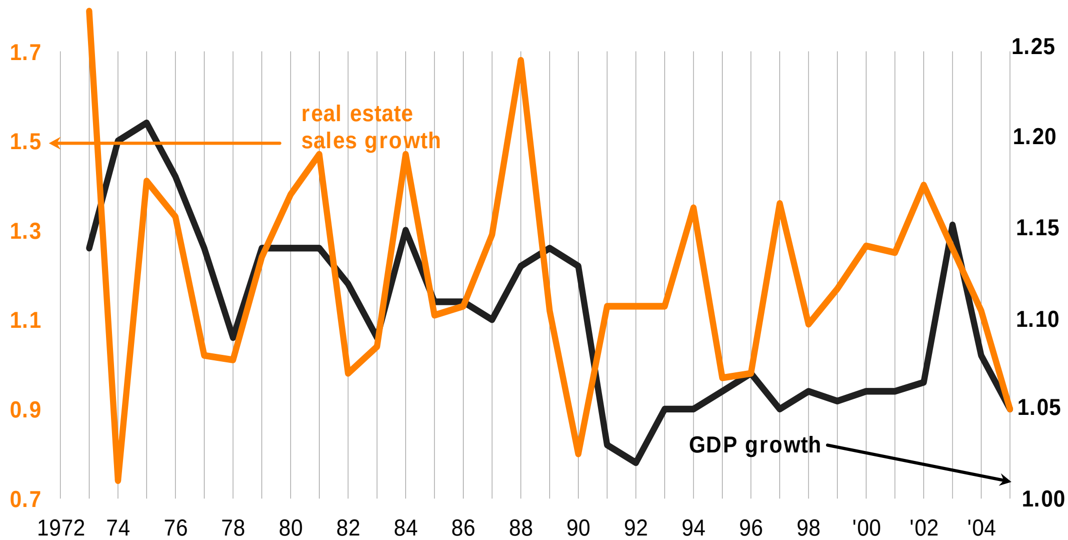


FIGURE 9

FIGURE 10

John Hewson-led federal Liberal opposition managed to lose 'the unlosable' election of 1993. That Hewson could not convince people on national TV how his proposed goods and services tax would affect the prices of a normal cake and a birthday cake *differently* played no trivial part in the Keating Labor government being returned to office.

A pattern emerges. Commercial/industrial bubbles alternate with residential bubbles, and major *barometer* peaks are found to be 15 to 16 years apart. There will usually be a lesser mid-term event that may or may not be a national bubble.

The volume of debt contained within the height and breadth of the recent residential bubble offers a strong degree of confidence to suggest that Australia will experience a severe economic recession within two years of the graph retreating back below the 19% bubble line. Scapegoats will undoubtedly be sought for the crash, for what is fundamentally a systemic problem. It is the *natural*, if constantly overlooked, outcome of a Mad Hatter's tax regime which suppresses employment and business activity as it works to inflate unsustainable real estate bubbles.

In the mid-90s, Queensland went solo to inflate its own property bubble, much the same as Western Australia has recently, and this coincided with property bubbles in the South-East Asian tiger economies. Deep recessions in Queensland and across South-East Asia in 1997 related entirely to the bursting of their real estate bubbles and the unsustainable levels of debt contained therein. Although the Howard government erroneously claimed responsibility for having averted national recession in 1997, it will be unlikely to accept its real part in the tanking of land prices by some 40% between 2005 and 2010. The subsequent mismatch between record levels of household debt and declining asset values during the period does not bode well for Australia's social and economic health.

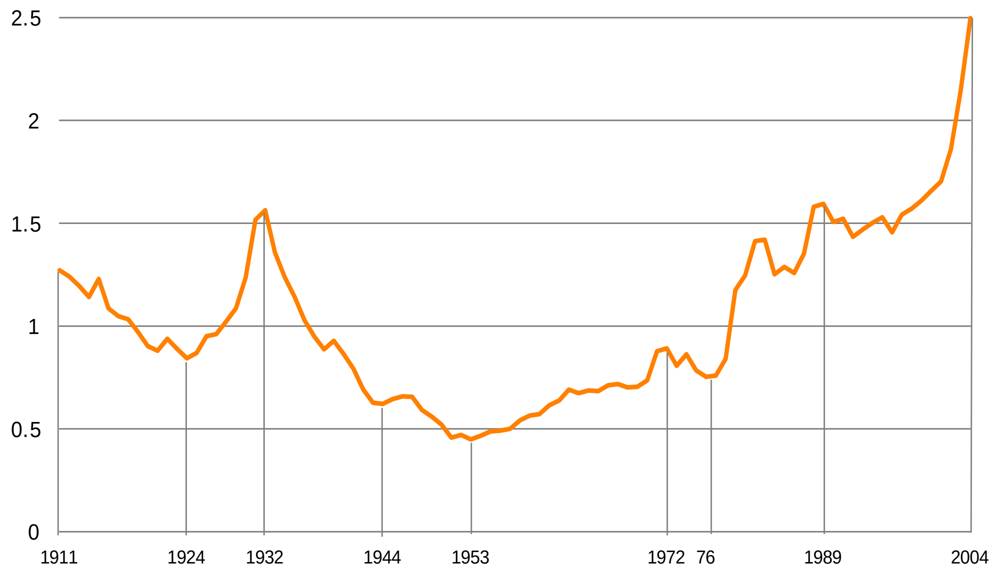
Sceptics may claim that the relationship between the Australian real estate market and the economy is *not* causal, because the economy drives the real estate market, not vice-versa; but this is not borne out by the facts. Figure 9 demonstrates that changes in the direction of the property market *precede* matching changes in the direction of the economy. So, we may conclude that economies march very much to the beat of pathological tax systems acting to drive property markets into bubble fantasyland at relatively regular intervals.

Australian economic historians reported that "Early fluctuations in the Australian economy were mainly connected with changing land prices. Two major boom periods occurred in 1826-28 and 1837-39." (*The Australian Economy in Perspective).* The great Chicago land economist Homer Hoyt had also documented the phenomenon of US property market peaks *preceding* each economic recession a little further back, to 1818. Under tax systems designed to *minimise* land value capture, it is difficult to imagine outcomes other than increasingly larger property bubbles and greater 'busts'.

That real estate currently *drives* the economy into boom and bust gives the *lie* to the often quoted investment cycle diagram shown at Figure 10 which purports the property market to be a *lagging* indicator.

Australia's total land values divided by GDP

- another indicator?



Based upon Dwyer, T. ***The Taxable Capacity of Australian Land and Resources***

FIGURE 11

LAND VALUES

The relationship between Australia's total *rateable land values* (not to be confused on this occasion with real estate *sales*) and GDP indicates the manner in which Australia's various tax regimes have shaped our land values since 1911; this is shown at Figure 11. Over the period, the relationship has *averaged* one-to-one. Whereas the chart hit a notable peak of 1.5 in 1932 during the depression, it now stands at a heady 2.5. The option of down-taxing labour and its products and capturing a greater part of community-created land and resource values offers government the only effective means of turning the portended recession around quickly when the market does correct. Otherwise, the period of social and financial distress promises to be protracted.

The best opportunity to institute a staged program to raise the level of public land value capture is, of course, in the event of such a recession, when land values will have already declined. It is on these occasions that government needs to react in the interest of the general community rather than that of residential landlords only, who will inevitably seek public compensation once again for their own peculiar 'burdens'.

ROLE OF THE RESERVE BANK OF AUSTRALIA

The RBA was appointed to maintain economic prosperity by managing full employment and stability of the Australian currency. The spirit of this brief is violated when 'full employment' is quietly redefined as the 'natural' rate of *un*employment. More obviously, the RBA fails its brief every time a real estate bubble is permitted to develop, because bubbles lead to recessions. The RBA can therefore scarcely seek to skirt the issue by claiming that real estate bubbles are beyond its jurisdiction. Nor may the Bank intend to cripple employment and productive activity when it raises interest rates in order to deter speculative borrowings at inflationary outbreaks; but, as interest rate policy notoriously fails to distinguish between speculative and productive behaviours, the crippling of employment and productive activity inevitably results.

As taxation growth is partly responsible for price inflation, the RBA is well placed to advise a superior attack on inflation, based on the down-taxing of labor and its products and greater capture of Australia's annual land values. This would complement interest rate policy and be the most direct way of deterring the property market from escalating into bubble territory. At the same time, it would make real estate *eminently more affordable* for future generations of Australians, who would no longer need to compete with speculators. A side effect would be to render Australian exports much more cost-competitive in international markets.

The Credit Boom

QUANTIFYING THE COST OF PROPERTY BUBBLES TO GDP

Question: *How much GDP did Australia lose in 2005-6 as a consequence of the bursting of the last three property bubbles and the ensuing interruptions to economic growth?*

The question would be pointless if there were no way to eliminate property crashes. Nor could it be answered without a reasonable estimate of economic growth based upon the *absence* of such crashes. Let's look at these issues.

Boom-bust cycles are more correctly described as *bubble-burst* cycles. One can eliminate the burst if one can eliminate the bubble, and one can eliminate the bubble if one can obviate its cause. Prices become decoupled from earnings in a **bubble** and are supported only by the assumption that someone else, the 'greater fool', will pay an even higher price at a later stage. When that assumption loses credibility, that is, when the market runs out of greater fools, there is no support for *today's* prices and the bubble bursts. Bubbles cannot occur in the market for *buildings*, because buyers understand that the price of a building is limited by its production cost, and this tends to decline with wear and tear; there is no expectation of capital gains, nor of finding a 'greater fool'. But bubbles can and do occur in the market for *land*, because land, being a gift of nature, does not have a production cost. A 'property' bubble is a *land* bubble.

But if a more substantial part, say at least half, of the rental value of land were taken as public revenue, any land owner who failed to generate income from the land would make recurrent cash losses, and would therefore feel pressured to use the land more productively - or to sell it to someone who will. Thus it would become unattractive to hold land for capital gains *alone.* Buyers would shift their emphasis from capital gains to *earnings*, and much of the speculative motive that inflates land bubbles would be removed. If the amount to be captured by government were calculated on the basis of the *capitalised* value of a site, then rising prices would cause holding costs to rise, which would repel buyers and reduce prices, while falling prices would cause holding costs to fall, tending to attract buyers and raise prices. Thus, land price growth would *stabilise* around the long-term trend: competition among buyers, whose spending power is influenced by economic growth, would cause land prices to grow, but grow no faster than the maximum *sustainable* rate.

It is quite realistic therefore to believe that property bubbles, and the recession following their bursting, may be eliminated. If Australia had done since 1972 as we here advocate, what would be the typical rate of economic growth, and what would be the effect on present day GDP? That part of the question is more difficult, but a range of arguments may be put.

The public capture of *half* the rental value of land would release both land and money for more productive projects by discouraging the holding of land for speculative purposes. It would also permit reduction of taxes that feed into prices, and thereby reduce inflationary tendencies, allowing more accommodating

Fin. year ended	GDP (2006$m)	Growth (YoY)	Cycles	Peak growth for cycle	GDP assuming peak growth within cycles	GDP assuming peak growth since 1972
1972	319,259				319,259	319,259
1973	328,766	2.98%			332,690	336,900
1974	342,597	4.21%	...End	**4.21%**	346,686	355,516
1975	345,094	0.73%	Start...		361,418	375,160
1976	355,793	3.10%			376,777	395,890
1977	367,583	3.31%			392,788	417,765
1978	370,987	0.93%			409,479	440,849
1979	386,752	4.25%			426,880	465,209
1980	398,625	3.07%			445,020	490,914
1981	412,426	3.46%			463,931	518,040
1982	424,848	3.01%	...End	**4.25%**	483,646	546,665
1983	415,618	-2.17%	Start...		510,370	576,871
1984	433,872	4.39%			538,571	608,747
1985	457,846	5.53%			568,330	642,384
1986	478,142	4.43%			599,734	677,879
1987	489,496	2.37%			632,873	715,336
1988	514,719	5.15%			667,843	754,863
1989	533,866	3.72%			704,745	796,573
1990	554,479	3.86%	...End	**5.53%**	743,686	840,589
1991	551,620	-0.52%	Start...		781,017	887,036
1992	551,814	0.04%			820,221	936,050
1993	571,295	3.53%			861,393	987,773
1994	595,968	4.32%			904,631	1,042,353
1995	622,082	4.38%			950,040	1,099,949
1996	647,656	4.11%			997,729	1,160,728
1997	672,612	3.85%			1,047,811	1,224,865
1998	703,839	4.64%			1,100,407	1,292,546
1999	739,169	5.02%			1,155,643	1,363,967
2000	769,157	4.06%			1,213,652	1,439,334
2001	784,188	1.95%			1,274,572	1,518,866
2002	813,481	3.74%			1,338,551	1,602,792
2003	839,512	3.20%			1,405,741	1,691,356
2004	872,855	3.97%			1,476,304	1,784,813
2005	896,366	2.69%			1,550,408	1,883,435
2006	922,494	2.91%		**5.02%**	1,628,233	1,987,506
Peak:		**5.53%**				
					Extra GDP in last year: $m **$705,739**	Extra GDP in last year: $m **$1,065,012**

monetary policy, reducing the internal rate of return needed for a viable investment, and therefore increasing the available range of investments. The need to find productive uses for land, or else sell it, would increase the supply of commercial and residential accommodation, strengthening the bargaining position of renters and buyers relative to lessors and sellers - thereby making accommodation more affordable.

The foregoing is obviously extremely conducive to *sustainable* economic growth. It is reasonable, if not conservative, to suppose that the *typical* rate of growth achieved *through such a deliberate pro-growth policy* would be *at least* comparable with the *maximum* rate of growth achieved *by accident* at certain points of the bubble-burst cycle under current *anti-growth* policies.

It should be noted that elimination of bubbles also implies elimination of cycles, and therefore of the retrogression in growth that occurs during each too-politely named 'business cycle'. Therefore, if we start with Australian GDP for the financial year ending 1972, expressed in 2006 prices, and assume that the highest real year-on-year GDP growth figure achieved since then had applied in *every* year, GDP for the 2006 financial year would have been a staggering $1.98 trillion, that is, more than $1 trillion higher than it actually reached - as shown in the spreadsheet opposite.

It might be alleged that this approach is optimistic in that it fails to allow for possible long-term variations in growth potential, and that it would therefore be better to raise the hypothetical growth rate for each cycle to the highest actual growth rate recorded *within that cycle* – ie. not the highest for the whole period under study. Accepting this reasoning, if the cycles are taken as beginning in the recession years, namely the financial years ended 1975, 1983 and 1991, and the highest year-on-year growth figure for each cycle (or part thereof) is applied to every year of the cycle, GDP in the financial year ended 2006 would nevertheless still have been $700 billion greater, as also shown in the spreadsheet.

Even on the more conservative calculation, the GDP lost due to current tax policy amounts to $35,000 per year *for every man, woman and child* in the country, a figure that should give pause to all Australian policymakers and politicians.

Property owners might also consider how the additional spending power brought about by tax cuts would affect the rental and resale value of their properties. In the scenario painted by these figures, one cannot escape the conclusion that property owners would also gain in absolute terms, *regardless* of the improved bargaining power of tenants and buyers. It would seem that Charles Bazlinton's *The Free Lunch,* for all, may indeed be a possibility.

There is opportunity for economic modellers to improve this analysis. Precisely how much existing 'investment' is speculative? What would be the quantitative effect on economic growth if the speculation were redirected into productive investment by public capture of at least one half of the publicly generated rental value of land? If existing taxes were reduced by a matching amount, what would be the effect on economic growth? In other words, can deadweight be redefined

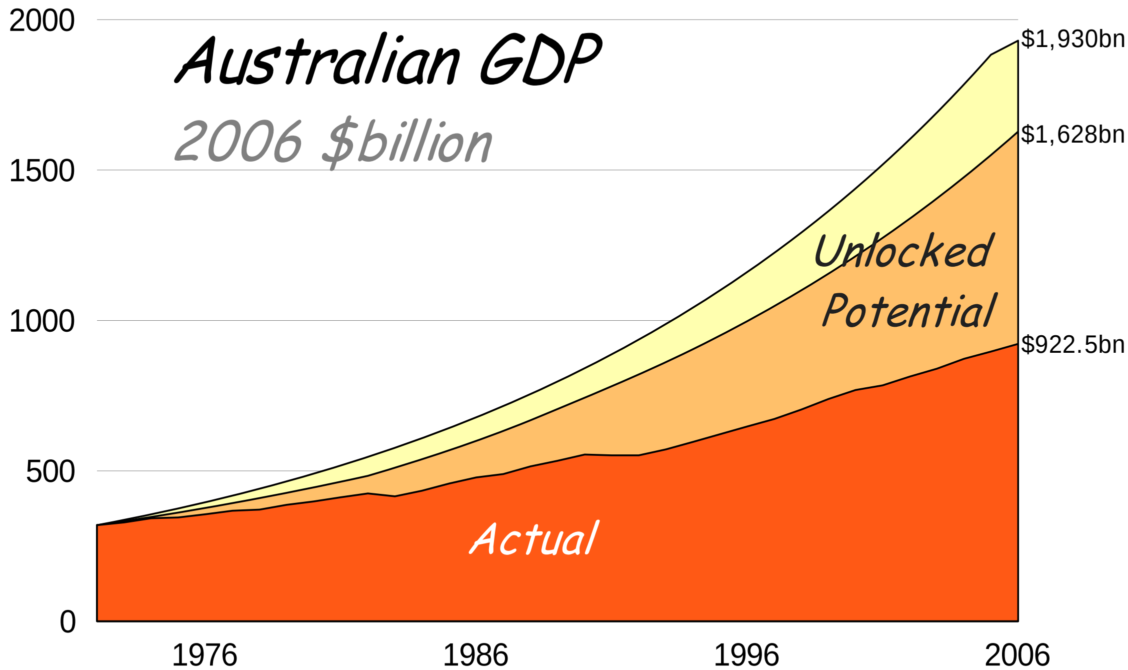

Australian GDP
2006 $billion
2000
1500
1000
500
0
1976
1986
1996
2006
$1,930bn
$1,628bn
$922.5bn
Unlocked
Potential
Actual

FIGURE 12

in terms of *growth rates* in addition to effects on static GDP? When these effects are quantified, is it possible that our more 'optimistic' estimate of additional GDP as shown at Figure 12 will be proven to be *conservative*? It would also stand to reason that GDP growth would be even greater were *more than* 50% of rent captured to the public purse and the deadweight costs of taxation reduced accordingly. In any case, taking account of locational values and other components of the 32% of the economy constituted by natural resource rents might introduce greater reality into economic modelling.

The adverse effects of present tax policy are not limited to GDP. People working longer and harder in downsized workplaces, and household debt levels having risen to accommodate the phenomenon of earned incomes now being less as a percentage of GDP than that which was received in 1972, characterise what are bruited to be prosperous times. Government advisors, seeming to confuse technological progress with economic progress and social welfare, succeed in painting a scene of prosperity because escalating asset values mask the true economic situation. The 'wealth effect' engendered by high land prices will prove to be ephemeral, however, when lending institutions are found to have provided credit against the 'security' of a bubble.

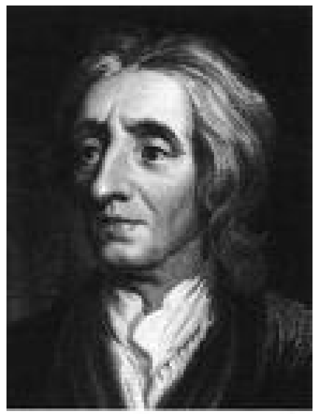
Nor are the adverse effects of taxation limited to the economy. Real estate bubbles create a greater human footprint than is necessary on the natural environment, as families requiring residential land must leapfrog over other land held idle by speculators. This leads to sprawling cities and long commuting distances. Meanwhile, as the RBA fights inflation by creating unemployment through artificially high interest rates, workers tend to become less discriminating about their job specifications. What logger of old growth forests, being a family man, will act upon a twinge of conscience to leave his tractor to go to the barricades against wood-chipping? He has a job to do and he will do it well. Upton Sinclair put it succinctly: "*It is difficult to get a man to understand something when his salary depends upon his not understanding it.*" Nick Naylor, the extremely successful lobbyist for the tobacco industry in the movie *Thank You For Smoking*, also cuts right to the heart of the matter when he says that he is directed by his mortgage to do what he does so well for a living. We might all be better off if we were to *rent* our properties, Naylor suggests.

When people had cheap access to land and a new federal land 'tax', Australia experienced the highest standard of living in the world. This study hints that she might easily attain the position she occupied early in the twentieth century again were she to exercise the same initiative to remedy what appears to be a terminally ill tax regime.

It is more likely, however, that both sides of politics will continue to pay their ritualistic deference to powerful landed interests for some time yet. Paradoxically, this report suggests that retaining the *status quo* will not only adversely affect the poor, the middle class, a sustainable environment, education, infrastructure and health, but also Australia's bunyip aristocracy itself.

The Mad Hatter's Tea Party meanwhile remains Australia's reality.

In a terribly sophisticated society, some truths go missing



John Locke (1632-1704)
Philosopher of Freedom

It is in vain in a country whose great fund is land to hope to lay the public charge 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, which when they are fallen, everyone knows they are not easily raised again, let him consider.

- Some Considerations of the Lowering of Interest

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Poverty is the mother of crime.

- Marcus Aurelius (121-180 AD)

The 3-legged stool