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The incidence of a tax on pure rent in a small open economy

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Abstract

This paper analyzes the effects of a land rent tax on capital formation and foreign investment in a life-cycle small open economy with endogenous labor-leisure choices. The consequences of land taxation critically depend on how the tax proceeds are used by the government. A land tax depresses capital formation, crowds out foreign investment and increases national wealth and consumption when the land tax revenues are distributed as lump-sum payments. If the proceeds from land taxation are used to finance unproductive government expenditure, the land tax will be neutral in its effects on the capital stock, nonhuman wealth and labor. When the tax revenues are used to reduce labor taxes, the land rent tax spurs nonhuman wealth accumulation and ambiguously affects the capital stock and labor.
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1. Introduction

In a non-altruistic OLG closed economy, where land serves as an input as well as an asset, a tax on land rent is associated with a higher capital stock and output per person in

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the steady state. The rationale for this result, discovered by Feldstein (1977), is that a land tax hike, by initially reducing the value of land, diverts saving away from land into real capital, therefore spurring capital accumulation and temporarily output growth. The increase in the capital stock in turn lowers the real interest rate and raises the marginal productivity of land as well as the wage rate. Steady state financial wealth, consumption and welfare rise.

The positive effect of the land rent tax on capital formation, which can be denominated the "Feldstein effect", is grounded in the portfolio choice. Since capital and land are the only assets of the economy, any "flight from land", determined by the land rent tax, is by necessity a "flight into real capital". The "Feldstein effect" is independent of alternative uses of land tax revenues.

There have been many articles analyzing the implications of land rent taxes for the resource allocation and incidence analysis.[1] Calvo et al. (1979) demonstrated that the Feldstein findings depend on the non-Ricardian (in the demographic sense) structure of the economy, by showing that in a Barro–Ramsey economy, a tax on land rent is fully capitalized in the price of land and no effect on capital accumulation occurs, as originally predicted by Ricardo (1817). Fane (1984) argued that, once a fully compensated land tax is considered in a model with finite-lived disconnected generations, the unique effect of taxation is to cause a fall in the land value with no shifting; a land tax is fully compensated when the land tax shift is accompanied by the issuance of perpetual government bonds, whose sale proceeds are used to make lump-sum transfers to the landlords hit by the tax, and the land tax revenues are employed to finance the interest payments on the newly issued government bonds.[2] The Ricardian results on the land tax shifting can also be obtained in a life-cycle setting with no-bequests if current consumption and future consumption are perfect substitutes in the individuals' utility function; see Kotlikoff and Summers (1987).

Chamley and Wright (1987) analyzed the dynamic incidence of pure rent taxation in the Feldstein (1977) model. They found that the impact response of the land price to an increase in the land tax may be positive or negative. If positive, this response is always smaller than one-half of the tax revenues; if instead the price of land falls immediately, the loss in value is never greater than indicated by the full Ricardian capitalization of the land tax.

In a finite-lived small open economy having unrestricted access to the world capital market and a fixed labor supply, saving diverted from land by a rise in land taxation is not directed towards real capital; under perfect capital mobility, in fact, the portfolio mechanism discovered by Feldstein implies that the "flight from land" necessarily determines a "flight into foreign assets". This was shown by Eaton (1988), who discovered that a land tax leaves the capital stock, domestic output and non-land input prices

[1] A particular line of research has focused on the consequences of land taxation on the gestation period of land investment projects. See, for example, Bentick (1979) and Mills (1981), who showed that a tax on land value favors land uses with early-payoff income streams.

[2] The equivalence between land taxation and government debt has also been demonstrated by Buiter (1989), who showed, by considering an overlapping-generations model without operative intergenerational gift and bequest motives, that "debt neutrality" prevails when government debt is accompanied by a tax on land.

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