How the Railroads Got Us on the Wrong Economic Track

H. William Batt

[1998 / Part One]

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Defining Real Property Historically

Just over a week from now, right here in Albany, the Property Rights Foundation of America will hold its second annual conference. These are the people who are the core of the so-called "wise use" movement, that is those who believe that the rights of ownership of real property stand above just about all other values in political negotiation, and that rights to private property are gravely threatened by a government that today seeks to encroach on the foundations of our forefathers' vision of society. In the American west it is better known as the "sagebrush rebellion." I won't talk much about whether or not these rights are soundly framed or well grounded. I will talk, however, about some changes that took place about a century ago that have had profound consequences for the directions of American society in the interim. Had those changes not taken place, it is doubtful whether the groundswell of anger over the place of private landownership would be as intense as it is today.

One must start by looking at how the meaning of the word property has changed over the course of centuries. In most societies of the world, as was true in classic western thought, property typically meant personal property clothing, household goods, bodily adornments and armor, and similar such items. Land was typically owned by society in common, or perhaps belonged to God or nature. Roman law made some effort to allot land titles to private individuals and families, but it was honored more in theory than in fact. Indeed, it was not until the now well-documented "enclosure movement" in early Tudor England that land titles began their long transformation from what has been termed "leasehold" to "freehold." Against the will of the King and his Council, noblemen seized the land for themselves, marking it into defined units, fenced off in their names only, even when they had no use for it. Karl Polanyi noted that:

> Enclosures have appropriately been called a revolution of the rich against the poor. The lords and nobles were upsetting the social order, breaking down ancient law and custom, sometimes by means of violence, often by pressure and intimidation. They were literally robbing the poor of their share in the common, tearing down the houses which, by the hitherto unbreakable force of custom, the poor had long regarded as theirs and their heirs'. The fabric of society was being disrupted; desolate villages and the ruins of

> human dwellings testified to the fierceness with which the revolution raged, endangering the defenses of the country, wasting its town, decimating its population, turning its overburdened soil into dust, harassing its people and turning them from decent husbandmen into a mob of beggars and thieves.

Rutgers Professor of Urban Planning Donald Krueckeberg more recently explained how real property became for the first time a "commodity," much as the market gives personal property exchange value. Native Americans tied the concept of property not to ownership but to use. "One used it, one moved on, and use was shared with others." But the colonists took their notion of real property from evolving British legal tradition, defined largely in terms of what its owners could subdue and control against challengers. John Locke's conception of property was, in one sense, more akin to the Indian notion in as much as one owned it only to the extent that one "mixed one's labor" with it.

Indeed the most widespread notion of property ownership, especially in realms where Roman law had left no legacy, was title in usufruct, meaning title to use. But that meaning has gradually given way to the prevailing conception of title in fee simple, even though legal constraints have grown to curtail abuses of such ownership and are even seen sometimes as assaults on it. Krueckeberg notes that as many as nine kinds of property rights have been distinguished: possession, use, alienation (the power to give away), consumption, modification, destruction, management, exchange, and profit taking. From the first application of the land law of the New England settlers there has been a gradual extension of private control over land titles first to simple use, then the right to benefit, and ultimately "to the idea of gain made by selling. Land speculation, which was to spread across the continent, radically transformed New England's democratic town pattern." Concurrent with this spreading application of titles in fee simple has come changes in the meaning of the word property, a term which, although employed in the Fourth and Fifth Amendments of the U.S. Constitution, was amplified only during the second half of the 19th century. The notion of land as a commodity has had pernicious effects on the course of our whole civilization.

As recently as a century ago classical economic thought still regarded land for the most part as the common heritage of mankind. From Adam Smith, through Thomas Malthus, David Ricardo, and finally with John Stuart Mill economic productivity was regarded as a function of three interacting factors: land, labor, and capital. John Locke also accepted these premises. To achieve optimal economic productivity, one had to exact the appropriate price from each of those factors. The price of labor was in wages; the price of capital was interest; and the price of land, particularly following the thinking of David Ricardo, was rent. Rent in its classical sense means payment for the use of something in fixed supply, or, more generally, payments above the costs incurred for its creation. Disequilibriums and inefficiencies in economic development resulted if the appropriate prices were not paid for each factor. But, as we shall see, there were powerful interests in this country, bent on not seeing any rent extracted from land use, that persuaded the nascent economics profession at the end of the 19th century no longer to regard land as a separate factor and to redefine the terms of production instead in two-factor theory. This was concurrent with the inclusion of land as property, since called "real property."

As land came to be transferred to other nobility and usurped under title in fee simple rather than in usufruct, it came to be regarded as a private financial asset. Earlier it was regarded as part of nature, much like air, water, wind and weather. Accounting practices now listed land as an asset "owned" in fee simple, and as a liability on the other side of balance sheets in money "owed" to banks. This tendency has been extended today so that we have privatized much of our air, water, wind, and even sunlight. Land came to be simply one special kind of capital, nothing special, nothing requiring further treatment. Ricardo's Law of Rent became an artifact of intellectual history. The conflation of land into capital to create two-factor economics is one of the greatest paradigm shifts in the evolution of social philosophy. How the premises and terms of economic discourse have been changed has been documented for the first time in a new book by a California professor of economics, Mason Gaffney. The account is put forth in fascinating detail entitled, The Corruption of Economics. It was indeed a corruption of a discipline, a deliberate putsch by powerful economic forces with an interest in seeing such definitions changed, and we have all been paying the price since that time. This revealing thesis is what I really want to relate to you, and to explain the dire consequences it has had for us in our contemporary world. I have come to believe it; it makes sense to me, both historically and in contemporary analysis, from several perspectives.

The Corruption of Economics

As I explained, classical economics emerged from a school of thinkers known as the Scottish moralists in the latter part of the 18th century. There ultimately evolved three major schools of economic thought a century later, one continuing tradition of Adam Smith through J.S. Mill, a second being the aggressive and emerging school of Marxism, and the third a proposal for two-factor economics being pressed largely by interests in America. Marxism was never a major force in United States; the primary challenge to the classical tradition came from what has since come to be known as neo-classical economics.

Professor Gaffney has for the first time shown how powerful economic interests in American society essentially bought the leading figures of the newly-established American Economics Association with all the blandishments that can be used to influence academicians. Leading scholars were induced to change definitions of terms so that special interests would be advantaged. What were those interests? Primarily the railroad industry, which at the time was probably the most powerful political force in America. By changing definitions and conflating the land factor into capital, it was no longer essential for land rent to be paid in taxes, and the railroads, holders of some of the most valuable land in the nation, were thereby able to escape their full duty. This is an astonishing story, one never fully spelled out until now, and it explains both how the academic community was beholden to powerful interests and how many of the social problems we see today could have been avoided.

The classical tradition of economic thought was ably synthesized and represented by one dominant figure of the age: Henry George. All but forgotten today, perhaps in good part due to the assiduous disparagement of his economic foes, one should note that he was more widely known in his time in America than anyone except Thomas Edison. His 1879 book, *Progress and Poverty*, sold more copies throughout the world than any book till that time except the *Bible*. Born in Philadelphia the son of a publisher of religious books, he travelled to California as a young man to make his fortune as a journalist. But what he saw in land speculation and the exploitation of labor soon led him to study the classical economists and to write his ideas down. Upon publication of his book he shortly became known throughout the world, and travelled and lectured widely as a social reformer for the rest of his life. By the time he died he had become so famous that he almost won the mayoralty of the city of New York. He ran twice, losing to Tammany Hall the first time in what was probably a corrupt election (but beating the third-place finisher, Theodore Roosevelt) in 1886, and died four days before a second election he might have won in 1897. As a spellbinding orator and lucid writer, he captivated the world with his vision of societies made more just by a proper understanding of economics. Gaffney shows that it was George, not Marx, that was the primary threat to dominant interests in end-of-century United States. He had to be stopped, and he was.

In classical economics, the definition of capital grew out of labor mixed with earlier capital. Land, by conventional definition, was not capital, nor was it a component of wealth. Rather land was its own category. Conflating land into capital allowed land rent to be hidden and diluted in ways so that the unearned increment arising from social improvements fell to speculators rather thabeing returned to society in rent. The failure of society to recapture the appropriate level of land rent from titleholders led also to depression of labor wages at the margin, creating poverty and artificial scarcity of labor where otherwise it could be relieved. Hence the title of George's book, *Progress and Poverty*. George recognized that the value of any land parcel arose out of its social activity, not from anything which a titleholder might have done to it. He recognized that many, perhaps most, titleholders in land were speculators, reaping the benefit of others' investments, and selling out at last when their price was met. Hence it made sense that society had a right to a return on what it had brought about, as well as from the fact that those titles could never be other than leaseholds. That land rent, shortly confused by use of the words "single tax," was, to George, the rightful return to society.

The railroad barons of the 19th century were not just coincidentally the land barons. They also had strong holds on the founding and growth of the major American universities of the period, some of which carry their names. Johns Hopkins, Andrew Dickson White, Daniel Gilman, John D. Rockefeller, George Leland Stanford, Nicholas Murray Butler were all as attached to various universities in the country as they were to powerful railroad interests. They were able, through their control of universities either as actual presidents or as benefactors to influence the dominant figures responsible for establishing the American Economic Association in 1885. The actual intrigue is too complex to be recounted here: who got appointed and promoted, who was funded in research, which were given endowed chairs, who got stock options, and so on. The preoccupation with defeating Henry George, Gaffney shows, was a paramount preoccupation of all of these figures. The central figures were:

- Francis Walker, first president of the AEA, then President of MIT and Director of the Census Bureau.
- Richard Ely, also founder of the AEA, and professor of economics at University of Wisconsin and later Northwestern, there granted his own Institute with railroad money.
- John Bates Clark, Professor of Economics at Columbia University, and whose patron was Julius Seelye, President of Amherst College and then Smith College.
- E.R.A. Seligman, Chairman of the Economics Department at Columbia University and scion of a wealthy banking family.

These figures are even today the honored founders of an esteemed profession. So great was their victory over rival schools of thought that they are a century later seen as paragons of clear thinking and virtue. The intrigue and the inside deals are long forgotten. The lineage to contemporary scholarship continues in a "chain unbroken from Seelye to Clark to Johnson to Knight to Stigler, Friedman, Harberger and now thousands of Chicago-oriented economists." Indeed, when Henry George ran for mayor of New York in 1897, it was against the wealthy patrician Seth Low, President of Columbia University, who had recently recruited Clark to come to Columbia. To really understand the academic tension of the period, one must look at the published papers, the speeches and debates, the newspaper articles, and the citations at the end of those articles. These, even more than the interlocking directorates of faculty appointments, explain how much George was opposed, perhaps more feared. Was it for the falsity of his views? Clearly not, as few critics then or since then have managed to strike a knock-out blow against his theories. Rather, it was the threat George represented to powerful interests that required him to be defeated, and in doing so they succeeded but only in the short run, as they were within decades victims of their very successes. Today we see that the railroads have failed in this country for lack of traffic. It will soon be evident why.

There were many arguments to be made for the classical tradition the result of which would be to rely upon payment of rent of land according to its value to society. George recognized that land value is largely a function of how society has elected to invest in any general neighborhood; there is no argument for any one titleholder to reap the reward of what others have invested. Gaffney points out that, from the standpoint of economic theory, the framework had the following virtues:

- It reconciled common land rights with private tenure, free markets and modern capitalism, a growing and persistent problem as the industrial society took hold.
- It enabled the lowering of taxes on labor without raising taxes on capital.
- It reconciled equity and efficiency. It constituted a progressive tax because land is concentrated so much among the wealthy and because the tax cannot be shifted. It was efficient because it is neutral among different land-use options.
- It constituted no disincentive to business location or population settlement. In this way it encouraged the most efficient land use and discouraged sprawl.
- It created jobs without inflation, and raised government revenue without any penalty upon its base.
- It strengthened public revenues and at the same time promotes economy in government.

Those economists who today still persistently hold to the view that there is something special about land that make it unwise to treat as a form of capital are known as *Georgists*. They represent a small minority of the economics profession, but, little known as they are, they are among its most esteemed members.

Two-factor economics, however, had advantages to influential individuals and special interests. Land speculators who were positioned to profit from knowing where locational values would increase, or were in a position to cause those increases, could quickly and easily reap a private gain. Simply by holding title to parcels of real property, without doing anything at all to increase their value, one could quickly turn a profit. This is because the increment of unearned increases resulting from social investments were left for owners to reap rather than recovered by society. In three-factor economics, land rent reverted to society in an automatic and efficient manner. When a railroad magnate like George Leland Stanford extended the Southern Pacific track to the east of Los Angeles on land that he was granted by the government, all he then needed to do was to sit back and wait for the land sales to give him a return on that which was made more valuable by his investment in the line. All across America, land speculators learned that capturing monopoly titles to tracts of land allowed them to quickly and easily turn a "profit" on their investment yet hardly raising a finger.

Assessing Sound Taxation

What David Ricardo called the "law of rent," and which Henry George integrated to a comprehensive economic theory, can be made the basis of a perfect tax measured by contemporary principles of tax theory. Public finance textbooks typically list them as economic neutrality, efficiency, equity, administrability, simplicity, stability, and sufficiency. Each of these words embodies an important virtue of sound of taxation going back to the insights of Adam Smith two centuries ago. And now you know a bit of where I'm headed.

Tax neutrality refers to the influence (or absence of such) that any particular design has on economic behavior. Typically taxes are perceived as a damp on economic activity taxing income reduces the incentive to work, taxing sales discourages retail transactions, and taxing savings reduces the propensity to save. The more a tax is perceived to be neutral the less the identifiable distortions it imposes on the economy. The common assumption of most tax theorists is that all taxes impose distortions; it's simply a matter of which ones are least burdensome to economic health. A tax which imposes no distortions is ideally best.

Tax efficiency is much like tax neutrality, and is the measure of how much shifting of behavior it imposes, resulting in what is called "excess burden," or "deadweight loss" on the economy. Tax economists usually hold that the best taxes are those that are shifted little if at all. Using a tax base that has little or zero elasticity is the best way of assuring that taxes are not shifted. Zero elasticity is another way of saying fixed supply, as, earlier noted, land is.

The principle of equity is central to any discussion of tax design. Tax design requires concern with both what is fair and the extent to which it must sometimes be compromised to satisfy the other principal criteria. Fairness can be evaluated according to what is termed "horizontal equity" the extent to which those in similar circumstances will pay similar tax burdens, and "vertical equity" how well those in different classes bear different burdens in the tax structure. It is this latter perspective that leads to the use of terms like "proportional," "progressive," and "regressive" in referring to tax structures. A tax is progressive with respect to income if the ratio of tax revenue to income rises when moving up the income scale, proportional if the ratio is constant, and regressive if the ratio declines. There is an ancillary question of whether taxing to reach greater equity should employ measures of income or of wealth, difficult as this is to measure. Such questions of equity are a matter particularly central when discussing the property tax. This is because people capitalize their income in the course of a lifetime frequently in property. Although claims are often made to the contrary and really comprehensive studies have yet to be done, available studies suggest that the property tax is really highly progressive, especially for the land component.

Administrability refers to the ease with which a tax can be administered and collected. Taxes which distort the economy are inefficient but so are taxes that cost lots to administer. This is measured not only in the direct costs of tax avoidance and accounting expenses, but in the level of evasion and cheating, and by the cost of government auditing and policing. When the taxpaying public perceives that a tax is easily evaded, cumbersome, and unfair, it loses its legitimacy and calls government itself into question.

This is why the principle of simplicity is important: the more complex the tax design, the more lawyers and accountants will find loopholes, encourage the appearance of unfairness, and drive up the cost of its administration. People know that with simple taxes other parties are also paying their fair share, and all this enhances the legitimacy and therefore the compliance of the tax system. Whatever you think of the current income tax, Steve Forbes certainly pointed out its problems recently.

Stability refers to the ability of a tax to produce revenue in the face of changing economic circumstances. Income and sales taxes, for example, vary greatly according to phases in the economic cycle; the property tax, in contrast, is highly stable regardless of the state of the economy. Followers of economist John Maynard Keynes believe that revenues should be inverse to the cycles of the economy; i.e., that the government should be used to stabilize or boost the economy as occasions require. I should add as an aside that there are some theorists who believe that, were revenue sources completely based on land value, economic cycles would disappear.

In assessing the value of a tax it is also important, of course, to understand its potential to bring in revenue for the purposes of government. This is usually deemed revenue sufficiency. Income, sales and property taxes, along with corporation taxes to a lesser extent, have come to be regarded as the workhorses of the American revenue structure. But, as anti-tax politicians are quick to note, the higher these taxes are, the more they impose a drag on the economy. This is why one should ponder whether to consider raising taxes which have demonstrable distorting effects. In contrast, if you take the time to look at a tax on land value alone, it measures up so well that it looks like the perfect tax!

The Costs of Poor Taxes

Society pays a price for not adopting taxes which follow the principles developed over the centuries. Here I want only to show how the resulting distortions that arose in the use of land ultimately caused the railroads to fail in being able to serve society. While in the short term the railroads certainly saved themselves from having to pay taxes on their vast land holdings the most valuable of which were right around their own investment in tracks and stations they ultimately lost the frequency of traffic which that tax structure would have induced. This is because the population and improvement densities needed to make public transit traffic economically viable did not come about. Taking the long view of society, George Kennen notes in one of his books that:

> The railway. . . was capable of accepting and disgorging its loads, whether of passengers or freight, only at fixed points. This being the case, it tended to gather together, and to concentrate around its urban terminus and railhead, all activity that was in any way related to movements of freight or passengers into or out of the city. It was in this quality that it had made major and in some ways decisive contributions to the development not only of the great railway metropolises of the Victorian age particularly of such inland cities as Moscow, Berlin, Paris, and Chicago but even certain of the great maritime turnover ports, such as London and New York.
>
> The automobile, on the other hand, had precisely the opposite qualities. Incapable, in view of its own cumbersomeness and requirements for space, of accepting or releasing large loads at any concentrated points anywhere, but peculiarly capable of accepting and releasing them at multitudes of unconcentrated points anywhere else, the automobile tended to disintegrate and to explode all that the railway had brought together. It was, in fact, the enemy of the concentrated city. Thus it was destined to destroy the great densely populated urban centers of the nineteenth century, with all the glories of economic and cultural life that had flowed from their very unity and compactness.

Failure to recapture publicly-created land rents through the tax mechanism provided the incentive to speculators to buy land, not to use it in production but to hold it for the rise. In this way, choice parcels remain undeveloped or underdeveloped relative to the full extent that their values warrant and development occurs instead in remote areas where opportunity for profit is more immediate. The result was low density development what we know as sprawl.

To some people this may be counter-intuitive. It may not be obvious that increasing taxes on a parcel of land will foster its improvement. Consider, however, the possibility that there are two parcels of land in roughly the same location and of equal size. You own a vacant parcel and another next to it has a twenty-story building. If only the land-value is taxed you will be paying the same tax revenue as your neighbor. What are you likely to do with your parcel? If you are rational, you will either build a twenty-story building or else sell the land to someone who will. In this way improvements tend to be clustered in high-land-value areas except where it is prohibited, perhaps for a park.

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Jessica Matthews, now with the Council on Foreign Relations, recently wrote a syndicated piece observing that,

> In a now familiar sequence, developers reach for the cheapest land, out in the cow pastures. Government is left to fill in behind with brand new infrastructure roads, sewerage systems and schools paid for in part by those whose existing roads and schools are left to decline. Property values rise in a ring that marches steadily outward from the city and fall in older suburbs inside the moving edge.

Because residential development can't meet the public bills, local governments compete for commercial investment with tax discounts that deplete their revenues still further. Property taxes then rise, providing an incentive for new development.

Years of such leap-frogging construction devours land at an astonishing pace.

Now if the full social opportunity cost of land occupancy were charged to landholders, the reward of (and incentive for) speculation would be obliterated, and land now locked up by speculators would be transferred to users. Users would employ more labor and engender more capital development instead of seeing it locked up in wasted space. Absent adequate taxation the regions at the periphery are the first developed, just as Ms. Matthews observes.

The economics profession is only now coming to recognize its responsibility for what it has wrought. Economists are coming to recognize the costs of sprawl, and studies show how astonishingly inefficient the suburban lifestyle is. One review of the literature on the subject of comparative development costs published by the Urban Land Institute revealed that "houses built in sprawling developments may cost 40 to 400 percent more to serve than if they were located close to major facilities, were clustered in contiguous areas, and incorporated a variety of housing types."

Transportation planners know that public transit typically takes a density of at least 8-10 households per acre in order for it to be economically viable. Because tax policies have been instituted that have the effect of deliberately fostering low density suburban sprawl, society has become dependent upon motor vehicle transportation rather than transit service. Had taxes been imposed heavily or solely upon land value, just the opposite would have occurred: development would have been most intense on the high land-value parcels, right by the transit services, making our society less dependent upon motor vehicles.

We face a far greater problem on account of the way in which America has allowed its landscape to be configured than most people today realize. Over-reliance upon the car causes inefficiencies in transportation patterns and thereby disenfranchises the poor, the disabled, the young and the old from their right to mobility. One 1993 study concludes that "when the full range of costs of transportation are tallied, passenger ground transportation costs the American public a total of $1.2 to $1.6 trillion each year. This is equal to about one-quarter of the annual GNP and is greater than our total national annual expenditure on either education or health." Just the costs of motor vehicle accidents nothing else represents a figure equal to 8 percent of the American Gross Domestic Product. Conventional American land use configurations and the automobile dependent lifestyle that goes with it sap our resources and what effort could be used for other ventures and activities. Since so much of this activity is consumption and not production, it weakens America's world economic position and precludes reinvestment in more productive areas. Because of the way in which we have encouraged development, people who need jobs are frequently too poor to own the cars necessary to get to them.

Because our society is characterized by suburban sprawl and is therefore motor vehicle dependent, community is destroyed. George Kennan expresses this well in the book cited earlier, but it is more empirically documented in a recent article entitled "Bowling Alone," which David Broder of the Washington Post considered the most important academic article of 1995. The author of that piece, Harvard Professor Bob Putnam, shows that our communal relationships are declining, and that an ever smaller proportion of the population is involved in social activities of a cooperative and communal nature. As Tocqueville noted, this used to be the unique strength of American society; we're now losing it. Suburban sprawl and the automobile play a large part in this. And the reason we have these land-use configurations is in good part, to my way of thinking, due to our property tax policies and our subsidies to motor vehicle transportation.

It doesn't take much reflection to realize that the practices which we are following are unsustainable. This is true not only environmentally but also economically and socially. Author James Howard Kunstler recently has described in his book Home from Nowhere how our cities are becoming not only ugly but unlivable.

The irony is also that, by having followed the legacy of classical economics, we could easily have provided for all our government services through taxes based on land value. Adding to this other fees to correct market failures would easily make our economy more efficient and enrich our quality of life immeasureably. A new discipline called ecological economics seeks to bring together two disciplines that have historically been at loggerheads. There is reason to believe that as badly off track as we have been there is still time to save ourselves from disaster.

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