

Current financial crisis, and how economic theory should be taught

Mason Gaffney, 25 Sept 2008

Yes, the current financial crisis highlights how scholars need to recast the economic theory that they teach. The key concept that is missing today is LAND VALUE. Classical economics divided factors of production into three: land, labor, and capital. Beginning around 1920, scholars conflated land with capital. This left them totally unprepared to cope with or explain the crash of 1929. At this time “macro-economics”, as we now call it, rose to the fore. For a time it eclipsed “micro-economics”, which had degenerated into the explanation of the allocation of resources among competing ends. Gradually, micro-economics came back to be integrated with macro, but in the process land value almost disappeared.

Scholars have “disappeared” land values in two main ways. One is to conflate them with values of man-made capital, overlooking or trivializing all differences. One obvious fault in this is that interest rates and land rents vary inversely.

The other way is simply to trivialize land values as a quantity. This is based on no respectable quantitative research whatever, and a systematic ignoring of research showing land values to be a major element of wealth.

When it comes to the dynamics that lead to crises like that of 2008, land values move in cycles of high amplitude, much higher than the values of reproducible capital. When values are high and rising they lead to great excesses of urban sprawl. These excesses fructify vast new areas around growing cities, resulting in an overhang of “ripening” land that far exceeds possible demands, resulting in a crash.

As to teaching money and banking, few or no texts recognize that expanding banks, by taking land under and around speculative developments, in effect “monetize” those speculative land values. When the wave of land values ebbs, and debtors default, banks have to contract, as they are now. Yet economic theorists, and those statesmen whom they have trained, attend mainly to the froth on the waves, ignoring the basic wave of land value that drives the cycle.

Another and related fault in theory is to ignore the turnover of capital. In a boom of land values, capital goes into investments that pay out slowly. The basis of allocating loans is not marginal productivity, but collateral security, as perceived by bankers who do not distinguish land from capital. The loan turnover of banks slows down, because a bank, no matter how positive its balance sheet, cannot lend much faster than its debtors repay their loans. The result is to slow down new loans and seize up the system, as we see today.

Tax theory is now based on the fallacy that a progressive tax must also be one that suppresses and distorts incentives. This reflects economists ignoring the high concentration of the ownership of land, and the positive incentive effects of taxing land in lieu of work, enterprise, building, and income-creating investing.