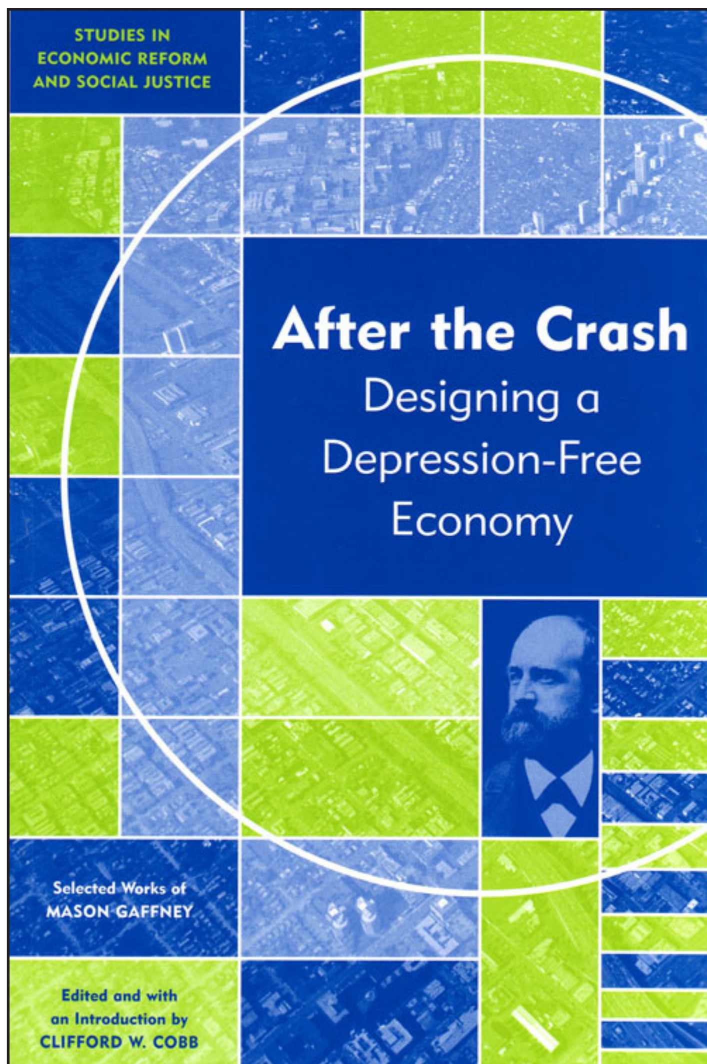

The Great Crash

www.afterthecrash-masongaffney.com

Mason Gaffney first read Henry George when a high school junior. After he served in the S.W. Pacific during W.W. II, this interest led him back to get a Ph.D. in Economics at Berkeley, where he tried to meet his teachers' skepticism and apathy with a dissertation, "Land Speculation as an Obstacle to Ideal Allocation of Land." Since then he has published many books and articles on land use, economics, taxation, and public policy. He has been a Professor of Economics at several Universities; a journalist with TIME, Inc.; a researcher with Resources for the Future, Inc.; the head of the British Columbia Institute for Economic Policy Analysis, which he founded; an economic consultant to several businesses and government agencies; and a frequent speaker on economic topics, domestic and foreign, and in political campaigns. He has been Professor of Economics at U.C. Riverside since 1976. His latest book is ***After the Crash: Designing a Depression-Free Economy***, published by Wiley-Blackwell for The American Journal of Economics and Sociology.

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way in the quake. On its hills and dales it housed, and linked with mass transit, a denser population than any major city except the Manhattan Borough of New York. It is these people and their works that made San Francisco so livable, the cynosure of so many eyes, and the commercial, financial, cultural, tourism, and light manufacturing center of the Pacific coast.

The whole U.S. can follow this model today, but on a grander scale and adapted to modern technology and values. Skeptics will wonder how we can take more taxes from rents when they are falling. Here is the key: the effect of untaxing trade, capital formation, enterprise, labor, and production is to raise and sustain land and resource rents as a tax base. This does not work through raising asking and holdout prices, but rather by raising bid prices, activating the market.

Today we recognize a great variety of new ways these rents manifest themselves to be tapped for public revenues (Gaffney, 2008). We can seize these opportunities, old and new, and pull ourselves out of the funk left by the great crash of 2008.

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THE GREAT CRASH OF 2008

(EXCERPTS)

Mason Gaffney - August 17, 2008

This crash is The Big One; it has signs of becoming a Category 5. How do we know? We’ve “been there and done that” so many times before, roughly every 18 years over the last 800 or more. Major wars and, rarely, plagues have broken the rhythm, along with the little ice age, reformation and counter-reformation, political revolutions and reactions, the rise of nation-states, the enclosure movement, the age of exploration, massive European imports of stolen American gold, the scientific and industrial revolutions, the Crusades, Mongol and Turkish invasions, and other upheavals. Yet, the endogenous cycle keeps returning, as soon as we find peace, and economic life returns to its even tenors. What President Warren Harding famously called “normalcy” soon evolved into another boom and a shocking bust, as so often before. Calm and routine prosperity has never been man’s lot for long: it somehow leads to its own downfall, cycle after cycle.

Homer Hoyt published his classic 100 Years of Land Values in Chicago, 1833-1933, in December, 1933. He covered in fine detail the 5 major cycles that crested and crashed in 1837, 1857,1873,1893, and 1926-29. At the end he generalized “The Chicago Real Estate Cycle”, a regular rhythm of boom and bust with the same features in the same sequence. The boom sets us up for the bust. He could have omitted the limiting word “Chicago”, its cycles were synchronized with national waves recorded by other scholars like Arthur H. Cole, Philip Cornick, Lewis Maverick, Frederick Lewis Allen, Harry Scherman, Carter Goodrich, Ernest Fisher, Homer Vanderblue, Herbert Simpson, and others—surprisingly few others, in fact. Alexander Field has recently reviewed much of this literature, but held back from seeing cycles in the present or future.

It is uncanny how the latest boom tracks the events that Hoyt recorded and generalized. There was “an increase in rents, building ..., and subdivision ..., each of which was carried in turn to speculative excess, and each of which interacted upon the others and upon land values to generate and maintain the boom psychology”. The cycle, Hoyt continued, is “the composite effect ... of a series of forces that ... communicate impulses to each other in a time sequence, ... in a definite order” (p. 369).

He breaks the major events down into 20 elements (pp. 373-403). We can consolidate a few to simplify, but the cycle is not so simple: if it were, mankind would have mastered it long ago, instead of constantly repeating it. Rather, I add a few events that others than Hoyt have noted— an asterisk (*) precedes each of these non-Hoyt elements, below.

•Population grows

•Building rents rise

•Values of standing buildings rise

•New building rises

•Easy credit comes forth to builders, land buyers, and subdividers

•Nationally, people moving to new areas raise total need for buildings, because migrants leave their old homes behind them

• *Construction itself makes jobs, with demand for more buildings

• *Outside money flows into growth areas, taking as security liens on new buildings and on lands. As to the local balance of payments, this has the same temporary effect as exporting the buildings and lands: unearned increments become part of the local economic base. However, this is a trap: it evolves into debt service, an outflow of funds that, over time, exceeds the original inflow

• Easy credit evolves into "shoestring financing" (the 1933 expression for today's "subprime lending")

• New buildings absorb vacant land; land prices boom and spread outwards

• Governments spend freely, on borrowed money, for street improvements and public works to boost land sales

• Population growth rate slows, but "authoritative" forecasts come forth of more population growth—today's "irrational exuberance", which Hoyt calls a "mania."

• *"Builders' Illusion" sets in, where builders conflate the rise of land prices with a return on their building investment, boosting the incentive to build above what the actual return on building per se would justify. This is because building, however legitimate, entails buying and selling land, a form of "flipping". Unearned increment becomes, for some parties, part of the incentive to build. Ditto for "flipper-remodelers": it's fun to remodel or just redecorate on a rising market. This illusion may be most extreme in large, self- contained, integrated developments, where each building is expected, even in a steady market, to pay for itself in part by raising the

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entails a fall from illusion to reality, from high to low, that will agonize many. New administrations will prolong the agony by trying to defer it. They will bail out a few of the victims and many of the culprits by raising the national debt and inflating the currency to validate bad debts and sustain land values.

Hope lies in observing how many cities and nations have risen from disasters to new prosperity. John Stuart Mill stressed in his Principles (1848) "the great rapidity with which countries recover from a state of devastation; the disappearance, in a short time, of all traces of the mischiefs done by earthquakes, floods, hurricanes, and the ravages of war."

Born-again San Francisco, 1907-30, makes a case study in fast recovery after it burned to the ground in 1906. What can it teach us? It had no State or Federal aids to speak of; no oil or gas royalties; no power to tax sales or incomes or payrolls; no lock on Sierra water to sell its neighbors, as now; no finished Panama Canal, as now; no regional monopoly; no semitropical climate; and little flat land.

* * * *

How did a City with so few assets raise funds to repair its broken infrastructure and rise from its ashes? It had only the local property tax, and much of this tax base was burned to the ground. The secret is that it taxed the ground itself, raising money while also kindling a new kind of fire under landowners to get on with it, or get out of the way. Developments are interdependent, so each owner could improve his land in the knowledge that other owners were subject to the same pressures, so needed complements would arise in sync with his own investment.

In 1907 the City Committee on Assessment, Revenue, and Taxation reported that revenues were still adequate, because before the quake and fire razed the city, 75% of its real estate tax base was already land value (S.F. Municipal Reports, FY 1906 and 1907, p. 777). The coterminous County and School District used the same tax base. San Francisco and Henry George were more in tune than perhaps either one realized. They did not rely just on jawboning and cheerleading. Civic spirit counts for a lot, but they had a substantive program that worked.

This firm tax base also sustained San Francisco's credit to finance the great burst of civic works that was to follow. People flocked there to open businesses, and find jobs and homes. The City bounced back so fast its population grew by 22%, 1900-10, in the very wake of its destruction; another 22%, 1910-20; and another 25%, 1920-30. It did this without expanding its land area, and while providing wide parks and public spaces. It even pulled back from the treacherous filled-in level lands that had given

International Journal of Social Economics. One of them, which Michael Hudson has explained in several articles, is to reform the personal income tax (if we must have one) to bear heavier on property income and lighter on wage income.

Another is always to base land assessments on current market value, and update them annually. Earlier I criticized private fee appraisers for using current comparables to value owner occupied homes, as follows: "'Expert' appraisals of land are based on sales of comparables, and upward price trends. These sales, in turn, were influenced by appraisers who based their opinions on earlier comparables and upward trends, and so on. This is because there is no cost of production to check excesses. Thus a herd mentality can take over, divorcing prices from reality: 'Irrational Exuberance'."

Why, then, would I ask public assessors to join the misguided herd? Because the public assessor is the one valuer whose overvaluation stops the herd. The Assessor by law is supposed to follow a bull market, not outguess it. When the "exuberance" appears in his wisdom to be "irrational", his job is still to go along, not judge. When private fee-appraisers go along they confirm and reinforce a boom, but when the tax Assessor goes along (and the tax rate isn't lowered) he douses a boom with cold water: higher taxes (Gaffney, 1985, pp. 91-109). It was the lack of such an automatic remedy that let the farmland boom of the 1970's soar so high above reality, then the urban bubble of the late 1980's, and now of 2001-2007.

* * * *

Banks should be regulated away from lending on land collateral. Following the South Sea Bubble there was such a movement in England. The emergence of the industrial revolution, flawed as it was, suggests the results were not all bad. I have not researched the history enough to say much more, but logically there is a powerful reason to regulate banks of deposit. This is because they are always technically insolvent, never able to meet their short-term liabilities from their long-term assets. A related reform might be to treat notes secured by mortgages as part of the property tax base. The counterpart is to tax the indebted landowner ("mortgagor") only on his equity, thus recognizing that the creditor ("mortgagee") is, de facto, part owner of the land. This idea is so radical and upheaving that I only hint at it here, its pros and cons would call for a book or two.

* * * *

Meantime, where is hope? Cleaning up the mess left from the last few manic years will cost sweat and tears and some fortunes, whoever undertakes it. Lower rents and land prices will finally let us recover, but the process of getting from here to there

value of adjoining parcels. The big developer, being human, may credit himself for the rising tide of the market in general. Such illusions, widely shared, can result in overproduction of new buildings relative to the basic demand.

• Land subdivision and development (or partial development) for urban use goes to greater excess than any other variable in the cycle. The quantity of land is fixed, but people spread out over more and more land. Call it bringing more land into the market, or bringing the market to more land, the effect is the same: a growing overhang of ripening land.

• *"Expert" appraisals of land are based on sales of comparables, and upward price trends. These sales, in turn, were influenced by appraisers who based their opinions on earlier comparables and upward trends, and so on. This is because there is no cost of production to check excesses. Thus a herd mentality can take over, divorcing prices from reality: "Irrational Exuberance."

• *Rising debt service overtakes inflow of new capital.

• *Corruption and graft that inevitably accompany easy money come to light, eroding and then cracking confidence in markets and banks and the "high, wide, and handsome" libertine boomtime philosophy that has papered over coven and fraud.

• *Lenders' loan turnover has to slow down as they turn from short-term trade credit or commercial loans to long-term loans based on land collateral. A bank that is all loaned out, no matter how sound its balance sheet, can not make new loans much faster than its debtors pay back the old ones. Today's loan originators can appear to escape from this constraint by packaging and securitizing bad loans for passage on to others, and finally to Fannie Mae and Freddie Mac, but that just blows dust over the iron rule that some lender, or the taxpayer, is left at the end of the line holding the bag. Our complex modern apparatus that seems so sophisticated is at bottom just a variation on how Andrew Jackson subsidized wildcat banks by accepting their notes for sales of public land. The more elaborate the deception, the greater the final letdown, as Treasury Secretary Henry Paulson is now learning. On July 26 the National Australia Bank shocked investors by saying it may lose as much as 90% of the value of its US mortgage-backed investments— worth more than $1 billion-and warning that the battered US housing market is poised to deteriorate further.

• *A rise of land prices cannot simply flatten out at a high plateau, because the increment has become part of the expected return that buyers are paying for, and lenders are relying on. So prices that cannot rise further have to drop: there is no equilibrium level. (I expand on this point a few paragraphs below.)

• At the crest, asking prices almost always drop slower than bid prices. This makes sales (deeds recorded) drop sharply, even as recorded prices hold steady.

• "Shoestring" borrowers face foreclosure; their distress sales force prices down, in a cumulative spiral

• Banks, whose capital and surplus is always a small fraction of their liabilities, lose much of their capital and surplus when many debtors default. They are always vulnerable, since they borrow short and lend long, so they have to stop making new loans. Some or many fail. Depositors may panic.

• *Lending slows faster than recorded interest rates rise, because banks cut off sub-prime borrowers. (Professor Ben Bernanke, in calmer days, developed this thesis for the 1930's.)

• *Self-financed firms fare better than bank customers, but their capital returns slower than before, or not at all, cutting their rate of reinvesting

• *Building stops; workers starve or emigrate; chaos reigns, we hit bottom

• *Governments and leading gurus blame the crash on falling land values, bend their efforts to bailing out big banks and sustaining land values, prolonging the depression. In the process most actors lose sight of the original cause, speculation in rising land values, and the stage is set to begin the next cycle.

* * * *

To Henry George, "land speculation" meant holding land off the market waiting for a rise. He likened it to an unconscious "combination" (a cartel) of landowners creating an artificial scarcity. George missed the next trick, however. He attributed industrial depressions to inexorably rising rents and land prices that progressively squeezed labor and investors off the land and into the unemployment lines. It was too simple. A good explanation must account for land value collapses, like today's, playing a key role in the crash itself. In George's scenario, lower land prices enable the later recovery, which they do, ultimately. What about the timing, though, the sequence of events? Urban land prices peaked in 1926; stocks crashed in 1929; unemployment peaked even later.

Like all cartels, the unconscious combination of land speculators creates a "price umbrella" under which new resources enter the market. Students of cartels recognize a "price-umbrella syndrome". Cartels create an artificial scarcity of a resource or

product and an artificially high "price umbrella" to shelter new competitors who come from outside the cartel. Previously marginal or untapped resources enter the market, often irreversibly. In urban growth, the cycle periodically thus creates an artificial surplus of half-developed land (graded, perhaps, roaded, platted, but lacking buildings). Other new land is even less than half-developed: accessed by new freeways, state highways, or county roads, but not even subdivided. At the same time, the lavish use of durable capital to bring settlers to all this marginal land creates a shortage of liquid capital, a shortage of loanable and investible funds, a rise of interest rates and a tightening of credit. The writer has analyzed elsewhere this lavish, irreversible misallocation of capital (Gaffney, 1976).

* * * *

I do not know of a single Nobel Laureate in Economics who forecast the present crash, or any other. Two of them, Chicago-Schoolers Robert Merton and Myron Scholes, founded Long Term Capital Management to demonstrate the brilliance of their investment theories. It went down in flames in 1997, saved only by a Federal bailout. Nothing daunted, media and public speakers seeking confirmation lean hard on Nobel Laureates whom they can cite. The media might better consider others with better track records.

Modern Georgists enter this period of danger and opportunity in relatively good shape. Several have outstanding scorecards calling the current crash. These include Fred Foldvary (2007, The Depression of 2008); Fred Harrison (2005, Boom/Bust); Michael Hudson (2006, "Guide to the Coming Real Estate Collapse", Harper's, May); and Bryan Kavanagh (2007, Unlocking the Riches of Oz). Each has a slightly different take on it, but they all saw it coming and stuck their necks out, far out, to forecast it in print. One of their distinctive commonalities is their recognizing that land rent and values are many times higher than most economists realize, and so play a major role in macro-economic ups and downs.

These Georgists who foretold this crash deserve a hearing, in preference to those who failed, and certainly to those who still deny it. What solutions would they offer? I do not speak for them, and they are not of one mind. There are a hundred more specifics than can even be outlined here, but the following elements seem reasonable and likely, knowing these authors.

One, of course, is to raise more public revenue from taxes on property in general and land in particular. These include property taxes, and in addition a host of other kinds of revenues. No less than sixteen of these are detailed in this writer's "Hidden Revenue Capacity of Land", forthcoming in the summer issue of the