MALINVESTING CAPITAL DUE TO OVERPRICING LAND, PART 2

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This is part of a "Pilot Paper", conference on the bank bubble, The American Institute for Economic Research, 1994. These notes were not published as such, but were melded by Editor Clifford Cobb into Part III, "Money, Credit, and Crisis", of our 2009 book, *After the Crash.*

Although written in 1994, after the "Thrift Debacle" (S&L collapse) of 1991, they could as well have been written, with a few different details, after 2008. Our leaders, political and intellectual, had learned nothing from 1991. The notes could be written again today, in 2012, since our leaders of "left" and "right" are still chanting the same old tired slogans I remember 13-year-olds shouting from the playgrounds of 7th Grade when Alf Landon ran against FDR. Hope springs eternal, so here are the notes. Someday, somewhere, new leaders will seek new insights and solutions. Tennyson wrote with hope, "Our echoes roll from soul to soul, and grow forever and forever". That has yet to happen, but remember, the last to escape from Pandora's Box was Hope.

John Stuart Mill long ago pointed out that the level of rents and wages determines the structure and character of capital. High wages evoke labor-saving capital; high rents evoke land-saving capital.

In addition, high land prices induce owners to withdraw equity, and that consumes capital. When assets appreciate, the owners regard that as current income, most of which they will consume. Selling the assets may be part of that process, but the process also occurs silently without a sale: they might just borrow on the assets instead. Even more silently, they let the capital run down without replacement, "eating the seed corn", letting the rise of the underlying land value serve in lieu of a proper CCA (Capital Consumption Allowance).

"Neo-classical" thinking has blinded economists to those simple truths by melding land with capital. This writer has shown in detail how and why and by whom this was done (The Corruption of Economics, 1994), and will not repeat the history here. Our present point is to follow Mill's lead and relate it to the problems of unemployment and boom/bust cycles.

I. Misallocating capital by substituting it for overpriced land.

When land is overpriced, it leads to overall locating capital to land-saving investments. This waste of capital leads to a shortage of disposable or "circulating" capital. It is characteristic of land-saving investments that their payout is very slow; the capital in them is locked up for many years or decades. In a word, it "turns over" slowly, if at all.

Here we meet an anomaly and an asymmetry that we need to recognize and resolve at the start. Substituting capital for overpriced land would seem to lower land prices, complement labor, and lead back to a benign free-market equilibrium, keeping this the best of all possible worlds. The hitch is that the kinds of capital that substitute for land are mostly what Adam Smith called "fixed" capital. Pouring capital into fixed forms drains it away from "circulating" forms, which complement labor more. Worse, sinking capital in fixed forms is not easily reversible, even once the problem is recognized. Often it is 100% irreversible and the capital is simply lost, dumped, as it were, over the edge of the world.

Again, we cannot change capital into land, but we can substitute it for land, and we do when rents and land prices are high. It is useful to carry this farther, and recognize five kinds of capital that high rents and land prices evoke and often overstimulate.

1. Land-saving capital, like high buildings. Land-saving comprises intensification of use of previously rentable lands, or "exploiting the intensive margin of production."

2. Land-enhancing capital, meaning capital used to improve land for a new, higher use. That includes, but is not limited to bringing previously submarginal land into production, 'way out on the frontiers. It also means converting rangeland to plowland, dryland to irrigated land, irrigated pasture to horticulture, and furrow irrigation to drip irrigation. In urban growth, it means converting farmland or wasteland to dwelling units. It also means replacing low-density estates with garden apartments; apartments with shops and offices; and obsolete structures with modern ones. Both country and city are marked by many "interfaces of supersession," where lower uses give way to higher uses.

Developing submarginal land is particularly capital-intensive, and the payoff is notably slow. A generic example is reforesting land that is high, cold, dry and sloping, where the timber does not ripen for over a century. In farming, an example is planting citrus or avocados on dry slopes requiring pumping the irrigation water and running drip lines to each tree. In urban growth, an example is subdividing outlying land where the improved lots have little value above the costs of their streets and utilities. See also #5, below.

3. Land-linking capital, like canals and rails and city streets.

4. Land-capturing (rent-seeking) capital, like squatters' improvements, and canal and rail lines built to secure land grants, and dams and canals built to secure water rights. These land-seizing investments are never optimal for society, and always waste capital. Land-seizing investments are laid out by self-seeking individuals ("rational economic agents") with no expectation of ever recovering the capital invested because the payoff comes as title to land, which never wears out. Canal, rail, traction, (continued on page 8)

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water supply, freeway and other such promoters are always mainly in the business of selling lands.

5. Rent-leading capital. In urban growth, an example is over improving land today, expecting higher demand tomorrow. This is "forcing the future." It occurs because there are "economies of simultaneity" in building. It is hardly ever economical to add stories to buildings one at a time. If you are going to build to four stories, you have to do it all at once. Suppose today's demand is high enough to justify a two-story building, but you see the demand rising steadily over the 60-year life of the building. You build a four-story building today, and absorb early losses on the upper two stories, as an investment for future years. A city builds a four-lane street, where two would do today, anticipating higher future usage. It puts excess capacity in its water and sewer lines, for future growth. Such examples are legion.

Economies of simultaneity are related to economies of scale. Building higher, taken by itself, suffers diseconomies, aka increasing costs. On the other hand, building larger, with horizontal expansion, evinces economies of scale. It also requires more land, meaning more land rent. It comes into style during periods of rent-leading capital building.

II. Land-saving capital and economic instability.

In a speculative land boom, land prices go prematurely high. Premature high land values profoundly distort the character of capital investment. High land prices stimulate land-saving, land-enhancing and land-linking investments. This is a rational economic response when and if the market is sending the right signals. Ideally, an optimally high level of land rents and values serves as a community synchronizer, causing everyone to build as though others were going to build complementarily in sync.

However, in the frenzy of a speculative boom the market sends the wrong signals. Land is peculiarly subject to inefficient, random speculative pricing in booms because it has no cost of production, so its pricing is entirely subjective, i.e. based solely on forecasts of future rents and resale prices, with no firm cap based on cost.

Overpricing of land reserves land for two contrasting kinds of buyers and holders:

Type A buyers would "force the future" with "rent-leading" buildings. They plan to and do develop land for a future demand higher than present demand. In Chicago, 1835, this was exemplified by building four-story buildings outside The Loop. Overpricing and consequent over improvement gets greater, the further out you go. In London, 1993, it is exemplified by Canary Wharf.

When that demand fails to materialize, Type A buyers cannot recover their money. They cannot rent out all their floor space, if that is what they built. Or they cannot use the full capacity of their tannery, harbor, shipyard, sawmill, packing plant, soap factory, brickyard, or whatever they overbuilt.

When Type A buyers develop land beyond the reach of existing infrastructure, they force extensions of same which are often losers, cross-subsidized by the whole system. This wastes social capital. For example, in May, 1993, British Prime Minister Major opened the 6-lane Limehouse Vehicular Tunnel, 1.1 miles costing $500m, the most expensive highway per mile in British history. The idea is to link the Canary Wharf Docklands project to The City. Britain also completed the 7 mile Docklands Highway, costing another $520m. There is a Problem: the Canary Wharf Docklands project is not renting up.

Type B landowners just hold land unused or underused. Rather than force the future, they would free-ride on the future. They are usually looking or expecting to sell for a rise. Type B-1 is the aggressive outside buyer, the stereotypical "land speculator," who does this calculatingly, cold-heartedly, as a purely pecuniary investment. Type B-2 is the ancient owner whose land just happens to lie in the way of growth. Type B-2 owners are sympathetic figures in popular drama and sentiment. They are passive victims of change, clinging to old values against mechanistic, impersonal, exogenous, amoral, modernizing forces. However, their market behavior has much the same economic consequences as that of Type B-1. Many turn out to be ambivalent, resisting change for a few years while quietly expecting to sell out for top dollar for their retirement.

The land of Type B landowners absorbs no capital directly, but much capital indirectly, by forcing the stretching-out of all land-linking investments in space, and generating no traffic or use to justify those that are built to and past them. Empty land also generates no synergistic spillover gains to raise the cash flow of surrounding, complementary lands. Thus it helps freeze up capital sunk in improving them.

The combination of (a), reduced net saving, with (b), waste and freezing of capital, leads to a shortage of disposable capital, tight lending policies, and a crash or slump.

III. Land speculation and credit institutions

There is another factor George hints at in Progress and Poverty. When land is first overpriced, credit is extended farther in order to accommodate it. That is, banks lend on overpriced land, counting on a further rise. When the rise slows, they extend the loans, sometimes even granting new loans for paying interest on old loans. They use political pressure to get governmental agencies (e.g. the World Bank) to extend or underwrite these risky loans (e.g. in Latin America). When the bubble bursts, the loans are not repaid. This destroys capital. Witness the collapses of Charles Knapp, Charles Keating, et al. (continued on page 9)

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The developing areas are supported by credit extended from older areas, until credit is recalled in a panic. Credit is, as George says, *like a rubber band that gives before breaking, until suddenly it snaps.*

J.S. Mill had advanced a related idea in his chapter on the tendency of profits to a minimum (Mill, Principles, Book IV, Chapter IV, Article 5). Mill sees profits driven down to a minimum by the formation of more capital than can find profitable use. Then investors, rather than accept safe, low returns, give a "ready ear" to riskier ventures promising higher gains but risking great losses, which in fact occur.

Modifying Mill with George's idea, profits are driven down, not by a glut of capital, but overpricing of superior land. Then investors give a "ready ear" to riskier ventures and more deferred returns, in land□saving and marginal developmental ventures. When the land bubble collapses, these risky ventures in saving and developing land prove to have been ill advised. Land now becomes too cheap to warrant and repay such outlays to have saved it. *Thus the capital is lost, and there is little recovery with which to meet the next payrolls.* Ricardo pointed this out long ago. Veblen developed a theory somewhat along George's lines, but with "goodwill" substituted for land value as the overpriced siren that leads the sailors on the rocks.

George's theory is incomplete, and yet contains an essential element to include in a complete theory of how a boom wastes capital, leads to shortage of liquid capital, causing a crash.

Today there are a dozen books on the S&L Collapse, the RTC bailout, etc. *Much of the capital loss is simply being added to the national debt.* What is needed is to show how this collapse is an integral, inevitable accompaniment of a political economy dominated by landowners who can first force down their taxes, and then further force up their land prices by perverting the credit system into an engine for subsidizing them with cheap mortgages based on overpriced land.

(GroundSwell does not have space for footnotes but they are available from Economics Professor Dr. Mason Gaffney. He may be emailed at .gaffney@dslextreme.com.

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EIGHT WAYS TO ENACT LAND VALUE TAXATION

By Dr. Seven Cord, Columbia, MD

We must admit that we Georgists have made very little political progress since Henry George's time, even though he was 100% right philosophically. I think it is because we don't realize how absolutely necessary it is for us to apply the single Tax *gradually*. It is most unlikely ever to be adopted all at once, although ethically and economically it should be.

In fact, the only LVT victories we ever have had in the U.S. have been because of *gradual implementation.* It will most unlikely be otherwise.

Fortunately, there are 8 easy ways to start Single Taxifying the nation and the world. These 8 ways primarily refer to cities, our easiest first target, but the states and federal government can also be *gradually* LVT'd. Here are the 8 ways. Your comments are requested.

(1) Assess Land Closer to Market Value Than Buildings. Often the reverse is true, in violation of the law (and of ethics and economics.)

(2) Establish a Two-Rate Property Tax. Levy a higher tax rate on land assessments than on building assessments using these formulas (but never exceed political acceptability).

(a) PBTR (proposed building tax rate) = 80% x CBTR (current building tax rate); a percentage other than 80% can be used (go faster if you can).

(b) PLTR (proposed land tax rate) = CBTR – PBTR, x BA/LA, + CLTR (current land tax rate); BA is total building assessments and LA is total land assessments.

(3) Levy 3 Rates – A higher rate on residential land, lower rate on residential buildings and a third rate on commercial and industrial properties – that's where our opposition is likely to come from; revenue neutrality must always be achieved. Set the third rate first (probably at what is is now), then decrease the tax rate on building assessments by no more than 20% per year while raising the land tax rate in order to maintain revenue-neutrality.

(4) Grant a $15,000 property tax reduction to all Building Assessments; maintain revenue neutrality (very important) by increasing the property tax rate, preferably on land only, in the years following, suggest building-tax reductions of 15%, 20%, 20%, 30%. These reductions, if revenue-neutral, would lower property taxes for most voters; *all* non-land-owning renters (both residential and office) will also pay less space rent (ask why).

(5) Establish a Separate Tax on Land Assessments Only for funding a current or new expense instead of either the current property tax or another disliked tax. Most voters and actual production will then get tax reductions (be sure to prove that beforehand).

(6) Tax-Exempt New Construction and Renovation (*not* the Underlying Land); achieve revenue neutrality by raising the property-tax rate on land assessments. Be sure to publicize the likely increase in building permits issues and the lower taxes for most voters.

(7) Apply #1-#6 Above in a Particular Ward or Other Section of a City. Then compare its economic growth to that of the rest of the city (as measured by building permits issued).

(8) Gradually Fund a Popular Project (maybe ecological, that sells these days) with #1-#7 above.

Then you *absolutely must* prove to the Council that taxing land assessments always lowers the taxes of most voters and booms the economy. Be sure to ask how to do that.

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A Peer Review is an exact replication of the empirical
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