How Wayward Land Markets Lead to Misallocating Capital*

Mason Gaffney, Working Paper

Misallocating capital has much the same economic effects as lowering the aggregate supply. Artificially raising demand for capital, leading it into wasteful, low-productivity uses, has similar effects. Overpricing land leads investors to overallocate capital to land substitution. This takes several forms.

I. Equity withdrawal 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. The process also occurs without a sale: they might just borrow on the assets instead. Commonly they let the capital run down without replacement, eating their own seed corn so to speak, letting the rise of the underlying land value serve in lieu of a proper CCA (Capital Consumption Allowance).

II. Overallocation of capital to save on overpriced land: Five forms of land-saving capital

When land is overpriced, it leads to overallocation of 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[1] for many years or decades. In a word, it "turns over" slowly, if at all.

Although capital cannot be converted into land, it can substitute for land, and does when rents and land prices are high. John Stuart Mill long ago pointed out that the structure and character of capital is determined by the level of rents and wages. High wages evoke labor-saving capital; high rents evoke land-saving capital. It is useful to carry this farther, and recognize five kinds of capital evoked or overstimulated by high rents and land prices.

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

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[1]Other words for locked-up are frozen, sunk, fixed, non-circulating, unrecoverable, clay (as vs. putty), etc.

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, 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 overimproving 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 buildngs 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 *dis*economies, 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.

III. 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 irrational 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 overimprovement 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.

IV. 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.[2] 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.[3]

[2]This is called "Ponzi finance," in deference to a famous swindler who paid dividends on his early sales of stock by using funds he got by selling more, and so on until he went to prison.

[3]In the present context I simply use "banks" generically for financial institutions. It is recognized that Knapp and Keating were S&L cases, and that after 1979 S&Ls were deliberately sacrificed to bolster commercial banks, so the details of the two kinds of institutional history differ.

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.[4]

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 land. Then investors give a "ready ear" to riskier ventures—and more deferred returns, in land-saving[5] 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.[6] 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.[7]

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.

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[4]George, who often chooses such striking examples, understates this point with an example of an English merchant selling gaudy calico and Birmingham idols, and financing his buyers. Actually, the heavy and significant credit went from England to the colonies to finance rails and cattle and such substantial developmental items.

[5]Consult other material herein, where we add to "land-saving" the corollary ideas of land-enhancing, land-linking, land-capturing, and rent-forcing investments.

[6]*Principles of Political Economy and Taxation*, Chapter 1, "On Value," and Chapter 31, "On Machinery."

[7]Wesley Mitchell, Veblen's disciple who pioneered modern business cycle research, had some such model on his back burner, too. Mitchell, unfortunately, was so dogmatically inductive that it became a compulsion, and he and his National Bureau finally couldn't see the forest for the trees.