How a Land Boom Destroys Capital

Revised Excerpt from "Causes of Downturn" 1982

Mason Gaffney, Working Paper, October 2005

These notes supply a missing link in the model initiated by Henry George, *Progress and Poverty*, Book V, Chapter 1, "The Primary Cause of Recurring Paroxysms of Industrial Depression."

George asks, "What limits the "speculative advance of rent?" (p. 260). The advance in rent is possible because much of the best land is locked up for the rise. In addition, in George's view, rents and land asking-prices keep creeping up whenever there is a period of prosperity and optimism, testing the limits. Landowners have the initiative to drive this process, since land price and land rent are prior claims on production. Labor and capital get what is left over.

What limits this rise is that labor and capital must be paid enough to survive and reproduce. When the landowners' overreaching demands leave them too little for that, many transactions can no longer take place, and production drops: a crash and slump. his in turn finally induces landowners to lower their asking prices to what labor and capital can afford and still survive and reproduce. The period of depression and readjustment is prolonged because land has more holdout power than labor and capital.

George is stingy with details on the mechanics of how this works. It is easy to see how excessive holdout prices for raw land would discourage building, or at least divert it to bad locations. But how about land under existing buildings? It is harder to see how a rise of its value can stifle production there. <u>Let us supply this missing link</u>. By doing so we can complete, and make sense, of this fascinating but elusive theory. What happens is that the rise of land value stops the capital from reproducing itself. This is the missing link.

Capital in old buildings may be consumed and destroyed by locational obsolescence, even when the building remains physically sound. In a dynamic, unpredictable market, a certain amount of this is to be expected, and is justifiable. However, in a major roller-coaster land cycle, towards the peak, there is a great deal of factitious locational obsolescence. The speculative land price swallows up the capital in the standing structure.

This takes the financial form of equity withdrawal. The owner takes the rise of land price as a substitute for storing up Capital Consumption Allowances (CCAs) to maintain his capital intact. Thus he consumes the CCAs as they inure to him.

That occurs whether or not the high land price later recedes. If it does recede, the fall is seen as negative income, tending to counteract the first effect. However it is likely to coincide with unemployment, bankruptcy, etc., making saving difficult and unlikely.

This is one of several mechanisms whereby a rise of land prices is treated by landowners as current consumable income, even though there is no corresponding production of real wealth. Result: negative capital formation.

Consider an existing building, solid, useful, and middle-aged. It is ready to be "milked," as a "cash cow." That means that most of its cash flow from now until tear-down will be regarded as CCAs (Capital Consumption Allowances), rather than income. CCAs are invested elsewhere, to conserve the owner's capital. When the building is finally torn down, the owner (and society) will have as much capital as ever.

Now suppose the price of the land under the building to rise, in a speculative boom, while the cash flow of the building remains the same. Let the land price rise so high it is now worth as much as the land+building were worth before. Now, the owner does not need to conserve any CCAs to conserve his wealth: the rise of land price has done it for him.

At the same time -- viewing the same point from another angle -- the cash flow from the land+building is now imputable to the land alone, to justify the land's higher price. The cash flow is all net income, because land does not depreciate. The owner may spend it all on consumption; being human, he begins to do so. Lenders descend on him and seduce him into borrowing on the land to increase his consumption. "Equity withdrawal" is the current term for it.

From yet a third angle, the building has undergone "locational obsolescence," and lost its economic value. Physically, it may look the same; economically, the land has sucked the reproducible capital out of it.

From a fourth and last angle, capital, to survive, must earn cash flow enough not just to cover interest on the unrecovered value,[1] but also enough above that to reproduce itself. As Mill said, "Capital is kept in existence from age to age, not by preservation, but by continual reproduction." Capital reproduces itself by yielding CCAs. When rising land prices devour capital, and/or rising ground rents arrogate its CCAs, capital stops reproducing itself. This is how rising rent drives capital out of production. It is not that capital "sulks." Such a metaphor is misleading: economic agents cannot afford to sulk. Rather, capital is drained and consumed by the rise of all-devouring rent.

This ruin occurs without apparent harm to the owners of buildings when, as is the rule, they own the land under them. It is silent and insidious, like a vampire in the night. It would only be contentious and "newsworthy" if the land were owned by a different party than owns the building, and the lease expired. There are such cases -- in trailer parks, and on the Irvine Ranch leaseholds in Orange County in the early 1980s -- when the sapping of capital is visible and contested. As a rule, though, it passes unnoticed: no one seems to be suffering, no one rebels or can plead injury, even as a big share of the nation's precious capital stock shrivels and dies without reproducing itself.

After that, there ensues a shortage of loanable and investable funds. That, in turn, slowly grinds down land prices and rents. This, I believe, makes sense of George's phrase, that rising rent cannot permanently force interest "below the point at which capital will be devoted to production." It would be clearer had he said at this juncture "below the point at which capital reproduces itself." Shortage of capital, and tightness of

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[1] To recompense the self-restraint of its owners (who are always tempted to consume it).

loans, finally force down land prices. Labor, meantime, endures a period of acute suffering after job-making investing dwindles down.

IMPLICATIONS.

A. Property tax assessors should revalue land annually, thus showering cold water on incipient land booms.

B. High property tax rates on land put a cap on land booms. Consider the basic, simplified valuation equation, $V = a/(i-g+t)$, where V is land value, a is current net rent, i is the interest rate, g is the expected growth rate of a, and t is the property tax rate. In the manic phase[2] of a land boom, as in California up to 1989, $g \rightarrow i$, and nothing holds down V except for t.

Through that mechanism, a high rate of property taxation applied to land (high t) averts negative capital formation.

[2] One of the great ironies is that during the manic phase, a theory with a name like "rational expectations," and corresponding pretensions, waxed dominant among economists. It is one of the recurring conceits of intellectuals to think that social life is, or could be, controlled by rational processes. One might even take the emergence of such theories as a sure sign that wisdom and judgment are being overborne by mob psychology and crazes. See Rene Dubos, The Dreams of Reason.