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FROM BOOM TO SLUMP

The feature, “Landing In Trouble”, first appeared in “Practical Politics”, Issue No. 29, in July 1992. It was subsequently reproduced by the Land Value Taxation Campaign in the booklet, “Crash Course”, in June 1993; a second edition was brought out in September 2002, with the accompanying material revised. The text below remains as published in 1992.

LANDING IN TROUBLE

For the purposes of this analysis, we largely take the political and economic situation as we find it. In particular we assume ownership of land in private hands and land rent privately appropriated. This in turn means that government revenue is obtained primarily from taxes on labour and capital and on their products. This in itself has deleterious consequences for the functioning of the economy, but, for the nonce, we allow this as “normal”, in order better to concentrate on the boom/slump cycle.

I Setting the scene

A. How progress affects land, and how land in turn affects economic development

Land is a resource in fixed supply. No more is forthcoming. Population grows, inventions and discoveries are made, and economic activity intensifies. The demand for land therefore rises, and the demand for the most favoured sites rises in particular. This increase in the value of land has certain important, logical, inevitable, and by no means necessarily undesirable consequences.

(i) Land of high value is subject to development which is increasingly capital-intensive. In the ordinary way, it is not sensible to hold or acquire an expensive site in the city centre and keep or put a hot-dog stall on it instead of, say, a gleaming department store.

(ii) The rising productivity which comes with growing population, greater capital formation, invention, and discovery, makes the use of previously marginal and sub-marginal land both possible and beneficial.

(iii) Rising land value leads to an upgrading of sites. This may take the form of a change of application, for example from agriculture to domestic, commercial, or industrial use; or it may involve site improvement such as draining or levelling.

(iv) To accommodate expansion, there will be infrastructural investments, for example throwing a bridge across an estuary, improving commuter road and rail links to burgeoning suburbs and satellite towns, and supplying all the concomitant services such as police, fire, health, water, sewerage, gas, electricity, and telephones. The availability of facilities like these adds, in its turn, to the value of land in the areas affected.

B. Economic expansion and its consequences for consumption and savings

(i) When the output from production is distributed, it becomes the income of those who receive it. Income may be consumed or saved. It is from such savings that capital is provided.

(ii) Capital is wealth produced but diverted back to the process of further wealth creation; it is not directly in the hands of the final consumer. Capital takes various forms. At one extreme, it is stock held pending delivery and sale. At the other, it is a small part in a major venture which takes months or years to come to fruition and start paying back – a reactor in the chemicals industry, perhaps, or an undertaking like the Channel tunnel. In between it is a piece of equipment relatively easily constructed and capable of showing a rapid return – a harrow, or an industrial sewing machine.

(iii) Savings sunk in long-term projects produce, self-evidently, nothing in the short term. If output is down, it follows that, in a static society, income is down and therefore consumption is down.

(iv) Given rational collective behaviour and sensible expectations, tolerable adjustment can be made. A reasonable measure of economic growth may in any case compensate somewhat for the decline in consumption which must follow dedication of income to big capital projects maturing only in the long term.

C. Land rents and prices

(i) Land may be privately owned to-day and be bought and sold, but, in political economy, it is not capital, and its rent is not interest on capital. The distinction, frequently not noticed or just ignored, is in fact vital. Unlike capital, its cost of production is nil – not least because it was not made by man, and, in the strict economic sense, was not produced at all. It does not respond to the price mechanism in the way consumer goods and capital goods do. When prices rise, no more land can be made and none can be moved from where it has little value to where demand is greatest. Land is fixed both in quantity and location.

(ii) As Ricardo and others have noted, land has its economic rent. This rent reflects the advantages (natural and social) which any one site enjoys over the poorest land in use. It measures its potential for greater productivity as compared with marginal land. The basis of the purchase price of land is capitalisation of the economic rent.

(iii) There are, however, other elements which profoundly affect land prices, and swell the capitalised economic rent by a speculative or “hope” factor. These derive from the uniqueness of land, its irreproducibility and its immobility. There will be speculation (a) on increased land value in the future, resulting from population growth and movement; (b) on economic progress and development, on how, when, and where, they will act to raise demand for land; (c) on public policy, on possible reallocation of land to higher planning use.

D. Investment criteria

(i) When a business invests, it makes cash flow projections. Money is laid out in the early stages of a new project, obviously without any compensating inflow. After completion, there are still outgoings, but money begins to come in and is expected to continue to do so throughout the operating life of the project.

(ii) £1 in one's hand to-day is worth more than the promise of £1 in, say, 12 years' time. Apart from questions of commercial risk and general currency debasement (inflation), it is evident that £1 put on deposit in a bank or building society now will be worth much more than £1 twelve years hence. Businesses therefore expect more than £1 in future for every £1 put down in the short term, and they discount future cash flow to allow for this, appraising capital projects by recourse to formulae such as d.c.f. (discounted cash flow), n.p.v. (net present value), and the profitability index.

(iii) Machinery and equipment, however well maintained, depreciate over the years and become obsolete. At the end of the life of a project, they may well cost more to dismantle than their value as scrap. This, though, is not true of the land they stand on. On the contrary, land will probably have increased in value, and will, if sold, bring in more (even after discounting) than on the day the project was begun. Expectation of significant rise in land value over the life of a project enhances that project's residual value, and hence the return on the original investment.

II From growth to boom

A. Prelude

At first everyone is level-headed and growth occurs without de-stabilising the economy. With progress comes greater competition for land. As is logical, land already in use is exploited more capital-intensively; marginal and sub-marginal land is brought in to beneficial activity; land is up-graded and put to higher use; outward expansion is facilitated by expenditure on the infrastructure. There are, though, already warning signals that trouble could be ahead. By no means all land is put to optimum use. Some remains under-used and some may even be held out of use altogether. This has a number of important consequences.

(i) Development does not take place in the most efficient manner. Under-use and non-use of valuable land tend to lead to decay in at least parts of the centre, and to sprawl in the suburbs and surrounding countryside. This in turn raises the cost and lowers the efficiency of public services, and it involves more extensive use of land that ought to have remained sub-marginal. It also artificially raises the cost of land that is made available for development or redevelopment.

(ii) Artificial scarcity adds to the pressure to capital-intensive exploitation of available land. One familiar example is the construction of massive (and massively expensive) office tower blocks, which are necessary for developers to achieve enough floor space, in relation to the underlying site area, to make the project pay. Another is the squeezing of a larger number of smaller houses on an acre of building land.

(iii) Land is increasingly acquired not for present use but to meet perceived future needs. Thus, to avoid the risk of being caught short, builders buy plots well ahead, and consign them to what are known as land banks. Conversely, there may be a stimulus to premature development, as, for example, when companies involved in oil and gas exploration bid for licences and find they have committed themselves, under the terms of those licences, to fund early production regardless of current market considerations.

B. Rising expectations

Land is the ideal object of speculation. Nothing can take place without it. No more of it is being made. There are virtually no outgoings on it if one has no intention of doing anything with it, nor is it likely to deteriorate if left in the open. On the contrary, it is more or less guaranteed to rise in value without the slightest expenditure of effort on the part of its owner. It becomes, for all of these reasons, expensive to buy. As expectations of future gains rise, it is seen as an even more desirable possession. Money is being made from land deals. The sight of all this, verifiable in the daily newspapers, the weekly magazines, and the trade journals, breeds confidence. Less allowance is made for risk (risk? what risk?). Illusion takes over. Land speculation has taken off.

C. Dear land and redevelopment

What may be acceptable as part of an orderly progress, becomes dangerous when carried to excess. So it is in particular with the urge, virtually an obligation, to respond to dear land by indulging in increasingly capital-intensive redevelopment projects upon it. These big capital projects are based on almost instinctive assumptions about the inevitability of ever more rapid growth in land values, and they come more and more to depend on that for their viability.

(i) Owners become aware of the “opportunity cost” of their land, even where it is already in profitable development. That is to say, the potential, speculative value of the site alone, exceeds the present combined return from the land and the building now standing on it. The tendency is thus either (a) to sell to a development company at a good price, or (b) to tear down the existing building oneself and replace it prematurely with something grander, in keeping with the enhanced, swollen land value. Whichever course is followed, there is a waste of capital.

(ii) Land prices are becoming unacceptably high, and are encouraging too much development and redevelopment on the most expensive sites, forcing otherwise viable businesses to close when rents are reviewed or when the owner simply decides to take his profit. Land speculation is undermining applications of labour and capital which are fundamentally economic, and sites are being moved in to uses which are justified only by illusory expectations.

(iii) All this capital-intensive development attracts savings and locks them in to long-term fixed capital projects. As noted at I B (iii) above, this reduces the capacity to produce finished goods for immediate consumption. Because output is checked, income is checked and so is demand (though there are other, ultimately destructive factors yet to be considered, which act to maintain and spur demand for a while).

(iv) Locking-up huge amounts of capital in long-term projects in this way is itself partly the cause of a subsequent slump. It should be stressed that it is the consequence of exaggerated and misleading signals from the land market.

D. Feeling good

Rising land prices encourage not only capital-intensive redevelopment, but they also act, perversely and indirectly, to encourage consumption.

(i) Landowners feel rich. The term, landowner, covers not only freeholders, but anyone who enjoys a beneficial interest in land, anyone who could make a profit from the simple process of further sub-letting his holding, whether he chooses to do so or not. Thus giant companies feel rich, big private landowners feel rich, many homeowners feel rich.

(ii) He who feels rich from appreciating land values, feels no special urge to save from out of his ordinary income. He thinks he may safely consume more and save less. Are not land values doing his saving for him? This attitude acts to counter, for a while, the check to consumption noted at II C (iii) above.

(iii) Thus consumers wish to borrow, intending to repay from future gains from land holdings – provided that lenders can be found who will have confidence in land as collateral.

E. Banks, building societies, and credit

(i) Building societies (in the domestic sector) and banks (in the extremely important commercial too) delight in playing the pawnbroker and lending against complete security. They see in land all the advantages set out at II B above, and, like everyone else, lose sight of the waiting traps.

(ii) Bloated land values are mistaken for real wealth. Credit is extended. Later, as the thirst for apparently profitable lending increases, credit is allowed to rip. This not only wipes out the check to consumption which ought to have occurred – as noted at II C (iii) above – it actually sets the opposite train in motion. Consumers go on a credit-buying spree. Lenders cannot distinguish the economic rent of land from feverish, speculative land values.

F. The overseas connection

The real economy can grow at only a limited, efficient rate. Demand, artificially stimulated and insecurely based, can now be met only by calling on resources from abroad. At home, savings have fallen and borrowings have risen.

(i) Exports fall away, as production is diverted to satisfy the home market.

(ii) Imports are drawn in to meet demand which current production is unable to satisfy (this is partly because of the demand stimulus resulting from easy credit but partly also because savings have been locked in long-term capital projects which are producing nothing in the meantime).

(iii) There is now a trade deficit. This is met by attracting savings from abroad. For every borrower, there has to be a lender somewhere! Such loans will need to be secured by maintaining at least a stable rate of exchange and by commensurately adequate rates of interest.

III At the peak

The economy, as a result of total refusal to recognise the fundamental rôle played by land, much less understand it and interpret its signals correctly, is now going rapidly off course and out of control.

(i) Speculative development schemes are being undertaken, under the illusion that continued, rapid growth in land prices will sustain the increasingly risky rates of return projected. Unhappily, this growth in fixed investment is not the result of conscious, orderly decisions to save more and spend less. Real saving has actually decreased.

(ii) Land values, seemingly inexorably on the rise, make it unnecessary to save from regular income. The ratio of savings to consumption, falls. Consumption is further fuelled by credit, based on land as collateral.

(iii) There is thus at one and the same time both a fixed investment boom and a consumer boom – and both are based on the same mis-reading of what is happening to land values.

(iv) The productive capacity of the economy cannot keep up with such an over-heated state of affairs. The economy is over-investing, over-consuming, over-borrowing, and over-lending.

(v) High real interest rates are now seen as necessary, (a) to encourage saving, (b) to hold back the trade deficit, (c) to attract and maintain foreign loans to finance that deficit, and (d) to hold back inflation, for output has not been keeping up with the growth in money supply during the easy credit associated with the latter stages of the boom.

IV Over the top…and down…in panic reverse

A. Rising interest rates cast doubts on land prices, however. The price of land is basically the capitalisation of the economic rent of land. To illustrate, when real (net of inflation) interest rates are, say, 5%, then the capitalisation of a rent (‘return’) of £1,000 a year gives a price of £20,000. If interest were to rise to 10%, that same land rent would capitalise at £10,000. That the difference would perhaps not at first seem so dramatic, is explained by the extent to which the underlying price of land is swollen by the various speculative “hope” factors. Nevertheless, eventually, as real interest rates do go up, investors tend to move away from and indeed out of over-priced land. The first doubts arise. Commentators usually notice problems appearing initially in the property market, where the connection with the price of land is directly obvious.

B. Real growth has led to speculation. Now the banks and other lenders have been brought in. Lower investment yields have been accepted, on the understanding that ever-rising land prices will boost the return. Profits on land deals look so spectacular that lower yields are being accepted on these too. It can not continue indefinitely, and it does not. The bubble bursts. The slump in land prices now throws the system in reverse. Scales fall from horrified eyes.

(i) Easy credit is no longer available. Rent charges and interest charges, negotiated in heady days, become a scourge.

(ii) Falling land prices no longer buoy the rate of return on investment. Businesses are failing. Homeowners who bought at the peak with high mortgages, are caught with properties worth less than the amount of the outstanding loan.

(iii) Falling land prices have removed the entire basis of the credit boom. There is now a rapid downward adjustment of expectations. Interest rates hurt.

(iv) Lenders are in trouble. Borrowers do not meet repayments, and the collateral for the loans is not there.

(v) Investor borrowing and consumer borrowing are depressed. Recession depresses land prices still further.

(vi) Both income and consumption are down.

(vii) When the big, capital-intensive projects are ready, consumer demand for them has gone. Capital has been wasted. They will never pay their way now.

(viii) Other big projects are abandoned. It is problematical whether they will ever be completed. More capital has been wasted. Entrepreneurs face ruin.

(ix) Unemployment rises.

(x) People do not feel rich. Falling land values discourage borrowing and spending.

(xi) Demand for both consumer goods and capital goods, falls.

(xii) Investment falls. The savings ratio rises once more. The paradox is complete: the boom combined a falling savings ratio with artificially stimulated capital-intensive investment, and now there is a slump with depressed investment and savings rising as a proportion of income.

(xiii) Potential sellers are reluctant to lower prices, but those who are in distress must sell, and prices continue to fall. Potential buyers are in no hurry, because the likelihood is that prices will be lower still to-morrow. The tendency of buyers to hold off, adds to the propensity to save.

(xiv) Government commitments rise, but revenue is falling. It becomes increasingly difficult to pretend not to have noticed what is happening.

V Coda

The development and evolution of the boom and the slump are a condemnation of the practitioners of conventional economics. The failure to foresee and forecast the course of the cycle, is matched only by the failure adequately to explain it.

If proper consideration of the rôle of land in the functioning of the economy is not in the syllabus, then it should be. If land is not represented in computer models of the economy, then it should be. If people who can see no difference between land and capital are in positions of influence, then they should not be.

Si monumentum requiris, circumspice! The price of maintaining establishment economics is paid by the victims of the recurring cycles of disruptive boom and disastrous slump. The doctrine that land is not important, must be interred. There will be few mourners, outside its own priesthood.

LAST WORD

This piece appeared right at the end of that same Issue of "Practical Politics", No. 29.

A slump is but the tragic and erratic correction of the fevered disorder that is a boom. Booms are based on illusory expectations, mis-interpretations of the signals coming from the behaviour of land. If land values were to be taxed, such speculative activity would be damped down. If the economic rent of land were collected in full – as we think it should be – then land speculation would disappear entirely. If the mere holding of land produced no income stream to the possessor, land as such would have no selling price. The capitalisation of zero is zero. If site rents were paid to the national exchequer, not only could existing taxes be removed or at least abated, but private profit could be made only from the activities of labour and capital. Undistracted by the siren call of huge speculative takings from land dealing, the economy could and would grow in an orderly manner, consolidating productivity gains and ensuring the rewards of enterprise and effort went appropriately to those responsible for producing them.

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