



## **Empty Spaces**

By Dr. Mason Gaffney

This article was first published in GroundSwell, a publication from Common Ground, USA. The Robert Schalkenbach Foundation has received approval from Common Ground, USA to republish this article at no cost for educational purposes.

Article citation:

Gaffney, Mason. "Empty Spaces." *GroundSwell*, Jan. 2009.

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# Empty Spaces

## How Our Tax Policies Caused the Present Seizure by Unbalancing Hard and Soft Capital

Mason Gaffney,\* February 2009

For “Insights”, a regular column in *Groundswell*, January-February 2009

“Phantom faces at the window.  
Phantom shadows on the floor.  
Empty chairs at empty tables  
Where my friends will meet no more”  
— Marius’ song, from Alain Boublil, *Les Mis*

### Why we have more buildings than we use.

Many stores have closed in the last year; they stand empty behind signs reading “Available”, “For lease”, or “First month free”. So have many industries, their gates padlocked, their girders rusting. The capital in them is wasted, poured down a rat-hole. Multi-million dollar freighters are mothballed at Subic Bay, with no cargos to carry; others sail with unfilled capacity. Vast warehouses stand half-empty. Fleets of trucks wait for loads that never come. Redundant McMansions stand waiting for buyers, some advertising “Bank-owned”. Freight trains haul too many “empties going back”. The square miles of idled passenger and cargo jets in the Mojave desert is evolving into a jet cemetery.

This brings us up against a weakness in locally-oriented Georgism, which emphasizes the benefits of modifying local property taxation to untax or downtax buildings. Not long ago the Building Industry Association in my city approached me to help lobby to lower various fees in lieu of taxes imposed on builders. I could have used the money, and easily repeated the litany of Georgist arguments against taxing buildings, when it occurred to me we have too many buildings already, and better uses for the capital needed to build more.

It looks stony-hearted to read we “have too many buildings” when there are still poor families crowded into “roach motels”, or outright homeless. However, that is due to maldistribution, and misdirected investments. Its remedies lie in making jobs, raising wage rates, untaxing labor, and uptaxing land values. It is the aggregate of buildings that are a drug on the market, while businesses wither and die for want of working capital needed to hire workers to fill and use the buildings.

In the previous Great Depression, as today, America was loaded with empty buildings and excess capacity.

“Once I built a tower to the sun, with bricks and rivets and lime  
Once I built a tower, now it’s done. Brother, can you spare a dime?”  
— Yip Harburg, 1931

Empty subdivided lots, too, went begging; owners abandoned many for back taxes. The Georgist message, locked into a paradigm from earlier times, seemed irrelevant and was shunted aside. This time around, we need to stress how taxes that “shoot anything that moves” keep things from moving. We need to show how removing taxes on labor and production and sales

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\* I am indebted to Polly Cleveland for major editorial help.

will raise the value of empty buildings and lands, so property taxes can yield more revenue to replace them.

I seek no quarrel with the many Georgists who give splendid service to the cause of downtaxing buildings to uptax land values. Their work is basic, demonstrating again and again, city by city, the feasibility and good effects of taxing land values separately from buildings and other capital. For it's not just the capital that's wasting. There is land under those empty buildings, often more valuable than the buildings themselves. It might as well be vacant. It's more than the land literally under the building, too. Even residences have yards, garages, and driveways; some have palatial grounds, in the choicest neighborhoods. Retail and wholesale and industrial buildings have vast parking areas and aprons for employees, customers, and deliveries. Some have wide yards for open storage. When city planners count up vacant lots, if they do, they usually see just lots without buildings, of which there are many, but nowadays there are as many or more invisible vacant lots under and attached to empty buildings.

We fret about Al Qaeda, and immigrants from Central America, but these empty spaces and vacant lands might just as well be ceded to the Taliban, or drowned like Atlantis, for all we use them. Osama bin Laden's attacks are pinpricks compared with the damage we do ourselves by mismanaging our economy.

Trivializers tell us that abandoned lands in declining cities are worthless, noting that the median house in Detroit now sells for only \$35,000 or so. However, that is to misunderstand three important matters. One is that Detroit not long ago was our fourth biggest and fastest growing city, home of the assembly line, core of the "arsenal of democracy" and the locus of our bellwether industry. Its location has not worsened, but improved with the St. Lawrence Seaway opened and global warming lengthening its ice-free season. The second is that Michigan's leaders can renew Detroit and their whole state any time by shucking their terrible counterproductive "modern" tax system and returning to the system that sparked Michigan's spectacular growth, as documented in this writer's previous "Insights" column, "What's the Matter with Michigan?" The third is that urban renewal in a free market proceeds from the fringe of a slum in towards the center. Richard Hurd taught us back in 1903 that land values are marked by continuity in space, because developers seek to anchor new neighborhoods to the best of the old. The heart of a slum may be hopeless, if you try to parachute renewal in there, but the edges are always renewable, and a market revived by untaxing new buildings can proceed naturally inwards from there.

So property tax reform remains basic. However, please consider this. Property tax reform carried more weight when Henry George wrote because the property tax was the major tax levied by both state and local governments; federal taxes were light. Also, taxable property included "personal" (movable) property as well as real estate, while most states today have exempted all or part of personal property from the base. Reforming the property tax then, in George's day, was reforming a major part of the whole tax system.

So we return to asking what's the use of new buildings when so many old ones are empty? To be sure, new ones may replace old depreciated and obsolete buildings, there is always some of that, but many of these unsold see-through buildings today are brand new themselves. Supply has outpaced demand, leaving us with a great housing crash. There were some 2.3 million foreclosure filings in 2008. It's not saying much that it's the greatest crash of this millennium so far—9 short years—but going back to the prior millennium it's worse than 1990, worse than

1975, worse than 1958 ... many are equating it to 1929, for like 1929 it has brought the banking system down with it, and the whole slumping world too. Beijing is suddenly stuck with more new office space than all of Manhattan, new and old, most of it empty as a broken promise.

Today we have sales taxes, business taxes, personal and corporate income taxes, payroll taxes for Social Security and Medicare, employer responsibility for workmen's comp and, in many cases, pensions. We have an income tax system, federal and state, that has turned owner-occupied housing into the greatest tax shelter while simple basic labor bears the brunt of what housing does not pay. On top of that we have subsidy programs for housing, while no one subsidizes the overtaxed worker for working. Income from commercial buildings is mostly untaxed, too, as Hudson and Feder's work for the Levy Institute has shown. This is done through a combination of accelerated depreciation, avoiding the capital gains tax, and repeated tax-depreciation of the same building by sequential owners. Viewing the tax system in its entirety, it's not buildings per se that are overtaxed. It is USING the buildings that is overtaxed. That is why we have more buildings than we use.

It also helps explain why we have such high unemployment. Construction makes jobs, yes, but not nearly as many jobs as using the buildings once constructed. Using buildings, in turn, depends on entrepreneurs' raising funds to hire workers. These come from commercial loans, lines of credit, and turnover. The greatest of these, and the least noticed, is turnover.

### **How the classical economists understood the importance of capital turnover.**

Turgot perceived in 1767 (*Réflexions*) that investing is the independent force that "animates all the work of society". Adam Smith, who learned his economics from Turgot and his allies the Physiocrats, added the factor of turnover. He put it this way:

"A capital employed in the home trade will sometimes make 12 operations, or be sent out and returned 12 times, before a capital employed in the foreign trade ... has made one." *Wealth of Nations*, Republished, 1937, pp. 338, 341, 349.

Adam Smith is using cargo as a metaphor for all capital. For generating employment, fixed capital frozen in buildings or turnpikes was so sterile as not to be worth Smith's mentioning: the payback is too slow. Time has not changed that much. One modern desk worker occupies about 200 s.f. of floor space. The cost of constructing that is roughly \$100 per s.f., or \$20,000 per desk worker. Some 20%-30% of on-site construction cost is labor, say \$5,000 per desk worker. If the mean desk worker earns only \$30,000 a year, and the floor space lasts 60 years, the labor input in using the space comes to \$1,800,000, or 360 times the construction labor. It is *using* floor space, not building it, that makes most jobs and produces most goods and services. The greater importance of building is that it gives labor better access to the location, which might otherwise go unused.

In the absence of working capital, however, as today, even access to land via floorspace is not enough by itself. There must be working capital, too. There are two sources of working capital: net new saving, and turnover (recovery of capital from sales of previously invested capital). The second item includes bank loans made from repayment of earlier loans. Most businesses, especially small ones, depend on lines of credit and commercial loans to finance day-to-day operations, and these depend mostly on banks' recovering funds they loaned earlier.

Consider retailing. Sales per s.f. in modern department stores might be \$300 per year—much more in downtown New York, less in smaller markets. Over 40 years, thus, sales total \$12,000

per s.f., or 120 times construction cost of \$100 per s.f. The flow of capital through the store—the throughput—accounts for so many times more jobs and products than the capital in the store building that a macro-economist can nearly ignore building construction as a job source.

What did other great economists say about this matter? We have David Ricardo on our side. His Chapter 31, “On Machinery” in his *Principles* makes the same point that Smith makes above. He draws on the reasoning of his classic Chapter One, “On Value”. Economists rightly venerate Chapter One, but then wrongly disregard “On Machinery” as an aberration, even though it follows the reasoning of Chapter One.

John Stuart Mill applied Smith’s insight directly to taxation, noting how a general sales tax would slow down investing. Mill’s reasoning, as always, is subtle, and his expression wordy, but readers who are interested in the history and evolution of economic thought will be fascinated. My guess is that that includes most readers, because the history of economic thought in *The Corruption of Economics* (1994) is more popular than anything else I have published in the last 20 years. Others may want to skip directly to the last paragraph; but here is Mill:

“... if there were a tax on all commodities, exactly proportioned to their value,... there would ... be a **disturbance of values**, some falling, others rising, owing to ... the **different durability of the capital** employed in different occupations.

... The gross produce of industry consists of two parts; one portion serving to replace the capital consumed, while the other portion is profit. Now equal capitals in two branches of production must have equal expectations of profit; but if a greater portion of the one than of the other is fixed capital, or if that fixed capital is more durable, there will be a less consumption of capital in the year, and less will be required to replace it, so that the profit, if absolutely the same, will form a greater proportion of the annual returns.

... To derive from a capital of 1000 £ a profit of 100 £., the one producer may have to sell produce to the value of 1100 £., the other only to the value of 500 £. If on these two branches of industry a tax be imposed of five per cent ad valorem, the last will be charged only with 25 £., the first with 55 £.; leaving to the one 75 £. profit, to the other only 45 £.

... To equalize, therefore, their expectation of profit, the one commodity must rise in price, or the other must fall, or both: **commodities made chiefly by immediate labour must rise in value**, as compared with those which are chiefly made by machinery.”—*Principles*, 1848, “Of taxes on commodities”. Emphasis mine.

Where Mill says “machinery” he clearly means durable capital of all kinds, including buildings, tunnels, trees, breeding herds, freighters, wells, highways, airports ... you can name a thousand examples. And where his numerical example contrasting two “branches of industry” is understated and abstract, let us contrast buildings with the “commodities made chiefly by immediate labor” inside the buildings.

A building may last for, say, 50 years, and return the principal of the capital in it in, on the average, about 2/3 of that time (a little in the first year, a lot in the last years, according to the standard formula that lenders and the I.R.S. use to divide level monthly installments between interest and recovery of principal). The “immediate labor” of workers inside the building adds value to materials to be sold in, say, a month, returning capital that the entrepreneur can reinvest immediately, for a turnover of 12 times a year.

“**Turnover**” is the single word that epitomizes Mill’s labored prose, and “loan turnover” expresses its effect on bankers. Taxes on commodities tax capital each time it turns over. They “disturb The Force” (as Darth Vader might say), where the market is The Force, and push capital out of producing commodities “made by immediate labor”, hence more into commodities and services rendered over long periods by durable capital: capital of slow turnover.

After Mill, the baleful influence of J.B. Clark engulfed the profession like a miasma. In his tortured efforts to conflate land and capital Clark deleted the turnover of capital from the professional consciousness. His followers call the new, improved approach “neo-classical economics”. His main objective was to avoid singling out land for taxation, but a byproduct was to remove capital turnover from micro-economics, as explained in *The Corruption of Economics*. He and his disciple Frank Knight were obsessed with attacking the “Austrian” economists who sought to keep capital turnover at the center of economic thought.

Other economists struggled for a while to fit the Austrian Böhm-Bawerk’s ideas into their neo-classical models from which time had been largely banished, only to reject or isolate such ideas when they could not fit them into their static, Clarkian models. From 1870-1920, “much of the economics was ... an economic theory of acapitalistic (note the prefix ‘a’) production. Considerations of capital theory proper ... simply disappear from the picture” (Lionel Robbins, 1934). It was Auguste Comte who wrote that all science consists of relations either of coexistence or sequence. Clark confined neo-classical economics into a box that shut out relations of sequence. Not until Keynes did they return, and then in distorted form.

Keynes picked up on Turgot’s insight, but in a twisted sort of way that loses much of its force. In Keynes, “investment” is the autonomous motor of the system, but it means net new investment only. He takes reinvestment and turnover for granted, as results of “consumption”, regardless of what is consumed—it could even be the services of land, for all he and his followers seem to care.

Keynes puts everything in monetary terms, the ultimate abstraction, with little attention to the corresponding flows of goods and services, as though their composition had no effect on the outcome. Thus for him construction is just as good as tailoring or cooking or delivering mail or waiting on table or baby-sitting for making jobs, and maybe even better because construction soaks up the capital invested for long periods, and Keynes saw capital as being formed in excess of need—quite the opposite of today’s problem when businesses are starving for want of working capital and commercial loans to finance day-to-day operations.

### **Our highest priority: untax work and turnover.**

What we need today is to get rid of taxes on Mill’s “commodities made with immediate labor”, and taxes on labor itself. We need to show that the present system, by seeking to spare property values, actually depresses them by more than would direct taxes on property, because of the “Excess Burden” of indirect taxes. As we make this great shift we should continue to champion focusing the property tax more on land rather than capital, but as we do so let us give higher priority to untaxing work and turnover and cash flow and sales than to untaxing buildings. We already have empty buildings to burn, with empty chairs at empty tables.