Aspects of Lender Risk and Bias
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Aspects of Lender Risk and Bias

1. The Bias of Lenders Against Marginal Production

Lenders prefer and demand cushions of borrower equity to protect them against risk of loss. They do not share profits, why should they share losses? Thus lenders shy away from borrowers whose only collateral is marginal land. They also shy away from marginal "increments of low quality" on all land. "Low quality" means the marginal net gain approaches zero.

Rent is a magnet that attracts loans. Some borrowers may use the money anywhere, even on marginal lands and increments. But many others are steered away from the marginal increments of "low quality." This is notably true of new buildings that outvalue their sites by several times, so the rent equity wears thin quickly and the banker's exposure on the marginal increments gets toward 100%.

It is true of allegedly "risky" crops like fresh market tomatoes. Here, because of high labor needs, successive possible increments of "low-quality" investment go on and on, with high ϵ values and low cushions of marginal gain. A lender could tolerate a few increments of low-gain investment if they were well covered by a high-gain average such that the financed inputs were only 50%, say, of the expected sales, as with barley. But with the tomatoes they approach 90%, and that is too much for the banker to swallow, even in cases where the tomatoes are likely to yield much higher net rent to the land, year in and year out, than the barley.

Zoning restrictions also increasingly hinder full development of the intensive margin of land.

Faced with these pressures, the holder of rent-yielding land is likely to use his discretionary cash flow to buy still more rentable land. The surplus wealth he piles up from his original holdings give him a differential advantage in bidding for still more. Nowhere is the advantage of a head start more vital than in the competition for land.

Here we need to adapt our chosen model, which began by holding land fixed. The original model is not adequate in explaining, analyzing, and predicting the behavior of an entrepreneur who has access to cheaper capital than his neighbors. It <u>is</u> apt in predicting the behavior of an entrepreneur with access to cheaper labor -- e.g. a lean, mean

immigrant with a large supply of loyal family labor. This immigrant applies the labor to his land intensively, as did immigrant Japanese farmers of an older generation in California.

But cheaper capital, that's different. With cheap capital one can also buy more land itself, or move to better land. Land has to be considered a variable at this point. Otherwise we fall into the Fallacy of Partial Constraint.

2. The Fallacy of Partial Constraint

What is this Fallacy? An example is when well-meaning energy conservationists get cheap subsidized credit to homeowners, so these can finance energy-saving insulation. The subsidized borrower then chooses instead to add another room to the house - "money is fungible," as they say. Another example is when a homeowner inherits a fortune and it is assumed he will improve his house and raise the ratio of building to land value. Instead he moves to a better neighborhood where the ratio of building to land value is lower.[1]

We will stick with the model, but caution that when a manager gets cheaper capital, look out: he is more likely to buy more land than to intensify what he has. A whole economy or society cannot convert capital into land, nor vice versa, but an individual manager can use money to buy either one.

Here we have an anomaly and an asymmetry in lender behavior, which affects the allocation and combination of inputs and warps them from simple optimality. The risks of investing capital at the margin of "low quality" are traditionally identified as "risky." As a result, they are suppressed by credit rationing. This leads toward the "Fallacy of Minimizing Risk by Maximizing AP." It is done by such devices as setting a hurdle rate of return on investments that is high above the borrowing rate. Why is this a "Fallacy"? Cf. these other papers: "Wasting Land by Saving Labor"; and "Optimal Combination of Inputs."

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[1]In economics we measure inputs by value, so dearer land is the same as more land. In Beverly Hills, and other such places, the ratio of building to land value gets down around 1/3, "Believe It or Not!". (By the way, as an exercise, show that the 1/3 ratio means the building fraction of the total value of land+building = 1/4.)

Here is the asymmetry. A high AP for capital and/or labor implies a low MP for land, as shown in the papers just cited. Thus, to escape one kind of "increment of low quality" (capital applied intensively), we create another such increment (too much land applied per unit of capital). A capital-sparing combination means a land-using one. Shunning one kind of intensity simply creates the other. That is hard to grasp, but important, so grasp it anyway.

However, lenders tolerate land increments of low quality. High hurdle rates of return are not applied to them. The risk is not perceived because land is bought with equity more than borrowed funds. This creates a strong bias to underutilize land. The bias is invisible to most economists, because Neo-classical Economics, the paradigm in which their minds are grooved, is designed to obscure it.

If the land is rented rather than bought, that is different. Now it is just another hired input, and gets the same treatment as other inputs -- rough, but equal. Risks would be perceived more symmetrically. Allocation of resources would be better if all land were rented from a fair, but exacting landlord.

Another, democratic alternative is to have private holders pay heavy property taxes for holding title to land. Such taxes used to be moderately high in California, before Prop. 13 stifled them (1978). This change in policy removed an effective social antidote to land-gorging. It leaves us with a strong bias against economical treatment of land in the economy. Managers in California must now live and cope in this environment. The quantity of land in the State is, of course, fixed, so a higher ratio of land to capital has to mean less capital in the State, overall. Many factors are involved, but a lot of firms and their capital have left the State since 1978.

3. The Bias of Lenders against the Poor, the Competitive, and the Risky

TO BE ADDED