Henry George Institute

Economic Science

Supplementary Readings:

	Page
Skill and Knowledge (Lesson 1)	3
Why Are Theories of Value Important? (Lesson 4)	5
Competition (Lesson 7)	9
The Corruption of Economics (Excerpt — Lesson 10)	12
Can We Eliminate the Boom/Bust Cycle? (Lesson 10)	20
Glossary of Terms (Terms appearing here are shown in **boldface** the first time they appear in the readings.)	25
Appendix: **A Most Harmonious Disagreement**	27

© 2004, The Henry George Institute, except for
The Corruption of Economics, originally published by Shepheard-Walwyn, 1993. Reprinted by permission of the author.

Skill and Knowledge

by Lindy Davies

"It is not in skill, but in the knowledge which can be communicated from one to another, that the civilized man shows his superiority to the savage", wrote Henry George in *The Science of Political Economy*. The original Henry George School course in *Economic Science* asked students, "Which of the two (knowledge and skill) is more important in the development of civilization?" and answered: "Knowledge is the more important because it can be stored and transmitted in many efficient ways, thus enabling human society to continually advance. Skill, however, must be learned anew by each individual and can only be stored and transmitted by individuals."

In Henry George's day this seemed to be a no-brainer. Knowledge, applied in the form of labor-saving technology, made possible a vast increase in the productive power of labor. The power of human skills seemed quaint by comparison — as shown by the example George chose: an aboriginal boomerang-thrower. In the late nineteenth century, the importance and power of human knowledge to improve life was thought to so far surpass the power of human skill that it seemed ludicrous to compare the two.

A hundred years later, however, society has reached the other side of the industrial revolution. As labor became ever more divided and specialized, "making a living" came to be further and further separated from any personal involvement on the part of those doing the work. Ever-more specialized knowledge came to be applied to everything people do, and to everything they come in contact with. For most people, making a living has become a matter of availing oneself of some sort of marketable knowledge, a "specialty" that will command better-than-average wages. Workers without special skills seek the protection of a trade union to protect their livelihoods from "scabs" who are willing to perform their undemanding jobs for lower pay. (The fragility of these arrangements is seen when improved information and communication technology allows jobs to be shipped overseas to lower-wage workers.)

For consumers, the march of specialization progressively eroded people's sense of involvement with, or control over, the things they use in day-to-day life. Goods and services were designed and produced by experts, and when they didn't work, experts had to be called in to repair them. The struggle to compete in increasingly specialized job markets left people no time for developing "skills" — not until they retired, at least, when they could then take up a "hobby". It seemed that the triumph of knowledge over skill was complete.

However, it began to dawn on people, as civilization began to turn into what some call a "postmodern" or "postindustrial" society, that some important things had been given up along the seemingly straight path toward efficiency (characterized by greater specialization and deeper knowledge). We were being told to "trust the experts" — but how did we know that the "experts" knew what they were doing, or were telling us the truth? (The popularity of the "consumer advocacy" movement showed that many people were justifiably uneasy about taking big corporations at their word.)

And yet — the benefits of advanced knowledge and specialization are undeniable. Without them, we could scarcely hope even to feed an expanding population. Must we simply endure the lack of choice, the feeling of being lost and disempowered, that seems to come with modern "production"? Is that simply the price of progress?

Surprisingly, our search for clear, consistent terms in the study of political economy can point a way out of this conundrum.

Knowledge, as we have seen, is very important to the development of civilization. With the advancement of knowledge, the "body economic" becomes vastly more efficient at producing wealth — the stuff that satisfies human desires. That is what led Henry George to conclude that knowledge is

more important than skill in the development of civilization.

But, what is the goal of production? Is it to produce "stuff" — ever-greater piles of widgets? No. The goal of production is to satisfy human desires. A factory can churn out widgets all night and day, but if they do not satisfy human desires, those widgets are worthless. They are no longer wealth; they are merely a waste.

Those post-industrial yearnings we mentioned a moment ago — for a sense of involvement, of empowerment, of choice and control — are human desires, too. If we can afford it, we are willing to pay more for goods and services that satisfy such desires. For example, let's say that you want a coffee table. What are your options? You could collect the tools and materials, slowly learn the necessary skills, and make a table for yourself. You could commission a local carpenter to build a table to your specifications. You could go to a high-class furniture store and purchase a table crafted by expert woodworkers. Or, you could drive to the suburban Big-box and buy a table that had been made far away by exploited workers you will never meet, and sold in a store that sells for less.

Which of those options would be more attractive to you? Which would be more expensive, in terms of money, or in terms of time? Which would be more expensive in terms of the satisfaction foregone by having to look at that piece of crap in your living room? Each consumer might weigh the factors differently. Yet we do know that the less time and money consumers have to put toward acquiring a coffee table, the more they will be drawn to the Big-box. The more people go to the Big-box, the cheaper and more convenient Big-box merchandise will become. Their low prices will make it harder for skilled craftspeople to compete; their convenience will make it less attractive for consumers to do the work themselves. What an odd situation! Yet there we have it: in an economy where many people are trying to hang onto their middle-class status while real wages keep falling, there is a boom market for cheap consumer goods, made by exploited foreigners and sold in Big Boxes.

Now, make no mistake about it: prodigious application of knowledge went into producing that coffee table. Just knowing how to build a table is the least of it! It had to be engineered to be produced for the lowest possible cost of material and labor, in some remote place, efficiently packaged and delivered just in time, at a price that beats the competition. We might not really like the products we buy at the Big-box, but we can't deny that they usually represent the best deal. Folks would very much like to buy a coffee table that could be delivered to their living room by means of a bit less (depersonalized, specialized) knowledge — and a big more good, old-fashioned skill.

Oddly enough, the very labor-saving processes that result from the application of knowledge are the means by which society can ultimately be liberated from over-reliance on them. It is by utilizing the labor-saving powers of technology, the results of the application of knowledge, that we can — potentially, at least — free up enough time and exertion to explore using a greater application of skill to more richly satisfy our desires. (This principle is the key to various new scales that are being devised to measure genuine prosperity, as opposed to the Gross Domestic Product — GDP — which just adds up everything consumers spend money on, even if it's just fixing stuff that was smashed by vandals.)

That is why I suspect that if Henry George were writing today, he would see knowledge as more important than skill only for seeing civilization through a certain stage of its development (just as skill was more important in an earlier, pretechnological stage). At a later stage, though, I think George would have discovered, like modern society is discovering today, that it is only through a healthy integration of knowledge *and* skill that society can use the benefits of technological progress without falling into the trap of dehumanization and alienation.



Why Are Theories of Value Important?

by Lindy Davies

Although the idea of value was a very important and contentious topic in the development of political economy, modern-day mainstream economics has little to say about it. One of today's most influential textbooks, for example, *Economics* by Samuelson and Nordhaus, does not trouble to define "value" at all — doesn't even mention it in its index. On the other hand, the concept of "price" is extensively explored. This represents the shift from a "**normative**" science of political economy, which seeks to design and build a just society, to a "**positive**" study of economics, which seeks to analyze facts and behavior, avoiding the notions of "ought" and "should".

However, very few people are content with the present state of the "body economic". All manner of "oughts" and "shoulds" are constantly being debated. In our attempt to evaluate them, it will be helpful for our modern study of political economy to turn once more to the notion of value.

The major debate about value has always been about whether it inheres in things, or is a function of human desires. Plato regarded value as inherent in a commodity, but Aristotle attributed it to a commodity's utility, and he said the standard of value lies in wants. Thus the field has been divided, ever since, between the "left" and the "right".

The Labor Theory

The "labor theory of value" — the idea that the value of a thing is a function of the labor expended in creating it — was a tenet of the classical economists, especially David Ricardo. It was Karl Marx, however, who most thoroughly developed the theory, and made it influential. According to Marx, the value of a commodity tends to be the "amount of labor time socially necessary" to produce it. This is most clearly seen in the mode of production called capitalism, under which commodities are produced, mostly by unskilled laborers, for sale in the market. The laborers exchange their labor time for wages, and the "capitalists" own both the means of production and the products.

What does "socially necessary" mean? It is defined as the amount of labor required to produce a thing under the normal conditions of production at a given time. In the capitalist mode of production, the "**labor value**" of a thing is made up of three parts: Constant capital (the equipment and location needed) Variable capital (the workers' wages) and Surplus value (the parasitical "cut" taken by the Capitalist class). Each piece of wealth that goes into the category of Constant capital (commodities such as a truck, a printing press or a factory) likewise has a labor value composed of these three elements, as does every single part that comprises each capital good. (If you think for a moment, you'll realize the mind-bending complexity of these calculations.)

How does this "labor value" compare with the observed market prices of commodities? Under capitalism, there exists at any given time a general rate of profit — simply an average of all the rates of profit in the various micro-markets. If the rate of profit in the market for a certain commodity equals the general rate of profit, then the surplus value of that commodity equals its profit to the capitalist, and its market price tends to equal its labor value. Of course, some commodities bring higher- or lower-than-average profits. In such cases, the commodity's labor value will not match its "price of production" — and comparing the two will be helpful to the economic planner (who will, once capitalism is superseded, have to determine optimum production levels, without the helpful feedback of prices).

According to Marxist analysis, capitalists invest in production in order to collect surplus value.

However, competition for market share will put a downward pressure on profits. To keep their profits up, capitalists will have to reduce wages (which will, in turn, reduce demand for commodities, leading to "overproduction" and depressions). The deterioration of conditions for workers will inflame class antagonism and lead to revolution. Then, the workers themselves, coming together to seize the means of production, will use the efficiency of modern industrial production for their own benefit (the "dictatorship of the proletariat").

The division of "labor value" into its three components (constant capital, variable capital and surplus value) gives us a glimpse of how a socialist economy could ever hope to function efficiently. Surplus value is merely the value of exploitation in a capitalist society; it is over and above the costs of Labor (Variable capital), and Land + Capital (Constant capital). If — according to Marxist theory — this exploitative surcharge were not imposed on the cost of every commodity produced, there would be a vast fund available for raising wages, providing social services, and "scientifically planning" an efficient socialist economy.

However, under the capitalist mode of production, decisions about "what?" "how many?" and "for whom?" are made with the invaluable aid of the invisible hand of a (more or less) free market. To Marxists, though, the market is precisely what leads to surplus value and all the structural failings of capitalism. Under the next phase of history — socialism — allocation decisions would not be made by the "higgling of the market", but by some form of objective planning. This is where the labor theory of value comes in very handy.

If value is not inherent in the commodity, but is a subjective determination of the buyer(s), then socialist "scientific planning" has no basis. For an efficient planned economy to be possible, value *must* be inherent in things. If the amount of labor embodied in a thing is a quantity that can be observed and measured, then it becomes possible for "scientific planning" to achieve efficient production patterns.

Marxist theory, then, in its requirement that class struggle lead society past capitalism into a socialistic mode of production, *depends* upon a labor theory of value.

The Subjective Theory

The other major contender for a modern theory of value is the Austrian theory, which traces its roots to *Principles of Economics* by Carl Menger. It tells us that value is subjective. It has nothing to do with anything inherent in the thing being valued, and therefore can have no relation to any amount of labor that went into it. It is simply a matter of how much each individual wants each thing.

To Austrian economists, if a glass of water is sold for a million dollars to someone who is dying of thirst, then, by golly, that's its value. A more conventional view would hold that, because of special circumstances, the glass was sold for more than its market value. But Austrian theory holds that there is no such thing as the "market value" of a good; value is revealed in particular transactions. One could compute an average of the various observed prices for which a good has sold, but that can only lead to an approximation of the thing's value. For Austrian theorists, "market value" is a meaningless concept.

Why is that important? Because if there is such a thing as "market value", then it becomes possible for things to be sold for more (or less) than their market value — in other words, it becomes possible for markets to fail. Monopoly, or subsidy, or political manipulation, might end up allowing sellers to pocket the gleanings of "**market failure**", enriching themselves at the expense of the community. This, then, would call for various kinds of interventions in the free market, to remove the unfairness of "market failures". (To Marxists, remember, the market economy is inherently a failure...)

In Austrian theory, this interventionism springs from very worst kind of circular reasoning. In order to correct supposed imperfections in the market allowing some "monopolists" to capitalize on "market failure", government imposes restrictions on free-market behavior! (Free-market

economists tend to believe that monopolies, far from being parasitical, benefit society by affording innovators the extra capital they need to create the means for industrial progress.)

If "market failure" exists at all, Austrian economists see it as a conflict between individuals or groups in their plans to use certain scarce resources. Efficient resolutions to these conflicts can be negotiated between the interested parties — but not if the resources are removed from the market process by confiscation or regulation.

This gets us back to the question of why value theory is important: If the value of a commodity is inherent, or socially-created in some way, then it would be possible for it to have a "true" value that is different from what it exchanges for in any particular transaction. This would open the door to intervention — to the temptation to remove things from that free interplay of individual desires, and individual plans for satisfying them, that constitute economic activity.

So, in Austrian theory there is no "overall economy" apart from individual transactions. This leads us to a political economy in which everything must be made private property if it possibly can be. If there is no "overall economy", then the community (or its representative) has no basis for interfering in individual transactions. If anything that *could* be held privately is, instead, held communally by order of the state's coercive power, then the free interplay of desires and plans is restricted; economic vitality and freedom are retarded.

Is this a hard-hearted view of things? Perhaps. But Austrian theory does not hold that ethical concerns have no place in social policy — only that they have no place in economic theory. Society might decide, out of some ethical or otherwise over-arching social concern, to communalize certain assets. Yet by doing so it would always limit human freedom. In the Austrian view of things, there is an inevitable trade-off between individual freedom and government intervention.

The Problem with Land

It's interesting to note that each of these "competing" theories of value encounters a pretty serious stumbling block when it comes to the question of land. Marxist theory accounts for the value of land as part of the "Constant capital" that goes into the production of commodities. Land itself isn't produced by labor, of course — so it can only acquire value when labor is applied to it in some way. This is similar to J. S. Mill's justification for property in land, which Henry George refutes in *The Science of Political Economy*. Land can become private property, according to Mill, when (and because) it is improved. Under the Labor Theory, that is also why it acquires value. However, it is evident that the value of improvements can easily be separated from the value of raw land, and that raw land can indeed have value. This is, of course, vitally important to the capitalist economy — for we see huge amounts of value tied up in urban locations that stand completely idle, with no labor applied to them at all, sometimes for decades.

Austrian theorists also get caught in a vicious circle when it comes to land. This is not because land value is not subjective, measuring the land's utility to the buyer; indeed it is. However, Austrian theory holds that unrestricted privatization leads to efficient allocation and promotes human freedom. This certainly seems to be true in the case of the products of labor — but it is clearly untrue in the case of land. Although some still try to justify it, using exotic interpretations of allocative efficiency, the evidence is overwhelming that private collection of land rent leads to economic dysfunction. (Public confiscation of the legitimate products of labor and capital does, too — but free-market theorists are eager to agree with that.)

George's Great Reconciliation

One of Henry George's most powerful attributes as a social philosopher is his unswerving faith that science, if it is correctly based on natural law, cannot lead society to violence or decay. The competing theories of value cannot truly say that. On the one hand, we have a Labor Theory

of Value. Reasoning logically therefrom, we determine that justice can only be secured by removing the great vitality that society gains from the free market. On the other hand, we have a Subjective Theory of Value, which leads us to a "best of all possible worlds" in which our access to the natural opportunities, which all of us need to sustain life, must be purchased from private owners, for the sake of "freedom"!

George examined the theory that value depends on the labor embodied in a thing, and found it to lack explanatory power; simple observation showed that value is not inherent, but a function of the buyers' desires. However, simple observation also demonstrated that private ownership of *everything* — whether or not it is a product of human labor — leads neither to justice nor efficiency. He managed cut through this dilemma by developing the concept of "value from obligation". George saw that the *amount* of value is subjective — determined by nothing more than the "higgling of the market". However, the *source* of value is not subjective! It depends on one all-important *objective* quality of a thing: whether it was or was not produced by human labor.

This distinction means nothing to the individual; land, stocks, money or physical wealth all have the same kind of value to us, as individuals. A political economy that sees the aggregate as nothing more than the sum of all individual transactions and values would, likewise, see no importance in the distinction between value from production and value from obligation.

Henry George showed that labor is not the source of all value — but it is the source of *some* value: the value that comes from production. Furthermore he demonstrated that the amount of value a thing has is subjective, bearing no relation whatever to that value's source. With this firm theoretical foundation, he could confidently build an economic theory that could reconcile freedom and justice, proving his contention (which he stated in *Progress and Poverty)* that "justice is the highest and truest expediency".

Competition

You think you are helping the economic system by your well meaning laws and interference. You are not. Let be. The oil of self interest will keep the gears working in almost miraculous fashion. No one need plan. No sovereign need rule. The market will answer all things. — *Adam Smith,* Wealth of Nations

Ah, the "magic of the marketplace"! No need to worry or plan, the "invisible hand" will guide us to "the best of all possible worlds" — such are the terms used to describe the wonders of a whole planet of human beings, unconsciously cooperating. Can all this really be true?

Whenever there is nothing stopping them from doing so, people tend to create efficient markets. Each person evaluates the available alternatives and chooses an economic activity which will most improve his or her own life. Producers and consumers alike are human beings who want to satisfy their desires with the least exertion. The tug-of-war between producers trying to maximize income and consumers looking for a bargain helps to create the best possible product at the right price.

This process works most wonderfully when there is plenty of competition. Economists refer to a market as **perfectly competitive** when it has many producers of goods that are easily substituted for one another, and all of them are equally free to sell their goods. Such a state of affairs gives consumers the best possible deal. Perfect competition is usually considered to be a theoretical ideal — but some markets, such as those for farm commodities, come quite close to it.

It's not hard to see that selling goods in a perfectly competitive market is no way to become rich. Where they can, people will seek to sell goods in markets where the competitive pressures are not so strong. A very common kind of market today is one in which there is a large number of suppliers, but the goods are strongly differentiated to the buyers — by having popular brand names, well-known advertising campaigns, special features or "fad appeal". Such markets, in which sellers do have some level of control over the prices of their goods, are termed **monopolistic competition**. Examples abound; the markets for personal computers, magazines, restaurant franchises and soft drinks are all examples of monopolistic competition.

Another kind of "imperfect competition" that has great influence is **oligopoly**, in which a small number of suppliers cooperate to reduce competition among themselves. Their products might be virtually identical, like steel, or similar, like automobiles. Oligopolies usually develop in industries that create a complex product that demands a lot of capital and technology. By working together to keep prices high, oligopolists take advantage of the fact that it is quite difficult for competitors to enter the market. However, oligopolistic industries within one nation still face foreign competition — and a national policy of free trade can bring the benefits of competition to oligopolistic markets (or, a national policy of protectionism can preserve oligopolistic privilege).

The most severe curtailment of competition is the case of **monopoly**, in which there is only one supplier and competition is not possible at all. One example of an industrial monopoly was the ALCOA Company, which, because of its control over lands containing bauxite, the ore of aluminum, had a monopoly over the market for aluminum for many years. It could therefore sell aluminum for a monopoly price: as much as buyers were willing to pay rather than go without the product. A current example is the Microsoft Corporation's monopoly over the PC operating system.

People provide for their own welfare very efficiently. Where there is plenty of competition, the free market provides for the most benefit for everyone. But people, seeking to satisfy their desires with the least exertion, try to find ways to limit competitive pressures. The level to which free competition is maintained and encouraged is the level to which "the magic of the marketplace" will truly benefit the whole community. However, privilege is the antithesis of free competition — and when privileges are granted to large corporations at the expense of small businesses, overall prosperity suffers.

Perfect Competition: Does It Ever Really Happen?

It is often said that "perfect competition" doesn't actually happen in the real world, that it is merely an abstract notion used by econ teachers to illustrate points. Producers of the goods that textbooks tend to cite as examples of perfect competition — agricultural goods such as wheat, corn, pork bellies, etc. — are often provided with public support in the form of subsidies or protective tariffs! The fact is that there are few, if any, goods that are sold in perfectly competitive markets, and firms seek to limit the pressure of competition in any way they can.

There is one market, though, in which perfect competition reigns supreme, and has for hundreds of years. In this market, the quality of one seller's product is virtually identical to that of any other seller, and the number of sellers is very, very large. Competition forces the price right down to the good's marginal cost. Not only that — this market is very important and ubiquitous; it is actually a fundamental building block of the economy.

What is it? The market for unskilled labor: workers who are simply selling their labor time, without the advantage of any particular skill, union membership or governmental regulation that improves their bargaining power. *In the "capitalist" economy that we know, the market for unskilled labor is perfectly competititve.*

An economist will tell you that in a perfectly competitive market, profit is maximized when the price is equal to the seller's marginal cost. But what could that mean, in the case of labor? What is labor's marginal cost?

Marginal cost is defined as the cost of bringing an additional unit of the commodity to market. In the case of labor, that means, essentially, surviving another day — the unskilled worker has no better alternative. So, although the worker is engaging, just like everyone else, in "profit maximizing" behavior, let's not forget the worker's very narrow range of options. "Profit maximization" in this case means working, instead of starving. Any wage rate higher than mere subsistence will always be undercut by some other worker who is just a bit more desperate. The marginal cost of unskilled labor is subsistence, and that is its **market-clearing price**.

Clearly, just selling one's labor is no way to get ahead. Labor has been forced to seek some sort of competitive edge, or find some way for the pressure of competition to be eased. And, thank goodness, a great deal of that has gone on — at least in the world's developed economies. When the bosses get rich while the masses of workers are given just enough to survive, society tends to become unstable — it gets into what is sometimes called a "revolutionary" situation. Nevertheless, wretched subsistence was the general condition of most workers during the rise of the industrial revolution in the 19th century. Over time, in the general interest of social stability, workers had to be given some relief from the crushing burden of pure competition in the labor market.

There were three basic ways in which this came about:

- ✯ Labor unions. Workers acted collectively — often at great risk — to stop or inhibit production until wages and working conditions were improved. Over time, their solidarity and sacrifice gave unionized workers better bargaining power. (In microeconomic terms we could say that unions restricted the supply of workers in particular industries, thus raising their equilibrium price.)
- ✯ Education. By enhancing their skills or gaining professional credentials, workers could raise their price. (In this case, workers took themselves out of the general labor market, seeking to enter less-competitive skilled-labor markets.)
- ✯ Welfare-state protections. Prominent among these are social security — which provides retirement benefits — workplace safety and health regulations, and minimum wage requirements. (These interventions effectively set a "floor" for wages — they were no longer allowed to fall to their market-clearing price, at least not for most workers; illegal immigrants

and other "marginal" workers would still have to take what they could get.)

These attempts to ease the crushing burden of competition in the labor market were largely successful. In the United States, Western Europe and Japan, they contributed to the creation of a large middle class, a huge group of eager consumers whose demand for goods created high levels of overall prosperity.

However, they carried the seeds of their own destruction. To see why, let's consider this matter from management's point of view. In the labor market the "market clearing" price for unskilled labor was: subsistence. Along come the labor unions (and later, the liberal politicians), saying the workers aren't paid enough. "Well, perhaps they aren't," the industrialist would reply, "but if I pay them more, I will lose profit!" No matter! The strike succeeds, let's say, and management agrees to pay the workers more of the wealth that they produce.

But: when the workers went back to the factory after the strike, had they suddenly become more productive? No: they produced the same amount of wealth per day as before. Yet management had to pay them more! In order to get back up to the same level of profit, management had to find some way to get more wealth out of the same hour of work. They had to invest in increased productivity.

Thus we see that an economy in which large numbers of workers can command high wages will tend to be innovative and highly productive — and an economy in which most of the workers have no better opportunity than bare-subsistence wages will tend to have trouble getting out of its own way.

Nevertheless: markets do what markets do; people seek to satisfy their desires with the least exertion. Or in other words, if employers are able to pay workers less, they will. They will seek to replace union workers with non-union workers... or to replace full-time, health-insured workers with part-timers with no benefits... or replace domestic health- and safety regulated workers with foreign competitors who work much cheaper. Although highly-paid workers tend, in the long run, to be good for overall productivity and progress, wages nevertheless tend to drift downward. Labor's gains, hard-won though they are, get whittled away in the marketplace over time.

Why? Because the market for unskilled labor is perfectly competitive.

But must it always be so? It is considered a truism that there will always be more workers seeking employment than there will be jobs for them to do. Henry George, of course, refused to accept that state of affairs as inevitable — and his analysis of political economy clarifies the question for us. Why, George asked, must abundant workers seek scarce jobs, when human desires are unlimited, and natural opportunities are being held out of use? The truth of the matter is that the private (and corporate) hoarding of land is the wedge that maintains "perfect competition" in the market for unskilled labor — but that wedge is removable. When we finally do remove it, then we'll begin to see the prodigious benefits of free competition that Adam Smith, and all his intellectual descendants, have extolled so mightily.



Excerpts from *The Corruption of Economics*

by Mason Gaffney, Ph.D.

Introduction: The Power of Neo-classical Economics

Neoclassical economics is the idiom of most economic discourse today. It is the paradigm that bends the twigs of young minds. Then it confines the florescence of older ones, like chicken-wire shaping a topiary. It took form about a hundred years ago, when Henry George and his reform proposals were a clear and present political danger and challenge to the landed and intellectual establishments of the world. Few people realize to what a degree the founders of Neoclassical economics changed the discipline for the express purpose of deflecting George, discomfiting his followers, and frustrating future students seeking to follow his arguments. The stratagem was semantic: to destroy the very words in which he expressed himself. Simon Patten expounded it succinctly. "Nothing pleases a ... **single taxer** better than ... to use the well-known economic theories ... [therefore] economic doctrine must be recast" (Patten 1908; Collier, 1979).

George believed economists were recasting the discipline to refute him. He states so, in his last book, *The Science of Political Economy*. George's self-importance was immodest, it is true. However, immodesty may be objectivity, as many great talents from Frank Lloyd Wright to Muhammad Ali and Frank Sinatra have displayed. George had good reasons, which we are to demonstrate. George's view may even strike some as paranoid. That was this writer's first impression, many years ago. I have changed my view, however, after learning more about the period, the literature, and later events.

Having taken shape in the 1880-1890s, **Neo-Classical Economics** (henceforth NCE) remained remarkably static. Major texts by Marshall, Seligman, and Richard T. Ely, written in the 1890s, went through many reprintings each over a period of 40 years with few if any changes. Not until 1936 was there another major "revolution," and that was hived off into a separate compartment, macro-economics, and contained there so as not to disturb basic tenets of NCE. Compartmentalization, we will see in several instances, is the common NCE defense against discordant data and reasoning.

J. B. Clark's capital theory "... gives the appearance of being specially tailored to lead to arguments for use against George" (Collier, 1979). "The probable source from which immediate stimulation came to Clark was the contemporary single tax discussion" (Fetter, 1927). "To date, capital theory in the Clark tradition has provided the basis for virtually all empirical work on wealth and income" (Dewey, 1987; cf. Tobin, 1985). Later writers have added fretworks, curlicues and arabesques beyond counting, and achieved more isolation from history, and from the ground under their feet, than in Patten's dreams, but all without disturbing the basic strategy arrived at by 1899, tailored to lead to arguments against Henry George.

To most modern readers, probably George seems too minor a figure to have warranted such an extreme reaction. This impression is a measure of the neo-classicals' success: it is what they sought to make of him. It took a generation, but by 1930 they had succeeded in reducing him in the public mind. In the process of succeeding, however, they emasculated the discipline, impoverished economic thought, muddled the minds of countless students, rationalized free-riding by landowners, took dignity from labor, rationalized chronic unemployment, hobbled us with today's counterproductive tax tangle, marginalized the obvious alternative system of public finance, shattered our sense of community, subverted a rising economic democracy for the benefit of rent-takers, and led us into becoming an increasingly nasty and dangerously divided plutocracy.

The crabbed spirit of neo-classical economics

Neo-classical economics makes an ideal of "choice." That sounds good, and liberating, and positive. In practice, however, it has become a new dismal science, a science of choice where most of the choices are bad. "TANSTAAFL" (There Ain't No Such Thing As A Free Lunch) is the slogan and

shibboleth. Whatever you want, you must give up something good. As an overtone there is even a hint that what one person gains he must take from another. The theory of gains from trade has it otherwise, but that is a heritage from the older classical economists.

Henry George, in contrast, had a genius for reconciling-by-synthesizing. Reconciling is far better than merely compromising. He had a way of taking two problems and composing them into one solution. He took two polar philosophies, collectivism and individualism, and synthesized a plan to combine the better features, and discard the worse features, of each. He was a problem-solver, who did not suffer incapacitating dilemmas and standoffs.

As policy-makers, neo-classical economists present us with "choices" that are too often hard dilemmas. They are in the tradition of **Parson Malthus**, who preached to the poor that they must choose between sex or food. That was getting right down to grim basics, and is the origin of a well-earned epithet, "the dismal science." Most modern neo-classicals are more subtle (although the fascist wing of the otherwise admirable ecology movement gets progressively less so). Here are some dismal dilemmas that neo-classicals pose for us today. For efficiency we must sacrifice equity; to attract business we must lower taxes so much as to shut the libraries and starve the schools; to prevent inflation we must keep an army of unfortunates unemployed; to make jobs we must chew up land and pollute the world; to motivate workers we must have unequal wealth; to raise productivity we must fire people; and so on.

The neo-classical approach is the **"trade-off."** A trade-off is a compromise. That has a ring of reasonableness to it, but it presumes a zero-sum condition. At the level of public policy, such "trade-offs" turn into paralyzing stand-offs, where no one gets nearly what he wants, or could get. It overlooks the possibility of a reconciliation, or synthesis, instead. In such a resolution, we are not limited by trade-offs between fixed A and B: we get more of both.

Popular responsiveness to problem-solvers

Voters faced with two candidates, each coached by a neo-classical economist, also face a hard choice. They often appear apathetic and take a third choice, staying home. However, history denies that voters are intrinsically apathetic. They have gotten turned on by candidates who try to lead up and away from dismal trade-offs.

In 1980 it was Ronald Reagan. Instead of the dismal **Phillips Curve** ("choose inflation or unemployment") he offered the happy **Laffer Curve**: lower tax rates would lead to higher supplies, higher revenues, and lower deficits, he promised. Lowering taxes, said Laffer, would eliminate the "wedge effect." He often cited Henry George in support of his position. Thus he would unleash supply, and collect more taxes while applying lower tax rates. The voters were sick of 2nd-generation **Keynesians** who had been reduced to preaching austerity, so they were game (if not wise) to buy into Reaganomics as advertised.

Unfortunately, the Laffer Curve turned out to be wildly overoptimistic, and Reaganomics partly fraudulent and hypocritical in application. The voters again tuned out and seemed apathetic. They are not saying, however, they don't care. They are saying "come back when you have something better, mean what you say, and deliver what you promise."

From 1936-70 it was Keynes and his apostles, who had a long run with the voters, in spite of virulent critics. Keynes's winning political formula was that consumption and capital formation are not alternatives to be traded off, but complements, reinforcing one another. Raise wages, he said, raise private and public consumer spending, and get more capital formation as a happy by-product. "We can have it all," he said; they called it "the economics of abundance." Who wouldn't prefer that to long-faced moralizers preaching we must suffer for the prodigalities of the past, or for the sake of a remote and uncertain future? Even puritans learned better as children from Longfellow's "Psalm of Life."

When the theory of the propensity to consume, and the multiplier, lost their charm, and some

strong trade unions (like Hoffa's Teamsters) showed their nastier side, the American voters tuned in to JFK and "business Keynesianism" in which the emphasis turned to fostering new investing. Keynes had been shrewd enough to cast his theories to accommodate either emphasis. Here the formula was to raise the "marginal efficiency of capital" (today we say the **marginal rate of return**) after taxes by giving preferential tax treatment to new investing, keeping tax rates high on income from old assets like land. It was a species of Georgism, applied via the Federal income tax. The key devices were fast write off for new capital, and the investment tax credit.

There was no talk or thought, however, of enriching capitalists by impoverishing workers. The promise was to enrich capitalists and workers together, as higher investing raised aggregate demand for labor and its products through the **"multiplier"** effect.

In time that happy glow of mutuality turned to ashes. After JFK, with his influential economist Walter Heller, the flame burned low; later leaders stumbled in the dark. They relied too simple-mindedly on demand management through **fiscal** and **monetary policy**, carrying them well beyond their power to stimulate supply. Thus they lurched into **Stagflation**: double-digit inflation and recession conjoined. They blamed the war, then the Arabs. They scolded the public, and they called for sacrifices, as leaders always do when they lack ideas. "You must mature and face the facts of life," they lectured. "There is no way to stop inflation except unemployment. Whichever evil you choose, don't blame us, we told you so." Faced with that, the voters exercised a third choice: they retired the patrons of those new dismal scientists.

Before Keynes there was another great reconciler, Henry George. In 1879, George electrified the world by identifying a cause of the boom/slump cycle, identifying a cause of inadequate demand for labor, and, best of all, following through with a plausible, practicable remedy. Like Keynes and Laffer after him, he turned people on by saying "Forget the bitter trade-offs; we can have it all."

George came out of a raw, naive new colony, California, as a scrappy marginal journalist. Yet his ideas exploded through the sophisticated metropolitan world as though into a vacuum. His book sales were in the millions. Seven short years after publishing *Progress and Poverty* in remote California he nearly took over as Mayor of New York City, the financial and intellectual capital of the nation. He thumped also-ran Theodore Roosevelt, and lost to the Tammany candidate (Abram S. Hewitt) only by being counted out. Three more years and he was a major influence in sophisticated Britain. In 1889, incredibly, he became "adviser and field-general in land reform strategy" to the Radical wing of the Liberal Party in Britain, where he was not even a citizen. It also happened that when Chamberlain bowed out, the Radical wing became the Liberal Party. It adopted a land-tax plank after 1891 (The "famous Newcastle Programme"), and came to carry George's (muted) policies forward under successive Liberal Governments of Campbell-Bannerman, Asquith, and Lloyd George.

How could a marginal man come out of nowhere and make such an impact? The economic gurus of the day, even as today, were in a scolding mode, blaming unemployment on faulty character traits and genes, and demanding austerity. They were not intellectually armed to refute him or befuddle his listeners. He had studied the classical economists, and used their tools to dissect the system. Neo-classical economics arose in part to fill the void, to squeeze out such radical notions, and be sure nothing like the Georgist phenomenon could recur.

The movement that history forgot

Again, are we not imputing too much weight to a minor figure? We are told that Georgism withered away quietly with its founder in 1897. That, however, is warped history. One of the great derelictions of American historians is to have neglected the single-tax movement, 1901-24. It is also a warped view of "The Single Tax" as a discrete, millennial change, a quantum leap away from life as we know it (Gaffney, 1976). Pure Georgism never "took over whole hog," but no single philosophy ever does. Modified Georgism, melded into the **Progressive Movement**, helped run the USA for 17

years, 1902-19, working through both major political parties. At the local level, it continued on through the early 1920s. Local property taxation was modified on Georgist lines even as it rose in absolute terms. The first Federal income tax law was drafted by a Georgist (Congressman Warren Worth Bailey of Johnstown, Pennsylvania) with Georgist goals uppermost. Real concessions were made: the politicians heard the voters. Historians of the Populist Party and movement often note that its ideas succeeded even though the Party failed, because its ideas were co opted by major parties. Georgism was a strand of American populism, later wrapped into Progressivism.

Consider, for example, that in 1913 Wm. S. U'Ren, "Father of the Initiative and Referendum," created this system of direct democracy for the express purpose of pushing single-tax initiatives in Oregon. According to U'Ren, another by-product of the single-tax campaigns in Oregon was the 1910 "adoption of the first Presidential Primary Law, which was quickly imitated by so many other States that (Woodrow) Wilson's nomination and election over Taft was made possible" To that we may add that another "Father of the Direct Primary," George L. Record of New Jersey, was a mentor of Woodrow Wilson and an earnest Georgist who had gotten railroad lands uptaxed to the great benefit of public schools in New Jersey, and to the impoverishment of special interest election funds. "... it was the passage of these great election reforms in the Wilson Administration (in New Jersey) that led ... (to) winning the Bryan support and the Democratic nomination for President". That helps explain the gratitude of President Wilson, who included single-taxers in his Cabinet (Newton D. Baker, Louis F. Post, Franklin K. Lane, and William B. Wilson), and worked with single-tax Congressmen like Henry George, Jr., and Warren Worth Bailey.

Consider that in 1916 a "pure single-tax" initiative won 31% of the votes in California. Even while "losing," such campaigns raised consciousness of the issue to a high degree, such that assessors were focusing more attention on land. Thus, in California, 1917, tax valuers focused on land value so much that it constituted 72% of the assessment roll for property taxation — a much higher fraction than today. Joseph Fels, an idealistic manufacturer, was throwing millions into such campaigns in several states, having earlier thrown himself and his fortune into the English land tax campaign that brought on the Parliamentary revolution of 1909.

Consider that there was a single-tax party, the Commonwealth Land Party. In 1920 its Presidential candidate was Carrie Chapman Catt, fresh from leading her successful campaign for the 19th Amendment, and just before founding the League of Women Voters. In 1924 its Presidential candidate was William J. Wallace of New Jersey, with John C. Lincoln, brilliant Cleveland industrialist, for Vice-president. In 1919 Georgists began working through the Manufacturers and Merchants Federal Tax League to sponsor a federal land tax, the Ralston-Nolan Bill. Drafted by Judge Jackson H. Ralston, it would impose a "1% excise tax on the privilege of holding lands, natural resources and public franchises valued at more than $10,000, after deducting all improvements" In 1924 Congressman Oscar E. Keller of Minnesota reintroduced it (H.R. 5733). In spite of Harding, Coolidge, and Hoover, Progressivism still lived in Congress. In 1923, for the first and last time, income tax returns were made public, giving valuable data-ammunition to land taxers.

Consider that in 1934 Upton Sinclair, so-called "socialist," almost became Governor of California on a modified Georgist platform. Two years later, Jackson H. Ralston, by then a Stanford Law Professor, led another California Initiative campaign to focus the property tax on land values. Norman Thomas, perennial Socialist candidate for President of the U.S., kept a land tax plank in his platform. Daniel Hoan, the "socialist" Mayor of America's model city, Milwaukee, had his tax assessor focus on upvaluing land. Hoan distributed land value maps to the Milwaukee public, to raise their consciousness of the issue.

Historian Eric Goldman (1956) found George to have inspired most of the major reformers of the early 20th Century. "... no other book came anywhere near comparable influence, and I would like to add this word of tribute to a volume which magically catalyzed the best yearnings of our

grandfathers and fathers". Raymond Moley wrote, "George ... touched almost all of the corrective influences which were the result of the Progressive movement. The restriction of monopoly, more democratic political machinery, municipal reform, the elimination of privilege in railroads, the regulation of public utilities, and the improvement of labor laws and working conditions — all were... accelerated by George".

Consider that most American states and Canadian provinces required separate valuations of land, for tax purposes. Professional valuers, responding to the general interest, were routinely valuing land separately from buildings, and developing workable techniques to handle the occasional tricky case. Valuation anticipates taxation. Lawson Purdy, one of those valuers, was Tax Commissioner of the City of New York, a founder of and power in the National Tax Association, a campaigner for George in the 1897 race, and a leader of the Manhattan Single Tax Club. Under this kind of influence, New York City kept its subway fares down to 5 cents, paying for most of the cost from taxes on the benefitted lands, It also exempted new residential structures from the property tax for ten years, 1924-34.

Consider that Wright Act Irrigation Districts were spreading fast throughout rural California, using Georgist land taxes to finance irrigation works. The Wright Act dated from 1887, and sputtered along fitfully until in 1909 the California Legislature amended the enabling legislation to limit the assessment in all new districts to the land value only. It also let old districts do so by local option. The old districts soon did: Modesto in 1911, Turlock in 1915. This was Georgism getting its "second wind," so to speak. Beyond much question, the idea was identified with George. The legislative leader, L.L. Dennett of Modesto, got the idea from his father, an old neighbor of Henry George in San Francisco.

In 1917, rural Georgism got a third wind: the California Legislature made it mandatory for all Districts to exempt improvements. They then grew to include over four million acres by 1927, and to dominate American agriculture in their specialty crops. They built the highest dam in the world at that time (Don Pedro, on the Tuolumne River in the Sierra Nevada), financing it 100% from local land taxes. Albert Henley, a lawyer who crafted the modified District that serves metropolitan San Jose, evaluated them thus: "The discovery of the legal formula of these organizations was of infinitely greater value to California than the discovery of gold a generation before. They are an extraordinarily potent engine for the creation of wealth". They catapulted California into being the top-producing farm state in the Union, using land that was previously desert or range. They made California a generator of farm jobs and homes, while other states were destroying them by latifundiazation.

If this is a "minor" phenomenon it is because the neglect of historians and economists has made it so. One searches in vain through academic books and journals on farm economics for recognition of this, the most spectacularly successful story of farm economic development in history. What references there are consist of precautionary cluckings focused on attendant errors and failures. "Economic development" theorists neglect it altogether, as though California's commercial farming had sprung full blown from a corporate office, with no grass roots basis, and no development period. It is as though the clerisy were in conspiracy against the demos, under some Trappist oath against disclosing what groups of small people achieved through community action, and through the judicious application of the pro-incentive power of taxing land values.

There is a common defeatist notion that "farmers" are implacably against land taxation. The California experience seems to belie it. In other states, also, The Grange and the Farmers' Union were pushing for focusing the property tax on land during the 'teens. In Minnesota, the Dakotas, and the Prairie Provinces the Non-Partisan League became a major power in state and local politics, electing a Governor of North Dakota and swaying many elections. North Dakota exempted farm capital from the county property tax, taxing land only. The spirit of Prairie Populism straddled the 49th parallel (the international boundary), radicalizing politics in rural Manitoba, Saskatchewan, Alberta, and British Columbia, all of which were focusing their property taxes on land in this period.

George's ideas were carried worldwide by such towering figures as David Lloyd George in England, Leo Tolstoy and Alexandr Kerensky in Russia, Sun Yat-sen in China, hundreds of local and state, and a few powerful national politicians in both Canada and the USA, Billy Hughes in Australia, Rolland O'Regan in New Zealand, Chaim Weizmann in Palestine, Francisco Madero in Mexico, and many others in Denmark, South Africa, and around the world. In England, Lloyd George's budget speech of 1909 reads in part as though written by Henry George himself. Some of Winston Churchill's speeches were written by Georgist ghosts.

Thus, to the rent-taker, the typical college trustee or regent, George's ideas remained a real and present danger over several decades: the very decades when neo-classical economics was spreading through the academic clerisy. With the development of direct democracy, open primaries, the secret ballot, direct election of US Senators, the Initiative, Referendum, and Recall, and the like, crude vote-buying such as prevailed in the late 19th Century would no longer dominate the electorate. Mind-control became the urgent need; NCE was the tool.

George's ideas and the allied Progressive Movement fell, not from failure to deliver, but to the Great Marathon Red Scare that has dominated much of the world from 1919 to 1989. This panic marshalled and energized rent-takers everywhere; by confusion, some of it deliberate, its victims included Georgists. It inhibited them until their message lost its vigor and excitement and became just a minor local tax reform. Its leaders have moved to the trivial center, downplaying George's grand goals for full employment, catering to the practical but small and prosaic advantages of median homeowners at the local level. Now, with the fall of the Berlin Wall, Progressive ideas might very well pick up again where the original Movement was aborted.

Henry George as reconciler and problem-solver

Let us itemize the several constructive reconciliations in George's reform proposal. This will explain its wide potential appeal, hence its ongoing threat to embedded rent-takers with a stake in unearned wealth. It will explain why they had neo-classical economists working so hard to put this genie back in the bottle.

1. George reconciled common land rights with private tenure, free markets, and modern capitalism. He would compensate those dispossessed and made landless by the spread and strengthening of what is now called "European" land tenure, whose benefits he took as given and obvious. He would also compensate those driven out of business by the triumph of economies of scale, whose power he acknowledged and even overestimated. He proposed doing so through the tax system, by focusing taxes on the economic rent of land. This would compensate the dispossessed in three ways.

a. Those who got the upper hand by securing land tenures would support public services, so wages and commerce and capital formation could go untaxed.

b. To pay the taxes, landowners would have to use the land by hiring workers (or selling to owner-operators and owner-residents). This would raise demand for labor; labor spending would raise demand for final products.

c. To pay the workers, landowners would have to produce and sell goods, raising supply and precluding inflation. Needed capital would come to their aid by virtue of its being untaxed.

Thus, George would cut the Gordian knot of modern dilemma-bound economics by raising demand, raising supply, raising incentives, improving equity, freeing up the market, supporting government, fostering capital formation, and paying public debts, all in one simple stroke. It's quite a stroke, enough to leave one breathless.

In practice, landowners faced with high land taxes often choose another, even better, course than hiring more workers: they sell the land to the workers, creating an economy and society of small entrepreneurs. This writer has documented a strong relationship between high property tax rates, deconcentration of farmland, and intensity of land use (Gaffney, 1992).

2. George's proposal lets us lower taxes on labor without raising taxes on capital. Indeed, it lets us lower taxes on both labor and capital at once, and without lowering public revenues.

3. Georgist tax policy reconciles equity and efficiency. Taxing land is progressive because the ownership of land is so highly concentrated among the most wealthy, and because the tax may not be shifted. It is efficient because it is neutral among rival land-use options: the tax is fixed, regardless of land use. This is one favorable point on which many modern economists actually agree, although they keep struggling against it.

George showed that a tax can be progressive and pro-incentive at the same time. Think of it! An army of neo-classicalists preach dourly we must sacrifice equity and social justice on the altar of "efficiency." They need that thought to stifle the demand for social justice that runs like a thread through The Bible, The Koran, and other great religious works. George cut that Gordian knot, and so he had to be put down.

The only shifting of a land tax is negative. By negative shifting I mean that the supply-side effects of taxing land will raise supplies of goods and services, and raise the demand for labor, thus raising the bargaining power of median people in the marketplace, both as consumers and workers. This effect makes the tax doubly progressive: it undercuts the holdout power and bargaining power of landowners vis-a-vis workers, and also vis-a-vis new investors in real capital. This effect also makes the land tax doubly efficient.

4. A state, provincial, or local government can finance generous public services without driving away business or population. The formula is simple: tax land, which cannot migrate, instead of capital and people, which can. By eliminating the destructive "Wedge Effect," the land tax lets us support schools and parks and libraries and water purification and police and fire protection, etc., as generously as you please, without suppressing or distorting useful work, and without taxing investors in real capital.

5. Georgist tax policy contains urban sprawl, and its heavy associated costs, without overriding market decisions or consumer preferences, simply by making the market work better. Land values are the product of demand for location; they are marked by continuity in space. That shows quite simply that people demand compact settlement and centrality. A well-oiled land market will give it to them.

6. Georgist tax policy makes jobs without inflation, and without deficits. "Fiscal stimulus," in the shallow modern usage, is a euphemism for running deficits. George's proposed land tax might be called, rather, "true fiscal stimulus." It stimulates demand for labor by promoting hiring; it precludes inflation as the labor produces goods to match the new demand. It precludes deficits because it raises revenue. That is its peculiar reconciliatory genius: it stimulates private work and investing in the very process of raising revenue. It is the only tax of any serious revenue potential that does not bear down on and suppress production and exchange. As I said, George takes two problems and composes them into one solution.

7. George's land tax lets a polity attract people and capital en masse, without diluting its resource base. This is by virtue of synergy, the ultimate rationale for Chamber-of-Commerce boosterism. Urban economists like William Alonso have illustrated the power of such synergy by showing that bigger cities have more land value per head than smaller ones. (Land value is the resource base of a city.) Urbanists like Jane Jacobs and Holly Whyte have written on the intimate details of how this works on the streets. Julian Simon (*The Ultimate Resource*) philosophizes on the power of creative thought generated when people associate freely and closely in large numbers. Henry George made the same points in 1879.

8. Georgist policies let us conserve ecology and environment while also making jobs, by abating sprawl. It is a matter of focusing human activity on the good lands, thus meeting demands there and relieving pressure to invade lands now wild that are marginal for human needs. Urban sprawl is the kind of sprawl most publicized, but there is analogous sprawl in agriculture, forestry, mining, recre-

ation, and other land uses and industries.

9. Georgist policies let us strengthen public revenues while in the same process promoting economy in government.

Anti-governmentalists often identify any tax policy with public extravagance. Georgist tax policy, on the contrary, saves public funds in many ways. By making jobs it lowers welfare costs, unemployment compensation, doles, aid to families with dependent children, and all that. It lowers jail and police costs, and all the enormous private expenditures, precautions, and deprivations now taken to guard against theft and other crime. Idle hands are not just wasted, they steal and destroy.

Ultimately, Georgist policy saves the cost of civil disturbances and insurrections, and/or the cost of putting them down. In 1992 large parts of Los Angeles were torched, for the second time in a generation, pretty much as foreboded by Henry George in *Progress and Poverty*. Forestalling such colossal waste and barbarism is much more than merely a "free lunch."

George's program would abort other, less obvious wastes in government. It obviates much of the huge public cost now incurred to reach, develop, and safeguard lands that should be left in their natural submarginal condition. Today, people occupy flood plains and require levees, flood control dams, and periodic rescue and recovery spending. Others scatter their homes through highly flammable steep brushlands calling for expensive fire-fighting equipment and personnel, and raising everyone's fire insurance premiums. Others build on fault lines; still others in the deserts, calling for expensive water imports. Generically, people now scatter their homes and industries over hundreds of square miles in the "exurbs," or urban sprawl areas, imposing huge public costs for linking the scattered pieces with the center, and with each other.

This wasteful, extravagant territorial overexpansion results from two pressures working together. One force is that of land speculators manipulating politics seeking public funds to upgrade their low-grade lands so they may peddle them at higher prices. The other force is that of landless people seeking land for homes, and jobs, and public funds for "make-work" projects.

Both these forces wither away when we tax land value and downtax wages and capital. This moves good land into full use, meeting the demand for land by using land that is good by Nature, without high development costs.

It also makes legitimate jobs, abating the pressure for "make-work" spending. Above all, it takes the private gain out of upvaluing marginal land at public cost. Such lands, if upvalued by public spending, will then have to pay for their own development through higher taxes.

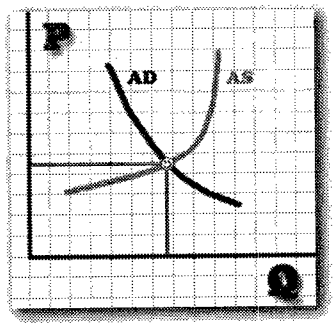
Those nine compelling features of George's program should be enough to persuade one that it had the potentiality of becoming very popular. Its premise, however, was socializing land rents through taxation. Its very strengths were its undoing, then, by evoking a powerful, intransigent, wealthy counterforce.

ES

Can We Eliminate the Boom/Bust Cycle?

Up to now we have had a whole Economics course without a single supply-and-demand chart. Alas, for those of your who've found that refreshing! We'll eschew them no longer. In this section we analyze the boom/bust cycle by means of the squirming-about of lines on that icon of Neoclassical economics, the Aggregate Supply and Demand Chart.

A supply-and-demand chart is merely a picture of basic relationships. We observe that



1. When things are costing (relatively) less, buyers tend to want more of them.

2. When things are selling for (relatively) more, sellers try to bring more of them to market.

3. Markets tend to move toward an equilibrium point, at which buyers want to buy just as many things as sellers want to sell.

4. When buyers suddenly want a lot more things, existing resources get used to capacity, and past that point, it costs a lot more to produce them.

The supply-and-demand chart depicts the dynamic interaction of those four forces. This is true of the microeconomic chart, which tracks the market behavior of a single good — as well as the macroeconomic, or aggregate, supply-and-demand chart, which looks at prices and output for the whole economy.

Macro vs. Micro We call these curves Aggregate Supply and Demand (AS and AD) to distinguish them from those used in a Microeconomic supply and demand chart (which would generally be labelled simply S and D). Those curves are shaped similarly, but they depict something different. Micreconomic charts show the quantities and prices of individual goods, with such variables as national income and price levels held constant. By contrast, the Aggregate charts we are considering here show the interaction of total output and price level.

The charts for individual products would probably display the influences of local factors, or trends that are peculiar to the market for a single good. Aggregate curves depict general economic trends in which all those local perturbations average out.

Business cycles are aggregate phenomena, of course. In fact, our focus in politcal economy is almost completely on the macroeconomic level: we are interested in understanding the basic laws that govern the production and distribution of goods and services in society.

Why are the curves shaped this way?

The aggregate demand curve is easy: it goes down (AD for Always Down). Why? The axes of the graph are labeled Q for Quantity and P for Price. The Demand curve shows the quantity demanded at any given price. For example, when the price is relatively high, a smaller quantity is demanded — so the demand curve slopes smoothly downward. It is smooth because we are exercising the economist's prerogative of "all else being equal". We're simply showing the relationship of quantity demanded to price. For the Aggregate Demand Curve, "all other variables" get averaged out into a smooth curve depicting overall demand for goods and services at a given point in time.

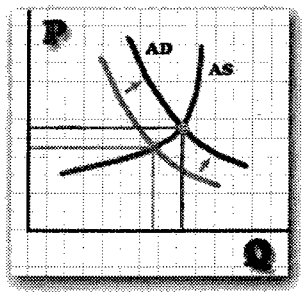
The Supply curve shows the quantity supplied at any given price level. For a time, it slopes gently upward. Although prices are rising across the board, prices for commodities are often more **elastic** than the costs of producing them (nominal wages, for example, will probably be sticky and take some time to follow the general inflationary trend). That means that for a time, as prices rise, producers will want to supply more goods. The AS curve's shape, however, is not smooth; it has a kink. Why? Up to a certain point, increased demand will be met with very small increases in price; this is because producers are not yet operating at full capacity, and it doesn't cost much more to simply crank out more things. But, when the cost of the **factors of production** rises to the same level as the price of goods, then producers cannot produce more without raising prices more rapidly. At that point, the AS curve turns sharply upward.

In this exercise — in which the charts depict the whole economy — the P axis of the graph is the general

price level, as measured by an index such as the Consumer Price Index (CPI), and the Q axis is the overall output of goods and services, on a measure of total output such as the Gross Domestic Product (GDP). Aggregate supply and demand curves can shift due to various forces that affect the overall economy — everything from oil price shocks to new consumer fads to rumors of war. The way in which these curves shift can help us to understand what is happening — or might happen — in the economy.

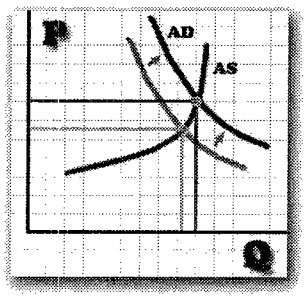
Now, let's look at some ways in which events can shift the curves around, and what those shifting lines signify in the real world.

Scenario 1: Good Times



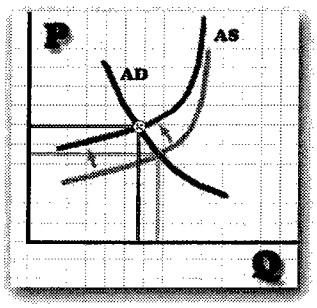
People have jobs; they're making good money. Houses are being built and parents are buying their kids lots of Christmas presents. People want more stuff, and they're willing to pay for it, so the Demand curve shifts upward. Note the new point of equilibrium: prices have increased, but modestly; output has increased by a greater proportion.

Scenario 2: Good Times Start to Overheat



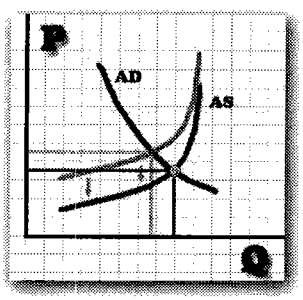
Demand continues to be strong, shifting the Demand curve past that kink in the Aggregate Supply curve! In other words, the eqilibrium point has shifted past that point that economsts call **potential output**. When they try to meet this higher level of demand, producers' costs increase sharply. Now, prices are increasing more rapidly than output. We may be heading into an inflationary spiral, one of the type known as ***demand-pull inflation.***

Scenario 3: The Supply Shock

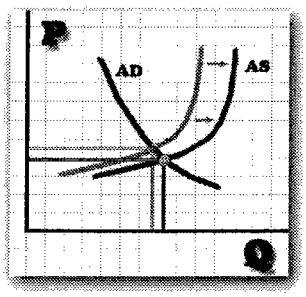


Here, a relatively sudden increase in the cost of some widely-need material or resource causes an increase in overall production costs. This time, the Supply curve shifts upward — things cost more to produce at any level of demand. Look what has happened to the equilibrium point! Prices have risen even as output has fallen. This is the condition commonly called ***stagflation*** — and the associated inflation is termed ***cost-push inflation.*** (The high oil prices associated with the Arab oil embargo of the early 70s is the classic example of this phenomenon. But, any factor could produce this effect. For example, a sudden doubling of the Federal minimum wage — all else being equal — could cause a supply shock!)

Scenarios 4 & 5: Are there *Good* Supply Shocks?!



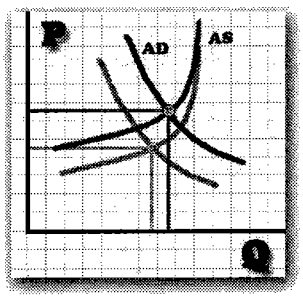
It is worth mentioning that now and then things can come along that shift the Aggregate Supply curve in beneficial ways. We would experience a positive supply shock if some widely-needed resource suddenly got less expensive — if we were to find a huge new deposit of easily recoverable oil, for example, or if high-temperature superconductors were to make electricity drastically cheaper. That would shift the AS curve downward, lowering production costs at every level of demand.



There could also be a widespread increase in productivity, allowing us to increase output by getting more production out of existing resources. Such a productivity increase — like that caused by the explosion of information technology in the

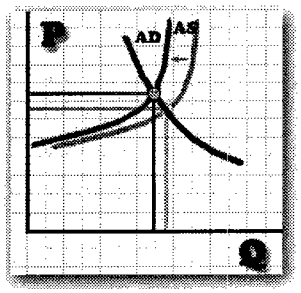
1990s — could shift the AS curve to the right. Here, output can rise much more than before, without surging past the potential output point — and triggering inflation.

Scenarios 6 & 7: Gloom and Doom



But: if the (bad) supply shock comes at a time when Boom Times are already pushing prices too far up the curve, price levels increase precipitously with little or no increase in output.

It is also possible for there to be a decline in productivity, shifting the AS curve to the left and making matters even worse. What would cause such a thing? A mis-use of existing resources. Perhaps the labor force turns out to be educationally unsuited to making productive use of new technology. Or, perhaps social strife, caused by racial or class conflict, wastes the productive energy of workers.



This is not a picture that macro-economic planners would want to see. Neither alternative — inflation or recession — has much to recommend it. At this point, output cannot increase without prices going up much faster — and, production would have to fall quite a lot before we would achieve much of a reduction in price levels.

Inflation and Unemployment

The economy depicted above is headed either for galloping inflation, or — much more likely in a modern industrial economy — a recession. Demand declines, output declines, causing further lowering of demand, causing less output... Much of the pain of this process is illustrated on our chart — for we note that output will have to decline quite a lot before prices ease back significantly. It would certainly be nice — wouldn't it? — if some sort of benevolent supply shock would step in and help things along...

The point at which the AS curve starts to ascend steeply is termed the **potential output** of the economy. That term is slightly misleading, however — because the economy is quite capable of producing more goods and services than that. If it does so, however, it will have to contend with higher prices. Potential output, then, is not "the most we can produce" but rather the highest level of output at which there is not an *unacceptably rapid increase in prices*. Another — similarly misleading — term for this is "full employment": the highest level of unemployment that can be sustained without too high a rate of inflation. The rate of unemployed workers designated as "full employment" is revised periodically by government beancounters, usually upward. It is a difficult figure to quantify, for there are various conceptions of which workers are or are not part of the labor force, but in a period of "full employment", *at least* three to five per cent of the labor force is unemployed. This was the case right through the booming 1990s.

We might wonder why everyone can't find a job at a time when demand is robust and inflation is low. Clearly, all the desires of all the consumers have not been satisfied; there are still things that people could be hired to do. Yet, if that last three to five per cent got work, we'd run into that kink in the AS curve and prices would rocket upward! But why? In the 1990s, for example, we haven't seen any precipitous increase in wages that would create a suppply shock — and technological improvements, along with international trade, have lowered production costs — so what is it that would make costs go up? Something must be soaking up those increases in output and retarding productivity growth. Something must be going up in price a lot faster than the overall rate of inflation.

Enter Henry George's theory of the business cycle — which, though it has never been refuted, is resolutely ignored in most of today's discussions of the subject. George observed that one of the factors that is absolutely necessary for all production — land — has an inherent tendency to rise in price, faster and faster, as the economy grows. When we think about what land is, the reason for this becomes clear.

Macro McManagement Economic policymakers, following the lead of J. M. Keynes, have accepted the boom/bust cycle as an essential feature of a modern economy, and have learned how to use **monetary and fiscal policy** to mitigate the severity of its effects. These "Keynesian" management tools have had considerable success. Since the great depression of the 1930s, economic downturns (and their flip-side, inflationary shocks) have periodically come and gone, but they have never wrought anything close to the devastation of the Great Depression.

If an "overheating" of demand brings about too much inflation, the central bank (in the US, the Federal Reserve, or Fed) takes steps to slow down the increase in the money supply, by raising interest rates. They can also limit the amount of available credit by increasing the required amount that banks must keep in reserve. Both moves are ways to increase the cost of borrowing money. Money that is borrowed is money that is placed into circulation — if less borrowing takes place, less money is available in the economy. That will slow down the rise in prices — but it will also probably slow down demand and output as well. In fact, the Fed can cause a recession by raising interest rates (the increased cost of money becoming, in effect, a supply shock).

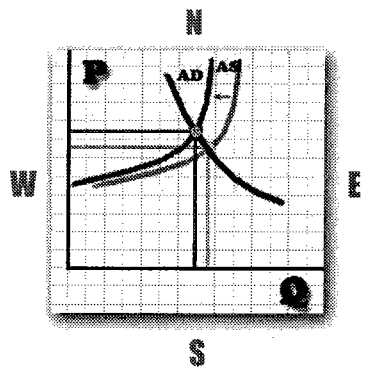
If output starts to cool off, the Fed can do the opposite: lower interest rates to make credit easier to get, in the hope of creating a positive supply shock.

The other main tool in the Keynesian arsenal is in the area of fiscal policy. Declining output can be pushed back up through the use of deficit spending: borrowing money for the government to use now to stimulate the economy. The hope (at any rate) is that it can be paid back later when times are good and booming output would create a generous tax base.

Since the 1980s, the "Supply Side" economic theories of Arthur Laffer and others began to influence policy. The supply-siders believed that high tax rates stifle production, and that the most effective form of economic stimulus is not "demand-side" decficit spending, but reductions in tax rates.

The quantity of land (the stock of locations and natural resources) is fixed. Its supply cannot increase. Therefore, when demand for land increases, its price must go up. Investors see this tendency, and they buy land, withholding it from use in order to take advantage of its increased value in the future. In every booming economy we see the prices of land, housing and rents increase far more rapidly than the overall rate of inflation.

In effect, land speculation creates a built-in supply shock, that kicks in as economic output increases! This is a systemic retardation of the economy. It operates as long as there is land speculation, creating an underlying tendency toward inflation or recession. So is land speculation always the cause of economic downturns? By George, it is! There are any number of contributing causes; things like oil price shocks, consumer confidence crises, international trade fluctuations, natural disasters — but none of these things creates the underlying weakness. Such things may be likened to a straw that breaks the camel's back!

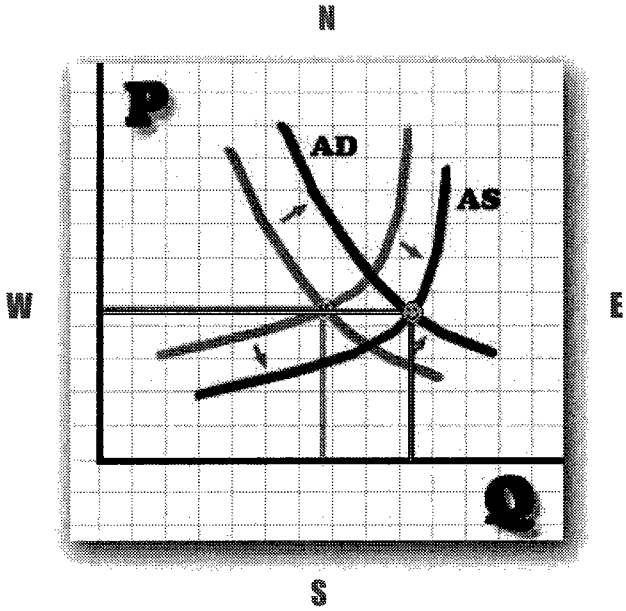


Land speculation retards the economy in two ways. It increases production costs by making land in general more expensive (shifting the AS curve upward) as well as decreasing productivity by denying access to the best locations, shifting the AS curve to the left and lowering "potential output". (In the same process, it also exacerbates sprawl, pollution, and waste of all sorts.)

In short, the "gloom & doom" tendencies of scenario #7 do not represent some sort of rare calamity of history. They are the normal state of affairs. In other words: our aggregate equilibrium point was *way* to the north-west — but our job, as public-policy citizens, is to move it as far as we can to the south-east.

Eliminating Land Speculation

The Georgist remedy, which came to be known as the "Single Tax", aims to remove the underlying problem that causes the boom/bust cycle. It would collect for public revenue the rental value of all land and natural opportunities, and simultaneously abolish all taxes on labor, production and commerce. The reform would have profound benefits:



Henry George's analysis of poltical economy shows that the dual burdens of land speculation and taxes on production are not necessary, but rather are impositions on civilization that benefit privileged interests at the expense of the general good. Removing these huge weights from our economy would eliminate our having to settle for a dismal trade between inflation and unemployment.

- ✯ A growing economy would no longer carry a negative supply shock in its wake — because there would be no incentive to hoard land. Locations would be available when they were needed, at prices that stimulate their profitable use.
- ✯ Productivity would be increased across the board, because the most desirable (and hence the most valuable) urban and commercial locations would no longer be held out of use. A tremendous waste of energy and infrastructure (characterized by "urban sprawl") would be eliminated.
- ✯ Production costs would go down, because labor and capital would no longer be burdened by taxation. Land rent would have to be paid, of course — but that must be paid today in any case, along with a speculative premium, and in addition to all the taxes that burden production.

Here's how Henry George put it: The industrial pyramid manifestly rests on the land. The primary and fundamental occupations, which create a demand for all others, are evidently those that extract wealth from nature; and hence, if from one exchange point to another and from one occupation to another we trace this check to production, which shows itself in decreased purchasing power, we must ultimately find it in some obstacle that checks labor in expending itself on land. And that obstacle, it is clear, is the speculative advance in rent, or the value of land, which produces the same effects as (in fact, it is) a lock-out of labor and capital by landowners.

This check to production, beginning at the basis of interlaced industry, propagates itself from exchange point to exchange point, cessation of supply becoming failure of demand, until, so to speak, the whole machine is thrown out of gear, and the spectacle is everywhere presented of labor going to waste while laborers suffer from want. Though custom has dulled us to it, it is a strange and unnatural thing that men who wish to labor, in order to satisfy their wants, cannot find the opportunity.

We talk about the supply of labor and the demand for labor, but evidently these are only relative terms. The supply of labor is everywhere the same — two hands always come into the world with one mouth; and the demand for labor must always exist as long as men want things which labor alone can procure.

We talk about the "want of work," but evidently it is not work that is short while want continues; the supply of labor cannot be too great, nor the demand for labor too small, when people suffer for the lack of things that labor produces. The real trouble must be that supply is somehow prevented from satisfying demand, that somewhere there is an obstacle which prevents labor from producing the things that laborers want. — from *Progress and Poverty,* 1879

Glossary of Terms

Clark's capital theory - John B. Clark, an influential early theorist of neoclassical economics, held that the economic factor of capital has no distinguishing quality other than its use as such. Capital, for Clark, is any economic input that is used as capital, i.e., is used in the process of production. This effectively lumped the factors of land and capital together, dividing the entire economic world into the fundamental elements of labor and capital.

Elasticity - A measure of how readily one variable will respond to changes in another variable. For example: if the prices of cigarettes and magazines both go up by the same proportion, yet sales of cigarettes drop less than sales of magazines, we say that the ***price elasticity of demand*** is higher for magazines (or that cigarette prices are more "sticky").

Factors of Production - The classical factors are ***Land*** (the entire material universe, exclusive of people and the products of human labor) ***Labor*** (all human exertion in production) and ***Capital*** (physical products of human labor which are used in production). Some texts introduce a fourth factor, Entrepreneurship, defined as risk-taking or mangerial forms of labor. From the standpoint of political economy, the introduction of Entrepreneurship as a "fourth factor" leads to confusion, and should be avoided.

Fiscal policy - The attempt by government to influence the direction of the overall economy by regulating governmental borrowing and spending. In an economic slowdown, the fiscal policy response would be to engage in deficit spending to "jump-start" the economy. If inflation were increasing, the fiscal response would be to increase taxes and/or to cut government spending, to slow down the increase in the supply of money.

Keynesians - Followers of the British economist J. M. Keynes, author of *General Theory of Employment, Interest and Money* (1936). Keynes considered the business cycle to be an integral part of a modern economy, which must be managed by government in order to avoid calamitous depressions.

Labor Value - In Marxist analysis, the true value of a commodity, the "labor time socially necessary" to produce it. Labor value is the sum of three components: ***constant capital*** (land and capital, the "means of production"), ***variable capital*** (wages paid to labor) and ***surplus value*** (the difference between market price and the sum of constant and variable capital).

Laffer Curve - The relationship noted by Arther Laffer between tax rates and overall economic activity. Laffer held that taxes stifle incentives to produce. He called for a reduction in tax rates, which would stimulate production and increase employment. Thus, lowered tax rates would (in Laffer's theory) bring in higher public revenue.

Marginal Cost - The extra cost needed to produce one more unit of output (or the reduction in total cost of producing one less unit of output).

Marginal rate of return - The additional income that comes from investing in one more unit of something (as compared with alternative possibilities for investment).

Market-clearing Price - The price at which quantity demanded equals quantity supplied — at which, in other words, the whole supply of goods bought to market are bought by consumers.

Market Failure - "An imperfection in a price system that prevents an efficient allocation of resources. Imporant examples are externalities and imperfect competition." (Samuelson & Nordhaus)

Monopolistic Competition - A type of imperfect competition in which many substitute goods are available, but large firms can affect the prices of goods through advertising and brand identification, etc. Examples are the markets for beer, soft drinks or magazines.

Monopoly - A market in which there is only one seller. A "monopoly price" is whatever the buyer is willing to pay rather than go without the thing.

Monetary policy - The attempt by government to influence the direction of the overall economy by regulating the supply of money in circulation. Facing a recession, the monetary response would be to increase the money supply by lowering interest rates and bank reserve requirments; facing inflation, the response

would be the opposite.

Multiplier - "...the change in an induced variable (such as GDP or money supply) per unit of change in an external variable (such as government spending or bank reserves)." (Samuelson & Nordhaus) The concept offers a means by which to judge the relative effect of various policy alternatives, by estimating how broad and deep their ramifications would be.

Neoclassical economics - The school of economic thought that grew in response to the 19th-century "classical school" of Malthus, Ricardo and Mill. (Today, some regard Henry George as the last of the "classical" economists.) Neoclassical economics focuses on microeconomics, examining individual proft-maximizing choices, and interpreting all economic phenomena as aggregations of such individual choices.

Normative - Analysis which seeks to improve the functioning of society by discovering and correcting social problems (as opposed to ***Positive***).

Oligopoly - A type of imperfect competition in which there are few firms, all of whom can have some effect on prices.

Parson Malthus - Rev. Thomas Malthus, author of *An Essay on the Principle of Population* (1798), which held that human population inevitably tends to grow beyond its means of providing subsistence.

Perfect Competition - A market in which there are many suppliers, and the goods are the same as others that can be substituted.

Phillips curve - The relationship, noted by A. W. Phillips, between inflation and unemployment. Phillips noted that if demand for goods increases beyond an economy's most efficient level of output (at any given point in time), the increased costs of satisfying that demand will lead to inflation. Therefore, an apparent trade-off exists between inflation and unemployment. Henry George's theory of the business cycle denies the inevitablity of this.

Positive - Analysis which seeks simple to descibe conditions as they are without imposing value judgements (as opposed to ***Normative***).

Potential Output - The highest level of production that can be sustained, at a given state of population and technology, without accelerating inflation. Also referred to as the NAIRU, or nonaccelerating inflation rate of unemployment. Potential output is conventionally considered to be lower than maximum output, but that is not necessarily true.

Productivity - The useful result, or output, that one gets from a given unit of a factor of production, or input. For example, labor gets more productive when workers produce more widgets in the same number of hours.

Progressive movement - A number of related social movements that emerged in response to the "gilded age" of the late 19th century, including labor unions, women's rights, and the Single Tax.

Single taxer - An advocate of the major reform proposed by Henry George and his followers, to abolish all taxation except for that on land values, which should be the source of all public revenue.

Stagflation - The simultaneous occurrence of (relatively) high inflation and (relatively) high unemployment. Prior to the 1970s, these two phenomena were thought ot be in opposition — but then concurrent higher levels of both began to be seen. The continued presence of stagflation is seen in the periodic upward revision of the "full employment point" — the highest level of unemployment that is deemed possible without an unacceptable level of inflation.

Tradeoff - As the Rolling Stones put it, "You can't always get what you want." It is true that human desires tend to be unlimited, and that in choosing something one always gives up the alternatives. This truism, however, leads some phenomena in macroeconomics to be presented in terms of trade-offs, when they really are not. Professor Gaffney cites a number of these (p. 13)**.

Appendix

A Most Harmonious Disagreement

The relationship between the academic establishment and advocates of Henry George's ideas has not, let us say, been one of admiration. It's probably true that each side has been weakened by its disdain for the other. This course, whatever its flaws, pays more attention to the terms and concepts of "Econ 101" than anything the "Georgist education" community has ever offered before. Over the years, many thousands of students have been introduced to political economy by a course based on *Progress and Poverty* that had very little to say about "that rot they spew in the colleges". Consequently, many of them ended up wanting to know what "modern-day economics" had to say about all this.

In this course, we've been over a number of points of convergence — and conflict. It might be worth recalling, though, before we close, that there is one point about which modern-day economics completely agrees with Henry George. And, the more closely we examine that point, the less it seems to be merely one happy convergence between two essentially different analyses. In fact, it begins to look like modern-day economics doesn't disagree with Henry George at all.

"That taxes levied upon land values," George wrote, "...do not fall upon the user of land, and cannot be transferred by the landlord to the tenant, is conceded by all economists of reputation. However much they may dispute as to other things, there is no dispute upon this point." The public collection of land rent "cannot add to prices, nor check production." That was true then, and it is true now; the fixed quantity of land (its inelastic supply, in other words) is a natural fact.

This fact has far-reaching implications. Henry George did not stress the general agreement on this point to court mainstream approval; he meant to show that the logic of the mainstream would lead to the very conclusions that academic economists were so busily denouncing! If, as generally agreed, the public collection of land rent does not add to prices or costs, it follows that collecting land rent for public revenue would lead to lower prices — for producers and consumers would be unburdened by taxation. That would lead to non-inflationary growth in employment (unhindered by advancing speculative rents, producers move to meet increased demand; increases in money supply are balanced by increases in production).

Is that not every politician's dream?

Grandiose, utopian claims — but mainstream economics textbooks make no attempts to refute them. Samuelson & Nordhaus' *Economics* goes so far as to endorse the single tax movement for the unquestioned efficiency of its proposal. However, there is immediate and, indeed, rather frantic backpedaling from that position. Samuelson reminds us that "an economy cannot run on efficiency alone," and that land value taxation "may also be perceived as unfair." He never says it *would* be unfair — for it is not the business of mainstream economists to make such value-loaded judgements — only that it might be perceived that way. (He omits the fact that fairness was Henry George's primary argument; when George contended that "justice is the highest and truest expediency" his point was not mystical but practical.)

Samuelson's discussion of rent, and the single tax, comes in a chapter devoted to income distribution. But "this theoretical section," he instructs the teacher, "may be skipped in brief courses." Furthermore, although he lauds the efficiency of the public collection of rent in this optional section, he refers to it not at all, not even in a cross-reference, in later chapters on taxation policy and alternative economic systems. It is as though Samuelson, having lectured for three hours on the dismal science, waited until his students were rustling their books and papers, heading for the door, and then *whispered* an unqualified endorsement of Henry George's economic remedy.



Henry George Institute
121 East 30th Street
New York, NY 10016

www.henrygeorge.org

