



Land Booms, Capital Stretch-Out, and Banking Collapse

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Land Booms, Capital Stretch-Out, and Banking Collapse

Mason Gaffney

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This is Part of a “Pilot Paper”, conference on the bank bubble, The American Institute for Economic Research, 1994. These notes were not published as such, but were melded by Editor Clifford Cobb into Part III, “Money, Credit, and Crisis”, of our 2009 book, *After the Crash*.

Although written in 1994, after the “Thrift Debacle” (S&L collapse) of 1991, they could as well have been written, with a few different details, after 2008. Our leaders, political and intellectual, had learned nothing from 1991. The notes could be written again today, in 2012, since our leaders of “left” and “right” are still chanting the same old tired slogans I remember from the playgrounds of 7th Grade when Alf Landon ran against FDR. Hope springs eternal, so here are the notes. Someday, somewhere, new leaders will seek new insights and solutions. Tennyson wrote with hope, “Our echoes roll from soul to soul, and grow forever and forever”. That has yet to happen, but remember, the last to escape from Pandora’s Box was Hope.

We need not fear that our topic has been preempted by others. At the 1993 AEA meetings in Anaheim, speakers worried that in 1990 consumers slowed buying. None of the economists present knew why. Professor Robert Hall of Stanford, head of the AEA and NBER committee that dates turning points in business cycles, ran through 8 traditional explanations of recession, from high interest rates to overstocked stores, and rejected them all. “. . . you cannot explain this one”, he concluded – but he still heads that committee. Olivier Blanchard of MIT offered that consumers just “got scared and stayed scared.” Blanchard soon rose to Chief Economist of the IMF. We may not do better, but we can do no worse. Here are some principles to orient us, and where they lead us.

1. Land and capital are mutually exclusive categories. Between them they include all assets with intrinsic value. Some of each is needed for all production (each is “limitational”), so both are always relevant.

As to formation, land (by definition) is what is given by nature. It is only Capital that can and must be formed by man, by producing in excess of consuming. Propositions relevant to capital formation must always distinguish land from capital.

Capital formation involves spurts of sacrifice, self-restraint, self-discipline, and self-control. Capital maintenance, and avoiding dissaving, call for continuous self-restraint, generation after generation, and throughout life cycles, not to “eat the seed-corn.” Land cannot be consumed, but Capital must be maintained and replaced.

IMPLICATIONS

A. Capital formation is not aided by, and may be deterred by raising returns to

land. All relevant analysis must carefully distinguish the two.

2. Land and capital are not mutually convertible. (Substitution is another matter, considered later.) Capital is convertible into any other kind of capital each time it turns over. With each turnover it is 100% fungible. Land is not convertible even into other land, and certainly not into capital.
3. A rise of real interest rates (i.r.s) destroys part of the real value of existing capital, in increasing measure of its putative longevity. This is an economic loss, a loss that is just as real as physical destruction. The cash flow from durable capital will, after a rise of i.r.s., be divided more in favor of interest, less in favor of Capital Consumption Allowances (CCAs). The appropriate accounting adjustment on the asset side is called "marking to market value." The loss of value occurs whether or not it is formally recognized on the books.

The basic mathematics of finance is available, and is quite precise and consistent.

Conversely, a fall of real i.r.s adds to the real value of existing capital, having the same effect as creating capital.

[Both those effects are muted by countervailing effects on ground rents and land prices. See point #9, below.]

IMPLICATIONS.

A. The response to a shortness of available (soft) capital is economically to destroy part of durable (hard) capital. This raises the possibility of a macro-economic "glitch," (a perverse episode of harmful "positive feedback," often called a "vicious spiral.") This effect, variously described and with varying emphases, has been noted by Ricardo, Jevons, Böhm-Bawerk, Wicksell, Spiethoff, Hayek, and others. Ricardo's Chapter 1, "On Value," and Chapter 31, "On Machinery," are good introductions. They are nominally well-known, and at the same time treated as non-existent: a feat of compartment-mindedness we find in too much economic writing. As Lionel Robbins points out, micro theory after 1870 became one of acapitalistic production. Capital theory simply disappears from the picture.

4. The property tax rate on capital items affects their value just as would a rise in the (real) i.r. of the same percentage. A rise in the rate thus destroys existing real capital; a fall in the rate creates real capital.
5. A rise in i.r.s lowers market prices of land by a much larger factor than it lowers prices of existing capital, because the value of land derives from more remote future prospects, overall. Land prices, accordingly, are hypersensitive to i.r.s. ["I.r.s" is used here to subsume all the conditions of availability of both loans and equity funds.] Thus land loans are a most undesirable basis for demand deposits. This was recognized by the English Bubble Act of the early 18th Century, and then alternately forgotten and rediscovered with each succeeding episode of land boom and bust.
6. Changes in the market price of land, when caused by inverse changes in i.r.s, do not represent changes in social wealth. In this respect they differ from changes in the market price, or Discounted Cash Flow (DCF), of depreciable capital. Many potentially useful analyses of our subject are deeply flawed by failure to hew to this difference.

Land prices are also sensitive to changes in expected growth rates of net income, both real and inflationary. These changes, likewise, do not represent changes in social wealth.

The third major factor determining land prices is the current net income (cash or service flow). This may rise for purely distributive causes, e.g. a fall of the

interest charge on financing a new building. (This is separate from the cap rate applied to the net income of land to find the selling price. Land prices are doubly sensitive to the i.r. for this reason alone.) A fall in wage rates may also raise the residual land rent. These changes, again, do not represent changes in social wealth.

Last, the service flow of land may rise because the land actually becomes more productive, e.g. from the spillover benefits of surrounding urban growth. This may represent a rise of real social wealth – I leave the question moot. The main point here is that most changes in land prices do not represent changes of real social wealth.

IMPLICATIONS.

A. Land is dangerous to use as debt collateral, because its price is so highly sensitive to i.r. changes. It is even more dangerous to let it become the collateral backing demand deposits.

B. Selective controls on credit extended by commercial banks may be used to prevent collateralizing land values. Another method would be to make mortgages taxable property, as provided for, for example, in the 1879 California Constitution. Such a provision is enforceable because mortgages (or deeds of trust) are always publicly recorded, along with land titles themselves. Such a provision would also ease the political case for raising property taxes, which otherwise fall solely on equity holders, and appear to exempt lenders (except as they erode collateral security).

Why are banks not lending much in early 1993? Interest rates (at least short-term rates) are low, but collateral requirements are very high. There are 3 problems, at least. 1, Banks are leery of any real estate collateral now. 2, They lack the needed capital. (They also may lack reserves). Both of those result from their recent losses. 3, Real interest rates are higher than they look when we factor falling land prices into the c.o.l index used to deflate nominal i.r.s into real i.r.s. This is a variation on Keynes' perception of a liquidity trap. By "variation" I mean it is the same phenomenon, only differently perceived and expressed.

Here is the sequence of a combined, reverberating land and banking crash. Land boom fizzles. Banks take losses. Their reserves and surpluses (capital) dwindle. They stop making loans and investments. By a process of positive feedback ("vicious spiral") this stoppage aggravates its own cause, viz. the fall of land prices.

7. A rise of i.r.s tends to raise savings rates via a strong wealth (or portfolio) effect. It lowers the current market price of land, especially. To a lesser extent it lowers the prices of items of durable capital.

There is a diminishing marginal utility of total wealth held (for retirement, for business use, for consumer capital, etc.). The fall of asset prices as a store of value thus tends to raise savings rates.

At the same time, a rise of the Marginal Rate of Return (MROR) on new investing raises the reward of saving as vs. consuming income. This is a substitution effect, conceded by all. The traditional counter-argument has been that there is a countervailing income effect: higher income from given sums invested tends to weaken the impulse to save. This counter-argument in turn, however, is offset and more than outweighed by the wealth effect recited above. The wealth effect reinforces the substitution effect, making saving respond positively to i.r. hikes.

Conversely, a fall of i.r.s raises the market price of land, swelling portfolio values, weakening the incentive to save. In the extreme, if there is no reward for saving (i.r. = 0), and no property tax on land values, land prices would rise

infinitely high. This, along with associated absurdities, would end all saving. These reductions ad absurdum clearly indicate that savings rates must be positively related to savings rates.

8. A rise of property tax rates on the land value base raises savings rates via the same wealth (portfolio) effect. Hikes in other kinds of taxes might have wealth effects, too, but there are two differences. a) The wealth effects are weaker; b) There are undesirable substitution effects, lowering the MRORAT. The land value tax stands alone in having the pro-saving wealth effect, coupled with the absence of marginal disincentive effects.

IMPLICATIONS.

A. To raise savings rates, raise the tax on land values.

B. Doubly to assure raising savings rates, couple such taxation with use of the proceeds to pay off public debt.

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

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

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

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

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

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

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

At the same time — viewing the same point from another angle — the cash flow from the land+building is now imputable to the land alone, to justify the land’s higher price. The cash flow is all net income, because land does not depreciate.

The owner may spend it all on consumption; being human, he begins to do so. Lenders descend on him and seduce him into borrowing on the land to increase his consumption. "Equity withdrawal" is the current term for it.

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

From a fourth and last angle, capital, to survive, must earn cash flow enough not just to cover interest on the unrecovered value, but also enough above that to reproduce itself. As Mill said, "Capital is kept in existence from age to age, not by preservation, but by continual reproduction." Capital reproduces itself by yielding CCAs. When rising land prices devour capital, and/or rising ground rents arrogate its CCAs, capital stops reproducing itself. This is how rising rent drives capital out of production. It is not that capital "sulks." Such a metaphor is misleading: economic agents cannot afford to "sulk". Rather, capital is drained and consumed by the rise of all-devouring rent. This ruin occurs without apparent harm to the owners of buildings when, as is the rule, they own the land under them. It is silent and insidious, like a vampire in the night. It would only be contentious and "newsworthy" if the land were owned by a different party than owns the building, and the lease expired. There are such cases — in trailer parks, and on the Irvine Ranch leaseholds in Orange County in the early 1980s — when the sapping of capital is visible and contested. As a rule, though, it passes unnoticed: no one seems to be suffering, no one rebels or can plead injury, even as a big share of the nation's precious capital stock shrivels and dies without reproducing itself.

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

IMPLICATIONS.

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

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

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

10. Misallocating capital has much the the same economic effects as lowering the aggregate supply. Whenever capital is drawn into "hard" forms, with slow payout periods, there is the danger of its freezing up in an episodic "glitch," or credit crunch, in which case its value is lost. It becomes unrecoverable, which is the same as consuming or otherwise destroying it. Artificially raising demand for capital, leading it into wasteful, low-productivity uses, has similar effects. Overpricing land leads investors to overallocate capital to substitute for land. This takes several forms. A good single word covering that thought is "MALINVESTMENT", a term used by "Austrian School" economists today. Tragically, those who rally today under the label "Austrian" err seriously by attributing malinvesting solely to central bank policies, sweeping away and ignoring all other factors.

IMPLICATIONS.

A. Heavy taxation of land, precluding overpricing, should prevent overallocation of capital to land substitution.

11. Taxing anything except land (e.g. retail sales, labor income, value-added) will sterilize marginal lands (and marginal activity on all lands). Thus, non-land taxes abort investment outlets, demand for capital, hence capital formation.

GroundSwell does not have space for footnotes, but they are available by emailing Dr. Gaffney.

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