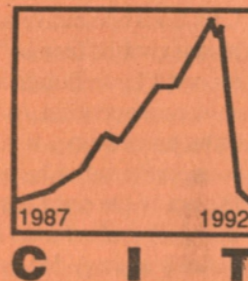


ECONOMIC INTELLIGENCE

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A LIFEBOAT TO SINK RECOVERY

INVESTORS in Britain searching for a medium term strategy must now accept that deflation will continue for the next year (unless there are more major U-turns in Downing Street). The government's strategy - the quest for low inflation - is a sham that conceals a policy vacuum which will persist until the Chancellor is told to prime the pump (and thereby generate inflation) for the 1996 election.

Premier John Major, backed into a corner by the hostile public reaction to his plan to kill 30,000 mining jobs, may say that he is now planning a "strategy for growth"; but he does not have a single viable idea how to achieve this goal.

The same gloomy prognosis applies globally. Policy-makers have still not learnt that constructive action can be taken to correct the economic malaise. So next year we will see a repeat of the Lifeboat Operation which, in 1974, swung into action to save the financial system. This time, however, the cost will be greater,

and will be attempted on the back of a global economy that is haemorrhaging badly. Banks may stay afloat, but more taxpayers will sink under the burden of taxation and high interest rates.

In the United States, taxpayers will have to begin funding a \$100bn bail-out of the thousands of failing banks which have been crippled by reckless loans to land speculators. Similar pressure is mounting in Japan, where the government is being urged to relieve the banks by buying 4m units of vacant housing.

Land prices are at the root of the problem. The boom began on cue in 1985, followed by south-bound prices leading the way into depression, as illustrated by the Bank of International Settlement data in the graph. The banks cashed-in on the craze, and now want to be rescued. In Japan, the Federation of Bankers' Association is finalising plans to create a corporation that would buy from banks the land which is being held as collateral

for non-performing loans. These non-performing loans are estimated at up to Y50,000bn. Unlike Japan, however, which has at least introduced a tax on land prices to accelerate the recovery (see EI/34), other governments are studiously ignoring the land market for policy-making purposes.

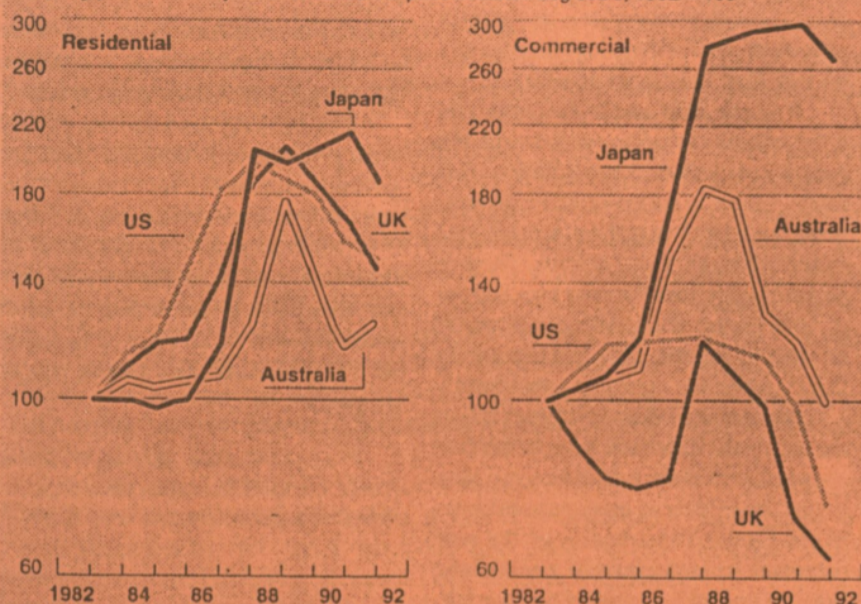
True, Britain's Chancellor of the Exchequer, Norman Lamont, now acknowledges that he is monitoring the price of housing as one of the measures that would guide decisions in the "battle" against inflation (sic). But that illustrates how governments have cornered themselves into an impossible situation. In Europe, governments need to reduce interest rates, to encourage investment in capital equipment and new jobs. But by reducing interest rates they would buoy up expectations about renewed growth in the price of land. And that does not make sense, given current conditions and policies. For if the market is to be left to itself, land prices will have to come down further before we see new growth.

This dilemma is highlighted in a new study by EI reader Andrew Tylecote, an economics lecturer at the University of Sheffield. The snag with lower interest rates, he notes, is that they encourage the speculative hoarding of land.

The solution, in his view, is the introduction of a tax on land values - a tax, indeed, which he regards as setting the standard for fiscal policy in general: "look for taxes which, besides raising revenue, improve both the distribution of income and the allocation of resources in the economy". Tylecote emphasises the virtuous impact of the land-value tax:

"One kind of wealth tax, however, has no distorting effect, because it is practically impossible to avoid whatever you do: the tax on the value of land...Land taxation indeed offers much more than

Property price index adjusted for consumer price inflation. Log scale, 1982 = 100



Source: Bank for International Settlements, Annual report, 1992

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BRITAIN'S Chancellor of the Exchequer, Norman Lamont, told a House of Commons committee on October 12 that he does not believe in "kick-starting the economy by artificial stimulus". That was an honest appraisal, for his alleged anti-inflation strategy - if it is a policy at all - was designed to kick the last traces of life out of the economy. That policy has now had grafted onto it an, as yet, undefined strategy for growth.

We are invited to rely on the chancellor's judgment on how he will respond to monetary aggregates. Secretiveness characterises that process, but we are told that he will now look closely at "asset prices", and particularly the rate at which house prices rise or fall. Does this suggest that the government has learned something from the policy failures of the past? Gone are the days when soaring house prices were welcomed as a sign of an "economic miracle." The new fear is that they signal deep-seated fault lines within the UK economy.

The faults rupture the economy by encouraging financial institutions and fiscal policies to create an imbalance between spending and saving. The outcrops of these faults are the debt overhang in the personal and company sectors, the "bad debt" overhang in the financial sector, and the large volume of unsaleable/unlettable properties.

But what is John Major's Government going to do about it? Nothing of substance, as evidenced by the way the government reacted when it saw the pound heading for the buffers in the ERM: it was too paralysed with fright to act, because "all necessary measures" to defend the pound - those which it had promised to take - were too damaging to the rest of the economy. When the defensive measures were not taken, the foreign exchange markets knew that they were on to a one-way bet by selling sterling.

But the government need not suffer paralysis about changes in house prices. Keeping them steady does not require a chainsaw massacre of producers and consumers through loosing artificially high interest rates upon them. It simply requires a surgical trimming of growth in land prices through the use of a specific tax on land rents. Land rents are - in the words of Adam Smith - "the species of revenue which can best bear to have a peculiar tax imposed upon them."

A TAX upon land rents is sure in its effect upon land prices. The effect is described

SURGICAL STRIKE OR CHAINSAW MASSACRE

by the tax capitalisation equation:

$$P_L = \frac{R}{(I - G + T)}$$

Where:

P_L = Land price

R = Rent

I = Interest rate

G = Growth rate (anticipated)

T = Tax rate on land

The tricky variable in this equation is the anticipated growth rate, but the government can set it at zero by making a constant aggregate land price its target, and taxing land rent accordingly. Land prices need not be at the mercy of "events - dear boy."

Not only would the target be hittable: hitting it would also control the institutional behaviour and fiscal policies that cause the frictions within the economy which weaken the currency and produce inflation.

Stabilized land prices would remove the "escalator to riches" route to consumption that by-passes the need to work. "Trading up" the housing ladder has allowed widespread access to this escalator. Rising land prices and erosion of the value of the related debts by inflation have raised personal and company net worth, and reduced the need to save. The high borrowing and spending level that has resulted has further stoked up inflation. The debilitating "stop-go" pattern of growth, and widespread dependency on inflation, have been the results.

It is the land under buildings that roller-coasters in price, and provides the basis for credit booms and inflation. This roller-coaster is controllable by government, and 1993 would be a propitious moment for this fiscal reform. There is no speculative stuffing to be knocked out of land prices: there will, therefore, be no need for fortunes to be lost in property values when the policy is announced.

Neither need property prices fall in the future: the important thing in this first phase of tax reform would be to prevent prices from rising to unaffordable levels in the future. The criterion of the new economic strategy could be that the land price aggregate will neither rise nor fall. Correctly pitched, the stabilisation tax on

land rents would prevent (or minimise) the violent amplitudes in land prices which are the major cause of economic instability. Not only need there be no wealth losses as a result of the policy, the security of property owners at existing levels would actually be increased.

Preventing land prices from rising would switch the economy into a production-led mode, and away from an asset price-led mode. The attack on inflation would be through the strengthening of the economy, not by weakening it via high interest rates. Adopting a no-growth target for land prices, and acting to achieve it, would deal a mortal blow to inflationary expectations and remove the need for the chainsaw treatment which Mr Lamont is inflicting on the economy.

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a harmless way of raising money. It would be highly redistributive in most countries... And since it would make speculative hoarding of land prohibitively expensive, it would make for much more efficient use of scarce urban land: less dereliction of unused properties, more construction jobs available in the inner cities, less suburban sprawl.

"A side-effect would be a reduction in house prices and thus in consumer borrowing out of capital gains anticipated by the owners. The mild deflationary effect of this would be amply compensated by the reduction in the debt burden to which it would lead, and it would free governments to reduce interest rates."*

But housing markets are now severely depressed, because negligent governments failed to work the land market into their expectations. In Britain, over 1m families own homes worth less than their mortgages. So the land-value tax will have to be phased in as the cornerstone of an investment/export-led recovery. EI elaborates on this strategy on pages 2-4.

* Andrew Tylecot, *The Long Wave in the World Economy*, London: Routledge, (reviewed in *Land & Liberty*, Nov. 1992, p.15).