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Echoes of Henry George in Modern Analysis

A Comment on Three Applications

By RANDALL G. HOLCOMBE*

ABSTRACT. These comments were prepared in response to the session "Echoes of Henry George in Modern Analysis" presented at the 2002 meetings of the Southern Economic Association. Professor Holcombe prepared his comments at this journal's request at a later time.

The three preceding papers all use the ideas of Henry George to analyze important policy issues. Each paper is interesting in its own right and as a group they show that, even a century after he wrote, Henry George's ideas are taken seriously as a foundation for policy analysis. This comment considers each paper individually, and concludes with some observations regarding the contemporary application of George's ideas.

Optimal City Size

THE EASIEST OF THE PAPERS TO COMMENT ON is Richard Arnott's paper on optimal city size. Professor Arnott asks whether the Henry George Theorem offers a practical guide to determining optimal city size and concludes that it does not. I agree completely. Despite Arnott's negative conclusion, his paper offers the reader much. It has a good review of both the Theorem and the related literature, with a special focus on Kanemoto, Ohkawara, and Suzuki (1996), who try to use the Henry George Theorem to estimate optimal city sizes in Japan.

Professor Arnott accepts the Henry George Theorem in principle, and after discussing it concludes that "the generalized Henry George Theorem holds very generally." Fitting existing data to the theory is what gives rise to the difficulties. A primary problem, which Arnott

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notes, is that agglomeration economies having nothing to do with local public goods may be the most substantial determinant of land rents. Arnott does not consider public choice problems, which may stand in the way of applying the Theorem at least as much as agglomeration economies. Cities are assumed in the Theorem to produce public goods with the tax revenues they collect, but in the real world public goods are not homogeneous—and what local governments produce are often private goods paid for at public expense. There are also likely to be inefficiencies in production because of bureaucratic suppliers, interest group politics, and rent seeking that further complicate the relationship between property taxes and public goods. This observation simply reinforces Professor Arnott's conclusion. Even if the problems he cites in his article were solved, there are more problems that hinder the use of the Henry George Theorem as a practical guide to optimal city size.

The Winner's Curse

PROFESSOR TIDEMAN OFFERS THE INTRIGUING HYPOTHESIS that land speculation tends to keep land undeveloped for too long because owners of undeveloped land suffer from a winner's curse. Economic theory, Tideman argues, is based on the assumption of perfect foresight, but when foresight is not perfect, the highest bidder for a piece of property will be the person with the most overly optimistic forecast of the property's value. Landowners systematically overestimate the appreciation potential of their land and, as a result, leave it undeveloped for speculative reasons rather than developing it.

This is an interesting idea, to be sure, but there are a number of reasons why it must be considered a conjecture rather than a solidly supported conclusion. First, the winner's curse was originally formulated to apply to auctions, but land is not typically sold at auction. It is sold on the market like other resources, and unless the real estate market is especially thin, the sale of other properties helps provide information to potential buyers about the value of a particular piece of property. One of the things markets do, as Hayek (1945) noted, is to generate information about the value of goods and services. The buyer of any good always is the person who places the highest value

on the item purchased, but would we then conclude that anybody who buys something has always overpaid because the buyer outbid others to make the purchase? Are people who buy cars the victims of a winner's curse? Would we conclude that someone eating a meal in a restaurant has overpaid because that person demonstrated the highest willingness to pay? To make a convincing argument, Professor Tideman first needs to show that land markets resemble auctions more than markets for other goods and services. Then there is the question of whether high bidders really do overpay. Even if the theory of the winner's curse is true for auctions (and that is open to question), the theory may not apply to land purchases.

A second problem with the idea is that people can develop and use land even as they are holding it for speculative purposes. There are several reasons why development might even enhance the appreciation potential of land. It could reveal the property's potential to generate revenue, for example, if development demonstrated the rents that tenants would be willing to pay. Perhaps more significantly, environmental and growth management regulation may present obstacles to development, and the resulting uncertainty about whether—or how intensively—a parcel could be developed may lower the value of a piece of property. If the property is already developed, those obstacles would already be cleared and the property would be worth more. Even if the winner's curse holds for land, more needs to be done to show that this also implies inefficient patterns of development.

To argue that land speculation does lead to inefficient development patterns, Professor Tideman argues that economically efficient development moves from the center of a city outward, rather than leapfrogging over undeveloped parcels. Leapfrog development would then provide evidence of inefficient development, possibly as a result of the winner's curse. However, leapfrog development is not a sign of inefficient land use patterns. Leapfrog development serves a valuable economic purpose, because it makes the leapfrogged land more desirable for high-density development. Shopping centers and other commercial uses of land are most effective when they are centrally located. If a city develops continuously outward without leapfrogging, all new development will take place on the periphery, and

because that land on the periphery is not centrally located, it will tend to be valued lower and be developed at lower densities. New sites at the periphery of existing development would never be ideal for commercial development because they are not centrally located. Leapfrogging makes the leapfrogged property more centrally located and so more valuable as a central location for higher-density commercial development. As a result, leapfrogging can result in more efficient development patterns.

I discuss leapfrog development and other development patterns in more detail elsewhere (Holcombe 1990; Holcombe 2001, pp. 137–142). The point here is that developing land continuously outward from a city center rather than leapfrogging does not necessarily imply efficient development and is not evidence that the winner's curse applies to owners of undeveloped land. In general, the invisible hand of the market allocates resources efficiently, and a better case would have to be drawn to suggest that real estate markets are not as efficient as other markets.

A better test of Professor Tideman's hypothesis would be to systematically examine the returns to real estate speculation and compare it to other investment options. Do real estate investment funds underperform when compared to stock funds and bond funds, for example? Professor Tideman emphasizes speculators holding back property from development, so perhaps a better test would be to compare the appreciation of developed versus undeveloped land. The winner's curse conjecture is interesting but, having made the conjecture, perhaps the best way to push forward with the idea would be to do some empirical investigations to see if it is consistent with any real-world data.

Environmental Policy in Developing Countries

PROFESSOR BACKHAUS'S PAPER IS MORE WIDE-RANGING than the other two, but there are a few ideas that are central to the paper and that raise some questions. The paper makes much about the goal of sustainable development, but *sustainable* means something different in this paper's context than in its typical environmental use. Professor Backhaus does not mean that resources should not be used up—for

example, that the rain forest should not be clear-cut for farming—but that the proceeds from natural resources should be invested rather than consumed. If the rain forest is clear-cut for farming, the proceeds from that farming should not be consumed by the farmers but invested to provide a sustainable stream of income to replace the lost resource. Why this should be the case is unclear. The present value of those resources might be maximized by present consumption rather than a stream of future consumption.

Professor Backhaus uses as an example of unsustainable development the pollution of the Rhine River, which does not fit the common conception of unsustainable development. If polluters quit dumping pollutants into the river, the river's water quality would improve. This is different from cutting down rain forests that can never be replaced in their original condition once destroyed and the destruction of which may drive certain species to extinction. But when sustainability is looked at in the way described in the previous paragraph, Professor Backhaus's point becomes clearer. If environmental amenities are consumed in development, sustainable development as Professor Backhaus defines it would occur if the proceeds from development were invested to produce a flow of income. Environmentalists will not like this definition of sustainability, but it is important to see what Professor Backhaus means by sustainability to understand his paper. In the case of the Rhine, what Backhaus means is that the value of the resource is being degraded, and nothing has been set aside to offset this damage. He would like to see those who use resources in this way set aside funding to restore them to their original state or to offset the damage from removing them from their original state.

Professor Backhaus sketches a procedure whereby developers would have to assure that funding would be available to return property to its natural state after it is developed. In his example, the developer of an airport would have to provide financial assurance, perhaps by buying insurance, that if the airport failed it could be returned to its natural state, thereby leaving no harm behind. This is an intriguing idea that combines George's ideas on land rent with Pigou's ideas on corrective taxes for externalities.

Several questions must be addressed if we are to consider this a serious policy proposal. First, it is unclear that every development of

a piece of land lowers its value. For example, if Professor Backhaus's airport did fail, perhaps that location would be ideal for a shopping center and, if so, the site preparation done for the airport would make it less costly to build the shopping center than if the land was in its original state. This suggests that the land's original state, or its prior state before the present user modified it, is not the appropriate benchmark for assessing the harm, if any, from development. Second, one needs to differentiate technological from pecuniary externalities. It may be that cutting down the rain forest in Brazil generates technological externalities because it will reduce the number of species of plants and animals and because the removal of a large area of forest could affect the world's climate. However, removing oil from the ground or developing a previously undeveloped piece of property entails pecuniary externalities for the most part, which should not be the subject of public policy. If there are clear private property rights in land and natural resources, then the market should allocate them to their highest-valued uses, both at a point in time and over time, just as with any other good.

These issues are especially important to consider if Backhaus wants to apply his policy to developing economies, because inappropriately applied policies could hinder development. From the standpoint of a developing economy, sustainability may not be an appropriate goal, either as sustainability is commonly understood or as Professor Backhaus uses the term. Wealth maximization may imply depleting resources to use the proceeds for investment, which would meet with Professor Backhaus's approval, or depleting resources to fund current consumption. Professor Backhaus's proposed procedure for funding sustainability also needs scrutiny, because surely the appropriate benchmark is not to provide funding to return land to its natural state.

Conclusion

Henry George's work retains its popularity more than a century after it first appeared, and at the beginning of the 21st century there even appears to be a resurgence of interest in his ideas. These three papers reflect that interest, but they also reflect the difficulty of applying

George's ideas to contemporary policy issues. That difficulty is clearly shown in Professor Arnott's paper, where he argues that, despite a well-developed Henry George Theorem, it does not appear to correspond closely enough with real-world data to offer an answer on optimal city size. Professor Tideman suggests that George's single tax might end speculation in land that results in inefficient development patterns because owners suffer the winner's curse. The issue is important and is very relevant to contemporary policy. The idea that George's insights could be applied to identify policies that can lead to more efficient land use patterns is intriguing, but as the paper currently stands, it does not show that landowners are, in fact, the victims of a winner's curse or that development patterns are inefficient as a result. Professor Backhaus's paper offers some very bold policy suggestions for using George's ideas to assure sustainable development in developing economies, but there are enough loose ends in his presentation that applying his ideas as they appear in this paper may hinder development. Professor Backhaus offers his proposals as a sketch, and it will be interesting to see how they hold up when more fully developed.

Each of these papers looks at important issues and uses Henry George's ideas to resolve them. If these papers do not present the final word on their subjects, they all do offer thought-provoking analyses on important topics. They show as well that Henry George's ideas remain alive in the marketplace for ideas. George's ideas have never fully entered the economic mainstream, and these papers also show the difficulty of applying George's ideas to arrive at meaningful economic policy conclusions. For those who are not sold on George's ideas, papers such as these will certainly raise interesting questions, but will be unlikely to win converts.

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