The theory of rent needs a theory of history

WALL STREET analyst Dr. ***Michael Hudson*** *argues that the Georgist fiscal philosophy will not make headway in practical politics until its advocates present a viable historical doctrine of the role played by land, its rent and its capital gains.*

He proposes two streams of action:
- *Promote serious professional discussion of the importance of taxing land so as to un-tax labour and direct capital investment.*
- *Explain the need to shift bank lending away from real estate speculation so as to steer the economy's savings back into direct capital investment.*

His research programme comprises two parts:
1. *Re-establish the importance of land and its rent as a shaping force of history by creating a group of economic historians focusing on the land issue; and organizing a prestigious series of colloquia on land use and the evolution of land rent and taxation.*
2. *Create a statistical model to demonstrate the importance of land and its rent in national income, and of land-value gains in the nation's balance sheet of wealth.*

For years, admirers of Henry George have been bewildered at how many leading economists acknowledge that a tax on land is the least intrusive and least distorting form of tax (because it does not deter the production of more land), only to drop the matter rather than making it a central take-off point for their theorizing and policy prescription.

While many academic economists grant the theoretical point they do not see its political importance. After all, real estate is taxed locally at only a fraction (about 1%) of its market price, and pays little significant federal income tax. There is little discussion of changing matters, for public discussion deems it fair to tax income and sales via a value-added tax and related taxes on consumers (that is, on labour).

Although land rent formed the central thrust of classical economics, it has become marginalized as a sub-discipline ('land economics'). To counter the popular neuralgia that views real estate as a dry subject, we need to give the study of land a critical ideological mass. It is necessary to take rent beyond economic theory, and re-establish it as a political doctrine by establishing popular awareness of its dominant role in today's banking and finance, economic polarization and general prosperity or depression. For economic theories are perceived by the public in terms of their broad sweep - their ability to explain where the economy is going over time. If a viable core theory is to be based on land and its rent, it cannot be viewed as being merely a marginal phenomenon; it must be perceived to be an important force shaping society's broad contours. More specifically, the role of land and its rent must be seen to be of such central fiscal and historical importance that it cannot be left out of account by economic theorists, historians or the designers of fiscal systems.

In the century since Henry George elevated land rent to a central political focus in *Progress and Poverty* (1879), the perception of land's importance has become marginalized even as its actual role has grown. Economists have telescoped the analysis of land into capital-in-general, despite the fact that land represents the major source of capital gains. The economic interpretation of history has been dominated by Marxists focusing on class conflict between labour and capital, not on the role of land tenure and rent in history.

The problem is thus not simply to get economic history into the core curricula, but to make the land issue central to economic history, and hence to the study of our own society's future.

For the idea of taxing land to become more widely discussed as a viable policy, the role of land and its rent - and of land's dominant role in the economy's capital gains - must be established. For this to occur, land value and the magnitude of rent must be re-incorporated into economic theory.

But this academic recognition in turn has a precondition. What is necessary is not only rent theory 'in the abstract', but a wide awareness that land value and rent are quantitatively important and behave uniquely. Fortunately, this can be statistically demonstrated.

1. Theories of land value and rent must go beyond technical microeconomic 'tools', to become a political doctrine.

Successful economic theories establish themselves as doctrines and 'isms' which involve policy advocacy at the broadest economy-wide level. Theories of land, for instance, are perceived in their embodiment as ideological doctrines. This is what made *Progress and Poverty* so powerful. Any theory must be capable of being persuasively applied to history as a law of social motion, for this is the way it shapes how people think about the future.

On the basis of Ricardo's treatment of rent, British political economy elaborated theories of value and prices, productive and unproductive employment, and a set of related concepts through which the economic history of civilization could be interpreted. To make this leap from theory to doctrine, however, it was necessary to go beyond analyzing economic rent in terms of value theory (i.e., as the excess of price over production costs, defined to include normal profits). The Ricardians showed how rent tends to rise over time at the expense of wages and profits, finally grinding economic progress to a halt.

Some of Henry George's followers tried to do the same by applying rent theory to urban real estate and natural monopolies, but the movement lost the historical thrust that it enjoyed at the hands of Thorstein Veblen, Francis Nielsen and a few others.

2. The importance of a doctrine of land-use and its taxation lies in its ability to explain (and indeed, to warn) how rent relations will shape society's future evolution.

A theory of land and its rent can demonstrate how today's polarizing economic trends are leading to something other than the commonly accepted 'business as usual' expectations. It can show the warping of our fiscal system, of our financial system (how savings are recycled largely to inflate real estate bubbles), and how tax favouritism for land speculation deters new direct investment and development.

What is remarkable is that no such perception exists, despite the excesses of the 1980s. Much of the explanation lies in the degree to which classical economics took a Marxist rather than Georgist path. In view of this development, it is useful to ask why Marxism emerged so victorious, driving George's name off the social and political stage.

The answer is not to be found in economic theory as such (i.e. Marx's theory of surplus value), but rather in the way that Marx's ideas were elaborated into a social doctrine and infused into the academic social sciences, while George's ideas were not.

At the hands of Marx's followers, historical materialism offered more than just an economic theory or 'tool' as such. It offered an explanatory key to the unfolding of history. Marx and Engels translated their ideas into anthropological terms by elaborating Lewis Henry Morgan's *Ancient Society*, and V. Gordon Childe followed up by describing the origins of urbanization in Marxist class terms. Marxist views of ancient and medieval history were expounded by Max Beer's *Social Struggles in Antiquity* (already before there were Marxist classes!). Moses Finley, Ste. Croix and others carved out the field in Marxist terms.

Unfortunately, much of what emerged was an anachronistic misreading of history. Antiquity's revolutionary cry was not one of wage-slaves, but a demand for cancellation of the debts and redistribution of the land.

Admirers of George included the German sociologist Franz Oppenheimer, but his work came to be absorbed into the Marxist tradition, as did that of Werner Sombart. For the fact is that it was almost only the Marxists who retained a long historical view. George's followers let the social dimension of *Progress and Poverty* be stripped away, narrowing his idea from a doctrine of collecting rent to fund public budgets, to the status merely of a (micro-) theory of price formation, exiled from the core economics curriculum to the academic wastes of 'land economics'. Singling out rent theory to the exclusion of all other dimensions of political economy, sociology and history turned George's idea into a narrow theoretical point.

Georgism might have countered Marxism on its own ground of historical materialism by pointing out the importance of the land question in antiquity, in medieval Europe, and in the tribal communities analyzed by anthropologists. Yet it was the Marxists who picked up what the French call *le longue duree* of social and economic institutions.

3. A doctrine of rent must be able to explain the broad sweep of history, including the future.

Instead of building on the classical economic tradition by doing for urban land prices what Ricardo did for the value of farmland, the followers of George have removed the theory of economic rent from its historical context. Marxism has thus been left alone to claim the mantle of classical political economy.

To become a doctrine, economic theory must place itself in the context of the social whole. It must involve a theory of history, of social behaviour, and even of intellectual history, for it is natural to think of the whole, and intellectually crippling to think of only the parts. Let us therefore ask what pitfalls befell the Henry George movement and blocked it from successfully institutionalizing its rent and fiscal theory as a viable doctrine.

To become a political doctrine in its own right, the theory of rent would have to involve a view of the economy at large, and indeed to become nothing less than a theory of society and of history. It would explain the progress of rent over time, and how the appropriation of rent (and the land's breaking free of taxation) has shaped societies for better or worse, affecting the distribution of income and wealth so as to promote prosperity or poverty.

By creating a political doctrine based on grounding taxation on the land's rental value, the theory of rent had an opportunity to mount a challenge to become the Economics of the Future. It might, in short, have become as full-blown a doctrine in its own right as Marxist socialism became.

To achieve this broad political appeal, it would have had to place the taxation of land in the context of overall fiscal policy, by calculating the volume of revenue available to be taxed. It also would have traced what landlords did with the rent they received. For if they used it to build new factories and employ labour so as to expand productive activities, they would have been vehicles for economic welfare. But as Ricardo, John Ramsey McCulloch and John Stuart Mill observed, landlords tended to dissipate their rental income by hiring unproductive labour (such as servants). The problem with *rentier* income was that it ate into investment, substituting a parasitic overhead for underlying economic growth. Under existing conditions, the monopolization of land rent threatened to grind prosperity to a halt.

This perception provides a key to understand today's post-industrial land bubble.

4. Any theory should be illustrated statistically.

A land tax requires popular awareness of the magnitude of rent and land-value gains. Yet today, a century after George's death, the magnitude of rent and land-value gains remain a secret that has not been demonstrated to the public at large (although the banking and insurance industries have learned it well). Followers of Henry George have not related the magnitude of rental income and land-value gains to the economy's overall income and capital gains, or to its fiscal needs. Without such a calculation it is not possible to gauge the extent to which the failure to tax real estate's rental income has been the major contributing factor to the US government's chronic budget deficits.

A statistical quantification of rent would show it to be the major element in the economy's build-up of wealth. This is why real estate forms the most important form of collateral underlying the banking and credit system, and hence is the foundation of credit bubbles and the business cycle. It also is an increasingly important element in industrial cost structures, and of living costs for consumers. Yet by playing these roles, real estate provides scarcely any of the federal government's fiscal needs. Indeed, land-value gains are generated precisely because real estate cash flow is virtually free of income taxation. Only by calculating the magnitude played by rent in each of these dimensions can its specific importance be demonstrated - its potential for taxation, on the one hand, or the extent to which private appropriation of rent is recycled into yet more mortgage lending to inflate the land bubble.

5. Georgist theory in particular must be statistically quantified to be deemed important.

The concept of 'fully' taxing the land has not been spelled out statistically. The real estate industry is left with its small print in the tax code, providing legal loopholes to minimize its fiscal obligations. Yet instead of advocating the full taxation of land, many Georgists have leapt on the anti-tax bandwagon opposing a rise in overall real estate taxes.

The upshot is that no Georgist institution today is calculating the annual magnitude of rent and of land-value gains. Failing to popularize such calculations, the Henry George movement has failed to get off the ground. Indeed, one may ask, what are its institutions all about, if not to undertake this basic research? What do they have to interest the public, if not something relevant to say about the volume and incidence of rent, year after year, and its impact on the credit system and other economic conditions?

The proper task of the Henry George institutions should be to carry forth the legacy of his spirit by translating rent theory into a quantitative statistical format, to explain to the world what is important about the land and other natural resources.

Yet not all groups in the Georgist camp endorse taxing increases in land value, or closing tax loopholes such as over-depreciation so as to impose an income tax on rental cash flow, or imposing property taxes of more than the nominal 1% of real estate values in an environment where prices are rising by about 10% annually. Such ideological disputes have deterred the necessary empirical study.

6. Rent and land-value theory need to be incorporated into the broad financial theory of saving. For in today's world, most rental income is paid out to mortgage bankers as interest, and is recycled into new real estate lending to inflate the land bubble.

Modern economies have transformed the social context of rent. Over the past century it has become normal to buy real estate on credit. The upshot is that the bankers and other mortgage lenders (including insurance companies and pension funds) have ended up with most of the rent, in the form of interest. They recycle most of this interest into new mortgage lending to inflate land prices all the more, thus generating yet more capital gains for real estate developers. Whereas British landlords a century ago were accused of dissipating their resources on servants, the church and other unproductive labour (including a penchant for military adventurism), today's mortgage bankers transform rental income into interest charges to pay for an increasingly burdensome financial sector.

Recycling mortgage interest into new lending tends to create an ascending spiral of land prices. Rent is extracted from the economy and paid to the banking system, which recycles it to inflate the real estate bubble. This makes home ownership more expensive, along with office space and industrial plant.

It is remarkable that today, more than

a century after *Progress and Poverty*'s publication, followers of Henry George have made little attempt to incorporate this financial development into their treatment of rent.

For a modern macro-economic rent theory to recognize these processes, it is necessary to integrate rent theory with banking theory to create a general theory of *rentier* income, and of society's growing debt - mortgage debt, public debt, business and personal debt. Every flow of income, of saving and of debt must be related to the whole system-wide process, not treated in isolation.

7. Today's fiscal crises stem largely from a failure to tax rent and land-value gains.

A strong case can be made that the United States, Europe and Japan have run increasingly large budget deficits as a result of their failure to tax real estate (along with the oil and gas sectors, mining and the air waves). The government's failure to tax real estate leads to budget deficits financed by yet higher interest charges. Yet the lion's share of the rental income freed in this way has not ended up in the pockets of the landlords, but has accrued to the banks and other lenders.

Rental income thus has been transformed into interest. On the economy-wide level, new savings tend to constitute an accrual of interest on past savings (by the wealthiest 10% of the population plus the large institutional investors) that are lent out in a credit pyramid growing at an exponential rate (the rate of interest).

8. Integration of the 'real' economy and finance — with finance the most 'real' driving force.

Economists analyzing land-rent should be in the forefront of all the groups to understand the remarkable stock-market run-up since 1993, for what has fuelled this run-up is accumulated rental cash flow, recycled as savings. The mechanism is classical in its simplicity. Rent is squeezed out of real estate and paid to the bankers and other mortgage lenders as interest. Indeed, landlords are willing to pay all their net rental income over and above costs as interest, in the hope of reaping capital gains - mainly, land-value gains.

The creditors recycle their interest income into yet more lending - mainly mortgage lending under normal conditions. But since 1991 there have not been normal conditions. The world real estate bubble burst (except in Russia, where it was just beginning). The banks' loan policy was based mainly on mortgage lending, which had fallen into depression. With this market dead, they lowered the interest they offered depositors, so as to reflect what they could earn by investing these deposits in government bonds. (The Federal Reserve System's quarterly flow-of-funds statistical reports clearly document this manoeuvring.) Depositors had grown accustomed to high rates of return during the bubble years of the 1980s. In search of continued high returns, they shifted their savings out of the banks into money-market funds and mutual funds. These in turn invested their new-found money not in real estate, where the banks had been putting it, but in the stock market. The upshot was a run-up in the Dow Jones from 4,000 to 6,500 points, while real estate prices barely budged.

The stock market has been inflated by savings that hitherto have gone into bidding up the price of land. Who should see this more clearly than Georgists? They need only remember their rent theory to see the extent to which real estate is the primary source of economic surplus, new saving and capital-market funding. Yet the Henry George movement has not pursued the analysis of rent to ask what happens to rental cash flow (and land-value gains) when it no longer is recycled into new mortgage lending. Land speculators are vilified, but not the mortgage bankers standing behind them and supporting their tax breaks politically, in the knowledge that most land rent will be transmuted into mortgage interest in due course.

A successful theory must warn of a major anomaly soon to appear. One seems to be at hand in the teeter-totter movement between stock market and real estate gains. As a symbiosis has developed between the real estate sector, finance and insurance, the dream of post-industrial economies voiced in the 1970s is turning out to be merely a real estate and stock market bubble (euphemized as 'gentrification'), rather than an upgrading of productive capacity and living standards.

It is the lull before the storm - a storm most likely to hit when governments find they have sold off all their assets in order to keep paying interest to their bondholders. At this point, they must either default or begin to tax their real estate holders and the financiers behind them.

The theory of rent and land value gains can offer an explanation of this crisis by showing how real estate investors expend their cash flow, and how the economy's savings are channelled to increase real estate prices so as to create financial bubbles.

As a proportion of total US state and local revenues, real estate taxes have shrunk from nearly 70% a half-century ago to just about 30% today. While gross rental revenue was in the neighbourhood of \$600-\$700 billion in the early 1990s, only about 0.3% of this was paid out as federal income tax.