# Comments on "Echoes of Henry George in Modern Analysis"

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ABSTRACT. These comments were presented at a session entitled "Echoes of Henry George in Modern Analysis" held at the 2002 meetings of the Southern Economic Association.

These three papers demonstrate how Henry George's late 19th-century economic thoughts not only echo but indeed resonate in modern economic analysis. George's influence is not confined to land issues but permeates into welfare economics, macroeconomics, urban economics, public economics, economic development, and environmental economics. However, too often in textbooks as well as in scholarly literature, George's thought is compartmentalized, acknowledged in discussing a topic such as how the elasticity of supply affects the welfare loss of taxation, but then ignored in the chapter on tax policy. So it is an excellent contribution to show how George's thought still resonates in the topics analyzed in these papers.

In an echo, a person calls out to a vista, and the voice bounces from walls and mountains back to the caller. An echo is more haunting than a mirror, because the returning voice is not a replicated reverse image. In an echo, it seems like the mountains and walls are returning the call. So, too, in modern echoes of George's thought, the modern analyst does not merely replicate but rather invokes George, harking back to him for inspiration, analysis, and expression.

To change metaphors, the citation and replication of writing are but the visible tip of the iceberg, the submerged part being Georgian influence and theoretical structure that is tacit, unacknowledged, perhaps unknown and even unknowable. Much of one's influence leaves no trace; it can be a student who gets an idea and much later expands it into creative new thought, the original seed long forgotten. It can be lines of analysis and structures of thought that subtly

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The American Journal of Economics and Sociology, Vol. 63, No. 5 (November, 2004).

alter one's view of the world, without being some specific text or proposition that can be explicitly cited. So the echoes in these papers represent only the visible, explicit echo of Henry George, while the more implicit and subtle influence perhaps has become such a part of the theoretical infrastructure that it is no longer seen as Georgian. Such may be the case, for example, in George's marginal analysis.

## Land Speculation

THE PAPER BY NICOLAUS TIDEMAN, "George on Land Speculation and the Winner's Curse," touches on auctions and land speculation. Land speculation is at the heart of Georgian macroeconomics, including George's theory of the business cycle and his explanation for poverty and wealth inequality, and yet this is the most neglected and misunderstood aspect of his thought. Free-market analysts (those who believe unimpeded markets work well) typically believe that since markets are necessarily and ubiquitously efficient, land speculation is rational, productive, and just. Those not so enamored of unhampered markets typically do not differentiate between the current intervention-skewed markets and the pure market and so, seeing "markets" as flawed, they seek immediate governmental remedies for effects; the concept that other interventions could have caused the dysfunctions lies outside their scope of vision.

The Austrian School of economic thought has given us the insight that all human action is speculative, seeking means toward ends in the face of an uncertain future. Therefore, speculation per se, as the imagining of future outcomes, and action based on this speculation of the future, cannot be a dysfunction. In Georgian analysis, the reason land speculation becomes a problem is that it takes place not in a pure market but in a market already skewed by intervention. But this is a type of intervention that lies outside the imagination of conventional free-market thought, because it is an intervention not of governmental malfeasance but of societal nonfeasance. It is the nonfeasant failure to harness site rentals.

Tideman invokes George's proposition that the taxation of site rentals is better than neutral, since not only has it no excess burden, it can have an excess benefit in enhancing the productivity of land

use by eliminating market-hampering land speculation. George's proposition is that people take title to more land than they productively use or let others use.

Consider a vacant lot in the city center, next to a tall building. There is much foregone rent in the vacant lot, perhaps generating a bit of rent as a parking lot, but only a small fraction of the potential rent, let alone the return on the potential building. But the holder expects that in a decade the growth of population, commerce, and infrastructure will warrant an even taller, bigger building. A building constructed today would have to be torn down then in order to make the best use of the land in the future. The building is a long-lasting capital good that takes much time to return the cost plus a profit. So construction is held off. And if in fact the expectations are realized, this withholding of use is rational and productive, as the gain from the rentals would be less than the cost of destroying the capital goods.

But in historical fact, such expectations are often not realized. Ten years into the future, the demand has not risen so much, but the holder now expects this to happen in the next decade, so he holds on. Yet once again, in the following decade, again the expectations were wrong, but the holder still expects the gains to come and holds on. And so the parking lot continues year after year, the holder constantly optimistic, even though the hopes turn out to be in vain. Ex post, the land is seen as underused and causing construction and production to be located elsewhere, namely, at the urban fringe, contributing to sprawl.

As Tideman writes, in a market economy we expect competitive markets to lead to efficient resource allocation. But, as Tideman notes, in fact the optimal time of development often does not get correctly identified by landholders. Sites stay idle long after the structures of nearby sites have been fully depreciated. Urban development leapfrogs out, a pattern inconsistent with efficient urban growth, and this cannot be fully explained by zoning and other government interventions.

Why would land speculation not optimally determine the most efficient time to develop the land, and why would errors in expectations not be seen as the normal functioning of entrepreneurial profit and loss, rather than a systematic market failure? The puzzle is solved by

the phenomenon called the "winner's curse." As Tideman notes, the various bidders in an auction, or markets that work like auctions, have differing expectations about the future. The highest bidders are those who have the highest expectations, but typically these turn out to be too optimistic, becoming errors.

Empirically, the winner's curse is persistent and prevalent across many markets for goods. Is it not irrational to make such errors, especially when bidders are aware of the phenomenon of the winner's curse? Economic rationality should be regarded as having two elements: economizing in the achievement of ends, and having consistent preferences. Rationality should not be regarded as requiring mathematically correct beliefs about future probabilities. Entrepreneurship is founded on hope and, without false hopes, fewer useful projects would be initiated, because some expectations that appear to many to be foolish do get realized and yield large rewards. Hope itself is a human good, something that provides utility. So the optimistic bidders, even while they fully realize they may be too optimistic, enjoy the utility of exercising their hopes. This is why rational people buy lottery tickets even when they fully realize the mathematical odds. The difference is the hope they enjoy in itself. Just being in the hope game has value aside from the possibility of winning.

The winner's curse actually has two different effects for land speculation. As Tideman points out, the systematic continuously unfulfilled expectations of escalating site rentals leads to the persistent underdevelopment of city centers and sends development out to the fringes, where there are higher infrastructure costs, reducing overall productivity. In Georgian terms, the urban margin gets shifted out to margins where rent is lower, and this increases rent in the city while it also increases the costs of transit and infrastructure.

The second effect of land speculation, noted by Mason Gaffney (1994), is that in some places there is too much investment in fixed capital goods such as office buildings or shopping centers, resulting in a dearth of circulating capital. Austrian and Georgian theories are complementary here, as Austrians recognize that excessive investment in higher-order capital goods, such as caused by an artificially reduced rate of interest, can lead to an economic downturn when the invest-

ment stops. Georgian analysis adds the land component, as land prices, driven higher by speculative buying, increase costs and squeeze out profits, thus contributing to the diminution of space-needing investment.

As Mason Gaffney (1994, p. 93) puts it, land speculation has two effects. In what Gaffney calls "type A," buyers "force the future" by developing for future rather than present-day demand. "Type B landowners hold land unused or underused" and "free-ride on the future."

This leads back to the question of whether the winner's curse in land speculation implies that, as Tideman states, a pure free market does not efficiently allocate site resources and patterns of site development. Does the pure free market fail? We need to first avoid the error made by many critics of free markets and realize that actual markets have been skewed by intervention. Hence, the outcomes we see are not those of pure markets. In particular, when government provides the civic infrastructure, including public works, security, schooling, and recreation, all this is capitalized into land values, and when the expectations of the continuation and expansion of such civic provision leads to holding land idle for future gains, this is no free-market outcome. In a pure market, there would be no taxation of labor and capital as such. The owners of real estate would need to pay for the civic services they use from private if not governmental providers, and this would come out of their rental revenue. Thus, much of the capitalization of the civic infrastructure would deflate and be gone.

Second, a pure free market would have atomistic agents bidding for sites not in economic isolation but rather in the context of organized civic communities. With all public goods provided by private-sector proprietary firms and voluntary civic associations, the apartment house or office building would be under the contractual governance of a proprietary or civic community that would have a stake in the rents and site values (MacCallum 2003). The members and proprietors would seek to maximize their rental income, which would lead them to charge for sites according to the potential current rent rather than the rental the title holder happens to get. For example, the company that maintains the streets, parks, recreation, and street

lighting is not going to let a site ride free on the services just because it is currently a parking lot.

The pure free market would thus induce efficient land speculation, as overly optimistic landholders would face explicit carrying costs that would make them confront economic reality. Moreover, the landholder would sometimes be a proprietor in possession of a whole business district and thus make development decisions that internalize the infrastructure externalities and could more easily reverse past errors with reconstruction. Large-scale owners of real estate would have boards, shareholders, and executives with diverse views, which would tend to reduce the winner's curse of the single owner.

Thus, while Henry George regarded the public collection of the land rent by government as the remedy for land speculation, the speculation that has occurred historically due to the winner's curse cannot be ascribed simply to market failure, since markets have been mixed with intervention, and pure markets would harness much if not all the rental for civic uses. In either case, the free market does not fail.

## Public Finance and Urban Economics: Optimal City Size

RICHARD ARNOTT'S PAPER ASKS, "Does the Henry George Theorem Provide a Practical Guide to Optimal City Size?" The paper invokes the Henry George Theorem (HGT), which states that at the optimal city population, the total civic land rent (aggregate rent minus the nonurban rent) equals the cost of providing public goods. The public good is fully paid for by the rent, with no user fee, since the marginal cost of providing one more user is zero. This modern Theorem echoes and vindicates Henry George's proposal for a single tax that finances public goods. The HGT thus applies to public finance as well as to urban economics.

Arnott's model uses a featureless plain where labor is exerted at one point. With identical individuals, utility is maximized at a population for which the expenditure for the public good equals half the commuting costs. The Theorem generalizes to heterogenous individuals and holds for any level of the public good. Applied to a market economy, developers compete in the creation of cities, choosing the level of public goods, and collecting the rents to pay for them. Since

rent is the revenue and the costs are the expense of the optimal amount of the public good, a zero economic profit implies the HGT, an efficiency result from minimizing the average cost in competition.

Arnott extends the HGT to contestable facilities, where the sum of land rents and Pigouvian user fees (i.e., payments equal to the social cost of the externality) cover the costs of constructing the facilities of optimal capacity. The HGT can also handle the complexity of metropolitan areas (club complexes), where different public goods (e.g., opera houses and swimming pools) can be efficiently provided in different but overlapping territories or "spatial units of replication." Arnott adds that the Henry George Theorem continues to hold in distorted economies when resources are evaluated at their shadow prices, in other words, their social opportunity costs.

Arnott states that the Georgian single tax is on "market rents" rather than on shadow rents, but actually, George intended that it be applied to the economic rent, what the land would fetch in its highest use, and so the single tax on site rentals is properly applied to the shadow rents or land values, reflecting the real costs, the social opportunity costs.

According to Arnott, the theory of optimal city size does not encompass the possibility of land speculation. However, if all the rent is collected to pay for the public good, there would be no land speculation, since future rents would all be tapped by the provider of the good. As to the question posed by the title of the paper, Arnott's answer is "hopefully in time." But the most useful application of the HGT is not to compute the optimal city size, but to confirm George's theory that site rentals not only offer the most efficient source of revenue for public goods but are also adequate to finance them. Do this, and profit-seeking developers as well as utility-seeking land users will sort themselves out in response to the rental payments and benefits.

## Environmental Economics

THE PAPER BY J. G. BACKHAUS on environmental taxes shows how George's thought also echoes in environmental economics. A key point made by Backhaus is often not appreciated by economists and environmentalists: that the use of natural resources is strongly influenced by the tax structure.

Backhaus notes that in modern public finance theory, Pigouvian taxes that compensate for externalities do not conform to the classical canons of taxation. But the canons state that taxation bear as lightly on production as possible, and since pollution and congestion impede social welfare, the compensation by those responsible does not impede production but, on the contrary, enhances the voluntary nature of the market and increases productivity. The bottom line of an economy is not the quantity of consumer goods but the well-being of individuals, which includes their time and health. Compensation for causing social costs is an excess benefit, not an excess burden, of taxing significant negative externalities.

The paper recognizes the systematic unity of Henry George's political economy. The Georgian tax constitution creates incentives for government officials to support development that generates "ever-increasing tax revenues." Unable to tax sales or income from labor and capital, rent seekers can no longer subsidize their land values from capitalizing public works, since the gain is offset by the downward capitalization of taxing the rent. The rent also sets a limit to government revenues, thus creating a tax constitution for Leviathan.

Taxing the economic rent of natural resources induces users to make optimal use of environmental resources. Use too little, and the tax is greater than the benefits received. Use so much that there are negative externalities, and those social costs get taxed, at no net gain, and in addition, the tax on natural resources includes a depletion component.

The paper by Backhaus is ambitious, extending to money, governance, and property rights, in an attempt to be comprehensive. The core of it, however, is that the current concern for the natural environment finds an echo in the thought of Henry George in that the tax on rent provides for efficient economic development and also the efficient use of natural resources, hence maximizing sustainable economic development.

## Conclusion

THESE THREE PAPERS DEMONSTRATE the echoes of the thought of Henry George in modern economic theory in the fields of auctions and

speculation with the winner's curse, in urban economics and public finance with the Henry George Theorem, and in the fields of economic development and environmental economics. Paradoxically, it is in George's core contribution, on the role of land speculation in the business cycle and distribution of income, where the echo is faintest, but perhaps a better appreciation of the thought of Henry George, along with more works like these that better reflect the echo, will lead to a stronger echo from this aspect of George's theory.

## References

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