Regulation of the Financial Industry

Do lenders need more cops or less temptation?

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Fred Foldvary, Ph.D.
Economist

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The financial crisis is creating calls to expand the regulation of the financial industry. The Federal Reserve system, Securities and Exchange Commission, Federal Deposit Insurance Corporation, and Departments of Commerce, Justice, and Treasury all regulate the financial industry. Moreover, the Federal Housing Administration and the Department of Housing and Urban Development regulate real estate, along with state laws and regulations. These agencies also provide insurance and guarantees. A reorganization of regulation would be warranted, as the current mix evolved without any integration into a coherent whole.

But beyond mere reorganization, there are calls to extend, strengthen and tighten regulations. The claim is that financial firms took on excessive risks, with nobody to stop them. They say the financial crisis was caused by defaults on a risky mix of mortgages packaged into securities which were sold to financial firms world-wide, and that the failure of any large investment bank or brokerage firm affects the entire financial structure, and so has to be watched and carefully controlled by government.

This is like taking a monkey from the jungle and keeping it as a pet in the house. The monkey goes wild and tears up the house. The owner concludes that the monkey requires greater regulation. The monkey has to be kept in a cage with strong locks. But the bigger problem is that one should not have captured the monkey and made him a house pet in the first place.

The financial crisis is not a result of the market being too free. There is plenty of regulation and a multiple of loan and deposit guarantees. The deep problem is not in the financial industry, but in the real side of the economy, in real estate.

The most important collateral for loans is land value. Trillions of dollars of land value back up real estate mortgages and packages of loans derived from real estate mortgages. Land seems superficially to be good collateral. There is trillions of dollars of land value, an almost inexhaustible supply. Land sits there and can’t disappear, move away, or hide. And best of all, land values increase over time, so if a bank makes a bad real estate loan, it can foreclose and sell the property for a higher price.

The problem with this is that land has a zero cost of production. So land values can fall down to zero, and the land will still sit there, but the loan will be worthless. Moreover, there have been real estate cycles for two hundred years, with periodic downturns of land value. When land values fall, of course the entire house of loan cards will collapse. Real estate loans are also based on the value of buildings and other improvements, but what goes up during the boom is the rent and land value, not the value of the buildings.

The rise in land values becomes magnified as land speculators jump in and buy properties for resale at higher prices. Land then becomes priced not for current use but for expected future demand, which at the peak of the boom is overly optimistic, as those speculators with the greatest expectations are the buyers, soon to suffer the winner’s curse.

Critics of freedom say that this is the free market at work, and this “unbridled capitalism” needs to be reigned in with regulations. But the rise of land values is not a result of a free market. Land values capitalize the benefits of locations. The infrastructure and civic services — streets, highways, parks, recreation, security, fire protection, and schooling - make land more productive and attractive, which increases rent and land value. If taxation were on this rent or land value, the price of land would get capitalized back down. But only a tiny portion of taxes fall directly on landowners. Most taxes fall on wages, goods, exchanges, and business profits.

Much of taxation actually indirectly falls on rent, as lower profits reduce the rent that merchants are willing to pay. But by tacking the tax to wages, business profits, and goods, the taxes also fall on production, creating an excess burden or deadweight loss, reducing consumption and production, a misallocation of resources that creates economic waste and less growth.

If these taxes were shifted to land value, the price of land would fall to a tiny amount just high enough to facilitate the sale of land. The gains from land speculation would vanish. Mortgage loans would be collateralized by the value of buildings and of income from tenants, rather than land value. The boom-bust real estate cycle would disappear.

Perverted fiscal policy is the root cause of the mortgage crisis. Shift to land value taxation, and there would be no need to mess with financial regulation. The only legal requirements for loans should be full disclosure of the terms, and the prohibition of fraud.

The steps from rising land value to mortgage defaults are easy to understand, yet they are not obvious to superficial thinking. The call for greater financial regulation misses the deep land-value cause of the crisis. If all they do is tighten regulations, after the economy recovers, there will again be a boom-bust cycle. Unfortunately, even economists and financial experts are not learning the right lesson from this real estate crash.

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Fred Foldvary, Ph.D.

Economist

FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org since 1997. Foldvary's commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He t

Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary's areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.