OXFORD ECONOMIST SHOWS HOW TO LIGHTEN THE GLOOM

Small step – but in the right direction

IN THE summer of 1987 it became clear that Britain was in the midst of a classic land boom. To the public, this took the form of a buoyant market in house prices. With unemployment decreasing, and inflation relatively low, a surge in the value of a family's prime asset - the house - was something to enjoy.

Tory politicians and academic economists wallowed in a sense of self-satisfaction: Prime Minister Margaret Thatcher's reforms to the labour and capital markets had seemed to do the trick, with productivity rising and Britain no longer the Sick Man of Europe.

As someone schooled in the dangers of speculation in the land market, however, I interpreted the signs as ominous. And on the basis of my readings of previous cycles in land prices, I was led to this prediction:

"The next major economic recession – the one that will cause widespread unemployment and business closures – will occur in 1992."[1]

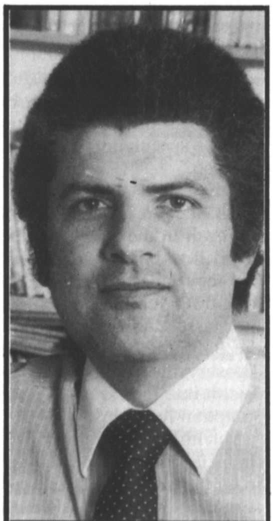
I also made several other predictions.

• "The Japanese .... will now buy real estate in the capitals of the world." They did; in the 1970s, it was the sheikhs who went on a property-buying spree, in a rush to spend the massive increase in oil-rents that flooded into the hands of the OPEC cartel.

In the late 1980s, it was the turn of the Japanese, who were at least spending the surpluses they had earned through trade with well-satisfied customers.

• "Is it possible to prevent the next great slump? Not this time. President Reagan's tax-cutting policies have left people with more money in their pockets, and the result - again, proved by history - is the tendency to push up the price of land."

The US land market exploded in the 1980s, crashing first in Texas, most recently in New England; and the banks are beginning to scream from the pain of non-performing loans to the real estate sector.



FRED HARRISON recalls his prediction that 1992 will be the year of depression.

AT THE time I published these forecasts, orthodox economists were breathing sighs of relief: the world economy had not slumped, following the crash of the stock markets in October 1987.

The economists - and government Treasuries - ought to have been sounding the alarm bells. Instead - complacency!

They were wrong. I was right.

But in terms of raw data, I had no more to go on than they did. The difference was that I was taking into account the trends in land prices, the historic lessons of which are there for all to see.[2]

To be fair, data on the land market is not readily available. It was not until last year that we had access to a thorough assessment of nation-wide trends in land prices in Britain.

Data in the United States is in an even poorer state. Because of their fiscal policies, information is in a more accessible form in Australia, but - again, because of theoretical misconceptions - little use is made of it to alert the policy-makers.

As a consequence, the seeds of destruction were sown during the high growth period of 1985-89. And now, even the most resilient of optimists are acknowledging the possibility that the world economy could dive into a "hard landing."

There is one honourable exception to the rule that

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• **When land speculation drives up prices, builders strive to make their houses affordable by cramming more units on to each acre at their disposal.**

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academic economists – those without a background in the philosophy of American social reformer Henry George – are blinkered.

John Muellbauer, of Nuffield College, Oxford, has closely studied the UK economy. As a result, he has developed a unique understanding of how the land market has undermined the efforts of the Thatcher administration to break away from the boom-bust cycles.

He summarises the work by himself and a few colleagues in a recent isue of ROOF, the magazine published by Shelter, the housing charity.[4]

He identifies all the relevant pressures on labour mobility and capital investment, and unambiguously declares: "Ultimately, it is the rise in the value of the underlying land that is the problem."

Despite the publication of Muellbauer's essays in academic journals, and his papers delivered to seminars in Whitehall and Westminster, he is alone – among mainstream British economists – in insisting that something needs to be done to curb the rise of land prices.

He acknowledges the role of other factors, such as deregulation in the financial markets, but returns to the comment that "Land speculation plays its part too."

Others, like City economist Tim Congdon, have warned that a growth in the price of houses could destabilise the economy, but they failed to differentiate land from trends in the value of other assets. As a result, "neither the Bank (of England) nor the Treasury incorporated housing wealth into their quarterly consumption functions."

Muellbauer explains: "With financial assets alone standing in for the wealth effect, one consequence was that after the October 1987 stock market crash there was a large overestimate of the reduction in consumer expenditure predicted to follow. Since house prices continued to rise strongly, the slight reduction in aggregate wealth was quickly washed away. Not recognizing this, and overemphasizing stock market wealth, monetary and fiscal policy were left far too loose".

Officialdom was therefore caught by surprise when the balance of payments tipped deeply into the red. To curb demand, it was therefore necessary to raise the cost of borrowing money; high interest rates are now crippling entrepreneurs – all because the land speculators were given a free hand to grab something for nothing!

THE ROLE of the land market on wages has also been monitored by Muellbauer.

High house prices crowd out workers from areas where the jobs are in plentiful supply, which helps to push up wages. In addition, as people's disposable incomes decline – with the rise in mortgage payments – they are compelled to seek high wage deals with employers, to restore their former living standards.

In the face of these fundamental pressures, the exhortations by politicians – "one man's wage increase costs another man his job" – means little. Mrs

REFERENCES

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2. Fred Harrison, *The Power in the Land*, London: Shepheard Walwyn/ New York: Robert Schalkenbach Foundation, 1983.
3. Ronald Banks (editor), *Costing The Earth*, London: Shepheard Walwyn, 1989.
4. "The Great British Housing Disaster," *ROOF*, London: Shelter, May/June 1990.

Thatcher is currently claiming that workers and their employers hold their fate in their own hands: the government has yet to learn the lesson that the fate of the labour market was sealed in 1985, when speculators started to buy and sell land at rates of profit that had nothing to do with the productivity of the economy.

This is the logic of a trend measured by Muellbauer: "Between 1981 and the second quarter of 1988, the price of an average building plot, relative to personal disposable income per head in the UK, rose from 1.6 to 4.1 in England and Wales, and from 2.3 to 7.2 in the rest of the south-east."

The expansion of borrowing on the back of the increase in asset values also drove up interest rates, at the expense of investors who wanted to create jobs and wealth

Completing the vicious downward circle into depression, Muellbauer notes the effect on the housing market. "With house and land price to income ratios at current levels, there is little scope for landlords to make good economic returns from renting property at affordable rents. Thus, there is little hope of expansion in a private rented sector offering affordable rents and so little hope of achieving improved labour mobility."

Throwing more money at the problem - Thatcher's solution, which Muellbauer rejects -only aggravates the crisis.

The distortions need to be eliminated - yet, surprisingly, these have been ignored by Margaret Thatcher. Surprising, because the central tenet of her economic philosophy is the need to free up the markets in favour of efficiency.

Instead of doing so, however, the government's abolition of the residential property tax merely consolidates the inefficiencies in this sector. What needs to be done? Muellbauer declares: bring back the tax on residential property - ideally, tax exclusively the value of land.

"First, it would be a tax on

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CONFUSING WEAKNESSES

IN SEARCHING for the flaws in conventional economic theory, Britain - as ever - provides an illuminating starting point. For two reasons: the UK is the neatest of the major economies to monitor, statistically, and the most volatile in behaviour, ***writes Ian Barron.***

Take inflation. Margaret Thatcher came to power as a "monetarist". Since 1979, however, Milton Friedman - arch exponent of monetarism - has disavowed key elements of the Conservative Government's actions. Not surprisingly, because much has happened that is inconsistent with the Chicago School's theoretical expectations.

Right wing economists in Britain - especially the ones associated with the Institute of Economic Affairs, who have taken a pride in advising a compliant Thatcher government over the last 10 years - are now faced with the extreme embarrassment of explaining why the economy is sliding into recession.

Events are rapidly depreciating professional reputations, but theories are also back in the melting pot; especially monetarism, which - as practiced - has been found to be wanting in the real world.

Christopher Huhne - an advocate of a tax on land values, who has been acclaimed joint winner of this year's Harold Wincott prize for excellence in financial journalism — (the premier award in Britain of its kind) notes:

"Some analysts became worried by the growth of credit and 'broad' money - bank accounts - in 1987. But why was the growth then any more worrying than the similar pace of growth in the preceding years, when there had been no ill effects? Why worry when M4 - the main broad money measure - had grown even more rapidly in 1981 and inflation had fallen?"

"The broad money measures were roundly discredited as an indicator of spending and hence of potential inflationary pressure. But other indicators hardly fared better. The main 'narrow' money measure, MO - notes, coin and bankers' cash at the Bank of England - failed to capture the inflationary problem of 1973-4. During the recent episode, it only began to accelerate above a growth rate of 5% at the beginning of 1988 when most of the problem was in the pipeline."[1]

One reason for the confusion is the failure to define "inflation" properly. Another is the failure to isolate the unique dynamics of the land market. These weaknesses are evident in a study by Geoffrey Wood, professor of economics at the City University Business School.[2] As a consequence, he emphasises a monetary strategy for future reforms:

"Control of the money supply implies a tight constraint on the rate of growth of the balance sheet of the banking sector as a whole. Even more basic is control of the rate of growth of the central bank's own balance sheet. Discipline should start at the top. The Bank of England should limit the growth of its balance sheet."

The USA has a well-disciplined, independent central bank which the British are now proposing as a model for the Bank of England. And Japan is not noted for financial laxity. Yet both have suffered from a boom in land prices, which is at the heart of current economic traumas.

No matter how stringent monetary policy, speculation will take place when the balance of advantage shifts in favour of the land market. That's where the trouble begins and ends: and monetary policy, lax or tight, does not play the prime role in starting or stopping it.

Monetarists need to get out into the real world.

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putes, rather than assuring the right of peoples to trade with one another, the nations put the emphasis upon the precise issue which is, itself, one of the most prolific causes of war.

All the great modern states are turning away from freedom of trade, and indeed, from trade itself, and forbidding their people the right to earn their own livelihood and to associate freely with one another in industry. In order to accomplish this end they are compelled to regiment the lives of their people under state bureaucracies and his can be accomplished only by a despotic state.

If the powers of the modern states are to be augmented by conferring upon them the right to run all industry, despotism is inevitable. A dictator may, by reducing the standard of living and regimenting the people, run all industry within the state over which he rules, but a democracy, which, if it is to be true to itself, must preserve individual initiative, can not do so without transforming itself into a dictatorship.

BANISH POLITICAL CORRUPTION

The third great principle which Henry George gave his life to promote was the necessity for government, especially in democracies, to free its processes from the influence of corruption. Indeed, in the great municipal campaign in New York City in 1897, Henry George waged a relentless warfare upon the corruption in both the Democratic and Republican parties of that day. The people of New York flocked to his standard. He had stirred them to their very depths; but his physical strength was not as strong as his indomitable spirit, and a few days before Election Day of that year, after three wonderful speeches the night before calling upon the people of New York City to free themselves and their city from the corruption which debased and degraded them, he died.

He laid down his life in that great campaign – the corruptionists won that battle, but his leadership in this direction generated a spirit which has asserted itself many times since then, and Henry George's stirring words in that memorable campaign made an impression upon many of the young men of that day who had been proud to enlist under his banner.

Since that glorious but tragic battle the spirit and the ideas embodied in Henry George's philosophy of freedom have gone marching on. Throughout the world he is known and his influence is profoundly felt. The truths which he enunciated have not yet been adopted, but they can never be forgotten. Those of us who believe in the Democratic ideal believe that they will triumph.

1992 AND ALL THAT ...

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residential land and land zoned for residential use. Second, it would be indexed annually to local land prices indices. Third, it would be collected by the Inland Revenue with the rates of tax being set nationally at uniform levels.

"Such a tax would have the major macroeconomic benefit of preventing house and land price to income ratios from beginning their upward march once again when interest rates eventually come down.

"It would permanently prevent the sort of overshoot in this dominant form of personal wealth, which has done so much damage in the last three years, both by reducing the housing wealth/income ratio and by dampening down the dynamic process we have analysed. It would therefore make it possible to run the British economy with permanently lower interest rates, thus stimulating business investment."

Muellbauer recognizes that this fiscal reform would have enormous knock-on benefits – for example, permitting the reduction of taxes on business, and ensuring balanced growth as between the regions, as well as "recouping to the Treasury part of the benefits accruing to landowners of public investment projects."

The proposal to tax the annual rental value of land is crucial, but ought to be generalised to encompass all land.

Britain, like other industrialised countries, is now beginning to suffer from the boom in the price of commercial and industrial land. Retailers facing rent reviews have already begun to close down their businesses; but we can expect to see a sudden increase in vacant office blocks, too, as the property speculators discover they have over-reached themselves.

But while John Muellbauer's proposal may be a partial one, it is a vital first step in the correct direction. It remains to be seen whether his colleagues also see the light, come the depression of 1992.