

# Policy-makers beware!

Fred Harrison warns economists that they will forever grope in the dark for answers to the recession – unless they consider the impact of land on the economy

**R**ONALD REAGAN'S tax cuts are giving the US economy a look that is distinctly similar to John F. Kennedy's phase of income tax cuts.

The experiment in the mid-'60s to boost investment and jobs through a reduction in the tax burden ended with a slump. Corporate profits and consumer spending reached a high point in 1965, but the economy went into a recession late in 1966.

The same pattern can be discerned this year, with profit margins recovering along with a spending boom in response to the largest tax cut in the country's history.

*The bottom line, however, is also going to be written in red.*

- The savings rate – on which the US depends for new investment – plunged from the normal six per cent to a 33-year low of four per cent.

- While capital spending continued to lag, investment in real estate soared – another re-run of the Kennedy era. The Reagan Administration's tax cuts were supposed to encourage capitalists to invest in productive enterprises; but there was a boom in tax shelters, with real estate leading the field.

- Consumer spending slackened in August, and the economic indicators turned for the worse – an outlook that Washington (and even Wall Street) glossed over as a slowdown for the better: too fast a recovery, went the soothing orthodoxy, would overheat the economy and send up interest rates.

Growth rates of 9.7 per cent in the second quarter and 7 per cent in the third quarter appear to be the best in the "recovery": growth could be down to 3 per cent in the first quarter of 1984.

Underlying the confusion was the absence of a coherent theory to explain the economic trends. Reagan's supply-side economics had not worked. For example, the tax cuts – worth \$245 billion over four years – were supposed to be self-financing: they weren't, and the budget deficit soared.

But did the deficits send up interest rates and curb entrepreneurial activity? Yes, said Mr. Reagan's chief economic adviser, Martin Feldstein, on September 14. No, said the President's

Treasury Secretary, Donald Regan, who could not resist a dig at his professorial colleague:

"Economists who continue to claim that deficits make for high interest rates should climb down from their celestial observatories and acquaint themselves with terrestrial fact."



● Ronald Reagan

Bereft of theory, economists have been grasping at straws for their optimistic predictions. Renewed activity in the housing and motor industries were taken to represent the upturn in growth rates; these sectors, alas, have failed to sustain their earlier momentum (see insets, this page and next).

**W**HAT HAS gone wrong with the "monetarist" strategy? Disinflation in Britain has had no measurable influence on the level of unemployment and capital utilisation.

Business failures continue at record levels. The worst hit sector is the retail trade in which bankruptcies rose by 76 per cent during the first nine months of 1983.

Mrs. Thatcher's government could claim that it is deliberately not seeking to intervene, this activity being the function of investors and employees, not politicians.

Whether the British government can be exonerated for what now happens, then, depends on one's view of whether such a passive role amounts to a benign framework for entrepreneurial activity.

President Reagan, however, claims to have engaged in a more active programme, principally through his 25 per cent tax cuts. In defending the final 10 per cent cut, the President attacked Democrats who wanted to increase welfare spending and cut budget deficits by raising taxes. He said on June 29:

"Liberals in the Congress have renounced John F. Kennedy's criteria for growth and opportunity – meaningful tax-rate reductions for every working American."

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## SHELTERED INTEREST

BRITISH house-builders have resorted to giveaway gimmicks to sell houses.

Even so, the promising upturn in starts early in the year began to peter out in the summer, and was 13 per cent down in the May to July period over the previous three months.

Almost half a million construction workers are jobless, and the prospects continue to be bleak as the buyers' ability to buy weakened in the face of a marked increase in prices relative to incomes between April and June.

Industry spokesmen continued to warn the government, which nonetheless maintained an upbeat view of the industry's ability to drag related sectors out of the recession.

There was no disguising the plight of families seeking homes in the US. An extra 1.5 to 2 million households are now in rented accommodation: under 1980 conditions they would be

owning homes, according to Massachusetts governor Michael Dukakis in a letter to the *New York Times* on September 8.

The house-building rate slackened in June and July, after prices rose to a record average of \$90,700. The industry is forced to turn out a higher proportion of land-saving multi-family units than before rather than the more profitable single-family houses, and the early upsurge in activity favoured the Sunbelt states.

Business analysts continue to blame the industry's woes on interest rates, even though the real after-tax rates for housing loans (calculated to be four per cent for the average taxpayer) was not high at all by historic standards. The real cost of land, however, continued to soar, thereby pushing house prices further beyond the reach of buyers.

But the cuts have not generated net benefits for every working American. The President claimed that a typical family's tax bill would be \$700 less after this year's cut. This may have pumped \$30 billion more into consumer pockets, but it was offset by the increase in state and local taxes, higher interest rates and tax "bracket creep": yet another similarity to the Kennedy experiment.<sup>1</sup>

While people on low incomes have ended up paying more to the Internal Revenue Service, the top income receivers are paying less – and they are the ones who have avoided entrepreneurial risk taking by pumping the savings into tax shelters.<sup>2</sup>

The President himself saved \$90,000 on his taxes last year because of his Economic Recovery Tax Act (1981).

Administration spokesmen tried valiantly to put a gloss on the statistics, but hawk-eyed critics were ready with the facts. In one devastating critique, Budget Director David Stockman was accused of "cooking the numbers."<sup>3</sup>

The tax cuts led to a lop-sided distribution of income that favoured the wrong kind of investments. Suppliers have acknowledged that buying real estate has an injurious influence on the industrial economy.<sup>4</sup> Their President, however, failed to neutralise the speculators who make fortunes out of land.

So there was a resurgence of interest in the country's 119 real estate investment trusts (REITs) during the summer. Their stock prices rose to their highest level since 1973.

REITs were the institutional mechanism through which speculators big and small fuelled the land market in the late 1960s, which was then translated into the speculative boom of the early 1970s.

## AUTO-SUGGESTION

THE MOTOR industry has helped to perpetuate the illusion of recovery.

Certainly, Chrysler and Ford started making profits this year, for the first time since they – and General Motors – went into the red in 1979.

There has been a boom in sales, and US dealers even ran out of stocks during the summer because of an inadequate supply of vehicles. But this resurgence has been the result of some acts of desperation.

US carmakers increased sales by 21 per cent in the first ten days of September, but this was the result of an infusion of 1984 models. What stunts are left for next year to buoy up the market?

UK manufacturers have also brought forward next year's sales by forecourt gimmicks that have slashed profits to the bone. Subsidised prices have in

some cases meant that new cars could be bought for less than the price of a one-year-old car. Bankruptcies are 29 per cent up on last year, and motor industry consultant Leon Wood warns:

"People who've taken advantage of cheap credit deals – you know, £99 down and the rest over three years – have been effectively taken out of the market for a long time. They obviously will not be coming back in 12 months or two years to change cars."<sup>\*</sup>

By buying business, then, manufacturers and dealers have misled the forecasters into thinking that there is real growth in an important sector. The sales, however, will probably not be sustained.

<sup>\*</sup>John Huxley, 'The gloom behind the car boom', *The Sunday Times* (London), Sept. 11, 1983.

## U.K. land, houses and rents

	House Price/Earnings = ratio <sup>1</sup>	Private house starts (000s)	Price per house plot: 1975 = 100 <sup>3</sup>	Commercial rents 1977 = 100 <sup>4</sup>
1973	4.11	187.5	146	79
1974	3.47	89.7	145	92
1975	3.17	129.8	100	94
1976	3.07	130.4	100	95
1977	3.03	115.6	106	100
1978	3.38	133.6	129	111
1979	3.69	121.1	183	133
1980	3.31	83.4	241	155
1981	3.03	99.6	250	169
1982	3.02	122.5	281	180
1983	3.13	75.0 <sup>2</sup>	N/A	185

1. Nationwide Building Society, 4th Q; 1983, 2nd Q.
2. First six months.
3. Department of the Environment; data for England and Wales.
4. *Investor's Chronicle*/Hillier Parker. Data for May each year.

THE IMPACT of land prices on the economy goes unmonitored because the connection is not understood to have theoretical significance.

In Britain, crude and limited data is published by the Department of the Environment on the price of housing plots, but these are quarterly figures available six to nine months after the event.



● Martin Feldstein

This contrasts with the availability of statistics that are considered to be important. For example, data on industrial production is available on a

monthly basis, and published within six weeks: so on August 12 we were told that during June there was a one per cent downturn in output of all industries (other than the oil and gas sectors).

But no official figures are yet available for housing land prices during 1983. For data on rents, and the impact of house prices and mortgages on people's incomes, we have to rely on private sources such as building societies, newspapers and estate agents (see table).

This is not to say that the British government is totally ignorant of the importance of the supply of land. On July 12, for example, Mr. Patrick Jenkin, the Environment Minister, declared:

"It is essential that future house-building should not be hampered by shortage of housing land. Except in areas of special restraint, local authorities should ensure that their plans and policies provide enough land to sustain a rising rate of house-building."

But this concern with the supply of land is not reflected in the Treasury's Keynesian model of the economy, which fails to assign weight to trends in the land market.

As a result of the theoretical hiatus, analysts will continue to be puzzled by twists and turns in production and employment levels, and the policy-makers will continue to grope around dangerously in the dark, ignorant of whether their "steady-as-she-goes" course is aimed directly at icebergs.

### REFERENCES

1. Fred Harrison, *The Power in the Land*, London: Shephard Walwyn, 1983, p.127.
2. Morton Kondracke, 'In fact, the numbers tell a story on the supply-siders', *The Wall Street Journal*, June 23, 1983.
3. Rober Greenstein, 'Stockman is still cooking the numbers', *The Washington Post*, June 19, 1983.
4. George Gilder, *Wealth and Poverty*, New York: Basic Books, 1981, pp.42-44.