

# The Coming Kondratieff Crash

## Rent-seeking, income distribution & the business cycle

Bryan Kavanagh

NIKOLAI KONDRATIEFF (1892-1938?) was a senior economist in the Agricultural Academy and Business Research Institute under the regime of Joseph Stalin. His empirical analyses suggested that economic depressions occurred at relatively regular intervals.

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He considered 36 price, value and quantity series, including wholesale prices, interest rates, wages, foreign trade, industrial productivity and commodity prices since 1789 for the US, UK, France and Germany. Smoothing deviations from the trend in these data, he concluded that economies displayed long-wave cycles of between 54 and 60 years in duration.

Tragically, Kondratieff's study apparently fell short of Stalin's expectations. He was convicted of being a member of a secret peasants' society and exiled in 1930 to imprisonment in Siberia, where he is said to have died.

Kondratieff did not attempt to give an explanation of the causality of the depressions determining the period of the longwave. He had shown only the approximate periodicity of the long-wave. Bryan Kavanagh argues that Henry George provided an explanation for economic depressions before Kondratieff demonstrated their approximate timing, and he explains why Australia, which is rich in the relevant real estate data, may be taken as a proxy for other industrialised nations when testing the current long-wave cycle

**K**ONDRATIEFF'S first cycle grew gradually from the 1788 depression to a peak between 1810 and 1817. It then troughed out into the next depression between 1844 and 1851, from which economies recovered to another high point from 1870 to 1875. Thence, they degenerated into a third depression from 1890 to 1896, from which time the cycle slowly recovered once again to a peak that Kondratieff had himself witnessed between 1914 and 1920.

*The World Economy and Its Condition During and After the War* set out his long wave theory in 1922. It remained untranslated into English until a version appeared in the *Review of Economic Statistics* in 1935. His study is sometimes claimed to have been commissioned to show that capitalism would inevitably fail. It instead depicted repetitive cycles, the first half of which tended to be inflationary, whilst the second half, especially the latter years, tended to be deflationary. At the time Kondratieff wrote, he noted that descent into another major deflation was already well underway.

As long-wave students tend to date the end of the last depression at 1949, Kondratieffian analysis would have the final deflationary phase of the fourth Kondratieff cycle (K-wave) occurring between the years 2003 to 2009. That a major price drop is currently overdue does not deny the K-wave, but shows rather its limitations: people may not with conviction set their wristwatches by the long-wave cycle.

ALTERNATIVE ANALYSES have been offered to account for the factors that may contribute to fashioning the long waves. They include the arguments of proponents of population increase, of innovation and new technologies, of monetary policy (as though the latter were unrelated to mortgages), or of economic depression as the "natural self-correcting mechanism" in the capitalist system. The data provided here seems better to support the case made in 1879 in Henry George's seminal work, which he had sub-titled: *An inquiry into the cause of industrial depressions and of want with increase of wealth ... The Remedy* (see Box 1, page 86).

### Competing theories of the cycle

In his *History of Economic Analysis*, the great economist Joseph A. Schumpeter says of "ND Kondratieff's long-cycle theory":

Kondratieff's work ... caused a great stir and constitutes, so far as I can make out, the peak performance of the work produced by a considerable number of competent economists (Perwuschin, Oparin, Sokolnikoff, and others); this work, in spite of the sinister implications of the fact that some of the authors have not been heard of since, may be taken as proof that serious economics survived until the rigors of the Stalinist regime fully asserted themselves.

Of Henry George, Schumpeter remarked:

### Box 1 Henry George's theory of recessions

IN CLASSICAL ECONOMICS, all production ( $P$ ), was distributed between land, labour and capital as rent ( $R$ ), wages ( $W$ ) and interest ( $I$ ), respectively; that is:

$$P = R + W + I$$

The classicists defined *land* to include all natural resources exclusive of man, that is, land, sea and air. This includes rents in the form of mineral licences, fishing rights, sites on the electromagnetic spectrum, aircraft flight paths, and so on.

American social philosopher-economist Henry George (1839-97) refined classical distribution theory further in *Progress and Poverty* (1879) by putting a syllogism along the following lines:

- (i) *Rent-seeking behaviours create the dual pathologies of increasing land prices and taxation, the servicing of which becomes a deduction from the incomes of labour and capital.*
- (ii) *Privately capitalised land rents and taxation devour the benefits of technological innovation, thereby creating unsustainable debt levels, involuntary poverty and recurrent periods of economic recession and depression.*

*Therefore, taking natural resource rents for public purposes, instead of taxing labour and capital, will obviate:*

- *the rich-poor gap created by a perverse distributional system*
- *unsustainable debt levels and poverty, and*
- *economic recession and depression*

By transposing non-earned rent to the left side of the equation, viz,  $P - R = W + I$ , George suggested that if all community-generated resource rents were captured for public purposes, then taxation and land price need not be deducted from people's earned incomes (from their work and savings). This "fiscal adjustment" would reconcile labour and capital, permitting a complementary relationship to develop between the operative factors of production.

George argued that the social capture of community-generated resource rents, a surplus in the production process, would correct the distributional system and remove the inducements to cyclical bouts of land speculation, the invariable outcome of which is socially damaging economic recession, or, less frequently, devastating economic depression.

But we cannot afford to pass by the economist whose individual success with the public was greater than that of all others on our list, Henry George. The points about him that are relevant for a history of analysis are these. He was a self-taught economist, but he *was* an economist. In the course of his life, he acquired most of the knowledge and of the ability to handle an economic argument that he could have acquired by academic training as it then was. In this he differed to his advantage from most men who proffered panaceas. Barring his panacea (the Single Tax) and the phraseology connected with it, he was a very orthodox economist and extremely conservative as to methods. They were those of the English "classics", A. Smith being his particular favourite. Marshall and Bohm-Bawerk he failed to understand. But up to and including Mill's treatise, he was thoroughly at home in scientific economics; and he shared none of the current

misunderstandings or prejudices concerning it. Even the panacea – nationalization not of land but of the rent of land by a confiscatory tax – benefited by his competence as an economist, for he was careful to frame his “remedy” in such a manner as to cause the minimum injury to the efficiency of the private-enterprise economy. Professional economists who focused attention on the single-tax proposal and condemned Henry George’s teaching, root and branch, were hardly just to him. The proposal itself, one of the many descendants of Quesnay’s *impôt unique*, though vitiated by association with the untenable theory that the phenomenon of poverty is entirely due to the absorption of all surpluses by the rent of land, is not economically unsound, except in that it involves an unwarranted optimism concerning the yield of such a tax. In any case, it should not be put down to nonsense. If Ricardo’s vision of economic evolution had been correct, it would even have been obvious wisdom. And obvious wisdom is in fact what George said in *Progress and Poverty* (Ch. I, Book IX) about the economic effects to be expected from a removal of fiscal burdens – if such a removal were feasible.

Preliminary Australian studies by the Land Value Research Group’s (LVRG) Tony O’Brien, complementing those of Mason Gaffney in the US, suggest that Schumpeter was unduly pessimistic about the quantum of natural resource rents.\*

AT LEAST IN THE WEST, where rent is capitalised into land prices, a time series analysis of a nation’s aggregated real estate sales will provide an empirical test of George’s theory that rent-seekers are responsible for recurrent recessions and depressions. As local or regional analyses will often be subject to local influences, compilation of such sales on a national basis will yield meaningful comparison against other national aggregates, such as GDP.

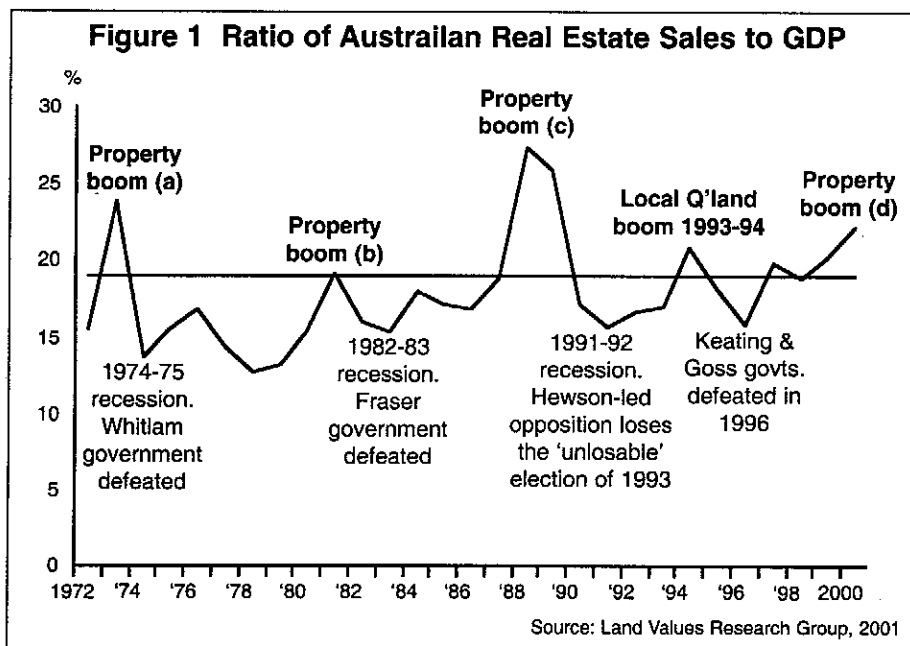
### Testing George’s Theory of Causality

The principle behind such an analysis is that the dynamic in real estate transfers, be they residential, commercial, industrial or rural sales in nature, is the land component. More precisely, it is the privately-capitalised value of economic rent that is *not* captured for public purposes. The more neutral component in real estate sales is represented by buildings, depreciating, rather than appreciating, assets. Although it may be argued that the inclusion of buildings will muddy an analysis of capitalised economic land rents, given that LVRG research concludes that land now constitutes approximately 65% of Australian property sales (compared to approximately 40% in 1972), and that the land share of real estate values is the more influential variable at times of boom and bust, certain insights may be gleaned nevertheless. Hence, analysis of real estate sales will map the progress of rent-seeking in real estate, or what is being allowed to happen with the “R” in George’s  $P-R = W + I$ .

\* Tony O’Brien, “The Pathology of Income Maldistribution”, *Geophilos*, Autumn 2000, No. 00(1).

Australia is well placed for such an experiment because its six States and two territories now all collect this real estate sales data. The State of Victoria's data first became available in 1972. Other States' and the two territories' real estate sales data were progressively available from 1979 (Queensland, Western Australia, Northern Territory), 1984 (Tasmania, Australian Capital Territory), and 1989 (New South Wales). Working from evolving sales ratios between the states and territories since 1989, the LVRG has extrapolated aggregated real estate sales for Australia back to 1972 for the purposes of developing the overview provided by Figure 1.

It is unremarkable to record that the shape of a graph of the *number* of sales has some similarity to the graph in Figure 1; that is, the value of sales is clearly numbers driven. The more difficult question is: What drives the numbers? Henry George's slant on classical distributional theory makes it eminently arguable that the dual pathologies of taxation and land price set the agenda. As tax regimes give preferential treatment to those seeking to capture increments in land price, people will logically follow this dictate. More productive pursuits become the casualties of taxation, which then reinforces the bias in favour of land speculation. The consequential decline in real wealth creates unsustainable debt levels and land price speculation. Excessive debt thus generated is eventually liquidated by recurrent periods of economic catastrophe. Whilst these financial collapses are said to be the "natural self-correcting mechanism of the



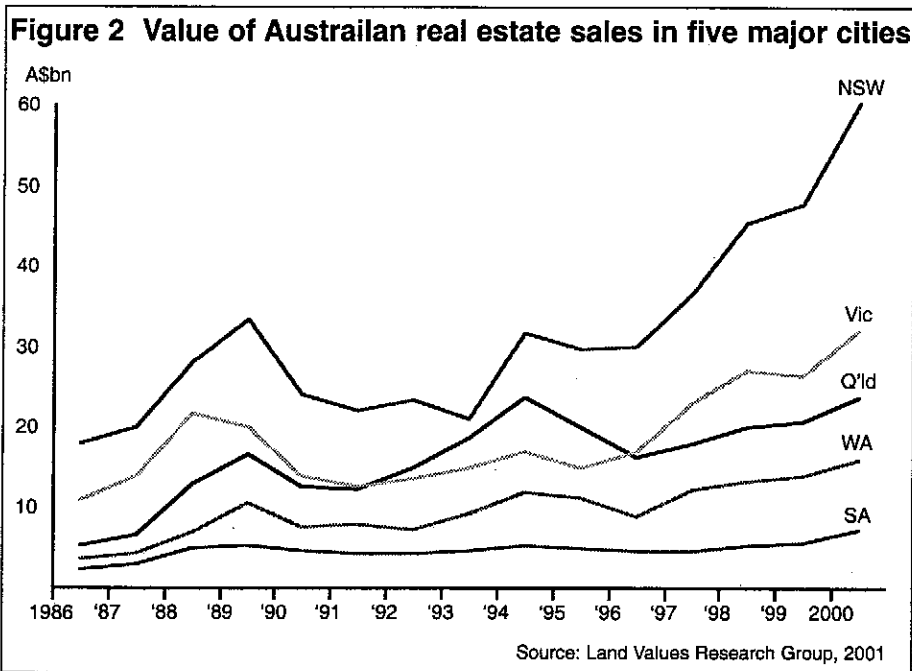
capitalist system”, the mechanism may neither be validly described as efficient or natural in view of George’s virtually untried fiscal alternative.

IN EFFECT, Figure 1 represents the “downward half” of the cycle from the peak, at end of the 1960s, of the fourth Kondratieff wave.

**After the peak: the downside**

In 1984, real estate sales achieved a ratio of 18% as against the Australian GDP, but economic recession did not ensue. Therefore, in graphing the property to GDP ratio, we have been entirely pragmatic in drawing a definitive line along the 19% ratio. Having arbitrarily defined a property boom as that situation where real estate sales surpass this ratio, it will be seen that recession has succeeded each property boom so defined. *Prima facie*, analysis in these terms appears to resolve some of the more perplexing problems of both the psephologist (hip pocket motivation of the swinging voter) and the financial analyst (cause and cure of business cycles).

Although the ratio reached 20.9% in 1994, that year has not been designated as an Australian property market peak. Whilst the level of sales activity was indeed high, nobody conversant with the Australian property market at the time would define 1994 as a boom in any State except Queensland. In fact, real estate sales in all other states were heavily weighted by the banks’ final commercial and industrial “distress” realisations emanating from the speculative excesses of the late 1980s.



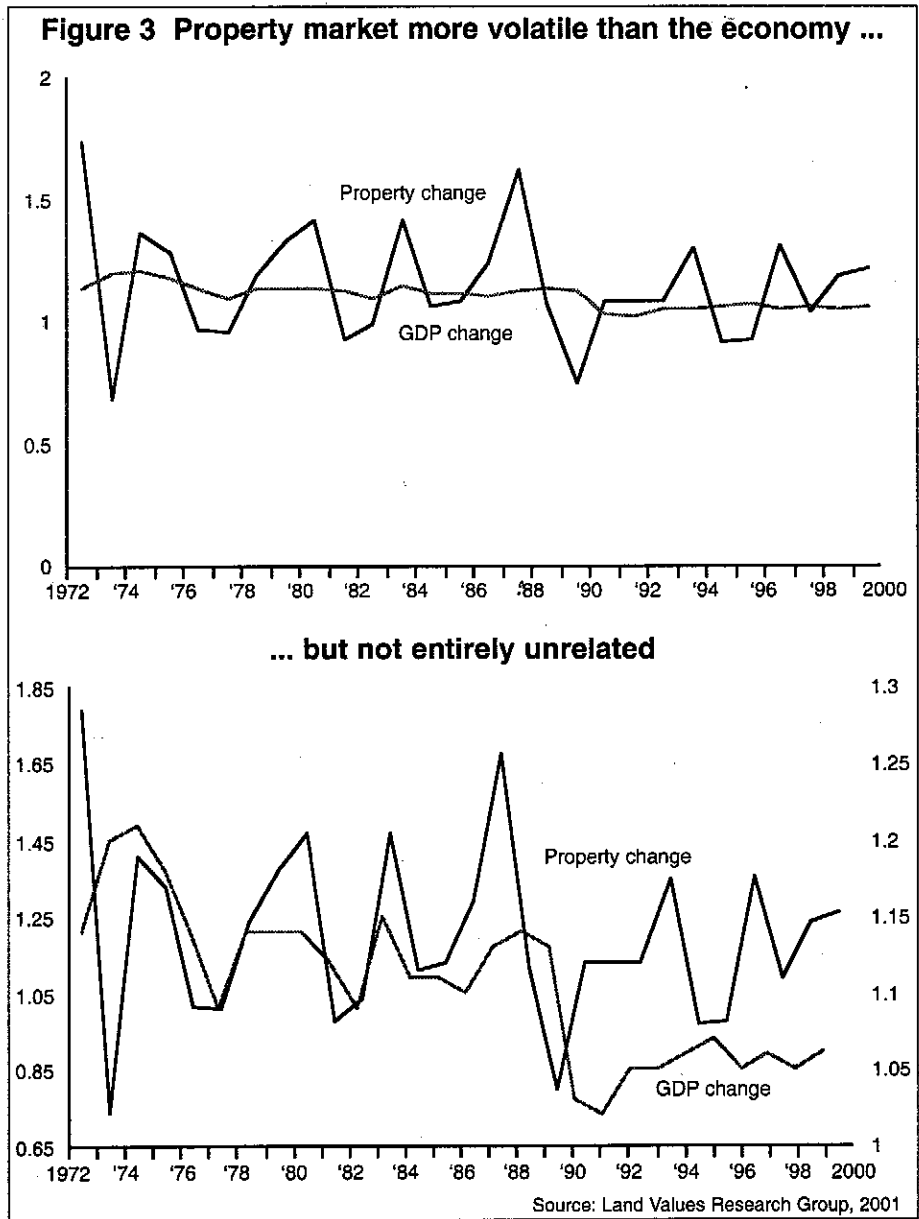
Queensland was another matter. From 1992 to 1994 Australia's third biggest state did indeed experience boom conditions (see Figure 2). In this respect, its property market was more synchronous with those of South-East Asia. In 1993, Queensland's real estate market not only surpassed that of Victoria, probably for the first time ever, but also seriously challenged the New South Wales juggernaut.

Wayne Goss, premier of the state of Queensland was one of the nation's most popular politicians when the Queensland property market burst in 1995 and 1996, contemporaneously with the markets of South-East Asia. At the 1996 Queensland election Goss was dumped unceremoniously by his recently adoring public. His State fitted the pattern developed here: it slid into a local recession of its own making following the bursting of the local property boom.

Kim Beazley and Simon Crean, respectively, are likely to be the next Prime Minister and Treasurer of Australia. Their fathers were ministers in the Labour government of Gough Whitlam which was sacked sensationally in 1975 by Governor-General John Kerr, at bottom, for economic incompetence. There is little reason to believe that economic management has improved in the subsequent generation, because Messrs Beazley and Crean junior continue to blame their political opponents for economic recession, instead of proposing to cut the Gordian distributional knot which has helped to widen a growing divide between wealthy and poor. As with the Reserve Bank of Australia, entrusted, *inter alia*, with a duty to protect the nation's currency, both sides of politics continue to rely on the blunt instrument of monetary policy as their key economic tool.

**Table 1 Total Australian Property Sales – A\$ billion**

Year	No. Sales	Value	Year	No. Sales	Value
1972	492,292	6.089	1986	508,473	40.513
1973	651,588	10.653	1987	529,932	50.034
1974	406,643	7.366	1988	694,106	81.672
1975	492,540	10.009	1989	661,503	87.709
1976	501,997	12.824	1990	486,812	65.454
1977	441,802	12.439	1991	490,167	61.993
1978	382,808	11.918	1992	532,506	67.028
1979	404,883	14.172	1993	549,183	72.246
1980	497,580	18.893	1994	620,286	93.638
1981	556,352	26.897	1995	540,909	85.708
1982	512,348	25.020	1996	505,216	80.059
1983	483,399	24.785	1997	554,287	105.068
1984	579,145	35.257	1998	555,469	106.267
1985	550,166	37.409	1999	617,217	118.893
			2000	673,422	144.188



Although monetary policy fails dismally to discriminate between rent seeking and wealth creating behaviours, politicians have been warned against looking in the direction of land taxes by a media beholden to an influential real estate lobby. As a result, the economic outlook remains bleak indeed.



This view is at odds with a talk given by the Governor of the Reserve Bank of Australia, Mr Ian Macfarlane. In his speech, entitled *Economic Developments at Home and Abroad* to Australian business economists and the Economic Society in Sydney on 10 July 2001, Mr Macfarlane made the curious statement that "asset price inflation of either shares or property had not become a problem" for Australia. He appeared to seek exoneration for the Reserve Bank for any downturn by suggesting that "The major threat to our future growth prospects now comes from the international economy, not from domestic factors." It is most difficult to reconcile these statements with Figure 1, showing Australia to be currently teetering at one of the portentous property market peak observed by Henry George. Kondratieffian analysis would have it as the prelude to the deflationary *fin de siècle*.

In the light of empirical facts suggesting that there is, in fact, a reciprocal relationship between real estate investment and the creation of wealth – in other words, between rent seeking and a nation's economic health – Henry George's remedy still awaits trial application. It is not only politicians, but leaders also of business, public instrumentalities and the churches who should be alarmed at the urgency of these economic signals. History will surely condemn their complacency should they fail to look at the extraordinary employment opportunities to be gained by shifting taxes off production and onto resource holding.

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 Office of The Valuer-General, Northern Territory  
 Office of The Valuer-General, Victoria  
 Residex Pty Ltd [New South Wales data subsequent to 1998]