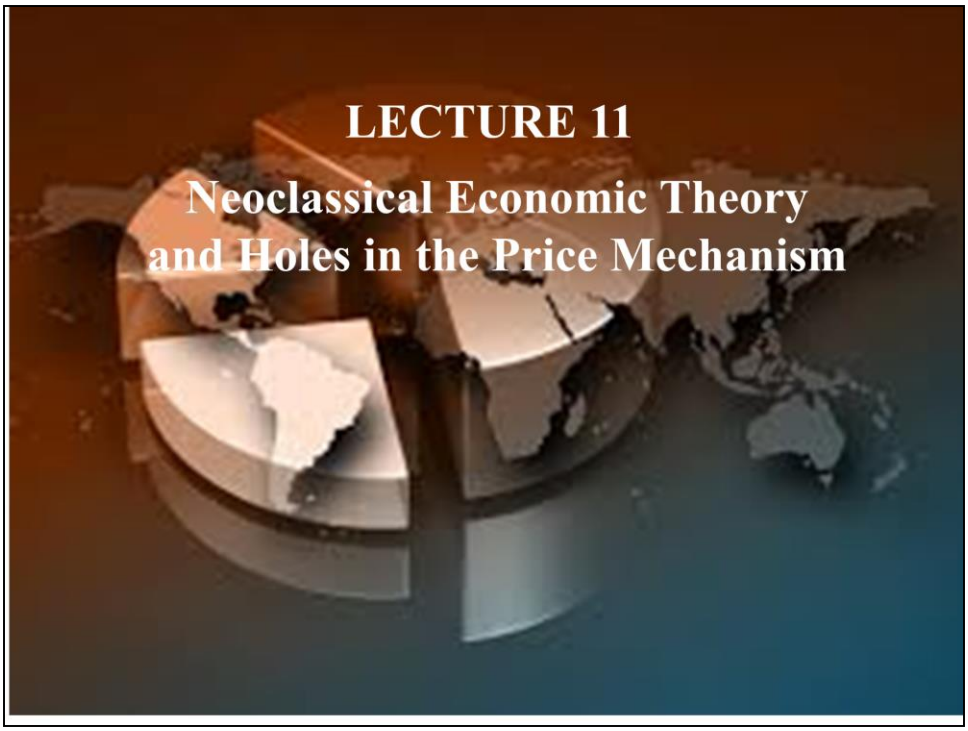
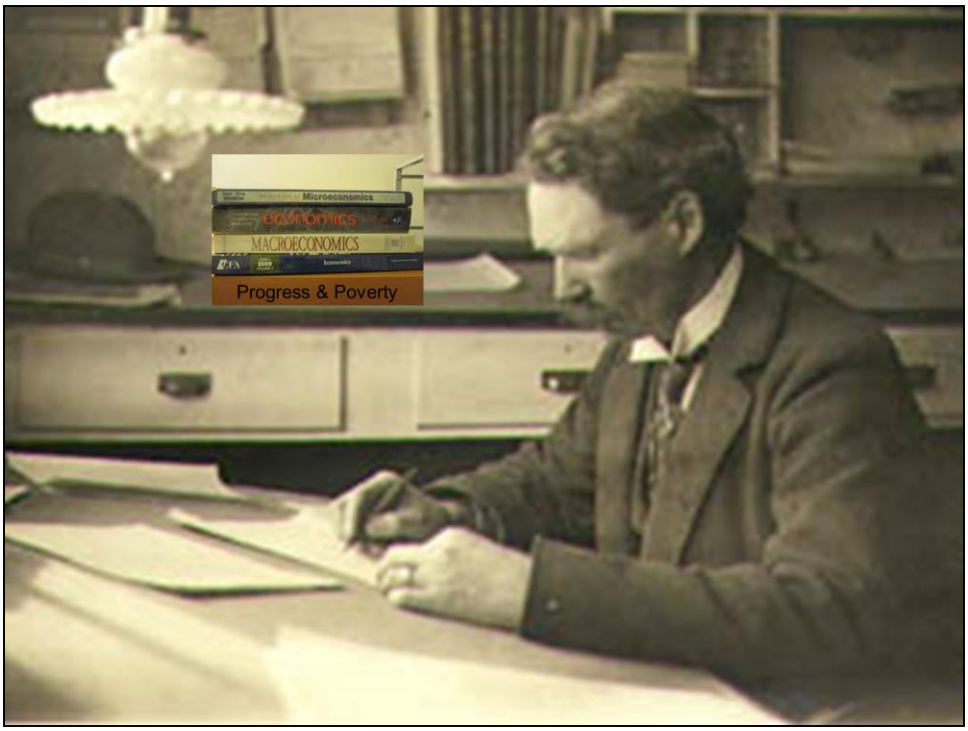
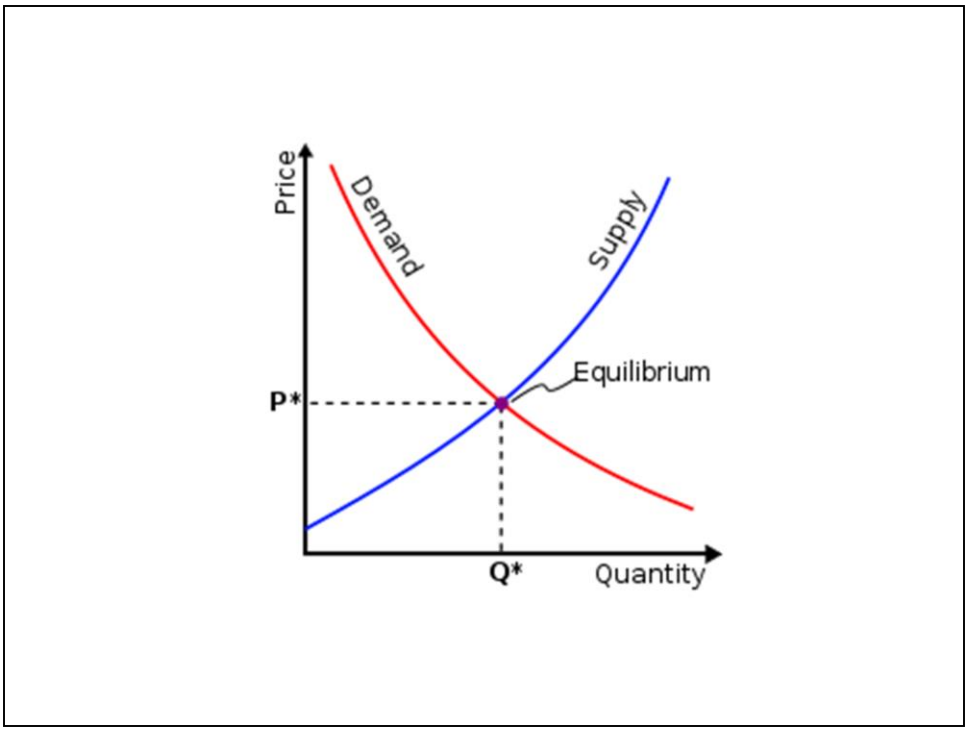

Understanding our Political Economy


LECTURE 11
Neoclassical Economic Theory
and Holes in the Price Mechanism

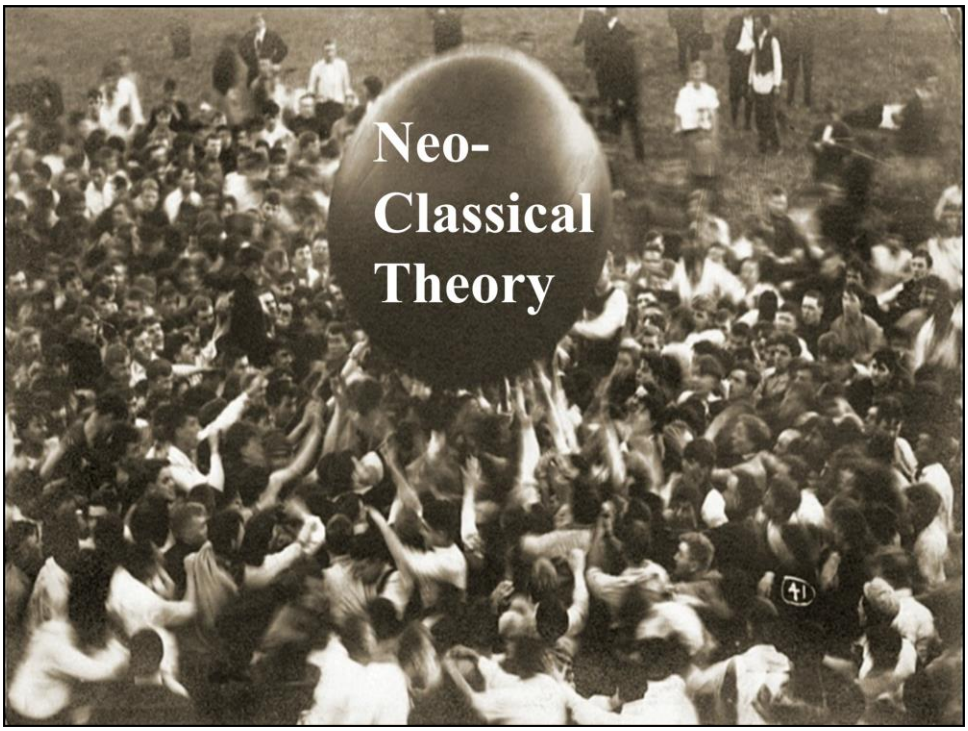
**Already during Henry George's lifetime, the political economy he worked to refine was under attack by the European-trained economists, such as Richard Ely, who sought influence and status within government and corporate circles.**



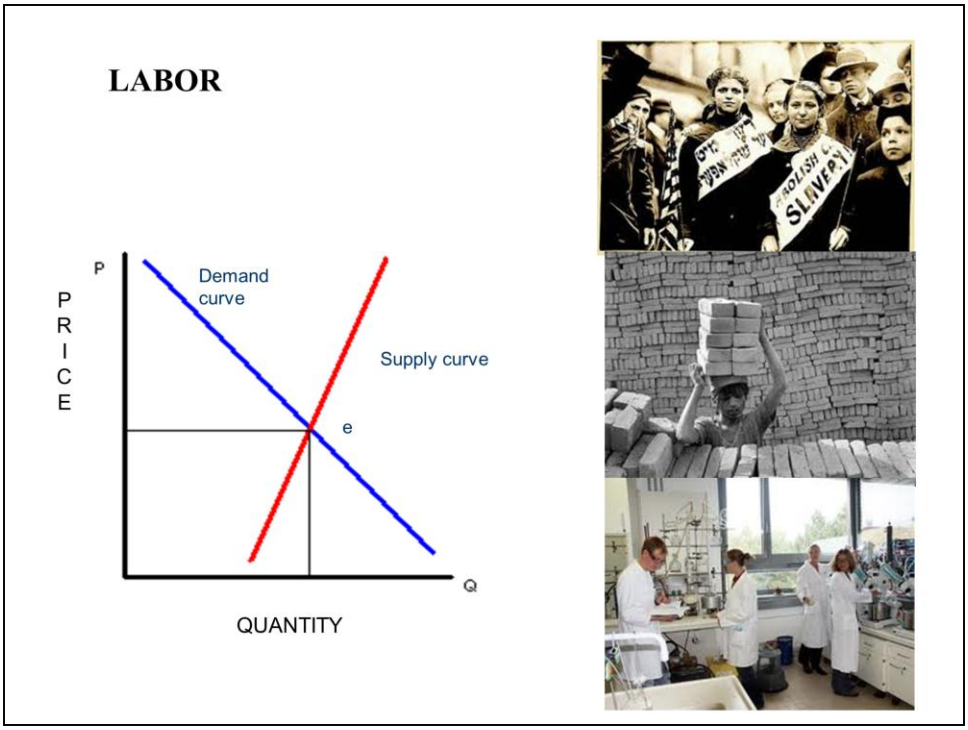

**The focus of the economists' research and writing was far different from than that of their predecessors and contemporary political economists. An important theoretical question economists wanted to explore was whether price clears all markets.**




**This graphical illustration of how price theoretically clears markets conveys the assertion that those who supply a good or service and those who demand a good or service will agree on a price for a given quantity. Where the supply and demand curves intersect is the point of equilibrium. An expansion of these relationships to the larger economy is the basis for general equilibrium analysis.**



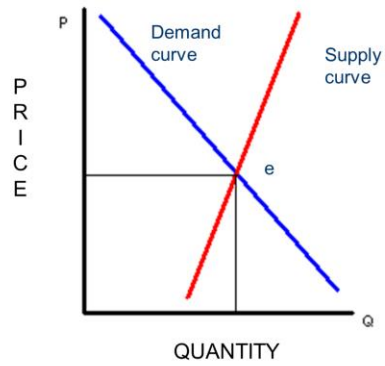

**Many of the European-trained economists embraced a simplified neo-classical theory of markets, asserting that price serves as a market-clearing function for all factors of production and that markets always return to general equilibrium, where price is high enough to satisfy those who bring supply to market and low enough to satisfy those willing to pay for any good or service.**




**Neo-classical theory applies in a general way to labor market dynamics because labor, in the aggregate and as a factor of production is quite sensitive to changes in the price offered in return for labor. Moreover, most people must continue to offer their services in exchange for compensation even as the wages they are offered are being forced down by market conditions. Of course, there is a lower limit to what individuals are able to accept as monetary wages, namely, what enables bare subsistence.**

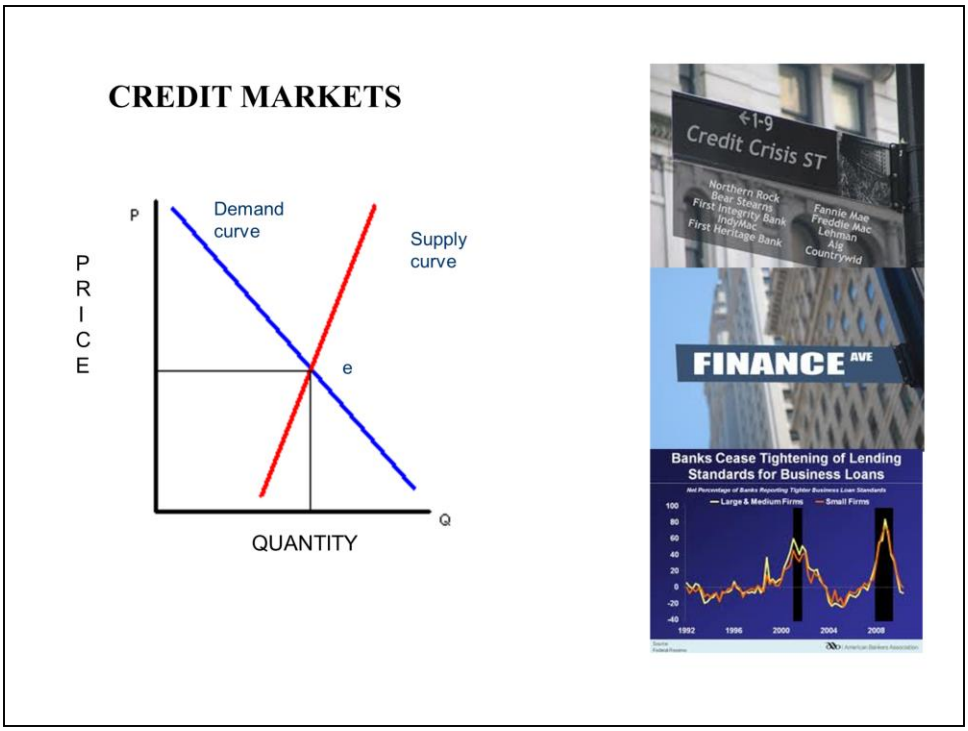

**Survival requires that the majority of us continue to produce wealth – or provide services -- without pause. Wages (what the effort of our labor produces) must be at least subsistence level or there is no incentive to actually expend effort to produce goods or provide services.**

## CAPITAL GOODS




**The same is true for the markets for capital goods, which are also sensitive to the price mechanism. Equipment, buildings, etc. all depreciate over time and suffer loss in "functional utility" as well as exchange value.**


**An important characteristic of capital goods is that they require continuous infusion of labor and new capital goods to maintain both use value and exchange value. Capital goods are depreciating assets, and some capital goods lose exchange value over a shorter period of time than their actual usable time.**

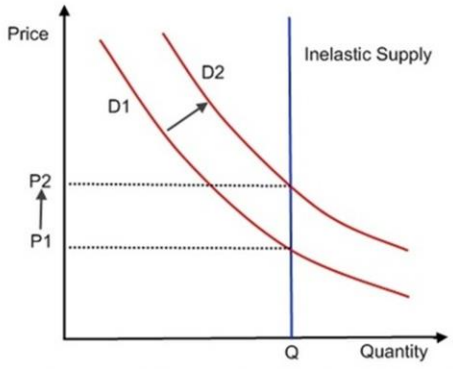



**Now, what about credit markets? The demand for and supply of credit is also relatively sensitive to the price mechanism. Central banks rely on this by lowering interest rate charges in order to stimulate borrowing or raise interest rate charges to make borrowing more expensive and thereby try to bring a halt to a general increase in the price of goods and services.**


**Deregulation of U.S. financial markets and of banking that began in the 1970s expanded access to credit and competition among credit providers – at least initially. Credit is normally competitively priced for risk – when the actual risk is analyzed and disclosed to lenders and investors or when other, generally political, considerations are not involved. An unforeseen consequence of financial deregulation has been a dramatic consolidation of the banking sector, which has resulted in expanded dependency on the continued operation of a small number of huge entities, entities that are perceived as "too big to fail".**


**Credit markets are also plagued by considerable fraud and predatory lending practices. Unfulfilled is the need for greater financial literacy in response to the complexity of newer financial instruments.**

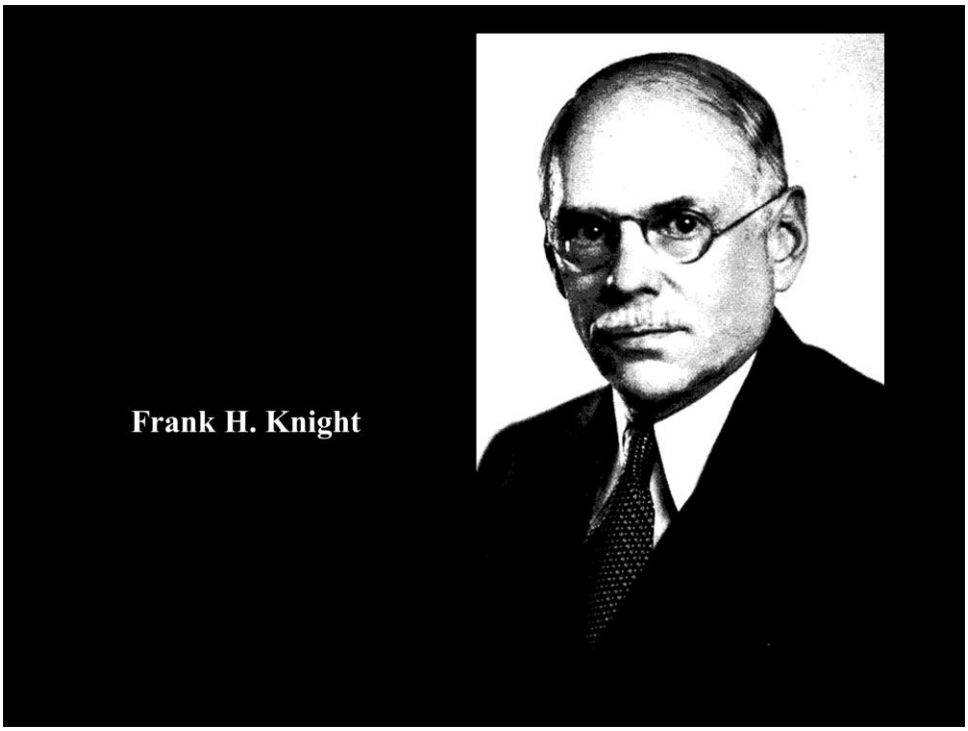
**THE PRICE MECHANISM DOES NOT OPERATE WHERE LAND (I.E., NATURE) IS THE FACTOR OF PRODUCTION**




When demand D1 is in effect, the price will be P1. When D2 is in effect, the price moves up to P2. Supply is perfectly inelastic, so the quantity supplied to the market = Q for both demand curves. Any shifts in demand will affect only price.

**Where neo-classical economic theory fails – and fails miserably – is with its attempted application of the price mechanism to markets for land (broadly defined to include rural, urban, and resource-laden) as well as natural assets with an inelastic supply. For such assets, the price mechanism does not work to clear markets; absent depreciation, the motivation is to hoard land or acquire it to hold for future increases in rental value or selling price. This is arguably the reason why the first generation of economists were compelled to remove land as a distinct factor of production. What economists could not explain away is that the supply of land is perfectly *inelastic*, which means the supply is inherently insensitive to changes in price.**


**Rising land prices provide a signal for land owners to hold land idle in anticipation of even higher price gains. Even when property markets collapse, deep-pocket investors see enormous opportunity for acquiring properties at foreclosure from owners who have run into cash flow problems.**



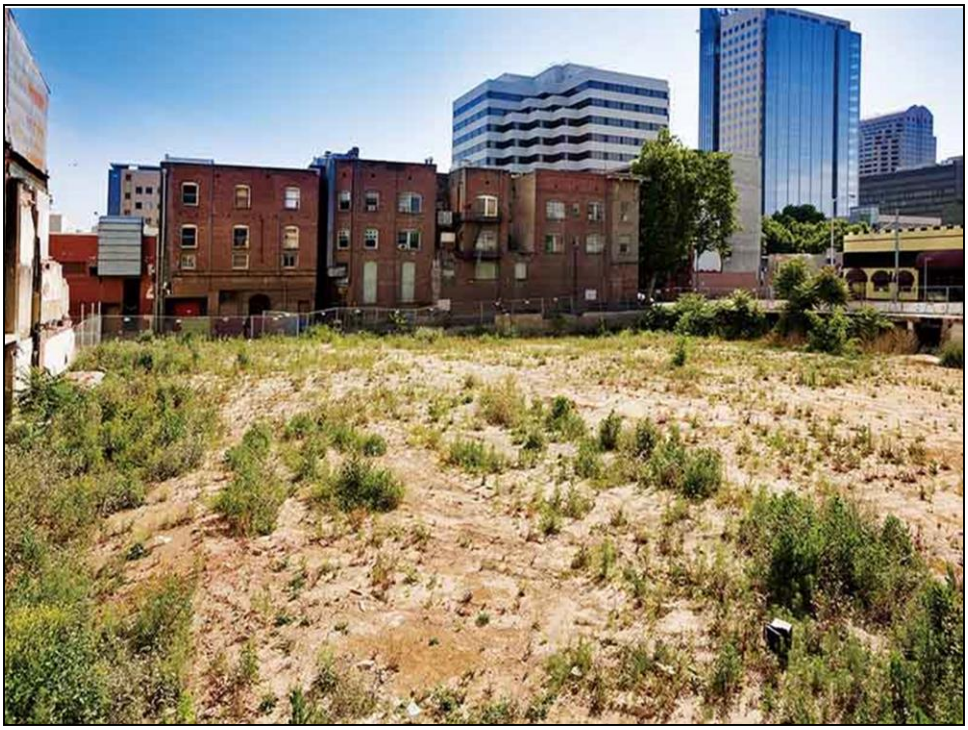

**One of the early leading proponents of the new economics, Frank Knight, attempted to justify the merger of land with capital goods for purposes of analysis. In 1956, he wrote:**

**"Land is capital merely; defined in any realistic way, it presents an infinite variety of conditions as to maintenance and replacement requirements, and possibilities of increase in supply, as does any other general class of capital instruments."**

**Frank H. Knight, *On the History and Method of Economics*, 1956, p.54.**

**"Land is capital merely; defined in any realistic way, it presents an infinite variety of conditions as to maintenance and replacement requirements, and possibilities of increase in supply, as does any other general class of capital instruments."**

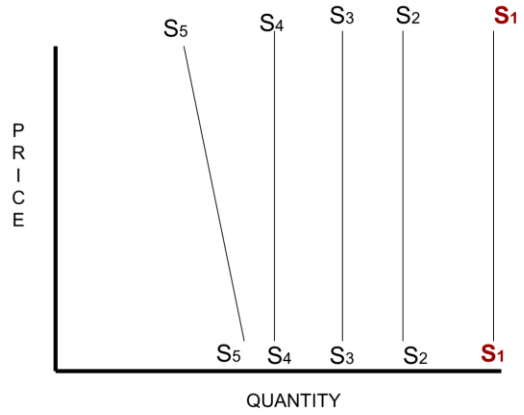
**Uniquely, however, land – as explained before, includes all of nature. And, nature has a a zero production cost in terms of labor and capital goods. Its supply is fixed, although the potential usefulness of land can change over time as a result of natural processes, human undertakings (such as the construction of dams) and technological advances.**



**In fairness to Frank Knight and other economists, it must be acknowledged that there is a degree of substitution between locations that have relatively similar advantages. This makes it seem that the supply of land is actually elastic and, therefore, responsive to changes in the market price being offered. The argument would be stronger if the land and natural resources of the United States (and virtually every other country) was more widely owned and less of it held idle when there is much higher potential productive use.**

**Getting back to the economics of land markets and the problem with the neo-classical assertion that price clears land markets in the same way price clears markets for labor, capital goods and credit, what follows is a graphical look at what makes land markets so different.**

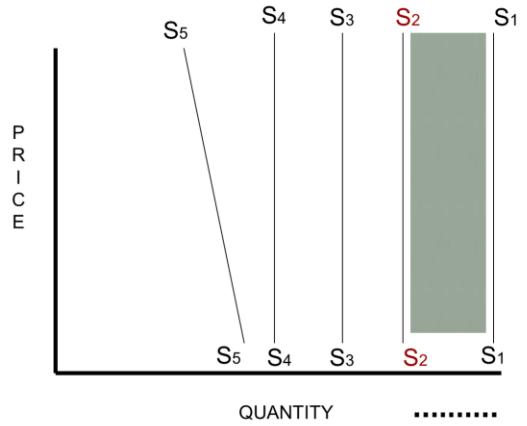
## NOT ALL LAND IS AVAILABLE FOR USE IN THE PRODUCTION OF GOODS (I.E., OF WEALTH)




$S_1$ = Total supply of land in a region without regard to topographic, other natural characteristics and societal organization

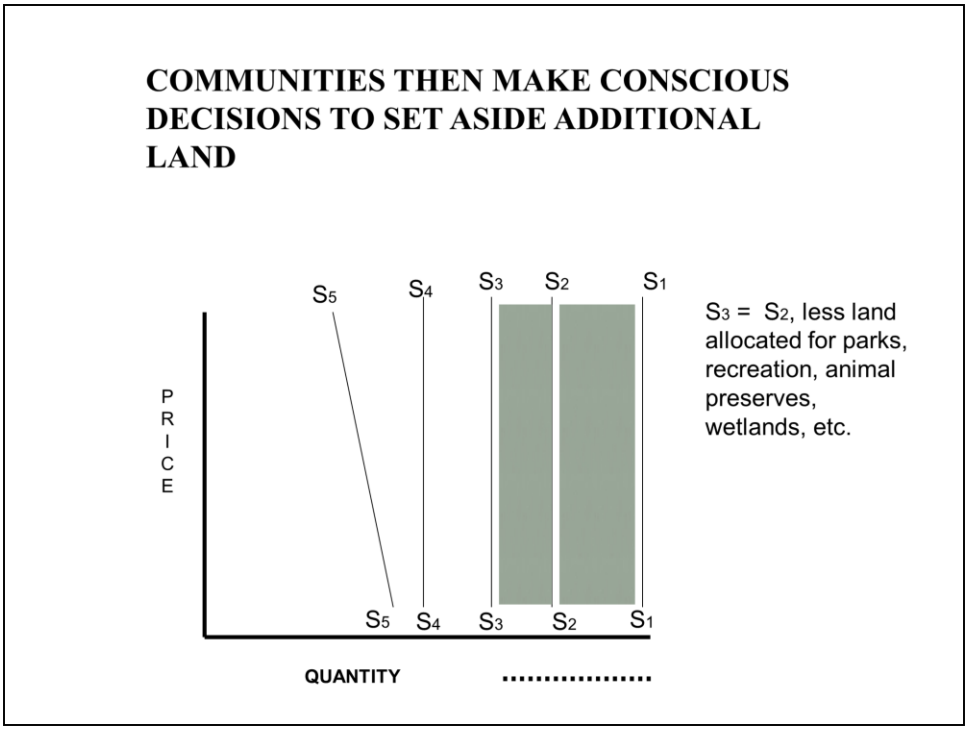
**Now, let's take a look at the supply of land that is actually available to be brought into production. In this graph, the total supply of land in a region – without regard to topographic or other natural characteristics, or to the degree of societal organization – is indicated by the curve labeled S1.**

**ANOTHER 10-15% OF THE TOTAL SUPPLY OF LAND IS NOT AVAILABLE FOR ADDITIONAL REASONS**



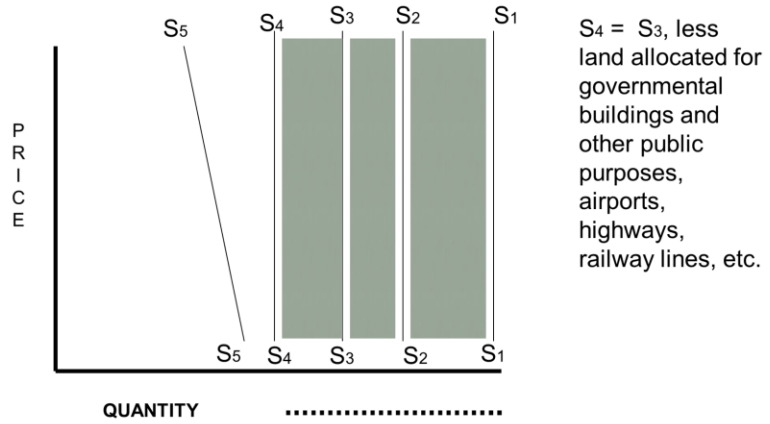

**$S_2$ = Total supply, less land that cannot be productively utilized for reasons of topography, being subject to frequent flooding, potential for earthquakes, etc. etc.**

**In our world, not all the land area of any region is available for development. A portion cannot – at least with the current technologies available – be productively utilized for reasons of topography, being subject to frequent flooding, potential for earthquakes, etc. The quantity lost to the total supply is reflected by the distance between supply curves S1 and S2.**



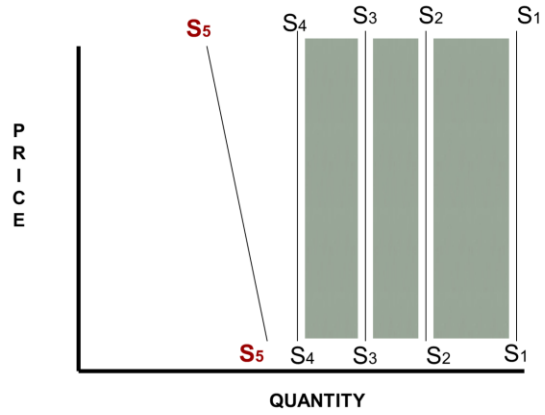

**Then, there are lands a community allocates for parks, recreation, animal preserves, wetlands, etc. In our hypothetical example, the amount of land removed from developable supply is the difference between S1 and S3.**

**PUBLIC GOODS AND SERVICES COMMAND ADDITIONAL LAND WITHIN A COMMUNITY**




**Every community also allocates locations in the community for governmental buildings and other public purposes, airports, highways, railway lines, and other public agency uses. Adding this amount of land to the total removed from supply brings us down to the supply curve S4. Thus, only half of the total supply of land is available for private development – for purchase and sale or for lease under market conditions.**

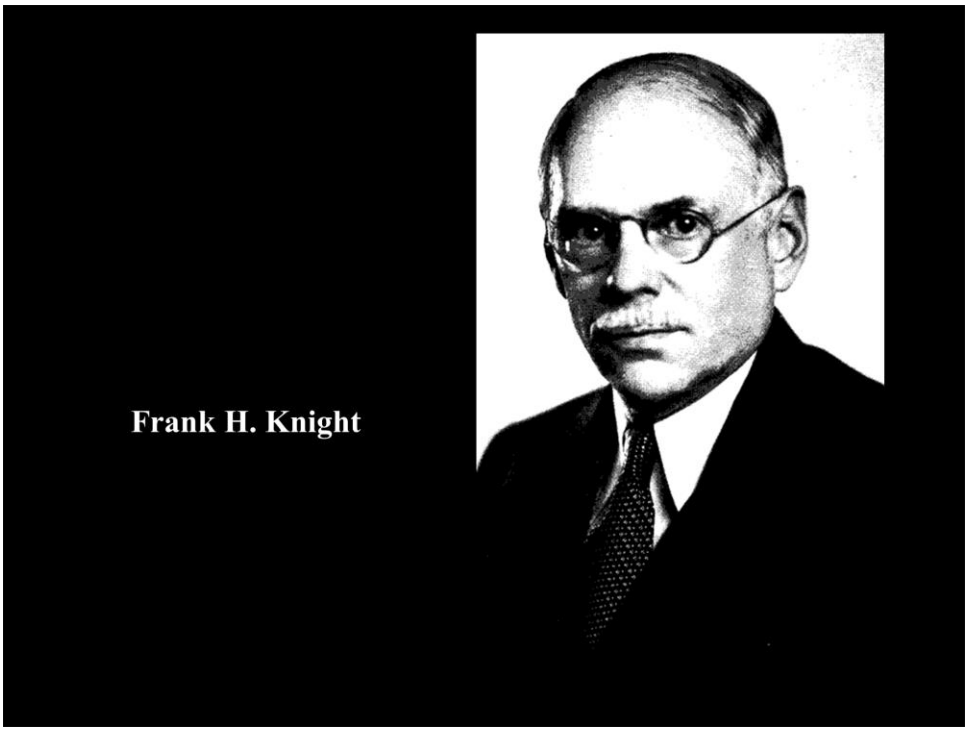
**THE NET RESULT IS THAT, ON AVERAGE, PERHAPS ONE-HALF OF THE TOTAL LAND AREA IS AVAILABLE FOR PRIVATE INVESTMENT AND DEVELOPMENT**




$S_4$ = land area actually available for development

WHY DOES THIS SUPPLY CURVE $S_5$ LEAN TO THE LEFT AS PRICES ARE RISING?

**Now, at that point, a somewhat strange-looking supply cure (S5) appears. The curve is leaning to the left, which is an indication that even as the price for locations is rising the quantity of land potentially available for development is falling. The reason is that the expectation of even higher prices is an incentive for owners of land to withdraw their landholdings from the market.**




**On the general subject of speculation, Frank Knight expresses the widely-taught view by economics professors that:**

**“All markets are speculative and, in fact, approach the character of an ideal market more or less in proportion to the degree that they are explicitly and effectively speculative, i.e., to the degree in which there is organized speculation.”.”**

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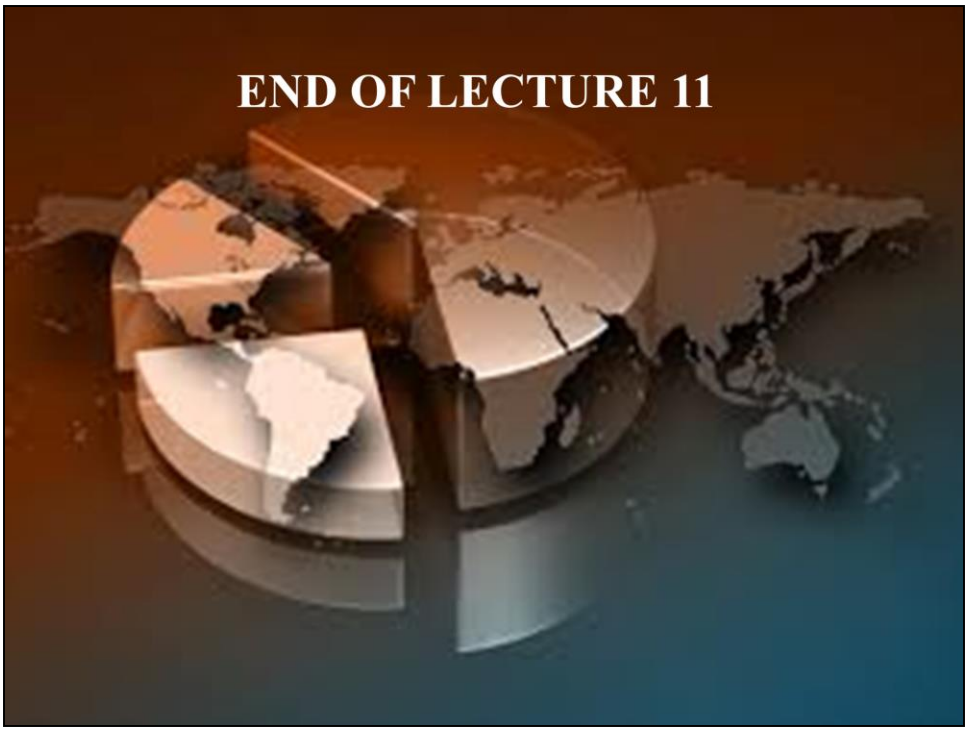
**The problem with Knight's analysis is that he does not consider the societal consequences of hoarding nature for speculative gain. The one market where speculation does not affect the general population is the market for "collectibles," such as art work or antiques or classic automobiles.**


**Speculation in the markets for financial instruments is another area where the consequences of risk-taking are sometimes imposed on the general population.**


**In this age of global, interconnected financial markets the portion of available financial reserves allocated to market speculation is huge. In this way, financial speculation draws funds away from the investment in capital goods production and real economic growth.**




**Let's now take a look at  the root cause of economic depressions.**