

Henry George School

5

Basic Economics

This lesson explores the cyclic expansions and contractions (recessions/ depressions) within the economy. In concept these economic problems are simply intensifications of the general conditions of low wages and unemployment.

There are many factors which tend to alter the production and distribution of wealth. The strongest impediment to production, and the fundamental force in altering the distribution of wealth is the inaccessibility to land.

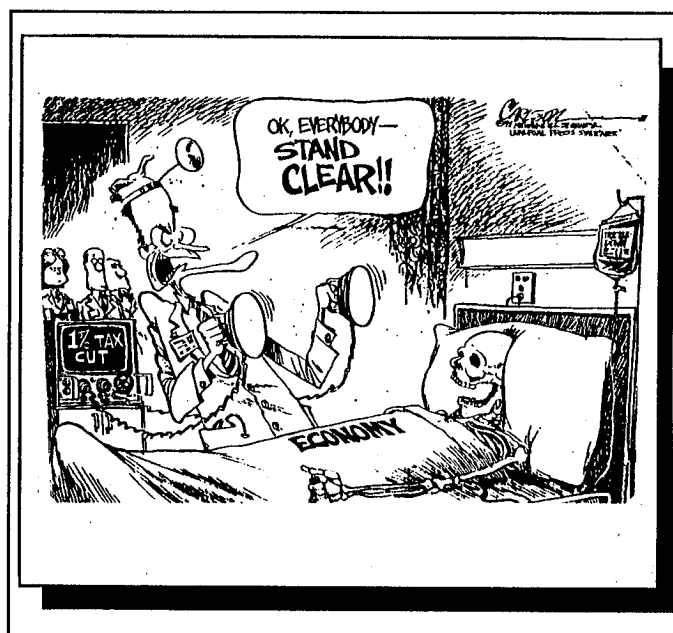
Access to land generally begins with a selling price, which in effect fixes the rent once and for all; the rent cannot be raised above the current value of the land or the user's projected ability to pay. (Buildings are not easily moved.) However, one might ask, how is a price placed on something that has no cost of production, cannot be reproduced? A parcel of land may offer an advantage and have an income, but how is that monthly or yearly income potential transformed into a single payment once and for all?

Land, which has an income, but no cost of production, is equated to capital which has an income and a cost of production. The exchange value of capital, regardless of its income (interest), will equal its cost of reproduction. Therefore a parcel of land which yields \$100 in income will exchange for the same value as an item of capital yielding \$100 in income. If interest is 4%, then the selling price of the capital and the land would both be \$2,500. The process is called capitalization. Another way to think of it is that at 4% interest, the seller would have to buy \$2,500 worth of capital in order to continue receiving the same \$100 income.

However, as the potential profits of the land increase, its price is based on the expected profits in the future. As technologies advance, the same labor and capital yield greater results, and greater profits. In many cases, by reducing the price of products, companies can so increase their volume of sales that it more than compensates for the lower profit per item, and further increases their overall profits. And it often requires more land to expand production. During periods of great technological advance, like the railroads of the last century, or computers of the present, the profitability of land increases rapidly and creates the expectation of even greater increases. As business strives to expand and increase their profits, they bid up the price of land. The owners of idle land do not experience any income from the land, the value of their asset increases. As long as the value of their land increases faster than the interest on a capital investment, the idle land is a more profitable asset. If you owned a piece of land, and every year someone offered you 12% more than you were offered the year before, the real estate tax was 2%, and the current rate of interest was 8%, you would simply hold the land for the future increase in value.

The more the economy tends to expand, the higher the price of land is bid, and the more profitable holding it as an investment becomes. At some point the price of land is bid so high that its owners refuse to sell. That's when businesses lay off workers rather than expand production. In short, when new inventions reduce the labor necessary to produce a product, the natural tendency is not to lay off workers, but to lower their prices, expand production and increase profits through increased volume. But, when the price of land necessary to that expansion is too high, it becomes more profitable to lay off the workers.

In turn the unemployed auto workers stop buying non-essentials; the reduction in the demand for non-essentials requires less people to make them; The unemployed producers of non-essentials stop buying



houses; the unemployed carpenters stop buying new cars, and so on. The reduction of demand reverberates throughout the economy in a cycle of recession/ depression.

As unemployment reduces the demand for goods and services and aggregate production falls, the price of land stops increasing and begins to fall. At that point, capital at any rate of interest would be a better investment. Therefore we could expect that land would be sold, capital would be bought, and the recession/ depression part of the cycle would over.

However, land speculators, like other investors, consider short term versus long term. When we consider the increase in land prices during the 1980s coupled with government projections of economic recovery, many of those who can afford to hold on to their land do. The more land that's held out of use, the more people are unemployed. Until the land is sold, labor and capital cannot engage in production.

In order for the land to be affordable, the economy to expand and the workers to be employed, one of three things must happen: #1. wages and interest fall; #2. the results of labor and capital increase; #3 the price of land falls. Every invention, innovation and new discovery increases the profitability of land. This increase in the profitability tends to narrow the difference between the profits from owning the land and the previously un-affordable selling price.

In the course of every recession/ depression the general rate of wages and interest fall. As aggregate production falls, less labor and capital are demanded; the laws of supply and demand lower wages and interest. The least productive workers who are still employed will get the same subsistence wage, but they will be more productive than the least productive workers were before the layoffs.

Eventually, through some combination of increased productivity, lower wages and interest, and a lower selling price of land, land becomes affordable, and the people go back to work. When a company buys a piece of undeveloped land, they not only have to acquire enough money to pay for the land, but they also have to acquire enough capital to maximize the potential of that land. If they have to borrow any part of the price of the land or the capital, the rate of interest on that loan will determine the profitability of their venture.

Sometimes the Federal Reserve increases the supply of money, and banks offer lower interest rates. This makes the land more affordable. Remember, it's the cash flow that's essential. If enough land is sold, and if enough people go back to work, the economy could expand enough to demand all the increase in the supply of money. However, if the landowners raise their prices and the land is not sold, then the increased supply of money causes the price of most everything else to go up (inflation).

QUIZ: #1. The selling price of land is based on: the rental value of the land. (A) ; the potential profits of land. (B)

#2. The selling price of land is based on: past and present profits. (A) ; expected profits. (B) .

#3. Can the anticipation of a technological discovery increase the price of land? (yes) , (no)

#4. A sudden increase in the price of oil or basic foods could trigger a recession. (t) ; (f)

#### Tokyo Nears Peak

Just look what happened to Japanese land prices last year. They soared abnormally amid speculative buying with surplus funds and low interest rates. According to the government's National Land Agency, the price of residential land in Tokyo rose 68.9% in 1987, nearly twice the prior peak gain of 35.9% in 1973, and almost triple the 1986 increase of 23.8%.

The highest land price recorded was 34 million yen per square meter, in the Chiyoda ward in central Tokyo's main Marunouchi business district. At 125 yen to the dollar, this worked out to a staggering \$6.72 billion dollars per acre.

Hold on, help is on the way. According to Oxford Analytica, a U.K.-based consulting and research service, Japanese government actions have curbed real estate speculation. In August 1986, Tokyo ordered new reporting requirements for real estate deals, postponed auctioning off of choice public lands, discouraged bank lending for speculative deals, and sharply hiked taxes on property held for less than two years.

The upshot: Land prices in the Tokyo metropolitan area are now 20% below their peak. That's the good news. The bad news, says Oxford Analytica, is that the decline is likely to be short-lived. It could bottom in June or July as real estate firms finish disposing of excess holdings. A new round of increases could follow. Reason: "Major public works projects in Tokyo Bay and neighboring areas are likely to fuel an urban-renewal boom, thus overwhelming the government's current anti-speculation measures." *Barron's* - April 4, '88