Secret of the Economic Sponge

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Politicians cannot be trusted: they do not keep their promises. That mantra is deployed to justify the apathy displayed at times of general elections. But the corrosive effect of that popular assessment is once again driving the rise of extremist political parties in Europe. The deep-seated cynicism is understandable, but it is corroding the foundations of the democratic process. What makes this crisis tragic is that both the voting public and the politicians seeking a mandate to govern are victims of a willful blindness in the theory of economics.

Most politicians sincerely want to improve the welfare of the people whose votes they seek. Earnest efforts are made to identify the policies that would make life more comfortable. And yet, time and again, large gaps separate the promises from actual outcomes. Why? The answer is to be found in the land market.

The land market operates like a sponge. Its job is to measure and collect the net income of society. The net income is what is left after deducting the wages of Labour and the profits of Capital. What remains is soaked up in the price of land. Now, because politicians are kept in ignorance of this process, they repeatedly make promises which will be defeated by people who operate in the land market.

Take, for example, the promise to cut taxes. This featured prominently in Britain's 2015 general election. Politicians sought to out-bid each other with promises to cut this or that tax. They created the impression that this would leave more money in people's pockets. And yet, in the fullness of time, people discover that they are not better off. So they assume that their government lied to them. Dissatisfied public, bewildered politicians!

So what actually happens? If wages across the economy are at competitive levels, a cut in income tax results in an equivalent increase in the price of houses. This happens because people operating in the property market are able to monitor the rise in take-home pay, and they exercise the power to charge more for the use of land. That insight is now beginning to percolate into the theorizing of a distinguished economist: Joseph Stiglitz.

The Crisis of 2008

Governments claimed that, if they expanded the money supply in response to the financial crisis of 2008, they would not only save the banks; they would boost employment and productivity. The defect in that strategy was not satisfactorily explained until Joseph Stiglitz analyzed it in December 2014.

Stiglitz is one of the most important academic economists in the world today in terms of academic status and experience (chief economist at the World Bank, former Chairman to Clinton's Council of Economic Advisers, and now professor of economics at Columbia University). In a presentation to the Institute for New Economic Thinking, Stiglitz explained why the trillions of dollars, pounds and euros created by central banks failed to deliver sustainable growth. His starting point is the distinction between *wealth* (which includes land) and *capital* (which does not include land).

Stiglitz follows the money trail to explain the major impact of the trillion-dollar credit creation since 2008. The money ended up in the land market. The credit resulted in an

"increase in the value of land – not the creation of more land, but just to the increase in the price of existing land. Indeed, the amount of capital goods may actually be decreasing, and society's future prospects may get worse even as the value of its wealth increases."

The Social Impact of Land Value

Stiglitz applied this theory to puzzles that continue to bewilder economists and governments in the post-2008 period. Those puzzles include the increasing gap between rich and poor, and the failure of productivity to increase. In discussing the work of French economist Thomas Picketty, Stiglitz notes the huge increase in *wealth* which has gone hand-in-hand with rising poverty. His answer: "Most of the increase in wealth is, as Picketty himself recognizes, in the value of land."[1]

An increase in wealth driven by a rise in the price of land does not lead to an improvement in prosperity; nor is it a cure for poverty. Stiglitz stressed:

"It is obvious that wealth and capital are two markedly different concepts. There are many forms of wealth that are not productive assets. Much of the increase in wealth in recent years is associated with an increase in the value of land; but the increase in the value of land does not mean there is *more* land, and that therefore the productivity of labour should go up."

Stiglitz warns that the rise in land values creates distortions that damage economic activity.

Stiglitz also explains that, in addition to the capture of rents through the land market, people in privileged positions are able to peel off some of the rents indirectly. For example, people with political influence can use their connections to gain benefits in the form of super-profits. This is "rent-seeking". So, Stiglitz writes:

"While monopoly rents are the most obvious example of an increase in wealth unassociated with an increase in the productive capacity of the economy, there are many other forms of exploitation, the capitalized value of any change in which would show up in a change in wealth."

Stiglitz cites the political influence exercised by bankers, who use their power to create credit and gain super-profits. Then there are the owners of land: they are able to borrow from banks at lower interest rates than the rates charged to small- and medium-sized businessmen. Bankers prefer to lend to those who can offer land as collateral. This damages the economy. This is who Stiglitz puts it: banks use mortgages to extract a share of rents which results in "distortions associated with too-big-to-fail banks [and] the productive capacity of the economy has been diminished".

Stiglitz illustrates the theory by referring to the property boom driven by Russian oligarchs on the French Riviera: "When the price of land in the Riviera goes up, the banks are willing to lend more. If the banks are willing to lend more, the price of land in the Riviera goes up." But the working people of France are not wealthier because the price of land has increased. All that has happened is that a part of the value which people create is *transferred* to the owners of land.

- Rents are a *transfer payment* to land owners who, *in their status as owners of land*, do not add value to national income. So monetary policy operated by governments disrupts the lives of working people.

Stiglitz emphasises this process thus: "Monetary policy *causes* both the increase in (non-productive) wealth and the increase in wealth-inequality."

Because fiscal policy is biased to favour land speculation, the impact on the economy is negative. This is so, Stiglitz declares, because "an increasing proportion of savings is absorbed by increases in the value of land, and…real capital accumulation diminishes." This leads to "real inequality". Why? By using money to buy land, rather than create capital that can be used by labour, the outcome is to "disadvantage workers".

The Significance of Tax Policy

Stiglitz provides examples of how conventional taxes on wages and profits damage the economy. One particularly distressing example is the way land values distort the distribution of savings, which in turn affects the fate of families that are not land-rich. People who own land enjoy an inter-generational advantage (through, for example, access to higher education and access to employment opportunities). Low-income families that do not own land are pushed into poverty. Stiglitz cites an OECD study that explores the family issue.[2]

- Stiglitz concludes that one outcome of the influence of land values in the present economic system is "economic segregation". This echoes my concept of the *economics of apartheid*.[3]

The discriminatory nature of tax policy is stressed by Stiglitz in blunt terms: "The presence of money and/or land has the effect of reducing workers' share of wealth."

A popular saying is that "money attracts money". Stiglitz analyses this by explaining that the biggest gains are achieve by "those who are lucky enough to own land [who] receive a large capital gain." A society that allows the owners of land to capture such capital gains "cannot claim that there is a level playing field, that there is equality of opportunity," writes Stiglitz.

In discussing the "bubble" economy, Stiglitz points to the damage caused by high land prices. One process by which the economy is rendered poorer: "The increase in the value of land crowds out capital accumulation – the capital stock declines, *even though wealth continues to increase*" (emphasis by Stiglitz).

Thus, rising land values create the illusion of prosperity. Ultimately, however, because of the way they are distributed, rising land prices distort the economy by reducing the living standards of working people.

The Threat to Democracy

Stiglitz warns that his analysis is a challenge to democracy. But governments can solve the problem of rising land values which trap people in poverty. How? He told his audience at Columbia University:

"There is an easy way of addressing the inequality that arises through capital gains on land: to tax capital gains, especially those associated with increases in land values. This, of course, has long been part of the progressive tax agenda – advocated in the 19^{th} century by Henry George."[4]

The policy implications for radical political parties in Europe, such as Syriza in Greece and Podemos in Spain, are clear. Their economies are in freefall. There is a serious risk of permanent unemployment for current and future generations. The fair solution is an altered tax structure. Progressive politicians need to adopt a programme based on two strategies:

(1) *explain* to people the social and economic consequences of rising land values. Under the current tax regime, the rise in land prices leads to unaffordable house prices. Vacant dwellings exist alongside homelessness. Existing home owners are enriched, but the future of their children is prejudiced. And
(2) *devise* a carefully structured plan to collect the rents of land. Armed with a democratic mandate, a government committed to tax reform could challenge the power of bankers and rent-seekers.

If governments understood how the land market operates like a sponge, they would be able to keep their promises. And the rents would be invested for the common good of everyone.

References

[1] Joseph Stiglitz (2014), "New Theoretical Perspectives on the Distribution of Income and Wealth among Individuals", unpublished MS.
[2] OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, Paris.

[3] Fred Harrison (2012), *The Traumatised Society*, London: Shepheard-Walwyn.
[4] Henry George (1879), *Progress and Poverty*; 1979, New York: Robert Schalkenbach Foundation.