Robert
Schalkenbach *Briefing on*
Foundation *House Prices*

Hubble Bubble, Toil & Trouble

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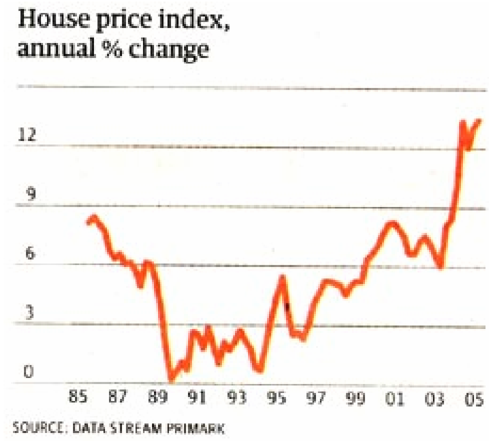
1. When is a Bubble not a Bubble?

THE role of house prices in the economy is still contested by policy-makers. No such disagreement exists among home-owners, however. Rising prices encourage the feel-good factor. We borrow against increases in the equity of our properties and spend the money in the shops. But for buyers, price rises are a menace – they take increasing proportions of disposable incomes. And for some first-time buyers, there comes a point where prices of the cheapest homes rise beyond the levels of affordability. So a consistently rising trend poses a threat to those who wish to start families within the security of their own homes.



In the US, in 2005, house prices rose at annual rates of about 14% a year (*see graph*), achieving a level of 16.6% in October compared with the same month in 2004. Is this good or bad news? For market analysts who track the performance of real estate, the prospect of a slow-down in prices is alarming. But what does such a slow-down signal? For outgoing Federal Reserve chairman Alan Greenspan, house prices were a challenge because, he claimed, it is not possible to identify a bubble until after the event. But what follows if a price boom is driven by speculative behaviour? Does a slow-down always result in a recession? Or can a bubble be followed by a “soft landing”?

Greenspan’s successor, Ben Bernanke, is relaxed about weakening house prices. He remarked in October 2005: “House prices are unlikely to continue rising at current rates…a moderate cooling of the housing market, should one occur, would not be inconsistent with the economy continuing to grow at or near its potential next year”.

US house prices have been stimulated by cheap foreign financing which made it possible to keep interest rates at low levels – and, in the process, stimulating consumption and maintaining high rates of employment. Can the good times keep rolling on?

2. Landing the Windfall Gains

TO understand the significance of property in the enterprise economy, we need to appreciate that prices rise at remarkably high rates because of the unique characteristics of land. Although the media gets excited about "house" prices, the remarkable increases are not located in the value of bricks and mortar. The price of building materials such as timber and glass respond to the capacity of industry to increase supply in line with demand. So, over the medium to long run, construction costs are fairly stable and in line with general rates of inflation.

The story is different with the land beneath the buildings. The supply is fixed in locations where people wish to live and work. Supply usually falls short of demand, and this is reflected in often giant leaps in prices. These deliver the windfall gains sought by speculators. And their function is not one of adding value to the wealth of the nation. They merely appropriate the rental values of land by anticipating the locations where urban growth will take place.

Curiously, given the importance of land in the market economy, the data on land prices tends to be poor. Analysts are not able to access information that enables them to relate what is happening in the land market to trends in the labour and capital markets. One result is that economists do not ascribe to land the attention which it warrants for the purpose of diagnosing the economic health of the nation.

Should land prices be accorded greater significance from the point of view of macro-economic policy?

3. Bernanke's Inflation Target

ALAN GREENSPAN used low interest rates to combat the risk of economic instability. Under Bernanke's stewardship in 2006, the only significant difference is expected to be a formal targeting of inflation. This will move the US central bank in the direction of the Bank of England, which works to a 2% rate of inflation. US inflation rose to more than 4% in late 2005.

But the commitment to interest rates as the primary tool for stabilising the economy creates an automatic tension in the markets. Policy pushes and pulls in opposite directions at one and the same time.

- When asset prices are rising, raising the rate of interest to try and cool the markets makes life difficult for businessmen who need a steady line of credit to run their enterprises. Raise the interest rate too high, and marginal businesses – those that would otherwise pay their way – are driven to bankruptcy.
- But when the rate of interest is reduced in response to a weakening of the value-adding economy, asset prices tend to increase – just when

families or entrepreneurs need the prices of such assets to be affordable.

Thus, the interest rate policy is a crude instrument which has proved to be insufficient for dealing with asset bubbles that traditionally signal the onset of a recession. Britain's Treasury studied 300 years of economic history to identify the major causes of booms and busts, and its finance minister, Chancellor of the Exchequer Gordon Brown, reached this conclusion:

> Most stop-go problems that Britain has suffered in the last 50 years have been led or influenced by the more highly cyclical and often volatile nature of our housing market.

The same sequence may be traced in the US, where real estate volatility tends to precede banking crises and the onset of recessions. But are these causally connected? And if so, is it possible to develop a stabilisation policy that might succeed where other policies have hitherto failed?

4. The Counter-Cyclical Policy

IF PRICE trends in property markets are the cause of instability, this can hardly be ascribed to manufacturers who deliver bricks and mortar at competitive prices. Output responds to demand, and competition prevents suppliers from raising their prices above uncompetitive levels. The points of friction are to be found in the land market.

Can the price of land distort patterns of investment and consumption to the point where growth is terminated? The thesis that land monopoly is the primary problem was originally developed by American social reformer Henry George in *Progress and Poverty* (1879). The subtitle of this remarkable work was: *An inquiry into the cause of industrial depressions and of increase of want with increase of wealth…The remedy.*

Henry George began his analysis at the American margin – figuratively speaking. He was working on the west coast as a journalist in San Francisco when he observed the poverty of many of the immigrant workers in California. He was puzzled by the fact that, in a land of potential plenty, many people were living on starvation wages. So he embarked on a methodical review of economics, both the theory and as it was practiced in the United States and Europe. The puzzle that he wanted to solve was the association of progress with poverty in the industrial economy.

George's conclusion was that the problem lay with public policy. It was the failure of governance that led to a system of public finance that rewarded land speculators and penalised people who worked for their living and invested their savings. A lop-sided approach to public finance subverted the value-adding economy. Greater rewards were to be made from trading in land than innovating products that consumers wanted to buy to improve the quality of their lives.

This led Henry George to propose a counter-cyclical policy: tax the value of land to capture the windfall gains for the benefit of everyone in the community. By doing so, the temptation to speculate in land values would automatically be removed. Furthermore, public charges on the rents of land and natural resources do not distort incentives. For example, they cannot be added to the cost of labour or its products – which means there is no price-raising “inflationary” effect. This contrasts with taxes on labour and capital, which are passed down the chain to surface as higher prices in the markets.

One negative effect of conventional taxes, then, is to reduce the competitiveness of the economy in international trade. US products, if they have to carry a higher tax burden than the equivalent products manufactured in an economy with a low-tax regime, may be unsaleable.

A historical review of the business cycle leads to the conclusion that Henry George’s policy proposal is the effective counter-cyclical instrument. It reduces the incentives to speculation in the land market without any negative impact on the labour, capital and consumer markets. Logically, a shift in the structure of the tax base seems to be warranted in terms of the principles of good governance.

The economics of global trade also give added urgency to the need for tax reform. The arrival of the Chinese manufacturer in world markets ought to make all Western governments pause and re-think fiscal policy. For China has a competitive advantage in its low labour costs. Europe has found itself unable to cope with this challenge, and its manufacturers are increasingly out-sourcing their value-adding activities to the Chinese. US industry has also felt the impact of China; even the once might General Motors has had to slash a further 30,000 jobs from the payroll to survive.

Western economies need to meet the challenge from Asia by raising productivity. Cutting the taxes that damage private enterprise is the one reform that would achieve the twin goals of making exported goods more price competitive while removing the incentives to speculate in land. The outcome would be balanced growth and an economy fit for survival in the tough global conditions that have emerged in the 21st century.

References

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