

How Rising Rents Can Devour Capital and Choke Off Production*

Excerpt from “Causes of Downturn” 1982

Notes by Mason Gaffney, Nov. 20, 1993

These notes purport to supply a missing link in the model initiated by Henry George, *Progress and Poverty*, Book V, Chapter 1, “The Primary Cause of Recurring Paroxysms of Industrial Depression.”

George asks, “What limits the “speculative advance of rent?” (p. 260). The advance in rent is possible because much of the best land is locked up for the rise. In addition, in George’s view, rents and land asking-prices keep creeping up whenever there is a period of prosperity and optimism, testing the limits. Landowners have the initiative to drive this process, since land price and land rent are prior claims on production. Labor and capital get what is left over.

What limits this rise is that labor and capital must be paid enough to survive and reproduce. When the landowners’ overreaching demands leave them too little for that, many transactions can no longer take place, and production drops: a crash and slump. This in turn finally induces landowners to lower their asking prices to what labor and capital can afford and still survive and reproduce. The period of depression and readjustment is prolonged because land has more holdout power than labor and capital.

George is stingy with details on the mechanics of how this works. It is easy to see how excessive holdout prices for raw land would discourage building, or at least divert it to bad locations. But how about land under existing buildings? It is harder to see how a rise of its value can stifle production there. *Let us supply this missing link.* By doing so we can complete, and make sense, of this fascinating but elusive theory. What happens is that the rise of land value stops the capital from reproducing itself. This is the missing link.

Consider an existing building, solid, useful, and middle-aged. It is ready to be “milked,” as a “cash cow.” That means that most of its cash flow from now until tear-down will be regarded as CCAs (Capital Consumption Allowances), rather than income. CCAs are invested elsewhere, to conserve the owner’s capital. When the building is finally torn down, the owner (and society) will have as much capital as ever.

Now suppose the price of the land under the building to rise, in a speculative boom, while the cash flow of the building remains the same. Let the land price rise so high it is now worth as much as the land + building were worth before. Now, the owner does not need to conserve any CCAs to conserve his wealth: the rise of land price has done it for him.

At the same time—viewing the same point from another angle—the cash flow from the land + building is now imputable to the land alone, to justify the land’s higher price. The cash flow is all net income, because land does not depreciate. The owner may spend it all on consumption; being human, he begins to do so. Lenders descend on him and seduce him into borrowing on the land to increase his consumption. “Equity withdrawal” is the current term for it.

From yet a third angle, the building has undergone “locational obsolescence,” and lost its economic value. Physically, it may look the same; economically, the land has sucked the reproducible capital out of it.

From a fourth and last angle, capital, to survive, must earn cash flow enough not just to cover interest on the unrecovered value,¹ but also enough above that to *reproduce* itself. As Mill said, “Capital is kept in existence from age to age, not by preservation, but by continual reproduction.” Capital reproduces itself by yielding CCAs. When rising land prices devour capital, and/or rising ground rents arrogate its CCAs, capital stops reproducing itself. This is how rising rent drives capital out of production. It is not that capital sulks; it is drained and consumed by the rise of all-devouring rent.

This ruin occurs without apparent harm to the owners of buildings when, as is the rule, they own the land under them. It is silent and insidious, like a vampire in the night. It would only be contentious and “newsworthy” if the land were owned by a different party than owns the building, and the lease expired. There are such cases—in trailer parks, and on the Irvine Ranch leaseholds in Orange County in the early 1980s—when the sapping of capital is visible and contested. As a rule, though, it passes unnoticed: no one seems to be suffering. No one rebels or can plead injury, even as a big share of the nation’s precious capital stock shrivels and dies without reproducing itself.

After that, there ensues a shortage of loanable and investable funds. That, in turn, slowly grinds down land prices and rents. This, I believe, makes sense of George’s phrase, that rising rent cannot permanently force interest “below the point at which capital will be devoted to production.” It would be clearer had he said at this juncture “below the point at which capital reproduces itself.” Shortage of capital, and tightness of loans, finally force down land prices. Labor, meantime, endures a period of acute suffering after job-making investing dwindles down.

¹To recompense the self-restraint of its owners (who are always tempted to consume it).