How Our Economy Really Works

A RADICAL REAPPRAISAL

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SHEPHEARD-WALWYN (PUBLISHERS) LTD
IN ASSOCIATION WITH
THE SCHOOL OF ECONOMIC SCIENCE, LONDON

First published in 2019 by
Shepheard-Walwyn (Publishers) Ltd
107 Parkway House, Sheen Lane,
London SW14 8LS
in association with
The School of Economic Science
11 Mandeville Place
London W1U 3AJ

www.shepheard-walwyn.co.uk
www.ethicaleconomics.org.uk

British Library Cataloguing in Publication Data
A catalogue record of this book
is available from the British Library

ISBN: 978-0-85683-529-2

Typeset by Alacrity, Chesterfield, Sandford, Somerset
Printed and bound in the United Kingdom
by 4edge Limited

Also by Brian Hodgkinson

A New Model of the Economy

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Preface

IN ONE SENSE this book has nothing to do with Brexit. It could have been written twenty years ago, or even much earlier. Above all it is a response to the fundamental questions that have confronted the UK economy for decades, and with which successive governments of the right and the left have failed to deal adequately. Some of these questions are obvious, such as, 'Why does poverty still beset a large number of people, whilst others are grossly well-off?'; 'Why are house prices continuously rising much faster than inflation, so that more and more people are left without a house of their own, or are borne down by the weight of a mortgage?'; 'Why does UK productivity remain persistently low, despite constantly improving technology?'. Other questions are less obvious, or are ignored through a belief in their arising from the natural order of things, such as 'Why do the majority of workers find themselves as employees in jobs that give them little real sense of fulfilment?'; 'Why is there awful traffic congestion, despite heavy expenditure on transport infrastructure?'; 'Why does the tax system fail to bring about greater equality, despite progressive rates of tax on incomes?' All these questions, obvious or not, are perennial ones, not particularly related to membership of the European Union, although some extreme advocates of Brexit might claim that they are.

In another sense this book has a lot to do with Brexit, for the simple reason that all would agree that Brexit leaves the UK economy in a new, unprecedented position. This inevitably arouses both hopes and fears of substantial change. Such hopes and fears may alike be irrational, but even so they raise the possibility of genuine reform. Yet it is my contention that Brexit alone does not change anything fundamental about the economy.

Why this is so emerges in the argument which follows. In short, it is that what requires fundamental reform is not any features of being or not being within the EU, but more deeply embedded ones, which have generally been established for a very long time. They are principally threefold: the taxation system, the land tenure system, and the banking system. All three are profoundly interconnected. All three require root and branch reform. The presence of concerns engendered by Brexit may provide an opportunity lacking in more equable times.

Perhaps one final concession may be made to the Brexiteers. Fundamental reform of all three systems might be easier to carry through outside the EU. Full national sovereignty gives, at least, an opportunity to make changes to the very structure of the economy. Ideally these reforms would spread beyond the UK, or perhaps there would have been a chance of the EU itself adopting them under the influence of the UK as a member. But that would require an even greater revision of endemic ideas than reform in the UK alone would necessitate.

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Introduction

ECONOMISTS HAVE long asserted that three factors of production lie at the root of their subject: land, labour and capital. Yet in the development of the subject into theories and practical applications there has been a thorough-going analysis of labour and capital and a grievous omission of the factor of land. This is reflected in the minimal place it holds in modern text books, in popular discussion and in political debate. Indeed much of the argument about major issues, like industrial production, the distribution of income and wealth and government policy, reverts to a polarised struggle between two antagonists, labour and capital. The third factor, land, hides in the background, unacknowledged yet exerting a fundamental influence upon the outcome of the whole economic process. This book hopes to present many examples of this neglected significance of land in the economy, but one obvious example may help to clarify the point initially. The price of houses has risen continuously at a rate well in excess of the rate of inflation, causing difficulties for new buyers, creating serious problems in the mortgage market, and profoundly changing the distribution of wealth between generations and between regions. Yet what is called the 'house price' is really a combination of land price and building price. These two prices operate quite differently and require quite different approaches by policy-makers. More will be said about this one example and the impact of the error upon the economy.

Why has this lacuna in economic thinking come about?

There are three reasons that have a bearing upon one another. Firstly, the land enclosure movement in Britain took place over a long period, reaching its peak in the early nineteenth century, by which time little land was left for public use and access. Private claims on land, particularly those of the major enclosing landlords, but also of all others who came to regard a piece of land as absolutely 'mine', developed vested interests. They preferred to ignore the older tradition of land as communal property to be used by individuals under conditions that took account of the interests of others. This absolute claim on land now extends to large commercial companies, including foreign ones, and crucially to the ownership of urban land, in which over fifty percent of the population now have a vested interest.

Secondly, economic thought developed on lines that seemed to justify the growth of such vested interests, whilst theoretical reasons appeared to support the omission of land from most of the analysis. It was no coincidence that as the private enclosure of land grew, alongside it grew a theory of supply and demand that only employs the concepts of labour and capital, and later a theory of macro-economics that treats the whole economy as producing and consuming in a landless environment. When land gets mentioned at all, it is usually treated as capital. The consequence of this egregious sleight of hand will be examined.

The third reason for the omission of land from economic thought is that as urbanisation developed, following land enclosure, the general awareness of the presence of land became gradually attenuated. How often do people in cities realise that they are living on land? Houses, factories, offices, shops, pavements, and indeed all the built environment, seem to establish a kind of screen between people and land. When a building is pulled down, or a road dug up, the screen is broken. Bare mud or rock provides a glimpse of the earth that lies ubiquitously but unseen beneath our feet. One result is that the term 'land' becomes associated almost exclusively with the countryside, where a minority of the population live or work. The 'land question' that so disturbed our ancestors, when it occasionally arises, is usually in the form of debates about farming tenancies or pollution of agricultural land. The city dweller is not concerned. Yet that same city dweller spends hundreds of thousands of pounds on a house, with at least half the price consisting of the land price. Similarly the worth of a retail business may be largely determined by whether it has a freehold on the land it occupies. Urbanisation makes land invisible. Only a few shrewd businessmen realise its worth, and make fortunes from trading in it.

Despite this general neglect of the factor of land, economists have usually retained a concept of land that refers not just to the dry surface of the earth, but also to the natural features attached to that surface or to the subsoil. In particular, these include natural vegetation, like forests, and minerals such as metals, coal and oil. Only when these materials are extracted by human labour are they described as wealth, production or capital. This original notion of land is a firm basis on which to examine how it operates as a factor of production. An example of this, which anticipates the following discussion of rent of land, is that the value derived from the use of land by exploiting such materials can be correctly classified as rent and not as a return on capital.

Following the founders of the subject of Economics, notably Adam Smith and David Ricardo, we may then continue to take as the starting point of any economic analysis the three concepts of land, labour and capital. Land has already been defined. Labour can be defined as the application of human effort of body and mind to the production of wealth and services, where wealth means actual physical production, excluding claims on it such as money and securities. Capital means wealth used in the production of further wealth. Retaining this threefold foundation throughout any economic discussion yields conclusions far different from the conventional ones.

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Rent

EXCEPT IN VERY exceptional circumstances, such as plague or war, every economy produces a surplus of output over and above what is necessary to support its population. How this surplus is used depends upon the nature of the society. The surplus may be directed, for example, to cultural aims, like art or architecture, or to warfare, or to scientific development. In economic analysis this surplus takes the form of rent.

Everyone is familiar with the concept of rent. We think of it as what has to be paid to a landlord. It may be rent of a house, business premises, a farm or whatever else requires access to a site or piece of land. Such a concept, however, is too restrictive for economic analysis. The concept of rent in Economics is broader, but at the same time more precise. It may be defined as the excess value arising from a site over and above the value arising from marginal land that is only just worth occupying or using. For example, the economic rent of a piece of very fertile farm land would be the excess value of the produce over the value of the produce of a piece of land barely worth farming. This means that both values must be calculated given the same application of labour and capital i.e. the same degree of effort and skill and the same quantity of suitable capital, such as farm machinery. In the case of houses the economic rent would be the excess value of living on a particular site measured against the value of living on a site only just suitable for habitation. Value here can be considered as whatever the occupier would be prepared to pay.

A major difference between rent paid to a landlord and economic rent is that the latter is the potential rent available if the site is put to its best use. Quite often rent paid to a landlord is for an inferior use, which is allowed to continue for a variety of reasons: inertia, inadequate knowledge, sentiment or even generosity. Such reasons do not affect the economic rent. This is determined by the objective conditions operating at the site concerned and at the marginal site.

What then are these conditions that determine the economic rent? There are four main categories of these. As noted earlier, they include natural aspects of the land, like fertility, vegetation, minerals, drainage, topography and climate. Secondly there is the presence of human population. This is a critical condition, which may even make natural features of little significance. For population provides a labour force, whose quality varies considerably with education, training and character of the people, and also a market for the products of economic activity, including living accommodation. Location in a city with a skilled and active population may completely outweigh any natural features of the site, especially when these can be enhanced by man-made services, such as water supply or landscape gardening. Thirdly there is the existence of other firms in the neighbourhood, which may provide services or supplies, or may simply make the site concerned more attractive, for example for shopping or recreation. Finally there are public services, which may include transport, law and order, schools, hospitals, power and water supplies and much else which is the function of government, whether national or local. The degree of law and order greatly affects the value of a site, as do flood control and other crucial public concerns.

Given that economic rent is the potential value arising on land and not just the amount actually paid to a landlord, there are obvious questions about how this is measured. In particular there is the situation where the tenant is the landlord; in other words when the tenancy is freehold. The economic rent is clearly not zero, even though no payment is necessary. It remains what it would be were a full rent payable to a landlord.

The importance of recognising this will become clearer when an industry like retailing – to take one example – is analysed later. If a large retailer owns the freehold of a central high street site, it may appear to be making very large profits. In reality much, if not all, of these are rent. Only if this is acknowledged can the proper efficiency of firms of any type be seen. Moreover the optimal allocation of land to its best uses can only be accomplished if the true rent is known, regardless of freehold tenure.

Economic rent can also be measured by the capital value of the site concerned. When land is sold in a free market, the price paid is approximately the capitalised value of the rent receivable in the future. This is true whatever the land use. For housing, for example, the future occupier of a house on the site pays what he or she thinks it is worth to avoid paying a rent for the site in the future; or if the house is to be built for letting the price includes the capital value of future rents to be received.

One of the consequences of the neglect of the concepts of land and rent in present-day economic thinking is that the actual differentials between the rent on different sites is often overlooked. This is partly because rent is not evident when it is not paid, as with freehold sites; and partly because vested interests are reluctant to disclose the rent receivable on valuable sites. On long established freeholds the economic rent may be hidden in the profit statements of the companies, in the private accounts of wealthy individuals, or in the beneficial occupation of land used for recreation. For example, who knows the economic rent of land held under freehold in the City or West End of London? Likewise who knows the economic rent of land held for grouse shooting or fishing in the Highlands of Scotland? Were the values of the economic rent of all sites in the UK publicly available, there might be more questions asked about whether it is being optimally used, and even about who is entitled to receive the rent.