it's the *land* economy, stupid!

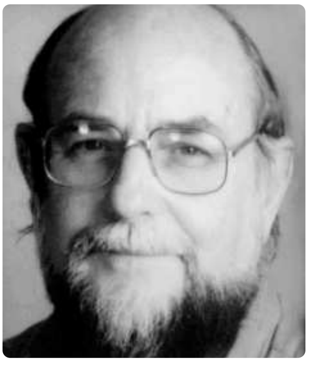
part 1: shortcomings in theory and practice

In the first part of a two-part article on land and housing markets, Stephen Hill looks at pioneering thinking and research on the potentially destabilising social and economic effects of land and house price speculation in the UK and other developed economies, and at the shortcomings of neo-classical economic theory and valuation theory and practice in shaping solutions to dysfunctional land and property markets

The legacy of Peter Ambrose

This article has been written partly to refocus our attention on some fundamental economic principles – especially the neglected discipline of land economics – as we continue to search for routes out of the current economic crisis. It is also a tribute to the work of the radical urban geographer, Peter Ambrose, who died in early August. Peter had been Director of the Centre of Urban and Regional Studies at Sussex University, and latterly an inspirational teacher and researcher as Visiting Professor of Housing Studies 'over the road' at the Social Science and Policy Research Centre at Brighton University. His work has much to tell us about the origins of the recurring crises of financial capitalism, and how we could stop them happening again.

Peter had no fear in tackling vested interests, and relentlessly identified the causes and likely effects of the conditions that led to the housing market crash and financial crisis in 2007-08. These are recorded in embarrassing detail (embarrassing for us all, in retrospect) in his *Memorandum to the Prime Minister on Unaffordable Housing* of 2005[1] – information and advice that was ignored by its recipient, the Commons Select Committee on Affordable Housing, and Treasury officials alike. At a meeting



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Peter Ambrose – 'relentlessly identified the causes and likely effects of the conditions that led to the housing market crash and financial crisis in 2007-08'

with Peter, one of the latter observed percipiently that the issues identified in the *Memorandum* were not a problem 'as long as the market is working'.

Like the early 20th century economist Thorstein Veblen, whose work is also described in this article, Peter leaves no 'school' of thought behind him; but a significant legacy nonetheless. He was most celebrated for his 1987 book *Whatever Happened to Planning?* Like the book's title, he has left us with a host of unanswered questions about housing and land policy (do we even have one?). These questions are very similar to those that Veblen put over a century earlier, and the answers to which they both would have called 'common sense'. They are the very questions that we all spend most of our time deliberately avoiding, in the mistaken belief that doing more of what we have been doing for the last 30 years will, one day, start to work. We need more minds like Peter Ambrose, not one less.

Conventional wisdoms under scrutiny

The recent US presidential election has reminded us again of the instant wisdom, beloved by politicians and political commentators, of 'It's the economy, stupid!' Its author, Bill Clinton, may have created a memorable sound bite, but he was not an economist. The problem for him and the USA, as for the UK and many other countries around the world, is that it is not '*the* economy' and has not really ever been; it's 'the *land* economy'.

'Conventional wisdom ignored the value and price of land in the formulation of economic and fiscal policy... It is only recently that some politicians and economists have begun to realise that something is not quite right'

We might generously forgo the 'stupid', perhaps. The legacy of the neo-classical economic 'thinking' that became the dominant economic world view in the early 20th century was that land and natural resources became invisible in economic theory. Conventional wisdom thus ignored the value and price of land in the formulation of economic and fiscal policy. For the three centuries before that, classical economists and rational thinkers clearly understood that land was central to understanding how political economies actually worked: not least because nearly all wealth and tax revenues were then derived from it.

It is only recently that some politicians and economists have begun to realise that something is not quite right. The EU Environment Commissioner, Janez Potocnik, explicitly questions the neo-classical assumptions of his own economic training that natural resources are 'free' and that the consequences of economic decisions on resource supply and use can be ignored. Making this case to the EU Environment Council in December 2011, Potocnik argued for resource use to become a mainstream issue in economics: 'We really do need to have the internalisation of these costs,' he argued, both for Europe to remain economically competitive and to sustain a decent quality of life for everyone. He predicted the need for 'drastic changes' to the structure of both local and global economies.[2]

Some leading neo-classical economists also understand the need for this paradigm to change. Martin Wolf, Chief Economist at the *Financial Times*, has explained what he now sees as the faults of neo-classical economic theory:

> *'Something strange happened to economics about a century ago. In moving from classical to neo-classical economics, economists expunged land or natural resources. Neo-classical value theory, based on marginalism and subjective valuation, still makes a great deal of sense. Expunging natural resources from the way economists think about the world does not.*
>
> *'In classical economics, land, labour and capital were the three factors of production. With neo-classical economics, the standard production function had just two factors of production: capital and labour. Land, by which we mean the totality of natural resources, was then incorporated into capital.*
>
> *'The idea that land and capital is the same thing is evidently ludicrous. Humanity does not make these things [natural resources]; it exploits them. Some of these resources are also appropriable and so a source of unearned personal wealth… Henry George argued that resource rents are not a reward for the efforts of the owners, but the fruit of the efforts of others. It would be both just and efficient to socialise rents, he argued, and then use the proceeds to finance the infrastructure that makes resources valuable.*
>
> *'But the powerful owners of natural resources wished to protect their unearned gains. In practice, therefore, the tax burden fell on labour and capital. Economics, one might argue, was pushed into supporting this way of organising economic life.*
>
> *'Yet it would seem to me that this way of thinking by economists is no longer sensible, if it ever was. Land must again be treated as separate from labour and capital… Thus, for both economic and political reasons, we should put natural resources into the heart of economics, thereby remedying a neoclassical mistake.'*[3]

Wolf was suggesting that the problem with neoclassical theory was not just its detachment from common sense about how the world really works, but that the adoption and indeed the maintenance of the theory was and is driven by the powerful vested interests of property owners and financial institutions; an idea that now seems more plausible in the continuing fall-out of the financial crisis. Wolf's blog, written in the high summer in 2010, provoked over 180 pages of comments, despite most *FT* readers probably being on holiday: an indication that the issue of land is very much on our minds and deserves a wider public debate.

E4 = M4/4 = not boring enough

Perhaps taking his cue from Wolf, the former Housing Minister Grant Shapps started just such a debate later that autumn. Asking 'What would an intelligent housing market look like?', he proposed that it should be 'boring… really quite predictable'. He asserted that 'we've all forgotten what our housing market is actually for… to provide a roof over our heads... Buying a home shouldn't be like playing the lottery',[4] and that Britain would be a better place if house prices did not rise in nominal terms during this parliament.[5]

Politicians normally avoid commenting on how property markets should behave, or on what values should be. Political convention is that there is usually nothing they can do about either; but these were and are exceptional economic times. Shapps was also voicing the now commonly expressed concern in the UK housing industry about land price: land costs too much, and the expectations of landowners are damaging our attempts to build enough homes for the still growing population – homes needed for an economically successful and socially and environmentally sustainable country. Such a debate has the potential to go beyond assertions that politicians can end 'boom and bust', to offer more intelligent insights into the purposes and uses of land, what kind of rewards it can generate through investment, and thus what values should be.

It is important to understand why this debate remains so central to the future of the economy, and to guard against the natural inclination to take comfort from the idea that 'things may be getting back to normal' once planning application or housing start rates begin to pick up. Every market has its cycles, and the first stages of recovery may seem reassuring, even though underlying problems remain untreated. So it is worth looking at the first effects of the credit and asset bubbles that followed the deregulation of financial markets in the early 1980s, to understand that the fundamentals of land and housing market failure have still not been addressed.

A comparative study by Ambrose and others examined two similar high-value areas with strong employment and economic demand – the E4 motorway corridor between Uppsala and Stockholm in Sweden, and the M4 corridor in Berkshire – over the period 1980-1988. The E4 corridor performed consistently better:

- 20% more efficient land utilisation;
- 65% of housing affordable to people on average local incomes against the UK's 15% (collapsing to less than 6% as the study ended in the crash of 1988, making many sites 'unviable');
- up to six different kinds of provider and form of tenure, including co-operatives and self-build housing, against just two in the UK – market sale and social rent; and
- nearly 50% of what we would call 'affordable housing' occupied by people in managerial and professional jobs, compared with 2% in the UK.

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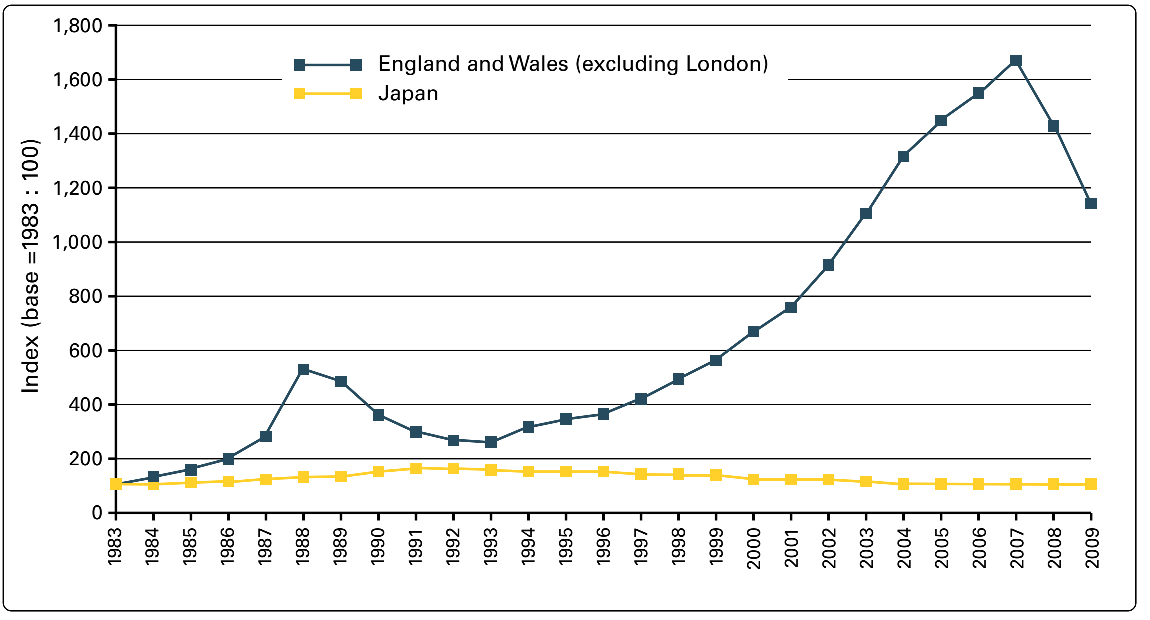
An ordinary site in an ordinary expansion area sold in 2007 at 60% of GDV – sales values would have had to increase by £400 per square metre over 12 months to make a normal profit

The most telling difference, however, was that Swedish land values rose by about 5%, compared with 436% in England, representing about 10% and 60% of Gross Development Value (GDV), respectively. E4 land ended up at one quarter the price of M4 land.[6]

The period 2000-2008 covered the second wave of credit-driven asset price inflation and speculation, with many similar characteristics. This period was turbo-charged by advances in computing power since the 1980s, and by a changed investment culture created by the growing weight of global capital seeking short-term speculative gains on assets and commodities in uniquely short supply – especially development land and housing, which will always be at their scarcest and most in demand at the peak of a business cycle.



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Comparison of residential land prices in Japan and England and Wales (1983-2009)
Source: 'Lessons from Japan'. Land Journal, RICS[8] (redrawn for reproduction)

As a 'safe haven', housing and indeed all land in the UK had become a natural target for global capital, enhanced by self-imposed limits on supply.

Population and economic growth were restricted primarily by chronic under-investment in infrastructure, as well as by complex planning and regulation and increasing anti-development sentiment; notably the socially acceptable and benign-sounding NIMBYism, but more accurately the selfishness of the already housed at the expense of the unhoused.

At the 2007/08 peak, development-ready housing sites were commonly selling at 30-40% of GDV. Exceptionally sites sold at 60% of GDV, in the expectation that there would be a significant and essentially speculative rise in sales values over the development period, sufficient to cover as much as half the normal build cost – a measure of the collective madness in which the market had ceased to behave rationally.

The problem with land price

The significance of land in house prices and to macro-economic policy has been highlighted in recent research studies for the RICS (the Royal Institution of Chartered Surveyors) which disaggregate the land element of house prices from the bricks and mortar, based on two large-scale studies over two decades.

In the first, *Land Leverage Dynamics in Property Markets*,[7] in the high-demand housing market around the booming city of Perth, Western Australia, between 1988 and 2011 the average aggregate land leverage ratio for the whole city (the proportion of land value to house price) was 36% for new-build properties, with the land value component rising more quickly year-on-year than the value of the buildings. However, for second-hand homes, the land leverage ratio was significantly higher, at 63%, with similarly high annual increases in land price relative to buildings.

In Japan, land price is already formally regarded as a separate asset from buildings, with the property price clearly distinguishing between the land and building costs. In a culture in which homeowners expect to replace the building element quite regularly, the building is correctly seen as a depreciating asset, needing constant reinvestment to retain its value. This makes land price movements particularly sensitive for housing markets, affordability and the wider economy.

A telling graph (see Fig. 1) drawing on the findings of the second RICS research paper, *Cities in Recession*,[8] suggests, to the UK eye, that the Japanese residential land market sustained itself in a remarkable state of equilibrium from 1983 to 2009, bumping along at an index value of around 100-125 – with what seems like the merest blip to 150-175 in 1991-92, but which was, in fact, the bursting of the bubble that decimated the Japanese economy for the rest of the decade, and the start of the recession from which it is still struggling to escape 20 years later. The research also tracked English and Welsh residential land markets for the same period, starting at the same index point of 100 and rising to 550 in 1988 (the M4 moment) and to 1,680 in 2007, before falling back to 1,150 in 2009: certainly not a market in any kind of equilibrium.

In both cases, the quantum and trajectory of land price emerge as being central to the volatility of house prices, affordability for all, and the workings of the wider economy.

In 2005, in a mischievous unpublished paper, *The Great House Price Fantasy*,[9] Ambrose explained how John Prescott's '£60,000 affordable starter house' was really possible, without fudging the issue of the land cost. Take average house prices in 1975 – £10,000. Apply retail prices index inflation up to 2005; result – a national average of £60,000, with regional variations from £39,000 in the North to £93,000 in Greater London. Not very scientific perhaps; but more seriously he looked at how, between 1980 and 2003, house purchase debt increased from 23% to 75% of GDP. On his analysis, if lending had risen in line with general consumer prices, over £600 billion would have been available for other purposes than servicing housing mortgage debt. Work ongoing at his death suggested that this figure had risen by 2010 to the equivalent of the national public debt of £1 trillion.

Value, values, poverty and the infrastructure conundrum

However one looks at these various pieces of research, it is not hard to see why thoughtful neo-classical economists are feeling increasingly uncomfortable. Infrastructure is not counted in the national balance sheet, whereas the combination of inflated and speculative land and housing markets is. Yet the consequential rises in housing-related debt, both for housing producers and occupiers, are consuming a significant level of resources from both personal and national incomes that could have been invested in improved quality of life, new low-carbon infrastructure, and other investments in UK plc.

'The absence of a coherent strategic planning framework for infrastructure investment, at national, regional and sub-regional level, remains the elephant in the room'

As a measure of economic success, our housing 'wealth' flatters to deceive. The deadweight of unnecessary extra debt for buying assets (that are largely untaxed) is totally unproductive in terms of its contribution to the wider economy, and is no doubt a contributor to the need for the current re-organisation of public finances that primarily affects non-homeowners and the least well-off in society.

Despite the extraordinary wealth to be found in allocated land, the housing industry was and is unable to afford the real costs of sustainable development. At times of crisis – for the industry – it appeals to government to reduce the burden of regulation and standards of sustainable development to get development moving again; as if that was the real problem. The non-viability of sites is a problem certainly for their balance sheets and for the housebuilding business model that has developed in the past generation; having to pay too much for land goes with the territory. Much more deserving of attention is the classical idea that 'development follows infrastructure' and that sufficient land supply 'in the right places' is created primarily on the back of infrastructure investment – an idea that was effectively abandoned in the last financial crisis in 1976, at the behest of the International Monetary Fund, but willingly supported by the Treasury.

Since then, we have struggled to make work an inefficient and costly process of new development being contingent on its ability to fund its own new infrastructure and the growing infrastructure deficit as the pre-1976 legacy of investment is expired. The latest attempt, the Community Infrastructure Levy (CIL), and Section 106 agreements are, as housebuilders correctly claim, taxes on what we want more of, imposed at the moment of maximum risk and uncertainty in the development process, and based on dangerously short-term and unreliable assessments of value.

Such ill-conceived mechanisms for capturing 'value uplift' through planning yield pitiful and unpredictable resources to pay for public goods. Despite the CIL's attempt to rationalise these public goods costs, no-one yet seems to be thinking about the practicalities of delivering the required infrastructure in a way that will support and speed up development. Basic issues such as local authority procurement experience, sourcing development finance to smooth the cashflow from uneven CIL revenues into coherent construction programmes, or creating new investment opportunities for long-term funders seem to be viewed as less important than the bureaucratic niceties of the CIL charging schedules and the wide variations in charging rates.

Understandable short-term concerns over viability miss the point, however. The absence of a coherent strategic planning framework for infrastructure investment, at national, regional and sub-regional level, remains the elephant in the room, without which strategic spatial planning cannot deliver the certainty needed to create investor confidence in long-term sustainable investment.

Instead, we find ourselves locked in the futile 'Catch 22' argument of 'no infrastructure… no growth' – sometimes deployed as an accurate description of a local situation, but often as a local defence against unwanted development that would be politically unpopular. No-one seems to be able or willing to pay the costs of new and sustainable infrastructure. Housebuilders are prisoners of a production system in which they must pay what landowners expect, often advised by property advisers whose approach might be crudely characterised as 'promise as little as possible, get planning permission and sell the client's land' – advisers whose fee is a percentage of the highest possible sales price.

The system of valuation and land assembly effectively seeks to externalise social, environmental and economic costs, and detach them as far as possible from any understanding and theory of asset value. That would accord with a neo-classical economist's view of how markets should work: now under question, at least in relation to land. Should the debate between the two schools of economic thought be important to professionals concerned with the value of land, and to their values as professionals? Almost certainly, the answer is 'yes'.[10]

The RICS is a public interest body, with a global remit. Probably the most important of the professional activities listed in its 1881 Royal Charter is 'securing the optimal use of land and its associated resources to meet social and economic needs'. Note the obligatory *'and'*, which might be a surprise to many today.

It would not have been at all surprising to the 19th century authors of the Charter, who were forthright in claiming that the purpose of the institution was 'to promote *the usefulness* [emphasis added] of the profession for the public advantage in the United Kingdom and in any other part of the world'. They would have been thinking about professional tasks and responsibilities in the context of John Stuart Mill's *Utilitarianism* and *On Liberty* – both essential reading in late-Victorian times. Mill described utilitarianism – the maximisation of utility – as a moral criterion for the organisation of society, which should aim to maximise the total utility of individuals, to achieve 'the greatest happiness for the greatest number of people'. He regarded 'utility as the ultimate appeal on all ethical questions'.

The foundations of the land profession were, therefore, firmly grounded in the rationalist classical economic thinking of the day. There is a direct lineage from the 19th century 'public advantage' in the original RICS Charter, and the then current pre-occupations with public health, to more recent formulations such as 'the public interest', 'sustainable development', 'community wellbeing', or even 'happiness', currently enjoying a 21st century political revival under the Coalition Government. By linking 'social and economic need' together, the Charter writers understood what now seems to have been forgotten, as demonstrated by the work of Ambrose and others: that social and economic needs are interdependent.

The failure to recognise that social and, now, environmental needs should be internalised to value means that professionals may be ignoring that interdependence; a potential failing not just of professional standards in valuation and professional practice generally, but in professional thought-leadership in the national, public social and economic interest.

Structural problems and reforms

Part 2 of this article, published in the next issue of *Town & Country Planning*, analyses the structural problems for national economies associated with excessive debt attached to real estate, and outlines a comprehensive programme of reforms needed to unlock investment in infrastructure and bring housing and land markets back into equilibrium to serve a positive function in the social and economic life of the country.

● ***Stephen Hill*** *is Director of public interest practitioners C_2O futureplanners and a member of the RICS Planning Policy Panel. The views expressed are personal.*

Notes

1 P. Ambrose *et al.*: *Memorandum to the Prime Minister on Unaffordable Housing*. Zacchaeus 2000 Trust, 2005. http://z2k.org/wp-content/uploads/2011/11/Memorandum-to-the-Prime-Minister-on-Unaffordable-Housing.pdf

2 Janez Potocnik, cited in F. Harvey: 'EU warns wasting environmental resources could spark new recession'. *The Guardian*, 29 Dec. 2011. www.guardian.co.uk/world/2011/dec/29/eu-environmental-resources-new-recession?newsfeed=true

3 M. Wolf: 'Why were resources expunged from neo-classical economics?'. Martin Wolf's Exchange, *Financial Times* blog, 12 Jul. 2010. http://blogs.ft.com/martin-wolf-exchange/2010/07/12/why-were-resources-expunged-from-neo-classical-economics/#axzz1kWatZS1n

4 Speech by (then) Housing Minister Grant Shapps at the Housing Market Intelligence Conference, London, Oct. 2010. www.gov.uk/government/speeches/housing-market-intelligence-conference-2010

5 Speech by (then) Housing Minister Grant Shapps at a Centre Forum event at the Liberal Democrat Party Conference, Sept. 2010, Birmingham. See www.insidehousing.co.uk/analysis/opinion/must-do-better/6512180.article?MsgId=19024

6 ESRC-funded research carried out by the Centre for Urban and Regional Studies, Universities of Sussex and Örebro. Reported in P. Ambrose: *Urban Process and Power*. Routledge, 1994

7 G. Costello and C. Leishman: *Land Leverage Dynamics in Property Markets*. Curtin University, Perth, and University of Glasgow, for the RICS, 2012

8 T. Dixon: 'Lessons from Japan'. *Land Journal*, 2012, Feb.-Mar. www.rics.org/uk/knowledge/journals/land-journal/recent-editions/land-journal-february-march-2012/ – reporting on *Cities in Recession*. Universities of Oxford Brookes, Osaka and Basel, for the RICS Education Trust and the Kajima Foundation, 2010

9 P. Ambrose: *The Great House Price Fantasy*. Health and Social Policy Research Centre, University of Brighton, 2005

10 The issues raised in this paragraph will be explored further in S. Hill, D. Lorenz, P. Dent and T. Lützkendorf: 'Professionalism and ethics in a changing economy'. Special Issue, *Building Research & Information*, 2013, Vol. 41 (forthcoming)