Noah Smith: Landlords are eating the world

By Noah Smith

For all the alarm about the "rise of the robots," or "software eating the world" or the peril of climate change, one of the most pressing economic dangers of the future is getting short shrift: Landlords are eating the world.

There is growing concern that wealth inequality has skyrocketed, and capital income accounts for a growing share of the economic pie. This was the theme of Thomas Piketty's "Capital in the 21st Century." But although we usually think of "capitalists" as they were defined by Karl Marx – i.e., owners of corporations – we forget that land also is a form of capital, which means landlords (and homeowners) are capitalists, too. Furthermore, according to Matt Rognlie, an economics Ph.D. student at the Massachusetts Institute of Technology, it is land, not corporate capital, that has been responsible for the lion's share of the increase in capital's share of income.

This increase is happening worldwide. A great report by the Economist showed that the share of residential property value as a percentage of gross domestic product has skyrocketed in European countries since 1950.

This is bad for the economy. To understand why, we have to look at the reasons land has value in the first place. That's not easy, because for most of human history, the value of land came mainly from the value of its natural productive power – the fertility of the soil, or the minerals beneath the earth. But in the modern age, land has value for a very different reason, summed up by the real estate mantra: location, location, location.

Land Value Tax is a property levy with exemptions for development. This encourages construction and development, while reducing the cost that businesses have to pay to locate close to one another. Pennsylvania has long used a version of this tax, sometimes called a "split rate" property tax, with encouraging results.

In a city or suburb, land's value comes from location. People want to be close to the companies where they work. Companies want to be close to the people they employ. Stores want to be close to the consumers they serve, and consumers want to be close to the stores. Companies in the same industry want to be close to one another, so they can keep an eye on rivals, absorb ideas and poach talent. And people want to be close to other people in general, so they and their children can have friends, enjoy culture and meet their romantic partners.

As our economies become more complex, there are more kinds of stores, more cultural activities and more industries to cluster together. Therefore, the value of location increases, which pushes up the value of land. It doesn't matter how much empty land is out there – who wants to live on the Kansas prairie? What matters for the value of modern land is the incentive to locate close to other people. And unless we all start telecommuting and living entirely online, location will become more and more valuable as our economy becomes more complex.

More stores, more industries and more culture are good things. But it's a very bad thing that location has become so important to us, because location is an inherently scarce commodity. When it becomes more important, it also becomes more scarce, and when it becomes more scarce, it puts a brake on growth, just as if oil became more expensive. The Economist reports that this scarcity may have reduced U.S. GDP by more than 13 percent since the 1960s.

This is exacerbated by the fact that cities themselves are so remarkably productive. When businesses and people cluster densely together, productivity increases for all of them. But ironically, the bigger the productivity bonus that density provides, the bigger the loss from the scarcity of urban locations. In economics jargon, this is an "externality" that means that land ends up getting paid more than the value it produces.

So the increasing importance of land is bad news for the global economy. What can we do? One approach, advocated by the 19th century economist Henry George, is to tax the value of locations. Essentially, a Land Value Tax is a property levy with exemptions for development. This encourages construction and development, while reducing the cost that businesses have to pay to locate close to one another. Pennsylvania has long used a version of this tax, sometimes called a “split rate” property tax, with encouraging results. Another approach to reducing the cost of density involves reducing zoning and other building restrictions, essentially allowing developers to create more locations where people can live and gather.

The problem, of course, is that these solutions are politically difficult. Landlords are powerful in local politics, and they will naturally resist any policies that cut into their windfalls. As in so many situations, economists know what needs to be done to boost the national economy, but special interests are almost certain to block those policies.

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