Speculation serves a useful social function

WALTER BLOCK

Walter Block is Senior Economist at the Fraser Institute in Vancouver, British Columbia. Born in 1941, Dr. Block received his B.A. in 1964 and Ph.D. in economics from Columbia University in 1972. A member of the British Columbia Association of Professional Economists, the Canadian Association for Business Economists, and an ex-university professor of economics, he has worked in various research capacities for the National Bureau of Economic Research, the Tax Foundation, and **Business Week** Magazine.

Dr. Block has published numerous popular and scholarly articles on economics, and is a regular columnist in **The Financial Post**. He is an economic commentator and lectures widely on public policy issues to university students, service and professional organizations.

In days of yore, oriental despots commonly treated the bearers of bad news in a rather extreme manner: they beheaded them!

We have made great strides in modern Canada, at least as far as humaneness of punishment is concerned. We no longer execute messengers. But in the case of at least one type of bearer of bad news — the speculator — our present understanding and appreciation of his task rivals even that of the ancient oriental despot — in its ignorance.

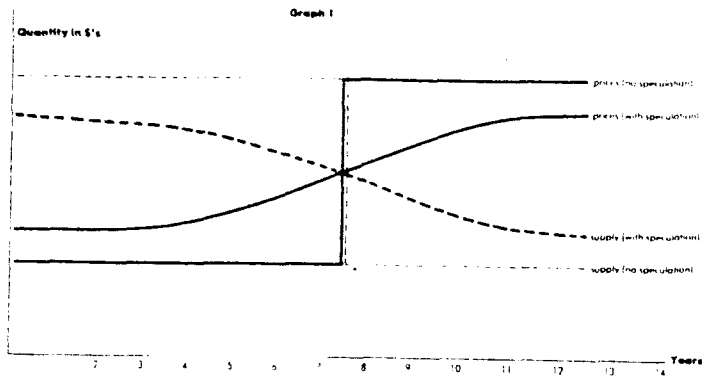
Yes, the speculator delivers bad news: high prices and shortages. Yet very few people interpret speculation in this manner. Instead, our pundits, editorialists and commentators heap abuse upon his head. "Profiteer," "gouger," "flipper," "flogger of paper," "exploiter," "despoiler of the poor," are some of the more polite monikers ascribed to the speculator. The others are not fit to print!

In the past few years, housing and especially land prices in the Vancouver/Lower Mainland area have been catapulting upwards. It is not uncommon for single family home values to have doubled in 1979 and then again in 1980 — according to stories in the local newspapers. And official statistics are broadly consistent with this account, registering a more than three-fold spurt in land prices in the 1971 - 1980 period.

But this phenomenon is by no means limited to British Columbia. As the roller coaster of western land and housing prices has begun to lose some of its momentum in 1981, and since real estate markets in places such as Toronto, Regina, Montreal, Winnipeg, Hamilton, Guelph and Halifax have been lagging

behind, these cities have been recently attracting "smart" investment funds and undergoing, as a result, significant rises in home values there as well.

If Vancouver's experience is any indication, we can soon expect a chorus of complaints blaming the speculator for rising home prices all across Canada — or rather a resumption of same, for since time immemorial speculators have been vilified for high and rising prices.



This view is incorrect; in fact the opposite is true: the result of speculation is to reduce the extent of price rises from what would have prevailed without it. To see this clearly, let us consider the uncontroversial example of "widgets", and then, having established the basic principles for the classic case, apply them to the special and more sensitive issue of land and housing prices in Canada.

Accordingly, we shall suppose that in the absence of speculation, the future supply of widgets is as in the Biblical story: seven fat years followed by seven lean. Given similar demand in the two periods, the years of ample supply would result in low prices and the era of short supply in high prices.

Enter the speculator. What will he do? If he has any sense, he will follow the sage counsel of profit-seeking: buy when prices are low and sell when they are high. His initial purchases will, to be sure, raise prices above the low levels that would otherwise obtain in the first period, as his additional speculative demand is now added to the demand to buy widgets for consumption purposes. But his subsequent sales will reduce prices from the high levels that would prevail, apart from his efforts, in the second time interval. This is because speculative sales, when added to other sales, must depress prices further than all other sales would have done by themselves.

The speculator will be seen by people to be selling at high prices in years 8 to 14. People will thus blame him for these escalated prices, even though they would have been still higher in his absence.

But the speculator does far more than merely iron out prices over time. By dampening price oscillations, he accomplishes something of crucial importance: the stockpiling of widgets during the years of plenty, when they are least needed, and the dissipation of the widget inventory during times of shortage, when they are most useful[1].

Furthermore, the speculator's actions in the market signal to all other businessmen that an era of short supply is expected in the future. His present purchases raise widget prices, and hence the profitability of producing them now. This

encourages others to do so before the lean years strike. The speculator is the Distant Early Warning System of the economy.

But, as in the days of yore when the bearers of ill tidings were put to death for their pains, modern day messengers — the speculators — are blamed for the bad news they bring. There is talk of prohibiting their activities outright, or of taxing their gains at 100% confiscatory rates. Such moves, however, deprive society of the beneficial effects of speculation.

There is only one possible fly in the ointment. If the speculator guesses incorrectly and see years of plenty ahead when belt tightening is really in store for the economy, then chaos will result. Instead of stabilizing prices and supplies of widgets, the speculator will destabilize them; instead of hoarding during the fat years and reducing inventories during famines — and leading others to do so as well — he will encourage needless saving under adversity and wasteful profligacy in good times.

The market, however, has a fail-safe mechanism to prevent just this sort of disaster[2]. The speculator who guesses wrong will buy high and sell low - and incur losses, not profits. If he continues to err, he will go bankrupt, and usually very quickly. Professional speculators who have survived this rigorous market test of profit and loss can be relied upon to forecast the future with far greater accuracy than any other conceivable group, including seers, crystal-ball gazers, bureaucrats, politicians, mystics, marketing boards or swamis.

Now let us consider the effect of speculation on land and housing prices.

As in the case of widgets, the speculator is observed to be selling at high prices, to be holding land off the market until yet higher and higher prices are reached. But if we carefully trace out the effects of such activities, we can see that the only time the speculator could have raised prices is when he **buys** — and that he bought when prices were low, before the increase in demand. We can likewise see that the only results of speculative sales is to **decrease** prices. No matter how expensive the level at which the sales take place, prices would have been higher still in the absence of this additional land and housing supply.

The speculator can function as a distant early warning line in this market as well. His initial purchases can encourage the construction of additional housing: at higher home prices, more profits can be earned in building, lumber, cement, wiring and so on. By definition, additional land cannot be created (barring reclamation from the sea, as in the case of Holland) but space can be converted to housing from other uses, such as farming and industry.

Let us now consider the housing and land markets in Vancouver, where prices had been soaring in 1981. Even in the absence of land speculation, there is absolutely no doubt that prices would have risen. In 1980, B.C.'s population had risen by an astounding 70,200 people. This is an average of over 1300 people per week! Although geographical breakdowns are not available, settlement patterns indicate that most of the settlement was in the Lower Mainland area. Net immigration from other provinces had been running at a white-hot pace, reaching an all-time high in the last three months in 1980 of 14,720 people. All those jokes about 17 people crammed in a Volkswagen heading west to B.C. must have some basis in fact.

Why do most housing prices rise under such conditions? (1) Many additional people have been seeking housing. (2) Government has refused to allow for additional building space through its agricultural land reserve policy. (3) Zoning

laws[3] have precluded increasing the intensity with which the limited amount of available land may be used. And of course, the supply of land itself is limited — as Will Rogers so accurately observed "they ain't making any more of it."

The speculator's role in all this has been to deliver an economic message — for all those capable of interpreting and translating it back into common parlance. By purchasing land, buildings, homes, and other real estate long before the present price rises, and beginning the process of development or redevelopment, the speculator functions, as we have seen, as a Distant Early Warning System. He gives notice that, at least in his opinion, shortages and higher prices are due in the future.

If others heed this message, they will act so as to solve the crisis before it even gets off the ground. Additional land in the G.V.R.D.* cannot, of course, be created, but more homes could have been built, land taken out of the agricultural land reserve, and more accommodation units placed on a given acre, by constructing highrises or by using smaller lot sizes.

This bewildering array of government activities — all seemingly aimed at worsening the local housing crisis, not solving it — has hemmed in the speculator. Speculators would have loved to convert Fraser Valley farmland worth a few thousand dollars per acre, at best, to home-building parcels worth hundreds of thousands and even millions per acre. But they are prohibited from doing so by the agricultural-land reserve policy. Only a small percentage of Vancouver's foodstuffs is grown in the Fraser Valley. Yet government has made a fetish out of trying to preserve this status quo, even though virtually everyone would prefer vast savings in their mortgage and rent payments.

Land developers would be more than willing to provide additional housing — on a highly concentrated unit-basis per acre — but are discouraged from doing so by zoning legislation that severely restricts such things as lot size and floor-space ratios and by tax reforms that have taken capital cost allowance privileges off the provision of residential accommodation, while maintaining them for movie production and other nonessentials.

Last but not least, provincial rent controls[4] diverted what limited funds and land space were available to real estate away from the rental sector, which needs it most. It is in this sector that the highest concentrations of single-parent families, the handicapped, minorities and people on low and fixed income are found.

The hated speculator would love nothing more than to "exploit" these people — by providing for their needs! But when rent controls take away the profit potential and increase the downside risk, they reduce the incentive to do so.

Where bureaucrats tread, landlords, developers and speculators fear to go.

Yes, the speculator raises housing prices through his initial purchases. But when prices turn upwards (because of immigration) and he begins to sell off his properties, the speculator causes housing prices to fall below the levels which would otherwise have been obtained but for his actions. The speculator, in other words, doesn't just increase prices, rather, he evens them out. His initial buying raises relatively low prices and his sales reduce relatively high ones.

The people to blame for the housing crisis in B.C. are not the speculators. While risking their own hard-earned money, the speculators have acted to

* Greater Vancouver Regional District

provide more housing. It might not have been any part of their intention to help solve the housing crisis, but by "buying low and selling high" they have contributed to the solution. Their actions compare very favourably indeed with those who say they are concerned about people's access to housing, and yet worsen the housing crisis by maintaining and supporting the agricultural land reserve policy and restrictive zoning legislation. Both of these policies reduce the effective supply of land available for housing, with the consequence, as any school child can predict, of uniformly higher land prices.

If these self-same "public servants" impose a 100% profit tax on land speculation, as they have threatened to do, they will only succeed in neutralizing the one group that has actually done something about housing. The profit seeking, land developing, speculator.

Now consider a speculative incident that recently took place in the Ontario real estate market. Greymac Corp. bought 11,000 rental housing units located in Toronto from Cadillac-Fairview at a price of $270 million, and resold these properties to Kilderkin at a price of $312 million, earning a cool $42 million on the deal. Kilderkin, not to be outdone, sold to Saudi Arabian interests for $500 million, chalking up a whopping $188 million profit. Subsequently, Toronto changed its rent control provisions so as to reduce the rentals the Arabians would otherwise have been entitled to collect.

A straight business deal, worthy of, at most, being buried on page six of a newspaper's financial section? Not so. Instead, this transaction has generated a storm of complaints and recriminations.

Many people objected to the property flip on grounds of speculation. They reason that Greymac exploited Cadillac-Fairview (and that Kilderkin did the same to Greymac) to the extent of the profit each company earned on the flipovers. They see no benefit conferred by either company nor any public interest served by such a financial arrangement.

It must be stressed, however, that none of the sellers were exploited by the buyers, even if resale later took place at a higher price. At the time of the sale, in the best estimation of the vendor, the property in question was worth less than the sale price. The deal would hardly have gone through otherwise. So, each seller gained the difference between its subjective assessment of this higher value, whatever it was, and the sale price. These are big boys involved in all these transactions. They went into these complex deals with their eyes open.

Nor was there any guarantee, at the time of purchase, that any of these properties could later be resold for a profit. On the contrary, each new owner took upon itself the financial risk of residential property ownership in these uncertain times. Each was able to successfully anticipate the future course of values. And this is surely an ability to be encouraged if our economy is to grow and prosper.

According to the controls legislation which existed at the time of the Saudi Arabian purchase, rents were to be set based on the sale price of a building. Under these rules, with the increased sale price, rents in these 11,000 units would have risen by as much as 50 per cent. Faced with this spectre, the Ontario government moved quickly. With the new rent control regulations, allowable rent rises were curtailed, by temporarily limiting the proportion of rent increases based on financing costs to 5 per cent.

The reason for this political move is obvious. With a depressed economy, it is difficult to see how tenants can afford rent rises of such magnitude (although many of the tenants in question pay a very small fraction of their incomes on rent). And with a vacancy rate of only 0.7 per cent, it is difficult to see many alternatives for the tenant population of Toronto.

But the shortage of residential rental units is a product of rent control legislation in the first place. In the office space market of metropolitan Toronto, where rent controls do not apply, the vacancy rate was a whopping 5.1 per cent in June 1982, and, according to preliminary reports, will reach the 7 to 8 per cent range by December 1982. Quite a contrast to the 0.7 per cent vacancy rate for residential units.

As has been definitively shown in the Fraser Institute book **Rent Control: Myth and Reality**, rent control lowers the supply and quality of housing, thus paradoxically **raising** rents in the long run. In toughening its rent control stance, the Tories will thus **worsen** the situation of the Ontario tenant.

The Blue Machine may have scored some short-run gains in the popularity polls by cutting the rent levels the new Arabian landlords would otherwise be entitled to, but the signals sent out by such **ex post facto** law are dangerous in the extreme. They will have an even further chilling effect on the incentives to invest in residential rental units anywhere in Ontario.

Instead, the statesmanlike path would be to phase out rent controls. In the long term, this would attract new investment, thus lowering rents and raising vacancy rates.

And it would help ameliorate conditions even in the short run. For under controls, below market rent levels encourage tenants to occupy dwelling space in excess of their true needs. Temporarily higher rents would thus lead to a better allocation of rental apartments. This would free up underutilized housing space, keeping rents within bounds until the new investments can come on stream.

If we are to continue to create an advanced industrial civilization out of the Canadian wilderness, we will simply have to promote foreign investment. Our territory is simply too vast, and the savings of our people too small, to be able to do the job completely on our own. In addition, foreign investment is sorely needed in order to free domestic funds which can be used to get our recession-plagued economy moving once again.

But what a signal the Ontario government has just sent out to would-be foreign investors! Coupled with FIRA and NEP, this punitive policy will surely help convince the world even further that Canada is no longer a safe haven for their investment dollar. It may gladden the hearts of the economic nationalists who fear "selling our birthright." But which is a better goal to aim at? One hundred per cent ownership of a small, depressed economy, or a somewhat lower percentage of an economy that is productive, vibrant and growing? In any case, such a decision should be made by **each** of us, with regard to our own property, rather than by an economic dictator, on behalf of us all.

By violating the property rights of the Saudis, moreover, the Ontario government is also attacking the property values of Canadians. For the fewer the number of interested bidders, the less our property will be worth.

Rent control tightening — however tempting — would be a disaster on numerous levels. One can only hope that the Ontario government will have the courage to reconsider, and to wisely resist pressures brought to bear on it.

Now let us consider several objections to the view that the speculator makes a positive contribution to the public good.

1. ***But the speculator's initial purchases start the upward price cycle even in the "fat years".***

Of course the speculators' initial purchases start the upward price movement during the "fat" years, when prices are low (and decreases prices when he sells during the "lean" years, during the time that prices are high). This is precisely the main effect of speculation: to dampen down the price oscillations, or cycles, that would otherwise prevail in its absence. Decreasing price variation must inevitably imply **raising** low prices, as well as decreasing high ones. To blame the speculator for this is like blaming apple pie for tasting so good. That's the whole point of the enterprise.

2. ***If the speculator hadn't scooped up the housing at that early point in the cycle and held on to it, exactly the same amount of housing would already have been available when the lean years arrived.***

This objection ignores the point, made above, that the speculator serves as a sort of Distant Early Warning System. By making his initial purchases during the "fat" years, when prices are low, the professional speculator may well encourage imitators. These people may want to "ride along" with the speculator, and thereby earn profits, in much the same manner as crap shooters bet on the player who seems to be in the midst of a run of luck.

Moreover, there is another reason for dismissing the claim that "exactly the same amount of housing would be available." The speculator, it must be remembered, is by assumption one of the **few** people who foresees the lean years ahead. Surely we may expect **more** housing to be saved (through better upkeep, maintenance, more investments in repairs, upgrading) by people such as the speculators who expect housing to sell at a premium in the near future, than by people who do not.

3. ***When the speculator finally sells, during the "lean" years, he will sell at homeowner prices instead of speculator prices - it being given that speculators can usually hold out for their desired loot longer than homeowners who need to sell quickly.***

If any proposition is more likely, it is the very opposite. For the speculator is more likely to be a person with his eye strictly out for the "main chance". Who has ever heard of a speculator sitting on a piece of land and refusing to sell for **any** price, because the house on top of it "was in the family for years" and has "sentimental value"? No. In land sales older people and homeowners can usually hold out[5] for longer time periods than speculators, who are ever on the search for yet another profit opportunity, and unwilling to keep their funds tied up in any one venture for a long time.

4. ***The speculator keeps land idle. This is wasteful, and deprives the economy of a much needed impetus[6].***

We can answer this objection in several ways. On a somewhat superficial level, it (usually) exposes the hypocrisy of the person who makes it. For most people who oppose speculation also favour conservation. But idle land is by definition land under conservation. If a person favours conservation, and thinks that speculation keeps land "idle", he thus cannot logically oppose speculation.

On a more fundamental level is the fact that land speculation serves several useful social functions.

First of all, speculation or an unhampered market tends to put land into the hands of the most capable property developers. Many people do not realize that property development requires any great amount of ability. They feel, somehow, that it is only a matter of renting (or selling) to the highest bidder.

Even were that the case, land development would still be a task calling for a great outlay of skill. How else can we account for the economic importance of auctioneers and brokers of all kinds, whose "only" job is to ensure that sales are indeed made to the highest bidder (and that all bids are as high as possible in the first place)? How else to account for the graft, corruption and otherwise poor records attained by city governments which have taken upon themselves the responsibilities of "contracting out" municipal services to private firms (in this case, trying to ascertain the low bidder)?

But real property development calls for far more than the ability to rent or sell to the highest bidder. Right at the offset is the choice between renting and selling. If renting is decided upon, there are an indefinitely large number of alternatives, including duration of the lease, security, financial terms, services provided, etc. A wrong decision in any of these dimensions can lead to lower profits and less social utility.

Land is valuable not only for what value it can create in the present, but for what may be accomplished with it in the future. Prescience, unfortunately, is denied mankind, at least on this side of heaven. Therefore the best future use of idle land is never known for sure. (Does anyone believe that present settlement and building patterns would have been as they now are, had we somehow been able to know what the economic conditions of today were to be like, 10, 30, or 50 years ago?)

This is the reason speculators oft-times keep their land "idle": they do not as yet perceive the future course of events as clearly as they think they someday might. They are willing to wait for some inspiration into the hazy mists of the future. They forego the present rents they might otherwise have obtained, in the opinion that the gains to be made by being flexible (keeping land idle and unencumbered) are likely to be higher than those alternatives. The speculator, in other words, fears that a better use for this land might make itself known later, right after he commits it to a poorer use; and that the cost of clearing up this mistake (demolishing a building, buying out a tenant's lease) might be greater than the additional rents he could have collected from the better use. In weighing these alternatives, the speculator attempts to determine the most valuable use the members of society place on his land.

Do the opponents of speculation really wish no land to be "idle", for these precautionary purposes?[7] If so, they cannot be motivated by a desire to satisfy consumer sovereignty. For there is an optimal building rate over time — that is, an optimal rate at which land is withdrawn from "precautionary balances" — deviations from which can reduce welfare. This rate is determined by consumer (and landowner) preferences, by interest and time-preference rates, by the prices of substitute and complimentary factors of production, etc. Perhaps in some conceivable circumstances this optimum rate might call for the immediate discontinuation of all "idle" land, as desired by the opponents of speculation. But even under these circumstances, speculators would themselves be led "as if by an invisible hand" to sharply reduce "idle" balances of land. Thus there would be no need to oppose the operation of the unhampered marketplace even in these circumstances.

Let us close with the observation that speculation is very much more widespread than its opponents seem to realize[8]. Not limited to land, speculation certainly applies to other organized markets such as stocks, commodities, currencies, metals, etc. But this is just the tip of the iceberg.

For speculation occurs even in the most ordinary of transactions. Every time the housewife goes grocery shopping she is speculating. If prices are falling, she might have been better off to defer her purchases; if they are rising, she might have done well to buy twice as much. Every time the worker upgrades his skills, he is speculating that the (discounted) value of the additional wages he may earn as a result, will be greater than the value to him of dollar expenditures, efforts and psychic costs he expended in obtaining the new training. Every time a child buys a toy he is speculating that he won't see another toy he likes still more — after the money is gone.

We may even say, that speculation is at the very core of human action. The opposition to speculation, then, is at root an opposition to human action.

FOOTNOTES

1. See Israel Kirzner, **Market Theory and the Price System**, New York: Van Nostrand, 1963, pp. 315, 316; Carl Menger, **Principles of Economics**, New York: New York University Press, 1981, p. 251.
2. Paul Heyne, **The Economic Way of Thinking**, Chicago: S.R.I., 1973, pp. 130, 131.
3. See Walter Block, ed., **Zoning: Its Costs and Relevance for the 1980s**, Vancouver: The Fraser Institute, 1980.
4. See Walter Block and Edgar Olsen, eds., **Rent Control: Myth or Reality**, Vancouver: The Fraser Institute, 1981.
5. For an analysis of monopolistic withholding, see Walter Block, "Austrian Monopoly Theory — a Critique" in **The Journal of Libertarian Studies**, vol. 1, no. 4, Fall 1977, pp. 271-279.
6. For a full critique of this famous charge made by Henry George, see Murray Rothbard, **Man, Economy and State**, Los Angeles: Nash, 1970, pp. 512-514.
7. John Maynard Keynes, **The General Theory of Employment, Interest and Money**, New York: Harcourt, Brace & World, 1964, pp. 170-172.
8. Ludwig von Mises, **Human Action**, Chicago: Regnery, 1963, pp. 252, 253; Kirzner, ibid., pp. 16, 17.