

FREEMarket

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PROFITING FROM KNOWLEDGE

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Entrepreneurs are in a danger zone when their activities are incomprehensible to the general public. People begin to regard unexplained profits as suspicious, and the entrepreneur encounters public hostility. Entrepreneurs who assemble physical objects may find their activities transparent enough to avoid the torch-bearing mob, but beware of those who make a buck off information.

Consider used car dealers. These people essentially find buyers whom the sellers could discover only by incurring high costs. As a penalty for dealing in information, they share the social stratum occupied by sub-prime lenders, network marketers, and TV faith healers. Anyone who profits only by gathering and using information, without changing the physical form of objects, risks the wrath of those who hold to what Thomas Sowell called the “physical fallacy”—that value is only created when an object’s physical properties change.

Real estate investors have come under fire for the common practice of “flipping” a property. An investor finds a seller who is willing to sell for a low price (perhaps because of imminent foreclosure or to gain immediate cash to pay other debts), then immediately attempts to resell the property to a third party. It’s the day trading of the real estate world, with advantages to those familiar with real estate law, finance, and the nuances of local real estate conditions.

If extensive repairs are done to the property before the resale, the flipping becomes the slightly more respectable operation called “rehabbing.” Perhaps the flip includes a new coat of paint or a little landscaping, but otherwise it may not involve much physical change in the house.

The profits from flipping or rehabbing—and they can be substantial—accrue to those who are able to match willing sellers with willing final buyers. An acquaintance of mine learned of a house he could purchase for less than \$20,000, which he put under contract sight unseen. On his way over to the house, he contacted a potential buyer, had the buyer meet him at the house, and sold it on the spot for \$70,000.

Those who appreciate the entrepreneurial knack for handling disparate pieces of information can marvel at the skill and cleverness of such investors. Yet the quick profits that sometimes accompany real estate investing attract equally quick condemnation.



Around the country, a suspicious mob is gathering, and they are lighting their torches. Several years ago, the Department of Housing and Urban Development (HUD) passed a rule penalizing property owners who resell the properties within a short period of time, citing concerns about property flipping. (The penalty is a restriction on obtaining mortgage insurance from the Federal Housing Administration.)

A September 2006 entry on a Western New York political blog was headlined “Federal Leadership Needed to Combat Property Flipping.” The targets were “absentee landlords” and “speculators,” alternately referred to as “slumlords and shysters.”

Last year, a Georgia congressman introduced H.R. 200, the “Prevention of Predatory Lending through Education Act,” which supported HUD in its desire to restrict or ban loan “flipping.”

Free markets do not guarantee freedom from fraud, and there are in fact a few slimy real estate investors who will lie and steal. The state thus gets its foot in the door, although anyone paying the least bit of attention would note that the state itself habitually lies and steals, under the direction of truly slimy politicians. Only a little actual fraud will suffice to justify clamping down on the entire industry. Proposed legislation regulating real estate flipping in North Carolina was based on three cases of fraud in the state, a tiny fraction of a large real estate market.

Even some nonslimy real estate investors are burdened with guilt over their occupations. One wrote that he was concerned that certain types of real estate investing might violate laws like

the Texas Deceptive Trade Practices Act. This law (Texas Business and Commerce Code Section 17.45) prohibits “an act or practice which, to a person’s detriment: (A) takes advantage of the lack of knowledge, ability, experience, or capacity of a person to a grossly unfair degree, or (B) results in a gross disparity between the value received and the consideration paid.”

Unfortunately, this sort of law is so ambiguous that it is worse than useless. If the sense of the law is merely that the contract should communicate clearly what is to be traded, under what terms, and for what payment, the law may be innocuous enough. But it seems to say much more than that.

Since all transactions involve unequal knowledge (and opinion) between buyer and seller, who is to say what is “unfair”? This leaves all transactions open to potential cancellation by the state, should the court decide that the inevitable inequality of knowledge was great enough to warrant intervention.

The second clause in the Texas statute could be equally damaging to the security of any contract. All transactions occur where there is a disparity between the value received and the consideration paid—and who is to say how much is a “gross” disparity? This problem emerges from a fundamental error that has plagued economic and political thought since Aristotle, at least.

Murray Rothbard, in his *Economic Thought Before Adam Smith*, explained Aristotle’s misunderstanding of exchange:

“Aristotle says that in order for an exchange . . . to take place, the diverse goods and services must ‘be equated,’ a phrase Aristotle emphasizes several

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times. . . . His reasoning was that for *A* and *B* to exchange two products, the value of both products must be equal, otherwise an exchange would not take place. The diverse goods being exchanged for one another must be made equal because only things of equal value will be traded.”

The Aristotelian concept of equal value in exchange is just plain wrong, as the Austrian School was to point out in the late nineteenth century. If *A* trades shoes for sacks of wheat owned by *B*, *A* does so because he prefers the wheat to the shoes, while *B*’s preferences are precisely the opposite. If an exchange takes place, this implies not an equality of values, but rather a reverse inequality of values in the two parties making the exchange.

If I buy a newspaper for 30 cents I do so because I prefer the acquisition of the newspaper to keeping the 30 cents, whereas the news agent prefers getting the money to keeping the newspaper. This double inequality of subjective valuations sets the necessary precondition for any exchange.

So what of the person willing to sell their home for \$20,000, when a real estate investor believes there is a reasonable chance of getting \$70,000 for the house? There is certainly a disparity of information. The seller may not know market prices for similar houses, and may not know where a person willing to pay \$70,000 may be found.

If rehabbing is necessary to bring in the \$70,000 price, the seller may not know what repairs to do, or which contractors would do the work well and without fraud. This is valuable information which the investor may have obtained only through years of experience in the business. It may have taken years of trial and error to find realistic appraisers, sources of financing, reliable and low-cost contractors, and efficient methods for reselling the house. To argue that the buyer is under obligation to reveal all this to the person willing to

sell at \$20,000 is to argue for a communism of information.

The home owner may be willing to sell at a steep discount in order to pay off the mortgage to avoid imminent foreclosure. For whatever reason, the owner wants liquidity and is willing to make a large sacrifice to get it. It may even be the case that the home owner knows more about the neighborhood than the real estate investor, so that what looks like a steep discount to the investor is no discount at all.

In the process of buying, fixing up, and reselling properties, real estate investors tend to leave neighborhoods much improved. This is urban renewal free-market style, in which property is paid for at a price voluntarily agreed to by the seller, not condemned or designated as “blighted” by the city and seized.

One real estate investor I know purchased a house from an absentee landlord whose drug-abusing tenants (relatives of the landlord) had completely trashed the house. Rotting mattresses, filthy clothing, and broken furniture cluttered the bedrooms. Chunks of daylight were visible through the ceiling, and the walls looked structurally unsound. There was a rodent infestation problem.

The house was so unlivable that the tenants had apparently remained out of doors as much as possible, judging from the table and chairs in the front yard. My real estate investor friend bought the house, gutted it to the studs, and turned it into one of the most valuable houses in the neighborhood in about a month. The neighbors were delighted, since it removed an eyesore and increased the value of their own homes.

Some observers have remarked that increased “flipping” activity is a marker of a real estate bubble. I doubt that is true for rehabbing, but it may be true for plain flips, just as the departure of employees to full-time day trading was an indicator of an overblown stock market in the late 1990s. Turning \$20,000 into \$70,000 in a couple of hours may be more common during a bubble, and it

might be more reasonable to expect real estate investing to revert to modest profit levels as real estate values settle.

Excessively “creative” financing schemes used by investors to buy real estate may turn out to be the real estate equivalent of buying stock on margin using a credit card. However, even

though the Federal Reserve’s monetary excesses may occasionally lure too many into day trading and real estate investing, both are worthy entrepreneurial activities. There is nothing inherently slimy about trading real estate, and certainly nothing warranting the state’s regulation of this market. ■

IS FREE-MARKET FOOD DEADLY?

Llewellyn H. Rockwell, Jr.

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This fall, the news of an *E. coli* infection that originated in a bag of fresh spinach packaged by Natural Selection Foods, kicked off a nationwide frenzy. More than 180 people became sick from eating spinach, 97 of whom were hospitalized. Three people died. The company in question went into total meltdown, and growers around the country are redoubling their efforts to make sure that every leaf is clean and pure.

At the first notice of problems, five different companies immediately announced a recall, as did merchants around the country. Baggers started shipping salad with greens other than spinach. Grocery stores immediately switched vendors. Once it became clear that Natural Selection of Northern California was the culprit, distributors started making contracts with Southern California and Canadian companies.

Consumers stayed away in droves, and parents around the country did an about-face on their opinions of spinach.

This is one of the benefits of the information age, when word gets out to hundreds of millions in a matter of minutes. The response was a marvel of how markets can work. A valuable product said to bring health suddenly becomes a source of sickness and within hours,

people not only stop eating it; it isn’t even available for purchase! Compare the response time with the way governments at all levels responded to Katrina, for example.

The story might have ended there, as the grocers isolated the source of the problem and the baggers turned their attention to the farmers and the farmers looked more carefully into the irrigation and fertilizer sources and otherwise sought to fix the problem. And why wouldn’t they? They are all in business to make money. You can only make money by selling things that people want, and this much is absolutely certain: people don’t want spinach that makes them sick.

But then, and inevitably, the government got involved. The FDA echo chamber started issuing recalls. Then, incredibly, the FBI got involved, as if we were talking about thugs and criminals and terrorists rather than bad soil or a mistake at the company. Criminal prosecutors began giving ominous warnings about how “certain spinach growers and distributors may not have taken all necessary or appropriate steps to ensure their spinach was safe.”

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News from the Institute

The Summit

Our Supporters Summit of 2006, held in Auburn, had much to celebrate! The topic was serious: lectures on the history and present reality of imperialism. But the mood was ebullient: the Mises Institute is making ever more progress in reaching students, professors, and people of all sorts with the message of freedom. Particularly exciting for us this year has been the blizzard of publications that have poured forth from our offices, books, and journals. The dissemination of ideas is the best way to fight against the rising tide—and it is even better when it can be done with the optimistic outlook that was on display at this year's Summit. ■

Power and Market

What can government do to enhance social and economic well-being? Nothing, says Murray N. Rothbard. *Power and Market* contains the proof. It will inoculate the reader against even the slightest temptation to invoke the state as a solution to any social or economic problem. It is the ultimate manual for completely demystifying the myth of the state. This beautiful new edition is the first to truly do it justice.

The Rothbardian claim is perhaps the most radical made in the history of political economy. But how can it be convincing? Rothbard systematically classifies every form of intervention into three types: autistic, binary, and triangular. Within each category, he discusses their ill effects, and does so with precision and insight. Free-market scholars have been using and expanding on his insights for years. But in this book we have the source. Rothbard shows that intervention is not helpful, no matter what type it is. And he provides the logic for understanding how all forms of government aggression make society worse off. ■

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The Scholars Conference!

The next big event at the Mises Institute is the 2007 Austrian Scholars Conference, where academics and students from around the world gather to present, hear, and comment on new research. It is a great occasion for professional advancement and also socializing in the tradition of the old Mises seminar in Vienna. The dates are March 15–17, 2007. Write Joseph Salerno, director, to propose papers or sessions: jsale@earthlink.net. To register for the conference go to mises.org/events or call 800-636-4737.

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Then the search warrants came. The FBI said, “we’re definitely looking into the possibility that there was a criminal violation of federal environmental laws” that took place. So you can go to the FBI site and see news of how they are arresting people for supporting terrorists, hunting down the nation’s most wanted cop killers, breaking up violent gangs, hunting down art thieves, and also muscling spinach baggers.

Has the government never heard of the difference between civil and criminal law? To place this in the category of criminal law means that instead of fines and reimbursements or, at worst, punitive damage payments in the case of negligence, the people being investigated are implicitly threatened with jail and other forms of violence.

For this to be a criminal case implies that the grocers, baggers, or farmers involved in this problem are seeking to harm people through nefarious tactics, or otherwise seeking to profit by making people sick. This is ridiculous. Also ridiculous is the idea that the FDA and the FBI need to be involved in regulating and punishing people in business for failing to serve the interests of consumers.

The truth is that the people who buy and sell are far more interested in the well-being of the public than bureaucrats who have no more professional stake in the outcome of the enterprising process than the man in the moon. Their only interest is protecting their power and position. Increasingly, they seize on any and every headline to whip up public frenzy.

This is government in the Bush age, in which every turn of events becomes a matter for federal goon squads to crack skulls. People often claim that the government used 9/11 as an excuse to do what they wanted to do in any case—to trample on the Constitution’s protections against violations of our personal liberty. Not only is that true; the government is now using the smallest and most petty excuses to do the same.

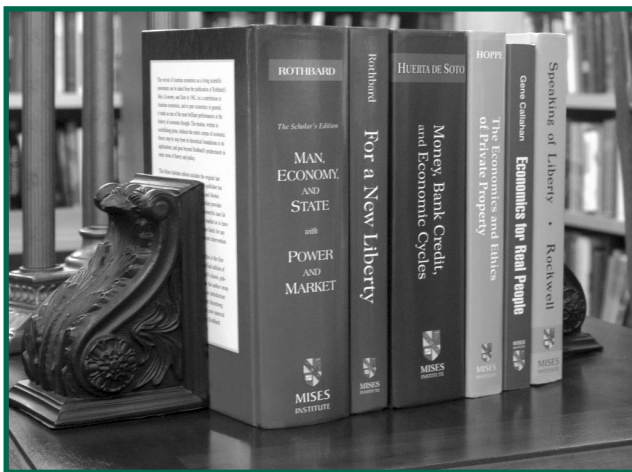
But you might say: at what cost? What is the big deal as to whether the FDA and the FBI are involved in the great spinach case or not? Surely the only result will be that merchants will become more careful about guarding the health of consumers.

Actually, I don’t think that is a foregone conclusion. Many more people die per day on government highways than became sick in this spinach scare, and I see no hysteria to prosecute road builders or bureaucrats at the Transportation Department. Far from protecting people, the government has a special skill associated with perpetually endangering people such as American soldiers in hostile foreign lands, not to speak of civilians. It is not at all obvious that government has the interests of our health at heart when it regulates and controls us.

There is also an ideological cost here. Whenever government demonizes merchants, it encourages the view that we must be forever on the lookout for dishonest business people who are seeking to make us sick, and from whom only the great civil servants in government can protect us.

These sorts of investigations actually encourage the view that free enterprise is a source of danger and a health hazard rather than our source of service and health enhancement. After all, a century ago, people would have found it to be nothing short of a miracle that greens could survive a cross-country trek and land on your dining table in pretty much the same state as when they were picked.

There is also a cost to freedom itself. We are being conditioned to believe that for every problem, there is a government answer. Even mild cases of food poisoning merit a nationwide investigation and crackdown on bad guys, who, we are encouraged to believe, are always in the private sector and never in the public sector. Well, when it comes to the choice between a totalitarian state and the possibility of some rotten spinach, I’ll take the latter. ■



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