

HOW TO THAW CREDIT, NOW AND FOREVER



Ed: Weaving the issue of debt into what he's previously written about speculation in land as the cause of the Great Crash of 2008, **Prof. Mason Gaffney** outlines the only long-term solution to this – and all reoccurring – economic busts

1. INTRODUCTION

Working capital is the bloodstream of economic life. It is physical capital, the fast turning inventory of goods in process and finished goods that supplies materials to the worker, and feeds and clothes her or his family. Short term commercial loans and trade credit buy it, but the capital is "real" — a fact often forgotten in the paper and virtual worlds of high finance whence come the highest inner circles of government.

The bloodstream metaphor harks back to François Quesnay, an 18th century French physician turned economist. Quesnay drew on William Harvey's (1578-1657) earlier discovery of how blood circulates. Adam Smith and other classical economists followed Quesnay, distinguishing "circulating capital" from "fixed capital," the kind that is stuck in the ground or otherwise lasts for many years. Today we call the bloodstream metaphor "macroeconomics", elaborated but not always improved from Quesnay's insights.

Now the economic blood is drained down, and what's left is slushy. We need to restore and thaw it, and get it circulating, right away as well as over time. To understand how, let's see what drained it away in the first place.

My thesis here is neither purely Keynesian, nor monetarist, nor Austrian, nor Georgist, but combines elements of all those models in ways that are off "mainstream" thinking today. A great fault in the first three models is ignoring the "wealth effect" role of land as "fictitious capital", and treating all taxes as alike. The fourth (Georgist) model lacks a good concept of how capital circulates. Some readers may find it puzzling and alienating to proceed without one of the old familiar models. Considering where mainstream thinking has led us, and how dismal are its forecasts now, and how it lacks any positive guidance for recovery, it is timely to seek a new mainstream.

2. PUBLIC DEBT AS VAMPIRE

Each Federal deficit draws more blood from the private

sector. Cumulative deficits add up to the national debt. Washingtonians used to joke about a hick Congressman whom the voters returned for several terms because he never voted against an appropriation or for a tax bill; but now the Republicans, once the reliable foes of public debt, have doffed their green eye-shades and become its champions. The debt was \$900 billion when Reagan and Bush Sr. took office in 1981. In 1984 Mondale/Ferraro campaigned to stop the bleeding, but voters chose the lure of lower taxes and higher spending. When Bush père left office in 1993 the debt was \$4,000 billion, a number so high we started counting it in trillions.

From 1993-2001 the pendulum swung back as President Clinton came to terms with the newly-thrifty Republican Congress. Equally important, he did not invade any other nations. Some military bases like The Presidio and Marin Headlands were actually closed, rare as that is; others, like March A.F. Base, were mothballed. Under this regimen the nation recovered from several shocks that might have triggered the collapse of a more anemic economy. Some of these were the Mexican bailout of 1994, the southeast Asia crises of 1997-98, the flame-out of Long Term Capital Management in 1997-98, the dot.com collapse of 2001, and the stock market fall from 2000-2002. Now, however, President Bush *fills* and his supportive Congresses have run the debt up to \$11 trillion, \$12 trillion, \$13 trillion or more, depending on who's counting. Whichever way recorders spin the story, the debt is a big fraction of the nation's capital – our economic blood. This has made us vulnerable to the housing crash and cardiac arrest of today.

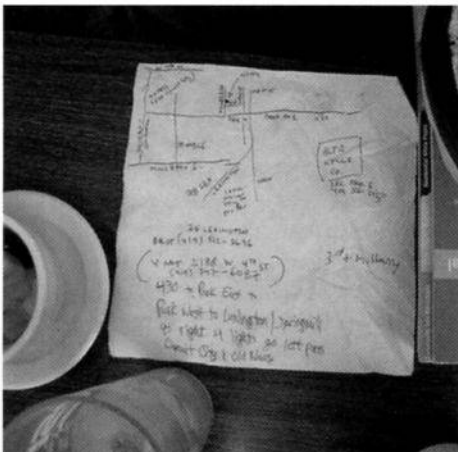
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How did Reagan and Bush persuade themselves to invert traditional Republican doctrine? There were two main gurus: Art Laffer, Jr., and Robert Barro.

Laffer drew his famous curve on Dick Cheney's cocktail napkin in 1974 and changed the course of history. Said Laffer, taxes suppress incentives so much that Washington can actually collect more money by lowering tax rates. He stressed how taxes "suppress" incentives to work and to invest. Others also stress how taxes twist incentives so people allocate resources less efficiently.

Anyone who has read Henry George will relate to how taxes suppress and twist incentives. Laffer, indeed, quoted him often and enthusiastically. Tragically, though, he only got half or less of George's idea. Laffer never specified WHAT or WHICH taxes suppress and twist incentives. George, of course, would maintain revenues by raising the neutral and even pro-incentive taxes on land values and rents, to compensate for down-taxing other bases. He noted that down-taxing other tax bases would enhance land rents and values as a tax base.

By 1979 Laffer had political distractions in mind, like rising with Ronald Reagan. The voters loved their message of lower tax rates cum higher public spending, and Reagan used it to



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help win his election. Laffer never rose to the heights of a Cardinal Richelieu, but he served on Reagan's Economic Policy Advisory Board for both of his two terms, as well as the Chief Economist at the Office of Management and Budget under Treasury Secretary George Schultz. Reagan and later Bush père bought into Laffer's plan to lower tax rates, even as Reagan's other economists advised against it. Laffer also got OMB to adopt "dynamic revenue forecasting" based on assuming that lowering tax rates would raise the tax base.

Within a few years it was clear that Laffer's tax cuts actually lowered revenues, and he lost favor. Yet today his ideas linger on in the highest circles of government. Professor Jeffrey Frankel of Harvard has published a series of Laffer-like quotes from Bush fils and various sympathetic Congressmen (2008, *Tax-cut Snake Oil*, Economic Policy Institute).

The other new guru was Professor Robert Barro, then of Rochester, now of Harvard. The same Dick Cheney, a believer, tersely summed up Barro's message: "Deficits don't matter". Barro claims to trace his idea back to Ricardo, and even calls it "The Ricardian Equivalence Theorem". It is loosely related to the assessors' theory of property tax capitalization - we leave that for another day. Barro's point is that deficits today mean higher taxes tomorrow. Present taxpayers and savers fully realize that, says Barro, so they will save more today to prepare for that burden of tomorrow. This higher private saving offsets government's dissaving. As of now Barro is still repeating this chorus with each verse: "... it matters little whether you pay for government spending with taxes today or taxes tomorrow, which is basically what a fiscal deficit is" (Interview with FRB of Minneapolis, Nov. 12 2005, in *The Region*). In other words, "Deficits Still Don't Matter" to Barro.

It was not just Barro. Iconic Milton Friedman, the very avatar of anti-Keynesianism, chimed in with "Why twin deficits are a blessing" (*WSJ Dec 14 1988*). (The other deficit was our national import balance.) Friedman had risen to fame by refuting Keynes and giving us his "monetarism" instead. Once in favor, however, with Keynes reduced to a memory, Friedman turned around and endorsed a new rationale for deficit finance, Barro's "Ricardian Equivalence Theorem".

This Barro-Friedman rationale has a seductive element of truth, but more error. The primary effect of deficit finance is that government bonds, to their owners, are an asset, a "store of value", and a substitute for real capital. George and others labeled bonds as "fictitious capital" - they are nothing but a lien on future taxpayers, yet they swell their owners' portfolios just as though they were real social capital. Thus they satisfy people's needs for retirement funds, and other comforts and joys of holding wealth, without the people's having created real capital by their saving. For most people (not all) the marginal satisfaction from holding additional wealth diminishes as they hold more. Economists call this "the wealth effect", even when the wealth is fictitious. (For those whose marginal satisfaction from holding

wealth does not diminish see Gaffney, 4- 04, *Auri Sacra Fames*, in *Groundswell*. The fable of King Midas is also in point.)

we have just been through several years of homeowners' heeding the siren songs of bankers to "unlock the equity in your house (and its land)" ... for extravagances that lust and envy and boredom and impulse can devise

By substituting for real capital, bonds lower people's marginal incentive to save and invest more. Barro recognized this wealth effect. His point was that it is offset by the negative wealth effect of the prospect of higher future taxes, so "Deficits don't matter".

It is true that some bonds do represent real social capital, as when public bodies spend the money wisely and honestly on useful objects and services of general value, like scientific

research, replacing worn-out roads and bridges, air traffic control, education, and so on. Ideally, all bonds would. The apparent dissaving would be offset by investing in public and human capital, raising incomes and land values to fortify future tax bases to retire the bonds.

History cries out, however, that nations in thrall to imperial overreach and its parasitic lobbies fritter too much capital away on sterile warfare (Kevin Phillips, 2006, *American Theocracy*). Urban history, studied with any insight, shows cities, counties, states, and nations, dominated by land speculators, doing the same on subsidizing urban sprawl. Alaska's "bridge to nowhere", even though aborted by the publicity and embarrassment surrounding its patent absurdity, dramatizes the matter memorably. (Alaska finally got the money anyway, for Heaven knows what.)

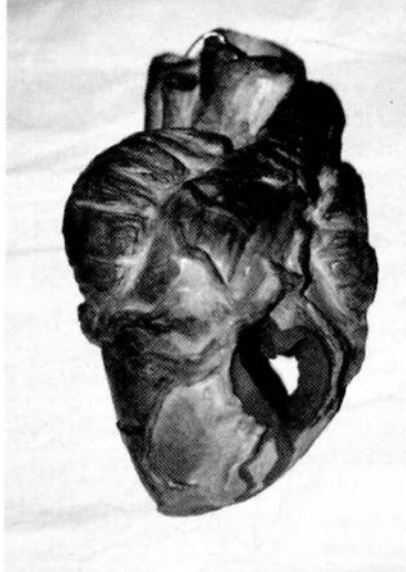
Our huge and ongoing foreign trade deficit shows that the investment crowded out of domestic industry must exceed private sector gains from public spending. That is why we have to buy so much from abroad, and can sell so little there. How could it be otherwise when so much public spending goes to maintain hundreds of military bases around the world, bribes to manipulate foreign rulers, long wars without apparent net benefit to the U.S., and the whole military-industrial complex?



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An analogy to slavery may make this clearer. It is a truism of economic history that slaves in the Old South satisfied their owners' need for wealth, substituted for real capital in their portfolios, and led to a culture of extravagance. Formation of real capital suffered. So, of course, did the slaves, who also substituted directly for farm capital. Underequipped Confederate soldiers paid the price on the battlefields.

As a secondary effect, the prospect of future taxes is a liability to bondholders and other future taxpayers - the "negative wealth effect", as Barro says. It is unlikely that this distant future possibility shows up on the liability side with the same weight as the bonds on the asset side, as Barro's critics



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have pointed out. Most of these critics, right as they are, have failed to add that our tax structures at every level have been growing less progressive, or more regressive, so future taxpayers are more and more likely to be the working poor, rather than the saving classes. Add to that that our system is fast making it worse by racing toward distributing wealth and income less equally.

(*snip!* – Ed: some Americocentric comments have been edited here)

3. THE GREATER DRACULA: LAND VALUE

There is a Greater Dracula, land value, sucking blood from our economy. Land value is invisible to most economists. Those cited above, however deep their insights about public debt, rarely mention it; their neo-classical training blinds them to it. Feldstein has written of “The Henry George Theorem”, but in another context, in a mental compartment sealed off from the present issues.

We noted earlier that U.S. bonds serve as “fictitious capital” to their owners, a store of private value that is not real social capital. So do land values, only more so. They satisfy the need to hold assets without there having been any corresponding net social saving by owners collectively, present or past. Individuals may save to buy land, but the seller dissaves in the same sale. Most home buyers, in fact, finance their purchase from selling a previous home. Mere ownership turnover of a fixed stock does not constitute net social saving.

Not only do land values substitute for real saving, they promote dissaving. Notoriously, we have just been through several years of homeowners’ heeding the siren songs of bankers to “unlock the equity in your house (and its land)” to pay for cruises, cosmetic surgery, golfing, yachts, vacation homes, fast cars, stables, and any other extravagance that lust and envy and boredom and impulse can devise. Rising land values seem to the owners like current income that they can spend on current consumption, so long as banks are ready to lend on them. That is the dynamic side of it. Then, after the values have risen, they stand in for wealth to some owner or lender, muting via the wealth effect their urge to save.

In the case of U.S. bonds there is a reverse or compensating Barro Effect. In spite of Barro’s overstating it, still there is something to it. It is a “negative wealth effect” from the prospect of higher future taxes to pay off the bonds, even though it is, as shown above, only an echo of the “wealth effect” of the bonds to their owners. There is no corresponding Barro Effect with rising land values, they rise up spontaneously, on their own. They are a free gift from human fecundity and progress, economic and social. They result from our having traveled a few more years through time, into the infinite future. Infinity remains infinite. It has simply grown more highly rentable, in the rosy visions of optimists, the ones who dominate the market. The land in a portfolio of assets is not, per se, a debt that someone must retire.

It is true that prospective buyers are now poorer, in that they must pay more for land. This might stimulate them to save more. However they, too, share the vision of higher future rents, so they are paying more simply because they think they are getting more. Sometimes they actually are. If the price to rent ratio rises it is because of the promise of higher future rents or resale values, whether or not the promise comes true.

Bernanke’s belief that we can depend on an indefinite glut of savings in foreign lands seems dreamy and even arrogant now that the glory days of American hegemony are fading fast

What about common stock? I omit it here for four reasons. One, a good deal of its value represents indirect ownership of real estate. Two, in our times its total value has dropped well below that of dwellings. Three, the media and public consciousness greatly overstate its role in the economic scheme. News reporters parrot phrases like “a fall of stock prices has wiped out a trillion dollars of wealth”. The wealth is still there; all that’s changed is expectations of future earnings, or taxes, or subsidies, or bail-outs, or even more trivial and superficial matters. Four, space and time limit us here and now: we must neglect something. What’s uppermost now is the housing collapse.

4. HOUSING AND LAND VALUES TOGETHER

(*another SNIP!* Mr. Ed has edited out more Americocentric references)

As to rental housing the renter cannot deduct the rent, but the owner’s rents are generally untaxed because the owner can often tax-depreciate the building much faster than it really depreciates economically, wiping the rental income off his tax return. This same benefit also goes to office, commercial, and industrial buildings, but not to wage and salary incomes, all of which are taxed – even the part that is taken away as the social security tax, as well as social security pension payments when the worker collects them – if he should live that long. Workers on average die a lot younger than renters.

When owner A has depreciated a building down to zero he sells to owner B, who does it all over again, and so do C, D, E, ... etc. until the building dies. When A sells to B the excess depreciation is nominally “recaptured” by taxing the nominal gain, but it is called a “capital gain”, subject to a lower tax rate, at a later date, a higher price level, and a new tax structure lowered from when A took the original depreciation.

When B tax-depreciates the building, he normally depreciates a good deal of land value, too, even though the land is appreciating. Michael Hudson and Kris Feder (1997, Levy Institute) have shown how all this lowers the taxable income from all the income property in the U.S.A. to an aggregate of zero – Repeat, ZERO!

Little people get a cut of the action, too, enough to nail down their

votes, but it’s the big people who own several mansions apiece in the choicest locations. Ever since labor got the vote in the mid-19th Century, politicians have fostered *la petite propriété* as a bulwark to protect *la grande propriété* from *la canaille*, the dogpack, the rabble. Peter Kropotkin noted how well this

system worked west of Russia. In a new "revolution the workers would have against them, not the rotten generation of aristocrats (of 1789) ... but the middle classes, which are far more powerful, intellectually and physically, (plus) the machinery of the modern state" (1899, *Memoirs of a Revolutionist*, p.290). Only Russia failed to foster its middle class, with the result we know so well.

Fast forward to 2001. Other kinds of consumer interest, as on credit cards and autos, were no longer deductible. Accelerated depreciation had been decelerated. The ENRON collapse taught investors to beware of overpaid CEO's and opaque corporate accounting.

The dot.com collapse taught us to be leery of rosy promises unsecured by hard assets. All the investment guru's told us to buy a home or two, it's the last and greatest tax shelter. And so we did, from ticky-tacky little houses on the hillside to McMansions to palaces and compounds for the super-rich, and bankruptcy-safe havens in Florida and a few other states, even Kansas, that protect residences from bankruptcy proceedings. If all this is supposed to protect family life you would not know it from our soaring divorce rate, so Tea for Two became tea for one each in two dwellings.

The arrangement has been and is bipartisan. Call something "housing" and it becomes sacred, a fetish, unassailable, even if it is San Simeon with its 82,000 (sic) attached acres and 17 miles of coastline. The result has been a massive overallocation of the nation's capital stock and land to housing. We are "overhoused America". There's not "too much housing" in an absolute sense. Many folks at the bottom are underhoused. Thousands are homeless, including many children. That's a matter of unequal distribution, but also at the core of modern politics. The former rabble has become the rationale for exempting mansions, playgrounds of the rich, and little castles of the middle class from taxation.

All that housing and land for the mansioners take capital and land away from other uses, and sequester it in unrecoverable form. Housing pays out slowly at best, and a corresponding 30-year mortgage ties up the lender's capital in a highly visible and countable way. A bank can't make new loans much faster than it recovers capital from the old ones. So we reach a point, as now, where new loans are hard to come by – to meet payrolls, buy materials, and produce the daily needs of life.

That's "at best". At worst, builders glut the market, values drop, and the capital is not even recovered slowly, it's down the drain forever. Thus this housing capital is thrice frozen. First, its "net service flow" above expenses goes mostly not to recover capital, but to pay interest (imputed or cash) and imputed rent on the resources, capital and land, tied up in it. Second an oversupply gluts the market so the owner cannot sell without a big loss. Third, bank loans secured by mortgages on this housing go bad, leading to a financial meltdown.

This is not just a domestic matter. Wall Street has been peddling these mortgages all over the world, and the international bills are coming due. We need to export more, but we can't export the surplus houses, and we can't recover the capital. That's where we are today.

So what are Congress and Treasury and Ben Bernanke proposing along with the bailout? More of the same, more "stimulus", raising the debt some more to save the housing-land market and the banks that have inflated it. Supply-

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braggart, bully, pariah, and
moral object lesson

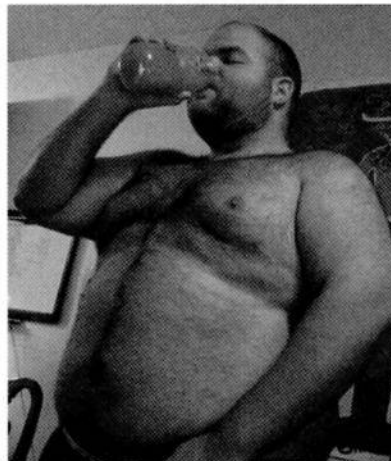
siders, faced with crisis, convert quickly into demand-siders; free-market fanatics into *dirigistes*. Even as we write, October 23, 2008, Alan Greenspan himself is admitting to Congress that deregulation failed. Even some kind of Federal regulation (but what kind?) is acceptable to prop up a failed system so we can repeat the same cycle that is crashing around us today.

Thus, traditional Keynesian macro-economic thinking, supposedly buried by monetarism, never really died; Friedman forgot to put a silver bullet through its heart, or bury it deeper than a few inches.

Today it has risen again in the high places in Washington. The idea that public borrowing and spending "crowds out" private borrowing and spending, dominant in the thrifter 1990's, is seldom heard today. Now the leading physicians picture clogged Wall Street as a case of cardiac arrest, to be cured by what FDR, in a more rural age, called "pump-priming".

Tragically, this year's Nobel Laureate Paul Krugman, like other influential liberals, is reverting to the same old demand-side panaceas. "... right now, increased government spending is just what the doctor ordered, and concerns about the budget deficit should be put on hold" (Paul Krugman, *NY Times*, Oct 16). At least Krugman's spending proposals are more egalitarian than those of Wall Street's Henry Paulson. Larry Summers and Alan Blinder, who are at least nominal "liberals" (I have my doubts), join the chorus for deficit finance. Like Paulson, they see this as a paper shortage, to be cured with more paper. This does not augur well.

Where is this new Federal money to come from? Borrowing from the public? That would mean more crowding-out of private borrowers, the very ones we need to have put capital back into the private sector. The other fallback is borrowing from Bernanke's willing Fed which will create new



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money, paper and virtual. New money without real goods behind it means inflation, more imports with fewer exports, devaluation, and a real risk that our foreign creditors will rebel.

Ben Bernanke has staked his reputation and our economy on his belief that we can depend indefinitely on a glut of savings in foreign lands (March 10 2005, Sandridge Lecture, and elsewhere). I suppose that comforting faith helped persuade him to accept his present job, but his claim seems dreamy and even arrogant now that the glory days of American hegemony are fading fast away. Wall Street has already sullied its credibility by dumping bad paper on the world. The U.S.

Treasury is not far behind. Let's ask what we should be doing instead.

5. SOLUTIONS

How can we raise the capital we need now? It's time to think big, it's survival time for the U.S.A. We need to tap two enormous sources of capital that the vampires have created, one public and one private.

The U.S. Government can create great gobs of lifeblood capital and quickly transfuse it into private arteries. We can do this without any giveaway, without rescuing failed banks with overpaid CEO's, without overpaying for and writing down toxic debt while pampered executives use our money to throw themselves lavish parties at sumptuous spas. We can do this without pouring capital into banks so they can go back to their prodigal ways. We can do this without Federal meddling with free markets and enterprise and playing favorites with bailout billions.

The principle is simple: pay down the national debt. It's called "reverse crowding-out". Governments can save, too, even as you and I, by earning more and spending less. The question would arise, in what shall the government invest without interfering in private markets? Thanks to our past prodigality the answer is easy: invest in paying the debt. Turn the vampire into a source of fresh blood, bringing new life and vitality to the once-hale, now pale and failing private sector.

The changes I propose are massive and radical, I know; but we have been massively, radically wrong

housing. It leads us back to the part of Henry George that Art Laffer suppressed.

Land value, we have seen, is fictitious capital, an asset and store of value for individuals that has no real social capital behind it. By taxing it and lowering its value we do not destroy any capital. On the contrary, we raise the owners' propensity to save and create real capital to restore the missing store of

value. We also raise revenues without suppressing or twisting the incentives of free markets, as generations of economists have shown and agreed.

As for how, this writer has published a catalogue of no less than sixteen ways to tax land and resource values at every level of government, using income taxes and severance taxes and even certain kinds of user charges, along with the obvious and traditional property tax. For some examples, we can and should levy what Netzer called "a family of user charges" for preempting space on, over, and under city streets. We should charge people, cities, water districts, power companies, and others for withdrawing water from surface and underground sources, and hamessing power drops. We should tax unearned increments to land values (miscalled "capital gains" by their apologists) in the Haig-Simons-Pechman manner as they accrue. We should let each building be depreciated only once, by the original builder, and land never. We should rent out, rather than auction off, the radio spectrum, adjusting values quickly and often as the market rises. We should tax polluters, rather than paying them not to pollute. For the rest of the long story see Gaffney, 2008, "The Hidden Taxable Capacity of Land", *International J. of Social Economics*; previewed in April 2006, *Groundswell*.

Retiring public debts is not enough. Andrew Jackson did it, 1829-37, and kicked off the greatest land boom and bust of the 19th Century. Andrew Mellon did it, 1921-32, and repeated the experience in the greatest debacle of the 20th Century. Where did they go wrong? It's of no benefit to pay off the national debt if the Greater Dracula, land speculation, guzzles away all the blood. In both decades land values swelled and working capital ran short. From 1798 to 1929 the 18-year cycle of land booms and crashes was broken only once, in 1911, 18 years after the crash of 1893. What went right then? That was the only time before or after when the nation's treasuries depended mainly on the property tax, and there was no big runup of land values.

What about banks and our money supply? Federal bonds and real estate have become their major assets. The pressure is on to issue more bonds, and support land values, to save the banks and the virtual-money they have created. Must we? Do the banks and mortgagees have us over a barrel? Banker and Treasury Secretary Henry Paulson never doubts it, and has already created over \$700 billion of new debt for their benefit. This is a big topic for another day – a long day.

The changes I propose are massive and radical, I know; but we have been massively, radically wrong, and the times call for equally massive, radical reforms. People will resist, will object, will twist and turn and contort in dozens of ways, as Washington now is, to protect banks and landowners and the current power structure, resisting the unwelcome inevitable. They have eaten, drunk and been merry on low taxes, cheap credit, foreign loans and rising land values. Meet The Great Reckoning: it is time to foot the bill. We can do it and turn America healthy in one stroke by taxing land values and rents to retire public debts. ■



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The principle may be easy but the practice is hard: we must tax more and spend less. However the present plan is to spend more anyway, selectively bailing out prodigals and debtors and the very culprits who led us into this morass. Better to invest in the nation's own credit, while pumping new capital back into the private sector. We have to do it soon anyway, and now is the time before interest eats us alive, our creditors lose faith and withdraw, the dollar collapses, and we become history's biggest fallen braggart, bully, pariah, and moral object lesson to illustrate *Proverbs 16:18*: "Pride goeth before destruction, and a haughty spirit before a fall".

But how, one naturally asks, can government tax more without suppressing and bleeding the very private economy we aim to revive? This leads us back to the second and Greater Draculas defined earlier: land value, and land value cum