How to Thaw Credit, Now and Forever

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 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.

Today, society's 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.

Vampire 1: public debt

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 become its champions. The debt was $900 billion when Reagan 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 were actually closed, rare as that is; others were mothballed. Now, however, Bush *fils* and his supportive Congresses have run the debt up to $11, $12, $13 trillion or more, depending on who's counting.

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. Taxes, said Laffer, suppress incentives so much that Washington can actually lower tax rates and collect more money. 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 George enthusiastically. Tragically, though, he only got half (actually less) of George's idea. Laffer never specified *what* or *which* taxes suppress and twist incentives. George thought they all did, save one: he thought that rent, in its various forms, was the only sensible thing to tax; he noted that down-taxing other tax bases would enhance land

rents and values as a tax base.

The voters loved Laffer's message of lower tax rates *cum* higher public spending, and Reagan used it to help win his election. Within a few years, however, it was clear that Laffer's tax cuts actually lowered revenues, and he lost favor — although his ideas lingered on until just yesterday in the highest circles of the Bush Administration.

The other new guru was Professor Robert Barro, then of Rochester, now of Harvard. Dick Cheney tersely summed up Barro's message: "Deficits don't matter." Barro argued that deficits today mean higher taxes tomorrow. Present taxpayers and savers will save more today to prepare for that burden of tomorrow. This higher private saving offsets government's dissaving.

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 "monetarism." Once in favor, however, with Keynes reduced to a memory, Friedman turned around and endorsed a new rationale for deficit finance.

This Barro-Friedman rationale has a seductive element of truth, but a greater error. The primary effect of deficit finance is that government bonds, to their owners, are an asset, a "store of value." 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. For most people, the marginal satisfaction from holding additional wealth diminishes as they hold more. Economists call this "the wealth effect."

By substituting for real capital, bonds lower people's marginal incentive to save and invest. 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 away too much capital on warfare. Urban history shows how cities, counties, states, and nations fritter away capital by subsidizing urban sprawl.

Our huge and ongoing foreign trade deficit shows that the investment crowded out of domestic industry must exceed private sector gains from public spending. 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 US, and the whole military-industrial complex?

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 did the slaves — who also substituted directly for farm capital. Underequipped Confederate soldiers paid the price on the battlefield.

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 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 more regressive. Future taxpayers are more and more likely to be the working poor.

The net marginal satisfaction from holding wealth actually diminishes more and faster when the wealth consists of real

capital. This is because owners of real capital, especially working capital, must manage and maintain it, and constantly replace it as it turns over. This is hard work, and risky, too. Bonds, in contrast, keep in a vault with no such cares. Only the most durable investments — gold, land, and some common stocks — can compete with government bonds in this respect. So big savers, as their wealth accumulates, more and more turn away from supplying working capital like short term commercial loans and trade credit.

Working capital, the coursing bloodstream of our private economy, needs a heart — the owner-entrepreneur — to pump it through the system and recirculate it constantly, often several times a month. But the stoutest heart cannot pump blood that is not there.

Government bonds "crowding out" private wealth from portfolios is part of how government borrowing takes capital away from the private sector. The other part of crowding-out is dynamic. When the Treasury sells new public bonds they crowd out new private bonds and corporate IPOs and new investing in unincorporated businesses.

The Greater Dracula: land value

Notwithstanding all that: there is a Greater Dracula 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.

We noted earlier that US bonds serve as "fictitious capital" to their owners, a store of private value that is not real social capital. So do land values, only much more so. They satisfy the need to hold assets without any corresponding net social saving. 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 their land to pay for cruises, cosmetic surgery, golfing, yachts, vacation homes, fast cars, stables, you name it. Rising land values seem to the owners like current income that they can spend as they wish, 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.

Unlike the case of US bonds, there is no corresponding "negative wealth effect" with rising land values. They rise spontaneously; they are a free gift from human fecundity and progress. They result from our having traveled a few more years through time. Land 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.

What about common stock? I omit it here for three 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." Most of the wealth is still there; in most cases all that's changed is expectations of future earnings, or taxes, or subsidies, or bail-outs, or even more trivial and superficial matters.

Housing and land values together

Ever since 1913 the capital invested in owner-occupied housing, and the land used for it, have enjoyed virtual exemption from

the tax levied on other forms of income. Income? What income? If A rents a house to B for cash rent, that rent is taxable income. If A evicts B and moves into the house for his own use, the taxable cash flow stops. In either case, however, A receives a flow of imputed income from land value appreciation. Economists recognize it as income, but Congress does not tax it as such.

Imputed income of owner-occupied land is not taxed, but interest on mortgages is deductible, unlike other consumer interest (e.g. on credit cards and auto loans). Most small homeowners do not itemize, so the deductibility of interest (and property taxes, too) mainly benefits richer people. If you own six or seven houses, a horse farm, a duck blind, a ski chalet, a lakeside cottage, a wild forty for hunting or riding, a golf club membership, a beachfront, etc., all that imputed income is exempt too.

The net income of a house — the building *per se,* that is — is far less than its service flow. The owner must rewire, replumb, reroof, replace the furnace and air, pay the utilities, fight termites, remodel and redecorate — and still lose value by depreciation and obsolescence. The site of the house, however, demands none of those, and generally appreciates besides — not in 2009, obviously, but more years than not. The current crash should not blind us to what has happened since, say, 1970. A $35,000 dwelling bought then, through a chain of sales and purchases, was worth about $1,100,000 in 2006, and still after a steep drop is worth about $700,000.

Unearned increments (aka "capital gains") are not taxed until time of sale, if that ever comes, although owners may take out cash, tax free, any time, by using a line of credit or other form of mortgage, whose interest is deductible. If one does sell for a gain the tax is deferred so long as you buy another home of equal or greater value within a two-year window. Most homeowners continue this chain of deferral until death, at which time all the accrued gains are exempted forever — the so-called "Angel of Death" provision.

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 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 USA 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 the rabble.

The arrangement has been and is bipartisan. Call something "housing" and it becomes sacred, a fetish, unassailable, even if it has 82,000 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 have become the rationale for exempting the playgrounds of the rich, and the little castles of the middle class, from taxation.

All that housing and land for the mansioneers 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 lost forever. Thus this housing capital is frozen. Its "net service flow" above expenses goes not to recover capital, but to pay interest. Then an oversupply gluts the market so the owner cannot sell without a big loss. Finally, 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.

So what are Congress and Treasury and Ben Bernanke proposing along with the bailout? More of the same: raising the debt some more to save the housing-land market and the banks that have inflated it. Supply-siders, faced with crisis, convert quickly into demand-siders; free-market fanatics into *dirigistes*. Alan Greenspan himself has admitted to Congress that deregulation failed. Traditional Keynesian macro-economic thinking has risen again in the high places in Washington. 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, the 2008 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" (*NY Times*, Oct. 16). 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 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. 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 US Treasury is not far behind. Let's ask what we should be doing instead.

Solutions

It's time to think big: it's survival time for the USA. We need to tap two enormous sources of capital that the vampires have created, one public and one private.

The 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 CEOs, without overpaying for toxic debt while pampered executives use our money to throw themselves lavish parties. 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." Even as you and I, governments can save, 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 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 Dracula defined earlier: land value, what is really meant by "housing" when we read about the housing bubble: the part, in other words, of Henry George that Arthur Laffer suppressed.

Land value, we have seen, is fictitious capital, an asset and store of value for individuals, with 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 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 Dick 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 harnessing power drops. 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. There is a great deal more; the taxable capacity of land is greater than many LVT advocates realize.

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, as Secretary of the Treasury, 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.

The changes I propose are massive and radical, I know. People will resist, will object, will twist and turn and contort in dozens of ways, as Washington is now doing, 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.

— Groundswell, *November-December 2008*

The writer owes Polly Cleveland for her searching criticism of an earlier draft. Remaining errors are, of course, my own. — M.G.