

On the State of the U.S. Economy

November 30, 2009

At a time when most everyone has an opinion about the state of the U.S. economy and the quality of decision-making in Washington, D.C., the voice of esteemed economics professor and former TIME magazine journalist Mason Gaffney is an important one. Currently teaching at the University of California, Gaffney has been publishing vital contributions to economics since his PhD dissertation in 1956. Western Canadians will remember him as the founder of the British Columbia Institute for Economic Policy Analysis.

I spoke with professor Gaffney last week about what went wrong with the American economy, and what he thinks president Barak Obama should be doing about it. (Hint: the president hasn't got it right.) Today's post sets out Gaffney's description of what's wrong with traditional government stimulus programs and U.S. tax policy. Part 2 will feature Gaffney on the trouble with macroeconomics. He also makes a startling prediction about U.S. unemployment.

You write that the state of the U.S. economy is a result of a misallocation of capital. What do you mean?

The emphasis here is on the allocation between durable capital, or capital that turns over slowly and working capital. Capital goes into highways, dams and battleships easily, but it doesn't come back out easily. That's where we are today. Any corner bakery or hamburger stand makes more jobs per dollar of capital than the massive public works that we depend on traditionally to fight unemployment. We depend on it, and it doesn't work. Yet we go on depending on it. It's been that way for hundreds of years. One of the worst examples, which sent many of our ancestors over to this country, was the English attempt to solve the potato famine problem in Ireland by putting Irishmen to work building roads. The people were starving to death, quite literally. They needed breakfast for tomorrow morning, and they were being put to work building roads for the next century. That, in an extreme case, is the kind of policy mistake that has been repeated time after time. What they needed was working capital for the private sector.

How do you provide capital for the private sector?

The private sector generates capital itself. Step one is not to take it away from it. Step two, in our own case, would be to pay down the public debt, because when you pay down the public debt, you put capital in the hands of the bond holders. If you don't give them the alternative of putting their money back into public debt, they invest it in the private sector. There's also a great deal of saving going on in the private sector at all times. It gets aborted by a phenomenon that I'll refer to generically as land speculation. That is what's been happening in the last eight years or so. The value of residences, or at least the land under them, has skyrocketed. The owners have borrowed on that through lines of credit and other means for consumption, with no production corresponding to it. The increase in land value appears to the owner of land as an income, but nothing is produced. So when you consume that, you're eating the seed corn, so to speak. You're consuming capital and not replacing it. I've been living on the old homestead myself for several

years and now I'm sorry. Along with millions of other people who ran up debts based on their expectation of rising residential values which have turned negative. It happens wherever there is real estate.

What's the answer?

Change tax policy, which would dehydrate the unearned increments of land value and keep them from getting started in the first place. If you focus your taxes on the value of land instead of on payrolls, let's say, that nips a land boom in the bud. As the boom gets started, the irrational exuberance would cause the tax levy to rise. That throws cold water on the irrational exuberance as it gets started. It keeps it from going to the extremes that we have just been through ... [Currently,] the tendency is to stick with the old values for several years. Tax valuations lag behind market valuations as the latter are rising. That lets the bull get off to a flying start. In California for example, the assessors are forbidden by law from following the market up. They're allowed to raise values by 2% a year at the most, while market values are going up, or were, by 10% a year. It wasn't long before the tax burden became negligible compared to the value of the land. In my own case, my own value went up so high and so fast, that my taxes were less than .2% of the market value at the peak of the boom. They didn't amount to anything; they were less than my fire insurance for heaven's sake. This situation let the boom in California and other extreme areas get completely out of hand, and we're now experiencing those results ... They should be revising tax policy in a drastic way, to exact less tax money from honest labour and productive labour and more money from unearned increments – capital gains.

By increasing taxes on capital gains, you tamp down market speculation.

That's correct. Once the capital gain has occurred, you have this enhanced value which is an excellent tax base.

http://www.sunlife.ca/slfglobal/v/index.jsp?vnextoid=b888775d62c45210VgnVCM10000abd2d09fRCRD&vnextchannel=c81ec8fb1f9a3210VgnVCM10000abd2d09fRCRD&vgnLocale=en_CA&chnpath=cwr

Mason Gaffney on the U.S. economy, part 2

December 02, 2009

Mason Gaffney is an esteemed economics professor and former TIME magazine journalist. Last week, he and I spoke about the state of the U.S. economy and its leadership. Part 1 of our interview covered the shortcomings of government stimulus programs. This follow-up offers a quick macroeconomics history lesson and a remarkable call on U.S. unemployment rates.

You've written about the faulty premises of macroeconomics. Can you explain?

[Keynes'](#) idea that consumer spending determines economic activity was the essence of demand-

side economics. In order to do that, he would have the government run deficits. Borrow and spend, in order to kick-start the economy. This kicking would go on for years and years without end, as it turned out. And then along comes [Milton Friedman](#) and says, no, that's all wrong. You've got to control the quantity of money by controlling banking. So whereas Keynes said borrow and spend, the new idea was control money and let the market control the amount of spending.

Then along comes George Bush I and George Bush II, and they go into deficit finance in a more extreme way than Keynes ever dreamed of. Milton Friedman supported this. He said, this kind of a deficit is a good idea. It merely reflects the fact that our credit is good, because we've been so good about paying our debts in the past and the economy is so strong because of our free enterprise system. He wrote an article called Why Twin Deficits are a Blessing, published on the front page of The Wall Street Journal, in which he said deficits don't matter because the extra spending by government will be offset by extra saving in the private sector because people are so smart. Their expectations are so rational, they will see higher taxes coming and they will save today in order to pay those higher taxes tomorrow. That sounds about as dreamy as you can get, and it turned out that way too.

But the original point here is that monetarists like Friedman and Keynesians ended up with the same policy. They just had a different name for it. The policy is borrow-and-spend. This comes from putting paper transactions, monetary control, in the saddle.

Until fairly recent times, banks made loans based on the collateral of accounts receivable and inventories and goods in process. Then when a land boom comes along, they start making loans based on the collateral of inflated land values. Here you have a positive feedback loop, or a vicious spiral it's sometimes called. As land values start to boom, banks have to lend more money to people to buy land. That additional money stokes the land boom, and makes the values rise still further. Then the higher values serve as collateral for more loans. We went through this from 2001 to 2008, and ended up with an enormous increase in the money supply, an enormous increase in spending based on that, and a banking system that depended on the maintenance of the high level of land values in order to remain solvent. The high level of land values was unfortunately based in large part on the expectation that they would go up still further. It was a highly unstable situation. To make it worse, the financial wizards on Wall Street started creating new kinds of securities, piling one form of security on top of another with fancy new names. Securities so complex that very few people even understood them. But they had faith in the great banks so they went on buying them in a house of cards. That, as we know so well today, was vulnerable to collapse and did collapse. We're living with the consequences.

How would you characterize Washington's response?

I'm very disappointed in what president Obama has done, guided by his advisors Larry Summers and Tim Geithner. What he's doing, which he calls stimulus, is basically continuing the policies that got us into this mess in the first place under his predecessor president George W. Bush.

Under George W. Bush, the American national debt more than doubled. The exact number is subject to spin. Some people say it's less than \$10 trillion and others say it's more than \$10 trillion. But it's enormous. If that didn't serve to create prosperity, doing some more of it isn't going to help any. And yet that's exactly what president Obama's administration is doing under the name of stimulus, under the name of rescuing the banks that are too big to fail. These are just new names for the same thing.

High unemployment continues to act as a drag on the recovery. At what point do we get back to a natural rate of unemployment?

This term [natural rate of unemployment](#), is a political buzzword. It's a confession of failure on the part of the economists in the 1980s and 1990s. They discovered that the rate of unemployment was uncomfortably high, so they said "well, this is natural." It wasn't natural before, and it hasn't been natural since. It's just a way of rationalizing what they couldn't cure. I would avoid that term natural rate of unemployment. Unemployment should be zero, in the sense that anyone who wants a job, and is ready, willing and able to work, should be able to get a good one. It's a strange and unnatural thing that people who have unmet needs and people who are willing to work should find some barrier between the desire and the fulfillment. It doesn't make sense.

The causes are to be found in public policy. Now if I'm an employer, and I hire somebody and I obey all the rules and follow all the laws, it's going to cost me about 50% or 60% more to hire that worker than the worker gets after the employer's taxes, the worker's taxes, after the consumption taxes that the worker pays. This of course induces employers to lay off all the people they can, and substitute machines for labour, substitute natural resources for labour. That's what's been happening, until our industrial base has fled overseas and we suffer. People ring their hands and wonder what to do about it. Well, what to do about it is to change the tax system to make it more profitable for people to hire labour to produce goods.

Will unemployment remain high?

Based on present policies of borrowing more money and spending it and leaving the tax system in its present anti-labour condition, I expect we've reached what Keynes called "under-employment equilibrium." That's another way of saying that unemployment will be 10% or more for the next several years. The natural tendency of a free market to generate full employment is suppressed by a tax system which is heavily biased against full employment and by government spending policies which are not geared toward full employment. Anything that fails to deliver the goods in the near future is basically siphoning capital out of the market system. Capital, which if it turned over in the normal course of business, would be making jobs every day.

What you're saying is that high government debt leads investor dollars into public debt instruments rather than private sector investment opportunities.

That's correct. I've been talking about massive public works like the Irish roads that the English built to help cure the potato famine. Today, our foreign policy is a massive sink of capital that might be used more productively than fighting losing wars, or stalemated wars or whatever you want to call them. Acting as a world hegemon, when we don't have the resources to do it. It's a historically proven path to national decline, and that's an enormous sink of capital, in addition to the sub-marginal public works. I haven't even mentioned urban sprawl, which kind of epitomizes the waste of capital in our settlement patterns which are so irrational and so uneconomic. I could wax into a whole new subject here.