The Four Vampires of Capital

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Employers are laying off workers for want of working capital. What happened to all that capital? Think of it as the coursing bloodstream of economic life, a metaphor used by Francois Quesnay, 18th-Century physician and land-tax champion who also pioneered an early macro-economics.

Vampire #1 is public debt.

Each Federal deficit draws more blood from the private sector, adding to the national debt. The Republicans, traditional foes of public debt, have become its champions. The debt was $900 billions when Reagan and Bush took office in 1981. When Bush *père* left office in 1993 the debt was $4,000 billions, a number so high we started counting it in trillions.

From 1993-2001 the pendulum swung back as President Clinton even ran a small surplus, pumping capital back into private business – they call it "reverse crowding-out". Now, however, President Bush *fils* has run the debt up to $10 trillion or more, depending on who's spinning the numbers. This debt is a big fraction of the nation's capital – our economic blood. This helps make us vulnerable to the housing crash and cardiac arrest of today.

Reagan and Bush said they were rejecting Keynes and his "demand-side economics", replacing them with their new "supply-side economics". How did they persuade themselves to turn their anti-Keynesian posture into our outsized national debt? There were two leading charlatans: Arthur 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.

Anyone who has read Henry George will relate to how taxes suppress and twist incentives. Laffer, indeed, quoted George often. Tragically, though, he got less than half of George's idea, the part he could orate at rich men's banquets for high fees. Laffer never specified WHICH taxes suppress and twist incentives: damn them all, he said. Worse, in California he campaigned for Proposition 13 of 1978, which cut property tax rates by 2/3, while opening the door to huge hikes in sales, income, payroll, and various business taxes. George, of course, would maintain revenues by raising pro-incentive taxes on land values and rents, while sunsetting other taxes.

The voters fondly believed they could have lower tax rates cum higher military spending, and Reagan won. Within a few years it was clear that Laffer's tax cuts actually lowered revenues, and he lost favor. Yet he lives on in the highest circles of government. Professor Jeffrey Franken of Harvard has published a series of Laffer-like quotes from Bush *fils* and supportive Congressmen (2008, *Tax-cut Snake Oil*, Economic Policy Institute). Our "new" President Obama has not radically changed the tenor of his economic advisors. Dick Cheney the person has been relegated to the role of Darth Vader emeritus, but the malady lingers on.

The other new charlatan was Professor Robert Barro. The same Dick Cheney tersely summed up Barro's message: "Deficits don't matter". Barro calls that "The Ricardian Equivalence Theorem" (probably unfairly to Ricardo). Barro's point is that deficits today must 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.

It was not just Barro. Iconic Milton Friedman, the very paragon 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 Barro's new rationale for deficit finance.

Meantime, as Bush *fils* more than doubled the national debt from $4 trillions to $10 trillions or so, private savings dropped toward zero. Private debts soared along with public ones. This would seem to demolish Barro's hypothesis by the simplest observation of fact. However, this was the new age of Faith over Fact. Bush partisans instead blamed low saving on various taxes on the rich, especially the estate tax and the capital gains tax, even though both had fallen sharply from earlier years.

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", 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. In this respect they resemble slaves in the Old South, who were a "store of value" to slave-owners without their having created any real capital. If half the people of a nation were suddenly to enslave the other half, it would be obvious that this did not create any capital. It would create a culture of extravagance, as happened in the Old South.

It is true that some bond proceeds are used to create real social capital; and some of that capital, like repairing crumbling busy bridges, is worth as much as it costs. To the extent that beneficiaries are the ones taxed to pay off the debt, the bonds represent real social capital. To the extent that others are taxed instead, the beneficiaries are free riders who see their gains (usually in rising land values) as current income they can and mostly do spend for pleasure, consuming capital. Thus voters in several counties around San Francisco Bay 40 years ago rejected a plan to pay the capital costs of the monumental Bay Area Rapid Transit System (BART) by taxing the benefited landowners. They chose (or were duped into) a sales tax instead. That made the bonds just fictitious capital, a lien on future taxpayers – the capital has been spirited away, by swelling the consumable income of landowners.

Professor Martin Feldstein sees our point about fictitious capital, but only with a class bias that leads him to obvious cherrypicking. Ignoring bondholders, he singles out social security payees as owners of fictitious capital. He blames them and the whole idea of social insurance for the shortfall of private saving. It would take another article to detail the faults in his case; we spare you here, and move on.

Vampire #2 is land value.

This is invisible to most economists; their neo-classical training blinds them. Land values, like public bonds, serve as "fictitious capital" to their owners, a store of private value that is not real social capital. 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 quantity is not net social saving.

More, land values on the rise promote dissaving. Notoriously, we have just been through another 18-year cycle of homeowners' heeding the siren songs of bankers to "unlock the equity in your home" to pay for high living. Rising land values seem to the owners like current income that they can spend on current consumption. Banks have been 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 may be a reverse or compensating Barro Effect, a vague feeling , weak as it is, that future taxes may rise. 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. Land as one's asset is not, per se, a debt that anyone else 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.

I pass over common stock here because a good deal of its value represents corporate ownership of real estate; because its total value has dropped below that of dwellings; because the media overstate its role in the economic scheme; and because space and time limit us: what's uppermost here and now is the housing collapse.

Vampire #3 is housing and land values conjoined.

Ever since 1913 in the U.S.A., the money invested in owner-occupied housing, and the land used for it, have enjoyed virtual exemption from the tax levied on other forms of income. Untaxed housing income comes in two forms: imputed income, and unearned increment. "Imputed income" is the service flow that an owner enjoys from her own house. If you own six or seven houses (who's counting? – not John McCain), 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 service flow of an owner's house as a building per se is not all net income. The owner must insure against fire, operate and clean the house, rewire, replumb, repaint, reroof, remit utility bills, replace the furnace and air, repel pests and termites, remodel and redecorate now and then, and still face a day of total obsolescence and depreciation. The site of the house, i.e. the space and location, needs none of those expenses, and generally appreciates besides – not this year, obviously, but more years than not.

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. The current crash is steep, but this writer’s $30,000 house and site bought in 1972, through a chain of moves and sales and purchases and a little luck, was priced at about $1,100,000 in 2006, and now after the crash is still worth about $700,000.

In the 1920’s, the first peaceful decade in the U.S.A. under the new income tax, popular music manifested the ethos spawned by the exemption of homes from the tax: “My Blue Heaven”; “Robins and Roses”; “Tea for Two”. These were to be followed by the more tentative “Just around the Corner there’s a Rainbow in the Sky”; and then, too soon, by “Brother, Can You Spare a Dime?”.

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. The arrangement has been and is bipartisan. Call something “housing” and it becomes sacred, a fetish, unassailable, even if it is Hearst’s Castle, San Simeon, with its 62,000 (sic) attached acres and 17 miles of coastline; even if it is the 15 beach lots Hearst assembled in Santa Monica for his spare wife. 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 mansions, playgrounds of the rich, and 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 money. A bank can’t make new loans faster than it recovers principal 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.

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 so much faster than it really depreciates economically that he can wipe the rental income off his tax return. 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 a junker. When A sells to B the excess depreciation is "recaptured" by taxing the nominal gain, but it is classed as 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.

This same package of benefits goes to owners of Commercial and Industrial (C&I) real estate. About 50% of the market value of real estate in Los Angeles County, as in most major cities, is C&I, so this, too, is a major item. 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.

Vampire #4 is the corporation.

Corporations save a lot of their income, instead of passing it out as dividends. It's called internalizing profits. When we read of Americans' low savings rate, that refers to personal saving, but stockholders let corporations do their saving for them. It's a way of avoiding taxes by converting "ordinary" income (dividends) into capital gains (stock values), taxed at a much lower rate. FDR once had the insight and boldness to propose a surtax on "undistributed profits", but no modern politician would dare; no modern economist even thinks of it.

Corporate saving would seem to create capital, but it doesn't, it merely redirects it from individual stockholders to corporate managers. It flows into managerial control without passing any competitive test. Some managers become glutted with more capital than they can manage effectively. They waste some on uses of low productivity; they use some to buy up other firms and lessen competition; they buy up assets of deferred yields and glue up markets for industrial sites for future expansion, leaseholds for future hydrocarbons, aquifers for future water needs, and so on; they inflate their own salaries in the outrageous ways that evoke so much resentment (but so little effective reform). Worst of all they invest offshore. They export not just their new savings, but recovery of old capital, too, from their Capital Consumption Allowances (CCA's).

As a side-effect they become independent of commercial banks, both as depositors and borrowers, forcing banks out of their proper commercial loan business whence they go into real estate, our vampires #2 and #3, discussed above.

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-siders, faced with crisis, convert quickly into demand-siders; free-market doctrinaires into *dirigistes*. On October 23, 2008, Alan Greenspan himself admitted to Congress that deregulation had failed. Even some kind of Federal regulation is now acceptable to prop up a failed system, but why? - so we can repeat the same cycle that is crashing around us today. Our leaders' thoughts go no deeper than that.

Thus, traditional Keynesian macro-economic thinking, supposedly buried, never died; triumphant monetarists drove no silver stake through its vampire heart. Today it has risen again to high circles in Washington. The idea that public borrowing "crowds out" private borrowing, dominant in the thriftier 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 and less medicated age, called "pump-priming", and modern motorists call "jump-starting.

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, 2008). At least Krugman's spending proposals are more egalitarian than those of Wall Street's Henry Paulson. Larry Summers and Alan Blinder, 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 bodes ill.

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. This 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.

What should we be doing instead?

We need to tap two huge sources of capital that the vampires have created, one public and one private. A national government can create great gobs of lifeblood capital and quickly transfuse it into private arteries. 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 stares us in the face: 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 Greater Draculas defined earlier: land value, and land value cum housing. It leads us back to the part of Henry George that Art Laffer dodged.

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 harnessing power drops. We should tax unearned increments to land values (miscalled "capital gains") in the Haig-Simons-Pechman manner as they accrue. We should let each building be tax-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, 2009, "The Hidden Taxable Capacity of Land", *International J. of Social Economics* 36(4):328-411.

Retiring public debts is not enough. U.S. President Andrew Jackson did it, 1829-37, and kicked off the greatest land boom and bust of the 19th Century. U.S. Treasury Secretary and Virtual President 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, sucks away all the blood. In both decades land values swelled and working capital ran short. The same occurred in 1857, 1873, and 1893. The "Bankers' Panic" of 1906 was successfully contained by bankers themselves, led by J.P. Morgan. 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? They would like us to think so; but not if we open new investment and job opportunities by sunsetting taxes on work, commerce, capital, production, and commerce.

The changes I propose are massive and radical, I know; but we have been massively, radically wrong, and the times call for 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 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.