

## **The Counter-Enlightenment, its Economic Program – and the Classical Alternative**

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The last few years have seen demoralized Social Democratic and Labour parties fall into disarray throughout the world. Retreating from the economic program that powered their takeoff a century ago, they have lost their traditional constituencies. Their golden age was an outgrowth of classical political economy from Adam Smith via John Stuart Mill to Progressive Era reformers advocating progressive taxation of land and other wealth, public infrastructure investment at subsidized prices, price regulation of monopolies, and public banking reforms to socialize the financial system.

Industrial protectionists, nationalists and neocolonialists – the parties of heavy industry and military power – also endorsed a strong role for government. Across the political spectrum the wave of the future appeared to be a rising role for public oversight of markets, subsidies for capital formation and education, public health, social welfare and infrastructure spending. This program was most successful in the United States, Germany and Central Europe.

The guiding assumption of democratic political reform was that voters – with the working class most numerous – would act in their own interest to legislate tax and regulatory reforms aimed at raising productivity and living standards while making their economies more competitive in world markets. Banks and other financial institutions were expected to play a key role, in conjunction with government policy (and indeed, a military industrial buildup).

The question of who would be the major beneficiaries of pro-industrial economic reforms depended on who would control the government to administer tax policy and subsidies, tariff policy, social spending and infrastructure investment. The two main contenders were labor and industrial capital, and there were many areas of

overlapping interest. The main loser was expected to be the landed aristocracy as the lower house of Parliament (or Congress) gained power relative to the upper House of Lords (or Senate). Finance was viewed as ancillary to industrial capital, not as an independent player except internationally. Public banking was the liberal alternative to finance capital's proclivity for trust building and similar manipulations.

Today, the parties of the left and even the centre have reversed the reform agenda advocated a century ago in the Progressive Era. They have endorsed a tax shift off property and finance onto labor and consumers; privatization of public infrastructure and enterprises; and deregulation of monopolies, above all that of banking and high finance. The result is an almost universal anti-government (and indeed, *pro-rentier*) model that leaves resource allocation and planning centralized in the hands of a financial sector that is being deregulated rather than steered along the social lines anticipated a century ago.

#### *Classical political economy as a program of fiscal and financial reform*

The result has been a political disorientation, which I attribute to the abandonment of the thrust of the classical economic reform program. This program was centered on three major policies. The first was to tax away the land rent that had been privatized since medieval times, restoring it to the public domain as the basis for public investment. The second was to minimize monopoly rent, by keeping key infrastructure in the public domain and providing its services at cost or on a subsidized basis to make economies more competitive. The third reform was to regulate prices for goods and services produced by natural monopolies in private hands.

The aim of this classical program was to bring income in line with actual labor effort and cost, thereby freeing markets from the unnecessary "free lunch" rake-off that added to prices and hence made economies uncompetitive. The labor theory of value found its counterpart in the concept of economic rent – prices and income in excess of cost value. Economic rent, defined as revenue with no corresponding cost of production, was to be taxed away or avoided altogether. Taxing land rent and

minimizing monopoly price gouging was expected to keep prices in line with the technologically and socially necessary cost of production.

Industry as well as labor endorsed a liberal tax system aimed at collecting the excess of market prices over intrinsic value. This excess economic rent occurred most conspicuously in land rent, mineral and resource rent and monopoly rent. Value and price theory thus was highly political in advocating a tax system centered on the land tax – collecting the rent that had been collected by Europe’s landed aristocracies since the era of military conquest parceling out the land among the conquerors.

Classical value and price theory aimed at defining costs in a quantitative sense so as to enforce anti-monopoly laws and kindred price regulation. In the United States, gas and electricity utilities were privately financed but publicly regulated. The idea was to prevent what railroad practice called watered costs – giving free bonds and stocks to owners and managers (and to favored politicians), factoring their interest cost into the prices charged to the public. The effect was to build financial pseudo-costs into these prices, inflating them over the intrinsic direct costs of production and distribution.

Today, the Social Democrats have been losing elections throughout Europe. I believe that this is largely because they no longer have an economic program. Yet they began as an economic reform party – the party of progress, progressive taxation, rising wage and living standards and public sector investment and subsidy. This has been lost. Labour Parties throughout the English-speaking world in particular have embraced an anti-government political ideology of privatization diametrically opposite from the views held a century ago.

By way of introduction I should introduce myself as a classical economist. That was the body of theory developed from the French Physiocrats and Adam Smith in the late 18<sup>th</sup> century to John Stuart Mill. He was a turning point, as the political economy discipline was soon traumatized by Karl Marx, who pushed classical analysis to its logical conclusion in dealing with wealth, property and income, earned and unearned.

*Post-classical economics as a reactionary move back toward a neofeudal rentier society*

Distinguishing between earned and unearned wealth – that created by one's own labor, and that obtained merely through hereditary or other political privilege – led to a fiscal policy (taxing away land rent) that naturally triggered an anti-classical reaction on the part of classes most threatened by this distinction. This political equivalent of Newton's Third Law of Motion (every action has an equal and opposite counter-reaction) should not be surprising in retrospect, but few economic futurists set to work describing what kind of economic dystopia this anti-classical reaction might end up sponsoring.

Today, matters are muddled by the fact that the anti-classical economics that emerged late in the 19<sup>th</sup> century calls itself "neoclassical." It should rightly be called anti-classical because it avoids dealing with wealth, debt and social structures. It focuses on "exchange" – of goods already produced, with "markets" characterized by purely marginal changes. The definition of "marginal" means that it is small and incremental – and leaves the existing social and political context in place, the existing set of laws and other institutions. Marginalist economics looks only at the status quo, not at possible reform. That was the essence of the "marginalist revolution": It excluded from analysis the core of what had been important for the preceding few centuries, namely, public policy changes. In a word, economics became trivial.

Also highly political is the way in which post-classical economics has been developed as an anti-reform ideology. It now looks at government spending, subsidies and taxes only as a deadweight, not as an investment. Government budget deficits are viewed as unproductive spending, not as investment in roads and transportation, other infrastructure, educational systems, research and development. This non-structural scope has led to mathematical models that in turn are merely marginal – that is, so small that the context, the economic environment is not changed. The focus is on individual psychology "choosing" from an existing menu that is offered – without

discussing how this menu comes to be offered (for instance, by advertising, deception, rent extraction, allocated prices) or the wealth relations behind it. The new fad is to create a logical “as if” economic model on the basis of personal psychological expectations.

To me, this is not science but the road to junk economics. And it is junk psychology too, because it ignores group psychology (as William MacDougall noted a century ago) and all other social dimensions beyond a crude Jeremy Bentham-style “calculus of pleasure and pain.” One result, for example, is the idea of “diminishing marginal utility” suggesting that personal self-interest is always only marginal and helpful, never turning into greedy wealth addiction. In this respect today’s economics lacks the scope even found over two thousand years ago in Aristotelian social philosophy. The role of the Greek goddess Nemesis punishing hubris (overweening pride and arrogance injuring others), the Greek dramas of miserly wealth addiction – all this scope is stripped away by economics trying to avoid looking at the social context. And this narrow scope is designed to avoid value judgments between earned and unearned income, the justification of wealth and property and other political issues of the 19<sup>th</sup> and early 20<sup>th</sup> century.

One can understand the right-wing parties moving in this direction. What is difficult to understand is why the Labour and Social Democratic parties have joined in this enterprise.

Part of the explanation must be that political discourse has been dumbed down to make financial analysis anthropomorphic, as when newspapers or TV commentators talk about markets going up because of confidence, or going down because they lose it – or simply correlate the stock market change to whatever the headline is that day. The reality is that markets for stocks, bonds and real estate go up and down because of the flow of funds – banks creating credit, and the terms on which it flows in and out of asset markets.

All money and credit is debt, and debt is owed by one party to another – in most economies today, owed by the bottom 90 percent of the population to the top

10 percent. Post-classical economics does not address this polarisation between creditors and debtors. Money and credit are viewed only as affecting consumer prices and wages, not asset prices. Hence, one misses the rising access cost housing in terms of wage levels and disposable personal income. One also misses the rising price of purchasing a financial income (via stock dividends, bond yields and capital gains) relative to wages and consumption standards.

The most interesting economic analysis concerns the forces that are changing and indeed, transforming existing economic, fiscal and social structures. How should the tax laws, for instance, be changed to promote economic welfare, prosperity and justice? The answer is, not until there is an alternative for people to vote for. And if academic economic theory excludes this topic from the curriculum, this will deter change. The fact that Social Democratic and Labour parties have not come up with one is responsible for their declining popularity in the polls. Why should anyone vote for a party that doesn't have an alternative to a system that most people can see what economists cannot: something is radically wrong with the economy.

A century ago it was expected that governments would operate basic infrastructure, especially natural monopolies from the Post Office to the railroads, so as to ensure competition to keep private sector prices and returns to wealth in line with what was needed to produce their services. Today, for instance, imagine what would happen if the credit card industry had a public provider – or even a regulatory commission that would regulate the rate that banks can charge for interest on credit cards, now up to 29% in the United States. And the credit card companies extract as much in fees and penalties as they do in interest. If an American deposits an out-of-state check, it takes an entire week to get credited, as banks still use basically the pony express time schedules as an excuse to extract as much as they can for their key functions.

Progressive Era regulatory philosophy would keep the rates in line with what the actual cost of producing this credit and monetary function. Entire economies are being turned into rent seeking “tollbooth” opportunities to charge access rents for

roads and other transportation, telephone service (*viz.* Carlos Slim's Mexican Telecom monopoly) and so forth.

Social Democratic parties prior to World War I aimed at bringing banks into the industrial era. The idea was to steer them away from merely the financing commercial trade in products that already were produced, and away from financing government deficits to wage war (which national Treasuries could monetize the credit, as the United States did with its greenbacks during the Civil War, 1861-65). Banking and high finance were to evolve in partnership with government to fund industry.

An associated idea for the French St. Simonians in early 19<sup>th</sup>-centur France was to keep debt in line with the ability to pay. Interest charges had to be paid regardless of the debtor's earnings or financial position. The St. Simonians sought to organize banks in the form of what today are mutual funds, profit-sharing ventures creating credit in return for equity shares (stock) rather than straight interest-bearing debt. The capstone of this philosophy was the Credit Mobilier created by the Pereire brothers. In central Europe especially a trinity developed between financial banking, heavy industry and the government, largely to build navies and armaments to be sure.

#### *World War I changes the political and economic trajectory of Western civilization*

World War I changed the dominant mode of banking to the Anglo-Dutch-American model. In fact, it changed the trajectory of world politics. The Allied Powers defeated Germany and the Central Powers, and their bank practice shaped the postwar world. Anglo-American banking was based on lending against collateral in place, not lending to create capital. The result was an increasing emphasis on mortgage lending. Real estate rather than industry and commerce has become the focus of global banking today. Some 70 percent of bank loans in Britain and the United States are mortgage loans backed by real estate.

World War I also brought the Russian revolution, which deteriorated into Stalinism. By the end of World War II in 1945, the Social Democratic and Labour

parties throughout the world realised that they couldn't achieve popular approval of their economic program until they disassociated themselves from Stalinism. So they joined the Cold War. In the United States, the Socialist Party and labour unions became strong supporter of the Vietnam War in the 1960's.

Surprising as it may seem, much of Wall St opposed the war (Chase Manhattan's CEO George Champion said that it was not fiscally responsible), while the labour unions and the socialist parties supporting it. The embittered feelings of leaders such as Michael Harrington and his mentor Max Shachtman led 80% of the Young Peoples' Socialist League – the party's youth group – to leave. The Old Left collapsed – and the New Left seemed more concerned with distributional issues, with poverty, with racial and sexual minorities, with people excluded from the core of capitalism rather than with the core of the economy itself, especially the financial core. And as nearly two thirds of the population became homeowners, the land tax – the core of classical economic reform in the late 19<sup>th</sup> century – fell out of favor. Followers of Henry George became lobbyists for the construction industry and the banking sector! So since the 1960s, financial and fiscal policy making has been left almost mainly to the right wing of the political spectrum.

So tonight I will review what I think needs to be the path for Social Democratic and Labour parties to regain the popular appeal they have lost.

*The excess of market price over cost-value for financial "services"*

The core of classical economics can be traced back to the 13<sup>th</sup> century, to the medieval scholastics who set to work refining the concept of Just Price – a price that reflected reasonable cost and risk. Economic thought from the 13<sup>th</sup> to the late 19<sup>th</sup> century elaborated the distinction between market price and intrinsic cost value, in order to isolate the extent to which prices in the marketplace exceeded the technologically and socially necessary cost of production (or more precisely, reproduction under existing productivity and cost conditions, regardless of original costs under old conditions). The labour theory of value was the first stage in defining



economic rent as this margin. It resolved costs ultimately into that of labour, including the labour embodied in capital and also in education, research and development needed to produce products.

The policy question concerned why prices were higher than this intrinsic value. Three causes were cited. One is the charging of interest and other financial fees. Today, banks create money and credit simply on a keyboard. Governments can do the same thing. Australia does it when there is a billion dollar inflow of foreign exchange as people or companies borrow from Americans at 1% and invest in Australian bonds and 3.25% to collect the arbitrage difference of 2.25%. The Australian bond seller turns the U.S. dollars over to the central bank, which then creates an equivalent amount electronically (or as newspapers put it anachronistically, “by the printing press”) in Australian dollars. In sum, the central bank simply “prints the money” to match the foreign exchange inflow.

Popular opinion accepts that it is quite all right for the government to create credit out of thin air to match foreign exchange inflows (for credit that foreign banks create “out of thin air” on computer keyboards in the United States, Britain or continental Europe) but that if they create money for public domestic spending in a similar way, this is somehow inherently inflationary and economically undesirable. The result is a policy asymmetry. It is not necessary, but reflects the interest in creditors in opening up high-interest markets such as Australia for arbitrage rake-offs in bond and stock trading, but keeping the domestic market for private creditors rather than public ones.

In practice the effect of public and private credit creation should be identical – or would be, if governments and commercial banks lent for the same thing. But they don’t, of course. Commercial banks lend money for the purchase of property. Governments create money to buy goods and services – to spend on domestic production and consumption, paying income to wage earners or buying domestic output. The financial sector seeks to gain financial returns both on international currency speculation (for which it seeks government credit creation to finance this

speculation) and in domestic bond financing (where it wants the government to leave the field free for private banks to create credit and lend out at a mark-up).

I will give you an example from the 1970's. Canadian provinces funded domestic spending not by public money creation, and not even from borrowing domestic currency from the nation's five major banks. Instead, they borrowed Swiss francs and European currency. Canadian interest rates were 6.5%, but they could borrow deutschmarks or Swiss francs at 4%. Provincial treasurers focused on the interest charges they were saving – some 2.5 percentage points. But the Canadian dollar then plunged against the D-mark, so the debt principal nearly doubled!

I had many arguments with local bankers at the time. (I was an advisor to the Canadian government.)<sup>1</sup> A banker from the Bank of Nova Scotia argued that he wouldn't want the government to come out and create the money. He claimed that Canada needed foreigners to play the role of "honest broker" and be the judge of whether Canada should borrow or not.

I replied that I thought it was wasteful for provinces to borrow abroad simply to convert into domestic currency. Provinces received their revenue in a soft currency, while owing money in those whose exchange rate was rising. Canada's government had to print a domestic-currency equivalent to finance provincial deficit spending anyway!

This premium was the price to be paid for letting banks provide public financial ideology using a false model of economic reality. I came to realize that few politicians have a clue about how money and credit are created. What is even more remarkable is that this is not even taught in the schools. Instead, academic economics courses provide students with a hypothetical "what if" world. And once their minds are set along this unrealistic pattern (a mistaken view highly remunerative to the banking sector), it is hard to explain to people how bank credit is created in a way that provides bankers with the proverbial free lunch. Most people assume a kind of fair play in which if someone has wealth, it must have been earned by labor and enterprise.

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<sup>1</sup> I described this problem in *Canada in the New Monetary Order: Borrow? Devalue? Restructure!* (Toronto: Butterworth, 1978, published for the Institute for Research in Public Policy [IRPP]).

Honoré de Balzac didn't believe this. In *Le Père Goriot* he said that behind every family fortune is a long forgotten crime.<sup>2</sup> Not necessarily forgotten, to be sure. Europe's aristocracy proudly achieved its landed estates by military conquest, and Gustavus Myers' *History of the Great American Fortunes* traced how most family fortunes were carved out of the public domain. So the question is, why is it that novelists and historians understand the acquisition of wealth so much better than economists, whose blind spot usually leaves credit and debt out of their narrative of how fortunes are obtained in today's world.

The upshot is that the complaints today about exorbitant executive salaries, bonuses, stock options, extortionate credit card charges and monopolistic price gouging all refer to unearned income. The distinction between income that is earned – wages and profits – and *rentier* income that is a free lunch was central to classical economics. It was the distinction between income that is necessary for the economy to operate and that which was unnecessary and hence wasteful and/or exploitative; between productive and unproductive labour, and between wealth and overhead.

The anti-classical reaction defined all income as being productive. This involved a circular reasoning that anyone who receives an income must have earned it by producing a service of an equal amount. So “output” is measured by how much is “expensed” against it, regardless of whether this expense takes the form of wages, profits, property rent or financial rent. By the same token, productivity is defined as the salaries in the service sector, divided by labor time. If a financial “service workers” get paid more, productivity in the sector is deemed to rise.

This kind of circular reasoning makes economics an exercise in tautology, not a science. Yet it appears as empirical statistics, exemplifying the GIGO principle: garbage in, garbage out. The practice will not be dropped until an alternative concept is proposed – and the alternative classical concept has been dropped from the academic

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<sup>2</sup> “Le secret des grandes fortunes sans cause apparente est un crime oublié, parce qu'il a été proprement fait,” translated (<http://ancilla.unice.fr/~brunet/BALZAC/Go/Go254678.htm>) as “The secret of a great success for which you are at a loss to account is a crime that has never been found out, because it was properly executed.”

curriculum, now that the history of thought has been excluded by today's censorial "free market" orthodoxy.

A similar problem existed in America after the Civil War brought protectionists to power for half a century. The equivalent of today's neoliberalism existed in the form of free trade theory taught in the prestige universities – Harvard, Yale and other universities that founded to train religious preachers. When the Republicans came into office in 1860, they sought to teach Americans a protectionist economic logic. Their solution was not to reform the old colleges, but to found state colleges, agricultural colleges and business schools. This left free trade British theory to be taught at the prestige universities in New England and the South, while state universities and business schools taught a different body of theory based on industrial technology. And the Department of Agriculture was formed largely to calculate the environmental and ecological affects of plantation exports (cotton, tobacco and so forth) on soil depletion and environmental exhaustion. An "economy of high wages" doctrine correlated wage levels, education and what today is called human capital with labour productivity. The effect was that the seemingly low-prestige state colleges and business schools taught a more technologically modern economics than was available in the prestige colleges, tied as they were to free trade doctrine.

I wrote my dissertation on the economist who drew up the Republican Party's program in 1853: E. Peshine Smith. He was the law partner of William Seward, who became Abraham Lincoln's Secretary of State. Republican protectionists found it easier to start an entirely new set of schools than to reform the curriculum then current. You can't retrain economists once their minds are channeled along a particular simplistic line. Yet the economic doctrine that steered the United States to industrial and agricultural supremacy doesn't appear in today's textbooks, or even in political or economic histories. It is as if they didn't exist.

The history of economic thought was still taught to every graduate economics student as a core course when I attended graduate school in the early 1960's. It has now been replaced with mathematical economics, trivialised by being based on a

combination of junk psychology and phenomena that don't matter much. My most imaginative students at the New School where I taught in New York dropped out of economics and went into sociology or something else. They had wanted to study economics to discover how the world operated, but were disappointed to find that this is no longer what the discipline is about.

Today's neoliberal junk economics was designed to avoid discussing the issues that the classical reformers addressed, above all the classical aim of freeing industrial capitalism from the carryovers from feudalism, above all from the legacy of a landownership created by the military invasions of England and other European realms. Europe had a vestigial extractive legacy of an idle aristocratic class living off its rents while governments ran into debt to wage foreign wars.

*The original liberal program to reform feudalism and oppose colonialism and national debts*

The American Revolution in 1776 saw an opposition to the legacy of feudalism and colonialism. Reflecting the new liberalism within Britain itself, Josiah Tucker in the late 1750's had called the American colonies an albatross around the neck of England. The cost of defending them against French designs was forcing England into debt to wage its seemingly perpetual wars with France. Adam Smith popularized a doctrine just the opposite of what today's neoliberals represent him as saying. Describing the national debt as having come into being almost entirely to finance wars, he opposed taxes to pay interest on this debt on the ground that it would be an unnecessary cost of production under a less belligerent regime. Book V of *The Wealth of Nations* provides a capsule history of each British tax imposed to finance each war, adding to the nation's cost of labor and hence of production. Each war had a new bond issue, with interest paid by imposing a new tax. Smith's idea was to make England more competitive by lowering the cost of living and doing business, by getting rid of war debts and the taxes levied to pay interest on them. This meant opposing wars and the growth of debt and the taxes they

brought into being. These became the three planks of classical economic liberalism: anti-war, anti-debt and anti-tax policy.

This flowered throughout the 19<sup>th</sup> century into a broad desire to free economies from *rentiers*. In French, a *rente* was a government bond. Somebody who held a bond was a *rentier*, receiving an interest payment at specific intervals. The idea of a regular payment, stipulated in advance, was applied to landlords as well as bondholders. Indeed, the concept of economic rent as revenue in excess of the necessary cost of production emerged from the medieval discussions of interest and Just Price. How much was it fair for a banker to charge to transfer money abroad, taking into account the risk of losing his capital? This was the logic of Thomas Aquinas, and the other Schoolmen. The analysis of rent was based ultimately on the labour theory of value.

By the 17<sup>th</sup> century, governments raised funds to retire their debts by creating national monopolies and selling them off for payment in government bonds. England did this with the East India Company in 1600, the Bank of England in 1694 and the South Sea Company in 1711, contemporary with John Law's Mississippi Company in France. The practice finds its parallel in the 1980's with Margaret Thatcher in Britain, quickly imposed globally on debtor countries by the World Bank and International Monetary Fund. Rather than declaring bankruptcy or defaulting on their loans, governments sold off the public domain and monopoly enterprises to buyers – often on credit. The new appropriators proceeded to erect tollbooths at key access or choke points to roads, the communications spectrum, access to water and other basic infrastructure.

Across America, strapped states and cities public are turning public roads into toll roads. In Chicago where I grew up, they sold the right to put up parking meters along the city's curbs. So governments are financing their budgets not only by taxing labor and sales, but also by privatizing public infrastructure services. The effect is to raise the prices that people must pay for essentials. Such rent-extracting privileges are prime collateral for bank loans, so the rental income is soon capitalized into interest payments. Banks end up as the ultimate recipients of these overhead charges, while national economic efficiency shrinks.

Short of default, local government's choice is between raising real estate taxes (which keeps down housing prices), raising sales taxes (which drives buyers to other states), raising income taxes (driving employees and companies to move out), or selling off public infrastructure. This phenomenon is spreading throughout the world. It is a *neo-rentier* phenomenon. *Sponsored mainly by the financial sector, it is a resurgence of what classical liberals wanted to get rid of.* Classical economics was a doctrine of how to regulate prices so as to save society from an unnecessary and indeed parasitic *rentier* class. It was a logic explaining how governments could best develop infrastructure and save it from falling into private hands. But you now have a self-proclaimed neoliberal doctrine defending *rentiers* and even depicting them as playing a positive role in privatizing public assets to provide valuable services. The "value added" represents the higher rental access charges being squeezed out.

This is a bankers' eye view of the wealth of nations, not that of Adam Smith and subsequent classical economists. Capitalizing rent-extraction privileges and selling them off builds in a rent overhead, adding to society's cost of living and doing business. The financial sector soon turns into a financial overhead by lending buyers the credit to purchase these rights. Buyers bid against each other and the winner is the one who agrees to pay the rental income to the banks or other creditors, hoping to come out with a capital gain as they squeeze more money out of customers using the infrastructure being privatized or for other market restraints.

Today's tax system subsidizes this process. First, it treats interest as a tax-deductible cost of doing business rather than a choice as to the mode of financing as compared with equity. Second, capital gains are taxed at a much lower rate than wages and profits ("earned income"). This fiscal bias supports debt leveraging and financial rent seeking, while deregulation opens the floodgates for real estate and monopoly rents. The rent recipient's gain is at the expense of payers – what economists call a zero-sum activity on balance for society at large.

In the United States, the commercial real estate sector paid almost no income tax from 1945 to 2000, when real estate rents rose sharply. If you sell a property and

buy a new one, you don't have to pay a tax on the gain, because it is considered "preserving your capital." The real estate sector was long free from income taxation as a result of being able to treat interest as an expense, and to pretend that buildings were wearing out so that property was losing its market price – even as soaring land values increased the price (especially as states and localities shifted the tax off property onto income and sales). So real estate (and by extension, other rent-extracting sectors) are given tax preference over industrial investment that actually increases the means of production rather than merely provides opportunities for extracting transfer payments.

This is what the classical reformers sought to prevent, and what the Progressive Era in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries addressed by tax reform and financial reform. What helped reverse this reform movement was the financial sector's intervention in support of real estate and monopolies, which were becoming its major customers. Bankers came to realize that they could ride on the backs of real estate landlords and monopolists by extending mortgage credit and lend for corporate takeovers (which investment bankers euphemize as "mergers and acquisitions").

What you have had since about 1980 is an inversion of what the classical liberals fought for. The *rentier* interests have fought back against the reformers, and they have won increasingly radical victories to reverse centuries of seeming reform along democratic economic lines.

If you look back at what writers in the early 20<sup>th</sup> century expected to see as a result of technological progress and rising productivity, we should be living in a Utopia by now. Suppose you had been told in 1945 about the breakthroughs in medicine, atomic energy, jet aircraft, electronics, computerized gadgets. If you had been told all this back in 1945 when World War II ended, you would have been justified in expecting that we would have a life of leisure by now. You would have wondered how much anyone would need to work each week. Statistics for productivity growth since 1945 show that agricultural productivity has soared even more than manufacturing productivity in the United States. So has productivity in mining – just the reverse of what Ricardian rent theory forecast.



So why are employees working longer hours and more intensively? Why are entire families – wives as well as elderly men – being forced into the labour force instead of having the life of leisure that technology seemed to promise? Why are life spans shortening, heart disease rising along with strokes and cardiovascular disease in the post-Soviet economies where neoliberal planners have had the freest hand to re-engineer “free markets”? Nobody expected this.

People are suffering. They know that something is wrong. But nobody has stepped forth and said that it does not have to be this way. There is an alternative. (I will suggest some later.)

The great problem of our time is financialization of our economic life – our business, our personal life and the government itself. By financialization I mean capitalizing every form of surplus income: personal income over and above basic expenditures, corporate income over and above cash flow (that is, after meeting the break-even cost of doing business), and whatever the government can collect in taxes over and above its outlay. All these flows of revenue can be pledged for bank loans at the going interest rate. From the banker’s point of view, equilibrium is reached at the point where the entire economic surplus is paid out as interest. The whole economy is capitalized, and the capitalized value is taken as the measure of the nation’s financial wealth.

The problem is that paying out all the economic surplus as interest leaves nothing over for living standards and hence labor productivity to rise, nothing for corporations to invest in new tangible capital formation, and no government spending for infrastructure or other social and economic needs. A Dark Age descends. Financialization of an economy thus becomes a form of neofeudalism, especially as bankers prefer to lend against collateral already in place than to finance new enterprise, and to back rent-seeking than more risky new direct investment.

Frederick Soddy pointed this out in the 1930’s. He was a good Nobel Prize winner by the way, showing that sometimes they do give it to good economists. However, he won the prize for his contribution to physics, not economics. Today’s

Nobel Economic Prizes are given for academics who fail to understand the simple point that Soddy made: that financial claims and bank loans, stocks and bonds, are not wealth as such, but claims *on* wealth. Adam Smith made a similar point in *The Wealth of Nations*. From Smith to Soddy, economists argued against counting an economy's physical means of production (on the asset side of the balance sheet) and at the same time the debt and property claims *on* these assets (which appear on the liabilities side of the balance sheet). You can count one or the other.

For businesses, assets on the left side of the balance sheet, and are equal the liabilities on the other side, plus net worth as the excess of assts free of debt. That is the essence of balance-sheet accounting. Yet public discourse these days emphasizes wealth in financial form – what Smith would have called mercantilism.

The maximum market price for real estate, corporate industry and other assets is defined by however much a bank will lend. Housing prices, for example, achieve financial equilibrium when a buyer fully mortgages the property's rental flow. The same is true of commercial office investment. Corporate raiders make a similar calculation when they sit down with their investment banker to calculate – and pledge – the cash flow to obtain a bank loan or sell junk bonds to the financiers. Market equilibrium is reached where a company's value is its value to raiders, which in turn is as much as banks and bondholders are willing to lend.

This is what the business schools teach students these days. The idea is to cannibalize an economy by turning over the entire surplus to the financial sector. The problem is that few financial returns are spent on goods and services or invested in new means of production. Most are lent out. The limit is reached and the economy collapses at the point where all the surplus revenue is capitalized to pay debt service. No money is left over for new capital investment, not even depreciation set-asides to replace equipment that is wearing out. No seed money is left, no revenue for governments to spend on infrastructure because all is earmarked to pay bondholders. Families are unable to afford an education or save for their retirement.

The economy turns down not because of the reason that John Maynard Keynes worried about in his *General Theory* – the prospect of people saving too much as economies became more prosperous – but because families, industry and the government have run too deeply into debt to afford to buy enough goods and services to keep the circular flow (“Say’s Law”) intact between production and consumption. Market demand and employment shrink. That is the essence of debt deflation, and that is the problem that is plaguing economies today.

This is what happened to the Roman Empire. It is a financial overgrowth that shows that the financial, insurance and real estate (FIRE) sector is extractive, not part of what I call Economy #1, the production and consumption economy. Economy #2 is wrapped around the real economy, extracting interest and rent charges. Mill defined economic rent – what we call a free lunch – as what a landlord can make in his asleep, that is, without working, without enterprise, simply by passively receiving what Henry George called “a payment of obligation.” Individuals who managed to gain wealth in Rome simply plowed it into the purchase of land, living off their rents, not industry.

Land is not a factor of production any more than air or water or sunlight. It is a property right. Money and credit likewise are not factors of production. They are claims for payment, created by institutional and legal structures that differ from country to country. The fact that they are the result of specific historical circumstance provides an opening for anti-classical economists to argue that they should be excluded from “scientific” analysis, on the ground that they are not universal. What is universal, it is claimed, is individual utility (pleasure and pain) and technology. The inference is that economics should focus on these “real” core relationships, excluding property and finance as “givens” or simply as “exogenous” considerations.

The result has been to trivialize economics, not make it more relevant to policy making. Economics is reduced simply to measuring supply and demand – what individual buy if a menu is put in front of them. Micro-economists focus on individual choice in the market place, but few ask what creates the market in the first place, or what is sold, or how fortunes are acquired. Lacking is an analysis of how the menu

came about, who created its contents, how high a price actually had to be paid, and most of all, who gets wealth and how – *e.g.*, by inheriting it, by special privileges, insider dealing, or by their own labor and enterprise. Yet these were precisely the issues that classical economists discussed. So economics has retrogressed, not gone forward.

I think the last land assessment in England was in the 1870s. They haven't done one since. They were so traumatized by the writings of Mill and "Ricardian socialist" reformers that they thought they had better stop doing any survey of land value. The guiding principle was that if the tax collector doesn't see it, there is less chance of it being taxed. So land – which used to be classed as "visible wealth," in contrast to finance as "invisibles" – became statistically invisible, not only to the tax collector but to government policy makers and the economics profession.

Wall Street analysts, however, spend much of their time poring over corporate balance sheets looking for undervalued land, hoping to buy out companies based on current earnings projections rather than the "breakup price" of selling their land at a capital gain. So academic and public sector economics lags behind the pragmatic world of wealth seeking.

Matters have gotten so bad that about ten years ago the mayor of London, Ken Livingston, sent his economist over to the United States for an economic meeting. I introduced him to Ted Gwartney, who at that time was the property assessor for Bridgeport, Connecticut. Ted explained that his job was to draw up a land map of the city. There were some people that didn't agree with him and protested their assessments, he acknowledged, but he won every court case. The London economist asked how long it took him to make a land map. Ted said that he had two assistants, and it took three months. The economist looked wide-eyed and said: "This is incredible. You should win the Nobel Prize for this! Are you the only person in the world who does this? I've never heard of such efficiency."

Ted laughed and told him that there are thirty thousand assessors in the United States that do just what he does, and they do it for every city and county in the nation

every two or three years. The Englishman was amazed, and we discussed whether London might sponsor a similar study.

The proposal never came to fruition, largely as a result of lobbying by the property interests. Real estate investors want to know what they are buying and selling, but want outsiders to know as little as possible. The reason is obvious. They worry that if the government measures land value – especially the appreciation of land prices – political pressure will arise to tax it. The upshot is that governments measure wages and corporate profits, but have only the roughest estimate of wealth, its distribution and rate of growth. Only Japanese statistics have good measures of land prices. And no national income statistics today measure the most important asset on which classical economics focused: unearned income and unearned wealth.

The concept that is most seriously lacking from post-classical economics is recognition of the fact that someone can earn an income without producing a service of equal social value. Matters almost have got to the point where if someone robs you in front of a bank teller or ATM and says “Your money or your life,” the national income and product accounts would provide this as a life-saving service, not as a zero-sum transfer payment. The NIPA incorporate this kind of circular reasoning. Newspapers and television report gross domestic product as if it were actual product, not simply “gross domestic cost.” GDP does not measure economic well-being, but includes a widening FIRE sector overhead wedge that is extractive, not productive.

An alternative to the neoliberal Washington Consensus that uses such statistics as its take-off point should begin by reformulating the national income accounts to produce a different kind of analysis. The aim should be to show that there is an alternative. It was worked out in the 19<sup>th</sup> century. While the Austrian school, the marginalists and psychic utility theorists were replacing classical economics, writers such as Simon Patten and Thorstein Veblen analyzed land rent and unearned income. They treated the finance, insurance and real estate (FIRE) sector, being institutional, a product of law and the privileges it secures.

They accordingly were called institutionalists, and the new mainstream was quick to exclude their idea of economic rent as a product of legal privilege to extract income without having to produce a corresponding service, and without an outlay for necessary costs. The idea of unearned revenue that has no counterpart in the actual cost of production became anathema. Yet this is just what occurs when the financial sector's CEOs give themselves hundreds of millions of dollars of salary and bonuses, you can be sure that this revenue has no necessary cost of production. If it wasn't necessary twenty years ago or ten years ago, it is not necessary now. But it is counted as adding to GDP in payment for producing a "financial service." Congress has a Financial Services committee, without recognizing how this idea is an oxymoron.

I find it remarkable that nobody has pointed out that Adam Smith did not say what neoliberals repeat when they count him as their patron saint. His aim, and that of subsequent classical reformers, was to free society from privatized land rent, from financial interest and fees, and from monopoly rents. It was to isolate these forms of revenue that classical economists developed their analysis and quantified it in the 18<sup>th</sup> and 19<sup>th</sup> centuries. These revenues come from purely property rights and privilege, not from basic technological or economic necessity.

Inevitably, the *rentiers* fought back. They naturally preferred a post-classical economics that was careful to avoid looking at what is really important in life, especially at how wealth was being obtained. Wealthy people like to think of themselves as earning income, not extracting it or getting a free ride. They even like to think of themselves as hosts, not as parasites – it is the poor, the welfare recipients and even their employees who are the parasites whose income is to be minimized, not their own privileged rake-off income, which they demand should receive special tax benefits because the wealthy financial classes are so essential for economic survival.

#### *The post-classical road to neofeudalism and debt peonage*

The banker's-eye view of the world has a blind spot that has subsidized a vacuum in today's political economy – so much so that when Communism fell, Russia

and other Soviet states had almost no idea about what to do. In every single post-Soviet economy an identical scenario unfolded. Neoliberals were sent from various universities – the Harvard boys to Russia, the Georgetown University boys to Latvia, and so forth. In every case there was a voucher program that pretended to give workers ownership of all the industry and public enterprises. This was called “peoples’ capitalism,” the term that Margaret Thatcher had coined for Gen. Pinochet’s Chile, which became the dress rehearsal in 1974 for the neoliberal reforms later foisted on the post-Soviet states and other gullible economies such as Iceland.

Iceland followed neoliberal advice to give away its commanding heights to insiders. In less than a decade it went from stability to debt-ridden bankruptcy, from one of the stars of world financial and real estate markets to a pariah. After the government privatized the country’s three leading banks in 2001, foreign loans and deposits flowed in as the economy was deregulated. This foreign-currency inflow was lent out to bid up housing prices, and enabled the central bank to a enormous splurge on imports.

Icelanders imagined themselves getting rich. By 2007, the United Nations cited Iceland as the world’s wealthiest and happiest economy. But its currency has plunged since its financial system went bankrupt in October 2008, while property prices have fallen by 70 percent, reducing its population to debt peonage as their mortgage debt service is in foreign currency. Bankruptcy rates are rising and foreign labor has left. Tax revenues are plunging as the economy shrinks, and the government is broke. Having given away its banks and other public assets, it is now being held liable for the debts the kleptocrats ran up to British and Dutch depositors in Icesave on-line bank branches. The suicide rate is soaring and labor is emigrating to escape its mortgage debt.

Much the same has occurred in the former Soviet economies. When they obtained their political independence from Russia in 1991 they had with no debt at all, and no property claims for rent or interest. Yet over the past decade they have become the world’s most debt-ridden countries, borrowing against real estate, fuel and mineral deposits and natural monopolies. Bank loans enabled buyers to bid up prices for these

assets, prompting the World Bank to applaud the “Baltic Miracle” in Latvia, Estonia and Lithuania.

The Soviet Union had dispersed most manufacturing production throughout its member states. These connections were uprooted when the post-Soviet states emerged from Russian domination. Breakup of intra-Soviet trade left these states economically dependent on Western imports for consumer goods and capital goods, food and many other essentials.

To pay for this trade dependency they needed credit. They expected that their commitment to join the European Union would be reciprocated by something like Marshall Plan aid, along with advice to help them develop in the way that Europe had done. This is where they were wrong. Most European countries had developed by enacting tariff protection, anti-monopoly regulation, public subsidy and infrastructure support of enterprise. Europe’s Common Agricultural Policy subsidized enormous dairy and crop surpluses. The last thing that European governments wanted was to nurture the Baltics and Central European countries into rivals. “Old Europe” saw them as prospective markets for surplus exports, especially for agricultural surpluses, and as financial colonies and markets for European bank lending.

Austrian banks, for instance, went into Hungary and made hard-currency loans to buy the real estate and other assets being privatized from the public domain. This fueled a real estate bubble there. Swedish banks set up Baltic affiliates to lend euros, Swiss francs and sterling. Local populations borrowed to buy the homes that had been occupied without formal ownership rights under Soviet rule. Political insiders developed hotels and the Old Town areas of major cities as tourist centers. By 2004 a post-Soviet property bubble was well underway, as in the West. From a point of just about zero market value and bank capitalization for real estate rights, post-Soviet housing and office prices soared toward equality with European capital cities.

All this was fueled by mortgage loans in foreign currency rated. This borrowing from foreign banks against the real estate and other public assets being privatized provided the post-Soviet economies with the foreign exchange to pay for their trade



deficits. This was the great trade-off – increasing debt for current imports. It was bound to come to an end at the point where all the real estate was fully “loaned up.”

Some 90 percent of Latvian mortgages are denominated in Euros or foreign currency. The same is true in Iceland. Since the real estate bubble burst in 2008, no more such loans are being extended to these countries. Yet their trade deficit persists. They still need to import consumer goods, fuel, machinery, food and other essentials. But instead of putting in place export industries to cover the cost of these imports, these countries simply ran up debts against their real estate and other assets inherited from Soviet times. The only solution so far has been to take out yet new loans – this time by the governments rather than the private sector, with funds owed to foreign governments rather than to commercial banks.

Inter-governmental loans always have been problematic. They usually involve a loss of political autonomy on the part of debtor countries to the International Monetary Fund and, in the post-Soviet case, to the European Union bureaucracy. The EU and IMF are lending funds to “stabilize” exchange rates only to sustain the payment of mortgages to European banks threatened with taking huge losses on their loans to the post-Soviet sphere. No lending is being made for domestic spending. Indeed, the terms of these official loans impose austerity, and even budget surpluses in the face of economic shrinkage. This is of course just the opposite of current U.S. Keynesian counter-cyclical “Stimulus plan.”

Latvia had over 150 hospitals and clinics when the Soviet period ended in 1991. By 2009 it had only around 40, and the IMF and World Bank demanded that it close half of these. While some consolidation was needed, many needed services, including trauma centers and ambulance services, were closed. Public health standards are worsening and life spans have shortened by several years for men – as has been the case in Russia. There has been a massive exodus of doctors and health specialists, especially to neighboring rich Scandinavian countries. This reflects a serious labor emigration that sees both highly skilled and unskilled workers alike departing. Moreover, formerly free universities are now charging tuition, so money rather than

talent now obtains higher education. This is the end product of financialization as Latvia struggles to squeeze out enough to pay its foreign creditors.

Latvia's GDP fell by more than 18 percent in 2009. It is anticipated GDP will shrink by close to 30% from the crisis' onset in fall 2008 until it ends. This shrinkage has left more people out of work (its unemployment rate is now reported to be 16.8 percent), so default rates are rising. Housing and other real estate prices have plunged by about 50-70% in most markets, and new construction has all but stopped. According to a recent poll, about a quarter of the male population aged between 20 and 35 years old plans to emigrate during the next five years.

One motive is to escape being frozen into homes that have fallen into negative equity. Unable to sell at prices that enable them to repay their mortgages, debtors are obliged to make up the difference as their personal debt. So the alternative to debt peonage is to leave. Mortgages are denominated in euros or other hard currencies, but the likelihood is that the currency will be devalued sharply if Latvia does not keep on borrowing from the EU and IMF – on terms that clash public spending and impose economic austerity all the more!

The inability to pay debts confronts Latvians with a quandary. Homeowners cannot sell their homes because their mortgages far exceed today's post-bubble market prices. This negative equity prevents them from moving, because they would have to pay banks the balance due. They are personally liable, as there is no European tradition of common law such as you have in England, the United States and Australia that leaves creditors only with the property that has been pledged as collateral, not with personal liability of mortgage debtors.

Families are so frustrated they have begun to fight back. In January 2009 a large-scale protests occurred in Riga – and also in Reykjavik, Iceland's capital. But their governments have not yet come up with a plan to extricate them from debt peonage left in the wake of the Bubble Economy's insolvency.

Iceland is a creditor's paradise – which means a debtor's hell. Mortgages at interest rates from about 5 to 5-6% are indexed to the exchange rate. This imposed an

18% on Icelanders by spring of 2008. So on balance, home owners had to pay over 23% mortgage interest (18% + 5%) on property that had fallen 70%. If they move, they are personally liable. So as many as a third of the Icelandic young adults are reported to be planning to emigrate. I spoke to mothers who told me that this is what they are advising their children to do.

Iceland held parliamentary elections in April 2008. I met earlier with a number of Icelandic political leaders and former Prime Ministers, and we discussed how the currency was likely to be devalued as a result of the debt overhang. They worried that to bring up this problem before the elections would upset most voters. The usual tendency is to vote for the politician who promises us the best future. So the election proceeded almost without any economic discussion. The Social Democrat-Green coalition won the election, with a prime minister who promised to take the country into Europe.

At that time about two-thirds of the voters expected that somehow Europe was going to help them. (This was the same vain hope that the post-Soviet countries earlier had held.) Today only about 40 percent want to join Europe. The government is facing a no-confidence vote by a number of parties over what to do about the debts that the British Labour Party and the Netherlands are claiming to be owed. A few months ago in Parliament, Gordon Brown was asked about depositors who had lost money in one of the Icelandic banks, Kaupthing. I say Icelandic, but Kaupthing actually was a British bank that was owned by Icelandic investors. It thus came under Britain's public regulatory authority. (By contrast, IceSave was a branch of Landsbanki, and hence fell under Iceland's own domestic neoliberal and purely private insurance scheme.) Yet Gordon Brown said in Parliament that he intended to lean on the IMF to refuse to lend any money to Iceland, and to block its attempt to join the EU if it didn't pay him what he demands!

The British acted without regard to the law, as did the Dutch. And like most lawbreakers, they have steadfastly and sanctimoniously refused to submit the issue to a third party for judgment. We are dealing here with pure creditor power – the power to

destroy an economy, to depopulate it, to starve it of essentials in what is the equivalent of a military blockade. And just as occurs in war, the effect is a great loss of life. Icelandic suicide rates are rising, emigration is rising as I noted earlier, and life spans are quickly shortening. This is financial neofeudalism!

Under European Union rules, if a bank goes bankrupt, it is given three months to settle with depositors. But the British authorities moved immediately within two days to repay all the depositors. EU rules gave a three-month breathing time for any bank to withhold paying depositors, and two more three-month extensions. So under EU law, the Icelandic banks had nine months to settle. Mr. Brown moved immediately using anti-terrorist laws against Iceland, because the only way in which they could grab the money was to brand them as terrorists.

Iceland is a country with no army, and it's hard to imagine anything that could have made them more resentful than being labeled as terrorists. Gordon Brown threat to lean on the IMF to act as a debt collector was basically illegal because Iceland didn't owe the money. Only its Icesave accounts were insured. These were computerized internet accounts offering a very high rate of return – higher than you could get from normal accounts, reflecting the risk of losing money to a banking system that had been neoliberalized with little regard for risk and scant local oversight of the kleptocratic insiders mismanaging the bank by using deposits to gamble in the world's financial casinos. Yet I'm told that the local council authorities in England were directed to deposit their money in Icesave because they had a "fiduciary responsibility" to put their savings where they could get the highest interest rate.

To save face in the wake of the Northern Rock bank collapse in Britain, Gordon Brown also paid British Icesave depositors. The same thing then happened in the Netherlands with its IceSave branches. So he took a hard line with Icelandic officials, who returned to Iceland with a bad deal that the nation's Althing parliament approved under severe political arm-twisting. The agreement called for Iceland to pay 4% of its GNP growth over and above 2007 levels to settle with European Icesave depositors

over a period of seven years. From 2010, there would be a seven-year waiting period, and from 2017-2024 Iceland is repay. But after 2024 it would re-examine the issue, and no further payments will be made if it is deemed that this would cause extreme distress.

Britain and the Netherlands rejected this condition. They continue to threaten not to let Iceland join Europe unless the government agrees to pay them in full for the mistake that their own bank insurance agencies made in jumping the gun. Iceland's own political parties opposing the Parliamentary agreement were overjoyed that England and the Netherlands turned it down. Iceland's President has put the matter to a vote, scheduled for March 5, 2010. Public opinion polls show some 70 percent of the population oppose the agreement – and have soured on the very prospect of joining the EU, seeing it as an exploitative financial power rather than the Social Democratic union they earlier had imagined it to be. They see themselves viewed as a financial colony, not as an equal.

*An alternative economic program to that of the neoliberal Washington Consensus*

Like many other Soviet economies, Latvia is a combination of the domestic population and the Russians since Stalin moved in during the 1950's, when he deported the middle class and others with professional backgrounds. Some 38 percent of Latvia's population are Russian speakers, and they form the major support for the Harmony Center ("Concord") Party. It was joined by ethnic Latvians frustrated with poor governance to become the ruling party of Riga, the capital city, and national elections will occur in October 2010. I head a Committee of Experts charged with drawing up an economic platform to rescue the country from the neoliberalism to which it has been subjected since it achieved its political independence from Russia in 1991.

Our first recommendation is that in view of the fact that the currency was about to be devalued and 90% of the debts were in foreign currency. The first plank is to make banks only able to take the house itself when they foreclose – the collateral that was

supposed to back the loan. Mortgage loans are not the same thing as personal loans, after all. Banks are supposed to take responsibility for keeping loans within the debtor's ability to pay. That basic rule has been violated throughout the world in recent years. This has been largely a result of the banks' greed in making loans more than limited to 70 percent of the property's value, as was long the rule in the United States. Personal liability is not going to be permitted. I don't know any other way to prevent banks from making irresponsible loans and then trying to blame the debtor. This is unconscionable, and we are going to prevent it from recurring.

Second, we urge that all loans and obligations should be re-denominated in domestic currency. This is similar to what U.S. President Franklin Roosevelt did in the in 1932 when he overruled the gold clause in most loan contracts. (The clause stated that if the price of gold changed, the debt had to paid in gold equivalence.) This was intended to prevent creditors from obtaining a windfall gain and indeed, a gain beyond the ability of debtors to pay and hence at the expense of economic recovery. The economy comes first, not the bankers. This is especially important in today's world, where there is no longer a constraint on the banking system's ability to monetize credit.

A third plank of our program is designed to cope with the problem of abandoned housing, squatters and crime that has plagued foreclosures in the United States. Upon insolvency or foreclosure of residential and commercial property, the foreclosing bank must put it up for auction within one month, to be sold at a market price. The current occupant (either the indebted owner or renter) will have the right to match the bid. Our plan is for the government to set up a bank to lend the occupant funds to buy the property, converting its current rental value into mortgage debt service. At current prices, the new mortgage may be about 30 percent of the existing debt – and it will be denominated in domestic currency. The oligarchs seem happy with this, because the same thing will happen with the large public utilities and other assets they have taken over and borrowed against.

In October 2009, Latvia's neoliberal Prime Minister endorsed the first plank of this program, saying that there should be no more personal liability for mortgage debt. The Swedish finance minister became furious and said that this would break all tradition. The Harmony Centre ("Concord") Party replied that the tradition to which Sweden seemed to be referring was feudalism, and reminded Sweden that Latvia threw off their yoke back in the 15<sup>th</sup> century, and threw out the German land barons in 1905. They have no intention of going back to feudalism, so the gauntlet is thrown down. We are having a meeting of European Social Democratic parties next May to draft a common program. We plan to reintroduce the classical economic reform of the tax system.

I have seen no discussion of this in the press, except for my own write-ups in the *Financial Times*. There is a case of cognitive dissidence when it comes to structural financial and fiscal reform. Most people are not aware that there really is a workable alternative, and indeed one that was viewed for a century as being the free market alternative – a market free of unearned income and "empty" pricing. The problem is that students no longer are taught that economic thinkers have spent the last seven centuries discussing better modes of taxation, banking and pricing. They came to a similar conclusion, based on the ability to distinguish between economically necessary costs and income, and unnecessary costs. The aim was to complete what was viewed as the economic program of industrial capitalism: to throw off the remaining legacy of feudalism, above all the landlord class that used to be called the idle rich, but also predatory bankers. These two classes now have joined forces to become a new aggressive power – financial speculators unnecessary for the industrial economy to operate but actually are slowing it down.

The most important plank of our entire program concerns the tax system. Like most other post-Soviet economies that have been neoliberalized, Latvia has a dysfunctional flat tax on labor. This flat tax is so high – about 59 percent – that it is the single major factor pricing Latvian labor out of global markets. We are urging that

the tax base be shifted off labor and its employers onto where the classical economists urged it to be placed: on the land itself.

This is going to be the plank of our reform program – reforming the reformers – against which banks and the EU will fight most viciously. But fiscal reform must be a key element in financial reform, because the two forms of reform are symbiotic. By taxing the land, we are preventing its rental value from being capitalized into bank loans. Our aim is to lead bank credit to focus on actually creating new means of production, not simply bolstering the privatized market price of unproductive, extractive privileges and property claims.

**Now that you've been here a week, what is your analysis of the Australian economy?**

It's hard to be an instant expert on an economy. It seems self-destructive for Australia to raise interest rates, ostensibly to slow the financial and real estate bubble. Raising interest rates will hurt public finance in three ways. Raising the rate by ¼% will oblige the government to pay more to bondholders. Homeowners with variable-rate mortgages also will have to pay more to the banks. This will leave less revenue available for spending in the domestic market. But most important is the third effect: Raising interest rates above those of other countries will enable arbitrageurs throughout the world to borrow from U.S. banks at less than 1% and lend to Australians at 3¼%, pocketing the difference. This foreign exchange inflow to buy Australian dollars will bid up the exchange rate, making imports more expensive. So higher interest rates will raise prices – just the opposite of what usually is taught in academic models.

This week I've read in the newspapers that manufacturing companies are lowering their profit forecasts because they realize that they can't make export sales – or even hold onto the home market with so high an exchange rate. This is what plagued Swiss industry for many years as a result of its bank inflows from crooks, tax evaders and kleptocrats throughout the world. Once Switzerland became a tax avoidance



centre, the franc went way up. Pharmaceutical companies moved their operations across the German border to operate at a lower cost. The nation's Manufacturing was rendered uncompetitive because of the franc's high exchange rate. I remember that when I went there to consult for Ciba-Geigy, a Coke cost 60 cents in the United States but was \$3.50 in Basel. High living costs meant high production costs as the economy was sacrificed to Swiss banking interests.

The same thing is happening here in Australia. A friend of mine who works for the Canadian government e-mailed me today saying that Canada is going through what seems to be happening here in Australia. Because of its soaring export proceeds for raw materials, the Canadian dollar has risen sharply against the U.S. dollar. That is hurting profits for Canadian oil and gas producers, while its manufacturers are losing out to U.S. industry.

The moral is that trying to regulate the housing and financial cycle by raising interest rates penalizes the economy, by raising its cost of living and doing business. Interest is a cost of doing business, and imports become more expensive, providing an umbrella for domestic producers to raise their prices.

Yet I have heard no public discussion here of holding down real estate prices and mortgage debt by increasing the land tax. Politicians avoid this because taxpayers react negatively to any kind of a tax rise. The distinction between economically inefficient and inefficient taxes has been lost from public discussion. A revenue-neutral tax shift – lowering sales taxes and income taxes on wages by the amount that property taxes are raised – would not take in any more tax revenue than now. But it would levy taxes in a way that holds down property prices. A positive financial effect would be to leave less revenue available for banks to capitalize into interest charges. Holding down housing and real estate prices – and debt – would lower the cost of living and doing business. This would make the economy lower cost. That should be the aim of every economy – to minimize the cost of living and doing business.

As matters stand, Australia is maximizing the cost of living and doing business by a tax system that favours property speculation. People seem to believe that they are getting rich from having their home rise in price. (Actually, it is not the home as such that rises, but the land site.) But all this really does is force them further into debt to buy a home. High interest rates raise the exchange rate, leading manufacturing to leave and even eroding profits on mining, while giving the financial sector a windfall gain.

**How could we implement this system? How would it work from the ground up?**

The same way that classical economists described in the 19<sup>th</sup> century. You start by making a land map so as to shift the property tax away from buildings onto the land. You explain to voters that this tax will leave the rental value of land unchanged, but instead of paying this rent to the banks as interest, it will be paid to the government, enabling it to lower income and sales taxes by an equivalent amount. A land tax thus will lower the price of property, because the land rent no longer can be capitalized into a bank loan, to be converted into an interest payment to the bank.

You would explain that you indeed want to see capital investment in houses and other construction, and you realize that they have to make a profit on their capital expenditure, but they don't have to make a profit on the increase in price of the land's site location – that is, what the landlord makes in his sleep. Today, real estate buyers bid against each other, and the winner is the one who pays out the rental value to the mortgage banker who creates the credit to finance the property purchase. So the financial sector has joined forces with the real estate sector to lobby against taxing real estate, and to tax labor and consumers – and industry – instead. This is the major political problem that Australia faces: the lobbying power of the symbiotic FIRE sector.

Along this same line you could enact a natural resource tax. Nature has provided Australia with subsoil wealth in the form of minerals, oil and gas with a lower cost of extraction than other countries have. So you can tax land and minerals without increasing their price. To the extent that you remove a similar volume of taxes from

labour and capital, you lower the economy's cost of living and doing business. This should be the objective, as it was to classical economists hoping to make their national economies more competitive by keeping market prices in line with actual costs of production – and making the distribution of income more fair in the process, by collecting the “free lunch” of economic rent as the natural tax base, as it was for thousands of years in older times.

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