Suppose you were alive back in 1945 and were told about all the new technology that would be invented between then and now: the computers and internet, mobile phones and other consumer electronics, faster and cheaper air travel, super trains and even outer space exploration, higher gas mileage on the ground, plastics, medical breakthroughs and science in general. You would have imagined what nearly all futurists expected: that we would be living in a life of leisure society by this time. Rising productivity would raise wages and living standards, enabling people to work shorter hours under more relaxed and less pressured workplace conditions.

Why hasn’t this occurred in recent years? In light of the enormous productivity gains since the end of World War II – and especially since 1980 – why isn’t everyone rich and enjoying the leisure economy that was promised? If the 99% is not getting the fruits of higher productivity, who is? Where has it gone?

Under Stalinism the surplus went to the state, which used it to increase tangible capital investment – in factories, power production, transportation and other basic industry and infrastructure. But where is it going under today’s finance capitalism? Much of it has gone into industry, construction and infrastructure, as it would in any kind of political economy. And much also is consumed in military overhead, in luxury production for the wealthy, and invested abroad. But most of the gains have gone to the financial sector – higher loans for real estate, and purchases of stocks and bonds.

Loans need to be repaid, and stocks and bonds receive dividends and interest. For the economy at large, people are working longer just to maintain their living standards, which are being squeezed. Women have entered the labor force in unprecedented numbers over the past half-century – and of course, this has raised the status of women. Mechanization of housework and other tasks at home has freed them for professional life outside the home. But on balance, work has increased.

What also has increased has been debt. When World War II ended, John Maynard Keynes and other economists worried that as societies got richer, people would save more. For them, the problem was to keep market demand high enough to buy all the output that was being produced.

And indeed today, markets are shrinking in many countries. But not because people are saving out of prosperity. The jump in reported “saving” in the National Income and Product Accounts (NIPA) in recent years has resulted from repaying debts. It is a negation of a negation – and hence, a statistical “positive.”

Paying off a debt is not the same as building up liquid savings in a bank. It reflects something that only a very few economists have worried about over the past century: the prospect of debts rising faster than income, leading to financial crashes that transfer property from debtors to creditors, and indeed polarize society between what the Occupy Wall Street movement calls the 1% and the 99%.

What also was expected universally fifty years ago – indeed, until about 1980 – was that governments would play an increasingly important economic role, not only as forward planners but as direct investors in infrastructure. To Keynesians, government spending served to pump money into the economy, maintaining demand and employment in cyclical downturns. And for hundreds of years, governments have undertaken basic infrastructure spending so that private owners would not use monopoly privileges to charge economic rent.

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Nearly all observers expected the fruits of technology to trickle down, not be siphoned up to the top, to the banking sector whose “financial engineering” played no directly technological role in the production process. Textbook models describe – or rather, assume – that rising productivity will be passed on to labor in the form of lower prices (reflecting falling costs of production, enabling wages to buy more) or, if prices are “sticky,” higher wages.

According to what the textbooks called Say’s Law, there is a circular flow between producers and consumers. Workers must be able to buy the results of what they produce. This correlation between output and consumption goes back to the Physiocrats prior to the French Revolution, who created economics and account keeping. Their founder, François Quesnay, was a medical doctor and a surgeon. He created the basic format of national income accounting on the analogy
of the circulation of blood within the body. An increase in production had to find its counterpart in increased consumption, creating its market by paying workers who spent their wages on buying the products they produced.

Working harder, producing more, but going into debt to buy it

After World War II many women stayed home and raised families. But since the 1950s they have been forced increasingly into the labour force for what are called two-job families – and now, three-job families (with only two family members). If you project labor participation rates, by the year 2020 every woman will have to work 18 hours a day or economic trends will falter.

What was applauded as a post-industrial economy has turned into a financialized economy. The reason you have to work so much harder than before, even when wages rise, is to carry your debt overhead. You’re unable to buy the goods you produce because you need to pay your bankers. And the only way that you can barely maintain your living standards is to borrow even more. This means having to pay back even more in years to come.

That is the Eurozone plan in a nutshell for its economic future. It is a financial plan that is replacing industrial capitalism – with finance capitalism.

Industrial capitalism was based on increasing production and expanding markets. Industrialists were supposed to use their profits to build more factories, buy more machinery and hire more labor. But this is not what happens under finance capitalism. Banks lend out their receipt of interest, fees and penalties (which now yield credit card companies as much as interest) in new loans.

The problem is that income used to pay debts cannot simultaneously be used to buy the goods and services that labor produces. So when wages and living standards do not rise, how are producers to sell – unless they find new markets abroad? The gains have been siphoned off by finance. And the financial dynamic ends up in austerity.

And to make matters worse, it is not the fat that is cut. The fat is the financial sector. What is cut is the bone: the industrial sector. So when writers refer to a post-industrial economy led by the banks, they imply deindustrialization. And for you it means unemployment and lower wages.

Financial dynamics vs. industrial dynamics

The accumulation of payments on interest-bearing debt leads companies to search for new loan markets, just as industrialists seek out new markets for their expanding output. This search means looking for assets in place to be pledged as collateral. The largest asset in any economy is real estate – mainly the land’s site value. So about 80 percent of bank loans are mortgage loans. But by 1980 property prices had turned down as interest rates rose during the Vietnam War and the general Cold War buildup throughout the world. Overseas military spending obliged the Federal Reserve to raise interest rates to borrow abroad to prevent the dollar’s exchange rate from declining.

So in the 1980s banks found a new market: corporate raiders treated companies much like real estate, to be bought on credit and managed to create a capital gain. The rise in interest rates to 20 percent by 1980 forced most states to revoke their usury laws, and credit card companies played states against each other in a race to the bottom when it came to protecting consumer rights. So the high-interest junk bond was born, largely at the hands of Michael Milken’s gang at Drexel Burnham.

American industry began to be financialized (and in the process, criminalized). But running a company to make a financial gain is different from running an industrial firm to expand production. Cash flow that was not paid to bankers and bondholders for the credit to buy out stock holders was used for purposes other than direct capital investment – above all for stock buybacks to support their price, and for mergers and acquisitions to acquire yet more companies.

The aim was not to increase production but to increase balance-sheet wealth – while extracting revenue from companies much like landlords bleeding a building. That is the time frame of finance capital, in contrast to industrial capital. It is short-term, not long term. This is why it is extractive rather than productive. The revenue has no counterpart in new direct investment in output, but rather in overhead debt extracting a rising flow of interest from the economy.

“Wealth creation” by debt leveraging – that is, asset-price inflation – was celebrated as a post-industrial economy, as if this were a positive and natural evolution. But in reality it is a lapse back into a rentier economy, and even into a kind of neo-feudalism. The post-2008 bailouts have vested a new rentier elite to lord it over the 21st century, thanks to the fact that most gains since 1980 have gone to the 1% – mainly the financial sector, not to the 99%.

In the end this shrinks the economy – and that means that more and more loans will go bad, until crisis levels are reached at the point where lenders realize that there is no more room to extract more, and stop lending. But in the absence of government budget deficits, bank lending is the only support for demand – so the financial rug is pulled out from under the economy. That is the point at which banks demand bailouts – giving them the money, rather than giving the economy the revenue to spend and pull itself out of depression. So government debt is increased by giveaways to the banks, not by spending into the “real” economy.

Economics textbooks teach supply and demand curves. Every marginal increase in supply lowers the price of what is being supplied. For the job market this means that the higher the unemployment rate, the lower wages will fall. Conversely, the more workers you hire, the more you have to pay to attract workers. Government officials and bankers are indoctrinated in these textbooks and conclude that the less employment there is, the more wages will fall – thereby presumably leaving a wider profit margin, assuming that the goods can still be sold at a steady price. So employers seek to earn more by keeping employment low enough to prevent wages from rising. This maximizes the power of wealth over labor.

Economists conclude that to make economies more competitive, they need to keep wages low so as to undersell other
countries. So a race to the bottom develops. But what seems to help countries compete actually hurts their domestic market.

Back in the 19th century this was called the reserve army of the unemployed. Unemployment keeps labour down. And even more important, to the extent that incomes do rise, they are paid out as debt service. A dynamic is put in place in which debt keeps labor down – not only by eating up its wages in debt service, but in making workers suffer sharp increases in the interest rates they have to pay or even risk losing their homes if they miss a payment by going on strike or being fired. Alan Greenspan explained that unemployment was not needed to keep labor down these days. All that is needed is to traumatize and disable them politically by debt leverage. (Quote his Senate testimony)

This is why, despite the fact that productivity has risen so dramatically, the real economy and its wage levels have tapered off in an S curve. The magic of compound interest has increased debt (and the savings of the 1%) to more than absorb the productivity gains. And this financial overgrowth has accrued to the 1%, not to the 99%.

Finance is what makes today’s economy different from that of 1945. We are at the end of a long cycle. Back in 1945 the private sector in every country was relatively free of debt. There was little civilian output for consumers to buy during the wartime years. Companies had little reason to invest, except for the government’s military demand. So most families had little debt – and a lot of savings, and good job opportunities after the return to peace. But today the economy is in reverse. Savings have been run down and consumers, real estate and industry is left in debt.

Untaxing land rent and monopoly rent so that it can be paid to the bankers, not to government

To stop this reversal, it is necessary to understand its causes. They are not only financial. The banking interests have gained sufficient power to distort tax policy, creating a dual fiscal-financial problem. Taxes have been shifted off the major bank customers – real estate and monopolies – onto labor and consumers. In the United States, two-thirds of state and local tax revenues in the 1930s came from the property tax. Today the proportion has fallen to only one-sixth. States and cities replaced property taxes with income and sales taxes. Europe and the post-Soviet economies have adopted the most anti-labour tax of all – the value added tax.

The rationale is that it is easy to collect. But it falls on consumers, not on the economy’s free lunch of economic rent as advocated by classical free market economists. The value added tax adds to consumer prices and shrinks the market, preventing labor from buying the goods it produces. This is done simply to free more land rent, natural resource rent and monopoly rent from taxation so that it can be paid to bankers as interest.

When voters threaten to elect politicians to pursue less bank-friendly policies, the EU announces that the country needs a technocrat to impose more taxes to bail out the banks for their bad loans. It is all in vain without changing the system, because today’s financial business plan cannot work for more than a short time. Being extractive rather than productive, it leaves a swath of bankruptcy in its wake. Yet it is the banks that the technocrats are saving, not labor and industry, the “real” economy’s employment, social spending and public wealth.

Changing Social Security from being paid out of progressive taxation to a regressive labor tax

In 1982, bank lobbyist Alan Greenspan was appointed to head a U.S. commission to shift Social Security out of the public budget (where it was funded largely by progressive taxation) and fund it by user fees that fall on employees and employers. The aim was to privatize it Chilean style. Wall Street’s dream is to turn wage set-asides over to money managers to buy stocks and create a stock market boom (and in the end, siphon off commissions and push contributors into high-risk bets on the losing side of the deal with large financial institutions, Goldman Sachs style). In effect, Mr. Greenspan’s position was that Social Security should not be a public service. It should be a user fee, so that prospective retirees would pay for it in advance. Their savings were to be lent to the government to enable the Treasury to slash taxes on the higher income and wealth brackets. So the effect was to reverse the long trend toward progressive taxation.

The upshot of the Greenspan tax increases (only on labor, not on wealthy earners) was to create a budget surplus for the Social Security Administration, enabling the government to cut taxes on real estate, on finance, and for the rich in general. Capital gains taxes in particular were cut in half. And real estate investors (absentee owners, not homeowners) were allowed to pretend that the value of their holdings were depreciating rather than rising in price, by junk accounting based on junk economics.

The end game came when the Bush and Obama administrations announced, in effect, “We’re broke. So now we have to balance the budget by cutting social spending and raising the Social Security tax further. We’ve cut taxes on the rich by so much that the workers have not paid enough to cover this give-away, not to mention fighting the Bush-Cheney war in Iraq and the Obama Administration’s war in Afghanistan – or for that matter, the class war against labour.

Under Pension Fund Capitalism, employees are encouraged to think of themselves as capitalists in miniature – and provide for their retirement by employee stock ownership programs rather than saving up their wages themselves or having pensions financed on a pay-as-you-go basis out of future production. The idea is to make money from money (M’ M’), not by producing commodities (M-C-M’). In America, half the employee stock ownership plans (ESOPs) have gone bankrupt, mainly by being grabbed by the corporate employers. Corporate raiders borrow credit from bankers and bond investors to fund management buyouts. The plan is to buy out stockholders, pledging the earnings to pay out as interest. And not only earnings; they loot the employee pension plans. George Akerlof won the 20– Nobel Prize for describing this. But novelists have recognized it more than economists. It was Balzac who said that behind every great family fortune is a great theft, often long forgotten to be sure.

Today’s economy is based on theft under the euphemism of “free enterprise.” It’s sometimes called “socialism for the rich” because they receive most government subsidy. But it’s not the kind of socialism that people talked about a hundred years ago. It is a travesty of social democracy and socialism. In a word, it’s oligarchy. But we’re living in an Orwellian world. No party calls themselves fascist today, or even anti-labor. They call themselves social democracy. But
it’s the opposite of what social democracy meant in the 19th and early 20th century.

Social Security has not yet been privatized, but education has – not only privatized, but financialized. Students no longer get free or low-priced education. In order to qualify for professional jobs in America, they have to take out loans that put them deeply in debt. Then, when it comes time to start a family, they have to take on a lifetime 30-year mortgage debt. They need to take out an auto loan to buy an automobile to drive to work, especially where public transportation has been dismantled as in Los Angeles. And when their paychecks are squeezed more, they can maintain their living standards and social status only by taking on credit card debt.

Paying the carrying charges on this debt diverts spending away from the goods and services that employees produce. The result is debt deflation. Employees have less and less ability to buy what they produce – except by taking on even more debt. That’s why banks and bondholders have ended up with the increase in productivity – almost synonymous with the 1%. They are the core of the Finance, Insurance, and Real Estate (FIRE) sector that now absorbs most of the economic surplus in the form of various types of economic rent: land and natural resource rent, monopoly privilege and financial overhead.

The inversion of classical free market reform to its diametric opposite

Classical political economy sought to mobilize democratic government to tax the rentiers: landlord, monopolists and bankers. The objective was to create an industrial surplus and, in the process, raise productivity, wage levels and living standards. To keep prices low and hence national economies competitive, governments were to undertake society’s largest spending programs: basic infrastructure such as transportation, power production, communications – all of which happen to be natural monopolies as well. So the aim was not only to provide basic infrastructure needs freely or at subsidized prices, but to prevent private owners from erecting tollbooths on roads and charging monopoly prices for power, phone systems (as in Telmex in Mexico or similar phone monopolies in the post-Soviet kleptocracies).

Post-classical economics (deceptively called neoclassical) seeks to untax the rentiers, and shift the costs of government onto labor and even onto industry. To achieve this, democracy is rolled back to oligarchies. But this time they are controlled not by landlords as in the case of Europe’s landed aristocracies, but bankers and financiers. And their aim is to privatize the public domain with its monopolies. Bankers advance the credit to buyers, who install tollbooths and raise prices for basic needs. By paying out their revenue in a tax-exempt form, as interest, they keep their income out of the hands of government – forcing national treasuries to tax labor and industry, consumers and producers rather than finance, insurance and real estate. Governments thus become the protectors of monopoly and its financing.

It is a short-term policy. By raising domestic price levels, financialized economies price themselves out of global markets – unless than can create a world order in which all economies are symmetrically debt-burdened. This is where the International Monetary Fund, World Bank and World Trade Organization are brought into play – to financialize globalization, excluding countries as pariahs if they do not join this self-destructive and self-terminating system.

An object lesson of the shift from classical democracy to post-classical oligarchy is a country that is held out to you as a success story: Latvia, where neoliberalists had a completely free hand, as they did in Russia. What they call a neoliberal paradise turned out to be debt-ridden kleptocracy. The country has a set of flat taxes on employment of 59 percent – and only a 1 percent real estate tax.

You can imagine what happened with real estate taxed so low and labor taxed so high. Employment was high-cost – but there was a real estate bubble. When I was Research Director at the Riga Graduate School of Law, I visited the government agency in charge of property assessments, and asked how they got the 1 percent. I was told that they based it on the most recent real estate appraisal they had. This turned out to be back in 1917, before the Russian Revolution. (The lead assessor had written her doctoral dissertation on this survey.) Whatever the tax collector gives up and relinquishes in taxes, is available to be paid to the banks as interest. So housing prices are bid up in price – on credit – while the tax collector has to turn to labor and industry for the revenue that has been given up. Instead of paying taxes, new homeowners pay interest to the bankers. The upshot is that the banks end up with the rent that used to accrue to the landed aristocracies of Europe. This is making bankers the new aristocracy.

When I headed an international investigative economic team in 2010, we visited Latvia’s bank insurance agency and were told that they had anticipated a collapse of the bubble. Their response was to advise banks to back their mortgage loans not only with the property as collateral, but to get as many family members as possible to co-sign the loan. That way, if and when default occurred, the parents, siblings or other relatives would be personally liable.

The bank regulators did not urge the government to tax real estate more. That would have squeezed homeowners on their bank loans – and left less new rental income to be capitalized into new bank loans. But it would have enabled the government to reduce its heavy taxes on employment. This was not the bank regulators’ concern – and bankers themselves saw their main business in lending to fuel real estate, not industry, given what the neoliberalists did to Latvia’s economy and that of the other Baltic states!

Unfair? Economically polarizing and destructive? Of course. But the bank insurers said that their task was to protect bank solvency, not create an optimum economic structure.

One result is that a recent EU survey found that one-third of Latvia’s population between the age of 20 and 35 either had emigrated or was planning to do so. As of 2012 the country’s population recently has shrunk by 15 percent. Marriage and birth rates are falling off, as they are throughout the post-Soviet economies. After all, who can marry and buy a house when your wages are taxed at 59 percent and you have to take on a debt?

Iceland provides another object lesson. Even more than Latvia, it became a rogue banker’s paradise – and also one for vulture banks. Their loans are indexed to the consumer price index – which means in practice to the foreign exchange rate. The krónur plunged after the banks crashed in 2008. The result a 1,000 krónur debt has become perhaps 1,800 –
against property that has fallen from the equivalent of 1000 krónur down to perhaps 400 krónur. This leaves many families in negative equity. And they are personally liable.

When the crooked banks of Iceland went under (and they’ve only recently begun to arrest some of the crooks) the government took them over and, on European advice, sold them to vulture investors, for around ten cents on the dollar. Despite the fact that Iceland’s constitution said that they were not allowed to increase debts by indexing, this is just what the banks did. If the government had taken over, it could have written down the debts to the ability to pay. But the new vulture banks have not done this. And the Social Democratic government backed their rights to make as much as they can, rather than giving priority to the welfare of the Icelandic people.

What I find so striking is how far to the right wing of the political spectrum the Social Democratic and Labour parties have moved. Iceland’s Social Democratic leadership explained that it wanted to be part of Europe. But this meant acting on behalf of the British and Dutch bankers, not democratically on behalf of Icelanders. They acted on behalf of the emerging financial oligarchy.

I’ve known many of the social democratic leaders of America and the world since I was a young boy. My father was a socialist labor leader and political prisoner from Minneapolis, which was the high point of American labor history as a result of its great General Strike in the 1930s. I was told by a Socialist Party leader (Terence McCarthy) in the early 1960s that the travel and hotel expenses of nearly every member of the Socialist International (the Second International, of which Dmitri Papandreou of Greece is President as of autumn 2011) was paid for by the CIA or its front organizations. I watched the Socialist Party in America come to support the Vietnam War, and Michael Harrington ban criticism of the war in its youth magazine – driving it to quickly lose most of its members.

Harrington and his mentor, Max Shachtman, took this position because they believed that the West could not be persuaded to be Marxist until the world was freed from the Stalinist travesty that claimed to be Marxist. So the Social Democratic Party of America joined the Cold War effort. Politics was turned upside down by the triangulation of socialism, Stalinism and the ability of the United States to back and finance European social democrats to support the banks and “centrists.” This became the tragedy of the old non-Stalinist left in America and other countries. So the Social Democratic leadership imagined (or simply sold out to pretend to believe) that “free financial markets” would lead the world into economic progress.

This was just the opposite from the Progressive Era and indeed, what industrial capitalism promised. The Social Democratic parties of Iceland, Britain, Greece, Scandinavia and other European countries have adopted the position that the way to re-employ labor is to impose austerity. Budgets are to be balanced by lowering wages by 30 percent, and shifting taxes off the finance, insurance and real estate sector onto consumers.

Taxes on labor add to its cost. So competitive power would be maximized by untaxing labor and consumer goods, by getting rid of the value-added tax. But not all taxes are bad. The classical free market economists endorsed taxes on unearned income: land rent and natural resources, monopoly rent and financial privilege. These categories of income have no counterpart in a cost of production undertaken by the rent recipient. The more that governments can shift the tax burden onto land and property, the lower housing prices will be – and the less governments will need to tax labor by income and sales taxes.

Bankers back anti-government ideology because they want to obtain all of the untaxed rental revenue as interest. So taxes that otherwise would be paid to the government will be paid to the bankers. The result – what you’re seeing today in Europe and North America – is an economic grab that is in many ways like that which gave birth to European feudalism. But this time around it is financial, not military.

Tags: Debt, Economic Theory, Euro, Financial sector

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