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The Economic Black Box

British Airways flight 038 from Beijing lost power as it approached Heathrow on January 17, 2008. The pilot was forced to belly-flop the Boeing on the grass verge besides the runway. What had gone wrong? Investigators could recover the answers from the flight deck's black box. Lessons would be learnt. The crews and engineers need the best data on the performance of all the working parts of the aircraft. We don't allow airline pilots to fly blind.

When the economy belly-flops and people lose their jobs, economists do not retrieve information from their black box. Vital data about what went wrong is not made available to government. So remedial policies are not developed to avoid similar events in the future. Lessons cannot be learnt. In economics, the black box does not exist. In its place, there is a black hole.

In practice, there is a blackout as effective as when London turned off the lights to confuse Luftwaffe bombers searching for their targets in World War II. This is a serious charge indeed. I allege that governments and their advisors fail to hold penetrating inquests to reveal why the economy crashed. I claim that vital information is hidden below the radar screen of the analysts.

Blind Men Walking

IN 2008, Britain entered the period of financial volatility with a leader who turned a blind eye to the emerging crisis.

Gordon Brown and his chancellor, Alistair Darling, agreed on the mantra: Britain was in good shape and could survive the turbulence under their stewardship.

The trouble originated in the US, and they would ensure that problems with Northern Rock did not "spread across the rest of the economy".

The subliminal message to the public: Northern Rock's difficulties were exclusively the doing of a poor management team; and foreigners were (somehow) responsible for the downturn in the UK housing market in the winter of 2007/8.

This denial of reality endangered the British economy. With the government's eyes turned to what was happening beyond its shores, political leaders were unprepared for the pressures surfacing from within the UK.

With the best will in the world, it is not possible to excuse Gordon Brown. He spent 10 years as Chancellor of the Exchequer. Brown then selected Alistair Darling as his successor, and the two neighbours stood shoulder-to-shoulder as the financial markets started to cave in during the summer of 2007. They maintained the fiction that the turbulence that was emerging in Britain was exclusively the fault of Florida land speculators, or brokers who mis-sold mortgages to low income families in Cleveland, Ohio. Brown and Darling could not bring themselves to admit the truth. The British economy was savagely exposed to home-grown instability. An astronomical national debt had been allowed to accumulate.

The two Downing Street neighbours defended their claim that there was no sub-prime problem in Britain. They ignored the facts that were plain to people on the ground. The evidence included dubious business practices, such as the collusion of mortgage banks with brokers to encourage people to self-certify their incomes. This enabled people to borrow more than they could afford, given their salaries and debts, and to borrow more than 100% of the value of the properties they were purchasing. On April 19, 2008, the *Financial Times* published a map of Britain's sub-prime hotspots. Newport, in South Wales, topped the list of toxic mortgages, with over 10% of loans to home-buyers with "a chequered credit history – making it the sub-prime capital of Britain".[1]

1 O'Doherty (2008).

The UK housing market was turning down because the government failed to adopt the counter-cyclical measures that I had identified for it 10 years earlier, in 1997.

The Celtic Tiger's Roar

WE SHALL TEST this allegation in relation to Ireland, which some commentators claim as one of the major success stories of the last business cycle. The so-called Celtic Tiger did turn a handful of its citizens into helicopter lifestyle billionaires who made their money out of property. Then the property market crashed in 2007 and people started to lose their homes.

I was invited to analyse the economy at a public lecture in Trinity College, Dublin on March 11, 2008. I wanted to offer my interpretation of the careering economy based on an examination of trends in their property market. An explanation was necessary because, according to the headline in the *Irish Times*, "Repossession of house orders up 50% last year".[2]

2 Gartland (2008).

Could the escalating tragedy have something to do with an out-of-control land market? Had prices been driven to insupportable heights, dooming the house of cards to collapse? To make sense of what was happening, I needed the statistics on land prices. There were none. On my behalf, my colleague Konrad Dechant contacted government, statistical agencies, academic institutions and property dealers. He drew a blank: such information was not collated by Ireland's economic "pilots" (see box opposite).

How was an investor supposed to make rational decisions without the data on one of the three factors of production? How could the pricing mechanism work properly if transactions were compromised by this huge void in information? How could government formulate efficient policies if it suffered from such myopia?

Efficiency is not the name of the game. This claim offends the official doctrine, that the capitalist economy is dedicated to delivering efficient outcomes. But if there is an information blackout on one of the components of the economic mechanism, the system must *necessarily* be inefficient.

Box 5:1

Ireland: Mystery of the Missing Land Data

To analyse trends in the property market, data on land prices over the business cycle was sought from the:

- Construction Industry Federation
- Economic and Social Research Institute
- Society of Chartered Surveyors
- Central Bank and Financial Services Authority of Ireland
- Department of the Environment, Heritage & Local Government
- Property Registration Agency
- Lisney, a leading real estate agency

None of these had information on the land of Ireland, and its value.

That left one vital question: was the blackout intended to camouflage activities that were against our interests?

The erasure of vital information is not an oversight on the part of government or scholars who specialise in the economy, or even the data-collecting agencies that are funded by taxpayers. The information void has to be deliberate. There is no other way to account for this fact, in what is supposed to be a rational, science-based society.

But there is an issue beyond the statistics which, no matter how exhaustively collated, are meaningless if they cannot be sensibly interpreted. To be meaningful, data must be crunched through theories that *explain* what is happening. I claim that the capitalist economy is structured to prevent people from gaining that comprehensive understanding.

Historically, it was necessary to distract our minds from deeds that offended people's sense of justice. To ingrain an amnesia of what had transpired, selectively targeted to camouflage the important turning points in the history of the quality of life in the population, important bits of data were excluded or collated imperfectly by national census and auditing agencies.

Am I paranoid? Only if I cannot offer a rational account of strange distortions to economic knowledge.

My thesis is as follows. *The perversion of economic knowledge was necessary if the privileges of the class that hijacked the community's income – the revenue paid to government – were to be protected.* What is the evidence to support this allegation?

The pricing mechanism, which registers what we pay for goods and services in the markets, as a result of the interplay of supply and demand, is the conduit for information that enables the economy to function. Prices are supposed to *integrate* all the factors of production (land, labour and capital) in combinations that result in the best rewards for all participants. That is the theory; and that's what would happen, if the pricing mechanism worked efficiently. But close examination of that mechanism reveals something profoundly disturbing.

We make decisions to "balance the books" – whether our household budgets or, through our political representatives,

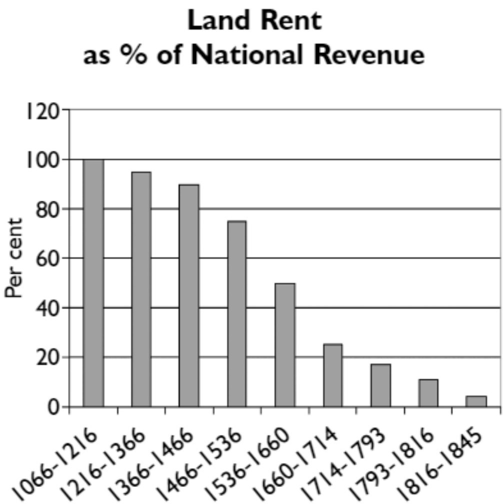
Box 5:II

The Rent Revenue Rip-off

Frim 1066 (when William conquered England) through to the 15th century, the bulk of public spending was funded out of the rents of the kingdom. Military defence, law and order and the upkeep of the Crown were costs placed on land, which was the natural source of revenue. Rent is the economy's surplus income, in the sense that it is what is left over after paying for the costs of labour and capital.

Then, in the 16th century, monarchs changed the rules of land ownership. They plundered the kingdom's rents for personal aggrandisement. The feudal class – barons and knights – got in on the act, to pocket the rents for their private use. Moving swiftly onwards, the aristocracy took control of tax policy in Parliament in the 17th century. Surprise, surprise! They invented new kinds of taxes to levy on people's wages, so that the public services were not funded out of "their" rents. ➤

Box 5:II (contd)



Today, a trivial sum is raised from rent, while the burden of taxes falls on people on the lowest incomes.

The data in the chart is taken from a speech in the House of Commons by Richard Cobden in 1842, when only about 4% of the state's revenue was raised from land.

the nation's books. If the pricing mechanism is efficient, as rational people we would, indeed, balance the books.

But the pricing mechanism includes what we pay for goods and services provided by the public sector. We pay taxes for what economists call the "public goods" provided by government. To achieve the best outcomes, the two mechanisms in the public and private sectors need to be complementary. A rational society would operate with a *single* pricing mechanism, not two competing systems. To avoid a split between our private and public selves, we need a financial system that is balanced and works smoothly. The pricing mechanism must function as an organic whole.

But we have inherited a pricing mechanism that disturbs our lives. Prices in the private markets are out of kilter with the prices (taxes) charged for public services. To understand why this is so, we need to identify the beneficiaries of this unholy mess. We begin to fathom the dynamics of this system when we clarify the motives behind certain forms of behaviour in the money markets which appear to be psychotic in character. Is there a rationale behind them that escapes notice?

The Sub-prime Butchers

A PSYCHOSIS is the generic term for a mental state that reveals itself as a "loss of contact with reality". If our culture suffers from such a condition, we are continuously exposed to dangers which – as rational individuals – we would prefer to avoid. An analogy, leading to one example of a social psychosis, will help us to understand why modern society exists in a state of continuous instability.

Suppose your neighbour was the proprietor of the local butcher's shop. Over the garden fence, one day, he tells you that he has received a consignment of contaminated meat from his suppliers. Ordinarily, that meat would be condemned by the health inspectors. He, however, has a clever idea. If he mixed the consignment with wholesome meat, grounds the lot up and sells it as sausages, the risk of someone becoming ill is reduced. After all, the dose of toxic meat would be spread among many more people, so the risk of infection by any one individual would be lower.

What would your reaction be to this ruse? As a public spirited citizen, you would report the butcher to the health authorities. How dare he put people's health at risk to maximise his profit?

In economics, however, so disturbed is our thinking that we celebrated the financial butchers who packaged rotten deals with prime cuts. That happened in the US money markets in the decade up to 2007. Brokers and banks advanced mortgages to borrowers who could not afford the repayments. They knew these people were bad risks, and that one day they would default on their mortgage repayments – and that would mean their homes would be repossessed. And yet, despite knowing that the mortgages were extremely risky deals, the money-lenders went ahead with them, then packaged them up with good mortgages and sold them to pension funds. Was this not psychopathic behaviour?

Psychopathy describes chronic immoral and antisocial behaviour. The comparison between psychopathic tendencies and the actions of people engaged in making money from money is compelling. Systematically luring people into borrowing money which they cannot afford to repay, and then offloading the risks onto innocent people in other countries, matches the definition of "immoral" and "antisocial".

These sophisticated financiers lost no sleep as they rolled up the high risk mortgages (the sub-prime loans) with cuts of high-grade mortgages, and packaged them into financial sausages called "collateral debt obligations". These CDOs "spread the risk". If sub-prime borrowers defaulted, the losses would be shared by others. The result would be financial paralysis in the world's banking system as the malaise mounted by the month as the global system seized up in the autumn of 2008.

Unwary purchasers of the financial sausages ought to have been alerted. The bankers thought they were being smart. They off-loaded the toxic packages of debt to banks in countries like Germany which did not engage in such practices. So when the US housing market peaked in 2006, many people were hurt by the dodgy deals. The trust on which the banking sector relies evaporated. Banks refused to trade in the securities, because there was no way of knowing who held the toxic mortgages which had been minced up in financial sausages. The pricing mechanism ground to a halt, because of the actions of the financial wizards who were detached from the psychological state of reality.

What blinded the moneymen? What compromised the flow of information within the economic system? Can we really trace the financial psychosis back to a perversion of economics as a social science?

Pock-marked Towns and Cities

THE TOXIC financial sausages were a surreal copy of an earlier variety of similarly toxic deals. Mason Gaffney, the renegade professor of economics who teaches at the University of California (Riverside), has made a life-long study of the way the land market was perverted, turned into a toxic dump for the fortune seeker's benefit.

As a student, Gaffney failed to court the approval of the supervisors of his doctoral thesis. His dissertation revealed how America's embryonic communities were distorted by property rights and taxes, which caused urban sprawl. He did not invent a new economic theory. He worked with the classical concepts derived from the works of Adam Smith and David Ricardo. They led him to distasteful conclusions about America's "free markets".

Growing up in Illinois, in the interwar depression years, Gaffney observed how towns were pockmarked with toxic land deals. Sprawling towns reduced the returns on the capital invested in their streets. Why was that scarce capital spread out so thinly over extensive areas, instead of being invested in compact cities to generate the highest returns? Gaffney discovered that some of his profession's luminaries had redefined the concepts of land and rent. The outcome was an acceptance of the waste of resources. He saw through that agenda, and insisted on spelling out the facts in his doctoral thesis.[3]

Land speculation was the driving force behind this process. As prices rose, speculators made windfall capital gains from buying and selling land. The speculators

3 Gaffney (1956: 108).

borrowed more and more money, to break up farm fields into sites that could be developed for housing or commercial use. Latecomers convinced themselves that, if they bought those sites, they could "flip" (immediately resell) them at an even higher price. And so avarice overcomes common sense.

This was not a rational market economy in action. The speculators were not making decisions based on people's needs. Their creed was greed. Resources were not allocated efficiently. But this failure was not due to the psychological failings of a few individuals. People *en masse* were receiving signals that directed them to commit resources that spread the investment of capital far and wide. Consequently, capital invested in public services (like highways and energy utilities) were over-supplied in thinly-populated areas, and under-supplied in densely-populated areas. The social costs were debilitating, but they were camouflaged by a rationale that legitimised the behaviour. The doctrine that concealed this reality was exposed by Gaffney in *The Corruption of Economics*.

For the rest of his teaching life, Gaffney insisted on explaining to his students that the pricing mechanism was defective. The problem was not with market prices, *per se*, but with government policies. So-called market failures – such as the wasteful use of land – were the result of a public pricing mechanism (taxation) that was biased in favour of land speculators and against wage-earners.

Waste in the economy is on a grand scale. Gaffney emphasised the under-use of capital locked up in infrastructure. This investment was spread over large expanses to support land speculators rather than the consumption needs of urban dwellers in compact communities. The under-use of capital invested in a locality meant it was *over*-invested; which was inevitably at the expense of general living standards. The capitalist economy was a dysfunctional system geared to the capital gains sought by land speculators.

Such manifestations of social psychoses erupted in the bouts of speculative mania that regularly devastated America. Bank failures were an integral consequence as property bubbles. What Gaffney wrote 50 years ago in his doctoral thesis resonates today as whole communities in America implode, as families lose their homes and neighbourhoods are boarded up. He wrote: "The cumulative effect of all these factors can be devastating, leading to the grasping for liquidity and security, the general chaos, disintegration and demoralisation of inter-dependent economic relations that is a depression."[4]

As with its financial manifestation, in which sub-prime mortgages were jumbled up with AAA mortgages, the communities of America were constructed so that sub-prime lots were jumbled up inside the dynamic urban fabric to create a toxic mixture of tenures. Gaffney was unremitting in his criticism of the laws and institutions that fostered such outcomes. He persistently exposed the agencies that skewed the information and tolerated the illegal under-assessment of land values and the mis-definition of titles to protect owners from their tax obligations.

Someone had to pay. Wage-earners bore the brunt of the brutal tactics of the US tax authority, the Internal Revenue Service

4 Gaffney (1956: 115).

(IRS). People who tried to survive by getting round the tax rules were exposed as cheats and even criminal. The IRS used all the brutal tools of an intolerant state agency, spying on citizens and hiring informers to hound them into paying taxes.

The Chicago Boys

AN ECONOMY driven by land speculation rests on a foundation of unreality. This brand of economics is taught in universities. A leading exponent is known as the Chicago School, which came under Mason Gaffney's forensic scrutiny.[5]

Gaffney uses the prism of the three-factor model (land, labour and capital) to analyse behaviour in the markets. He applied this model at a conference in Chicago, in 1985, when he reviewed the history of banking crises. From his perspective, the major cause of recessions was land speculation. Because of the practices authorised in America, land values are the medium for a vicious cycle in the money

5 Gaffney (1985: 5). For access to Gaffney's articles, go to http://www.masongaffney.org/.

markets. It starts like this. Banks extend credit to the owners of land; the owners then "monetize" those values, by borrowing against a rise in house values; this upward twist in land – *not* house – value, then encourages banks to increase further the credit advanced to the property sector, and so on. The end result, time and again, is a "bubble" in the land market. People trapped in the pursuit of capital gains naturally want prices to continue rising. Their deals cause the bubble to continue inflating ... they do not think about the risks of the recessions that always follow a housing bubble, the pricking of which is followed by mass unemployment.

Gaffney's analysis rests on the claim that the driving forces that cause booms and busts emerge out of the market economy itself. This undermines the integrity of the doctrine of property rights and public finance favoured by the Chicago School. To distract people from the facts, it has to offer straw villains. Milton Friedman and his co-author, Anna Schwartz, came up with that villain in *A Monetary History of the United States*, one of the sacred texts of the Chicago School. If the repetitive syndrome of booms and busts was not due to property rights, blame had to be attributed to fallible individuals. They picked on the personality quirks of the governors of America's central bank, who regulated the money supply. Thus, the waves of bank bankruptcies were attributed to the foibles of a few men in the Fed!

Now turn to the banking crisis of the new millennium. Who was to blame for the credit crunch that destroyed hundreds of billions of dollars of shareholders investments, and the savings of pensioners? Who was culpable for the drop in the wealth held by American households of \$533bn (£265bn) by the end of 2007?[6] This personal tragedy and systemic crisis could not be the pre-programmed outcome of a misaligned set of property rights and prices, according to the Chicago School. So Professor Anna Schwartz, the surviving member of the duo, claimed:

> There never would have been a sub-prime mortgage crisis if the Fed had been alert. This is something Alan Greenspan must answer for.[7]

6 The estimate was by the US Federal Reserve. Guha (2008).
7 Evans-Pritchard (2008).

WHEN THE ECONOMY went belly-up in 2008, Britain's Office for National Statistics reviewed their failure. Government agencies had been responsible for reckless misinformation. The ONS study[8] contains nothing enlightening about property prices – the most sensitive indicator.

As residential land prices headed for their peak in 2007, I contacted the economists who prepare the Valuation Office Agency's forecast. They were predicting strong land price rises to July 2012 (graph). Their mathematical methodology (they insisted) was state-of-the-art. Forecasts were not modified until, mysteriously, the graph disappeared from the VO website in July 2008. Land prices had collapsed (-16% in the six months to July '08, –20% [Jan '09], and –11% [July '09]). They did the maths, but didn't see the collision coming. Japan has the best land price stats., but fails to use them properly; instead, relying on GDP data which led to farcical forecasts in 2009.

8 Simkins *et al* (2010).

Graph 5:1

The Mathematician's Forecast of Land Values (UK: 2008-2013)