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REAL WORKING CAPITAL & THE ELEPHANT IN THE BOOM AND BUST CYCLE

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(The following is a transcript by your GroundSwell editor of the presentation in slides made at the banquet at the Council of Georgist Organizations conference in Orlando, FL on Aug. 19, 2016.)

I prepared this presentation originally when I thought that Mason Gaffney was going to be here, and it is in his honor, it is kind of a story of his ideas based on George but taking it further with new research and it has a lot to do with elephants. I sent it to Mason to see what he was going to think about it, and he emailed it back to me today, "Imagine me as an elephant!" I suppose Mason is sort of an elephant in the Georgist movement. We prepared for elephants in the Boom and Bust Cycle because this is an area where Mason has taken off from Henry George and I think solved some problems that Henry didn't. Henry George, of course, wrote Progress and Poverty, and Henry George recognized that the boom and bust cycle was caused by land speculation. He knew that it wasn't money or overconsumption or underconsumption and he knew that land taxes were the remedy but he was kind of missing on the mechanism. And this is where Mason has stepped in and, at least in my view, has produced a satisfactory mechanism as to what drives the boom and bust cycle, apart from speculation.



I hope some of you have read some of Mason's pieces about real working capital, the lifeblood of the economy. He has written several pieces about it and I guess this is an important piece, How to Thaw Credit, Now and Forever. He writes that "working capital is the bloodstream of economic life. It is physical capital, the fast turning inventories of goods in process and finished goods that supply materials to the worker, and feed and clothe her family."

So this is a focus on a particular kind of capital. Here is where George diverged from classical economists who divide capital into fixed capital (buildings, big solid durable things) and working capital called circulating capital which was inventories of various things, including especially tools for the workers.

So what is real working capital? Inventories of consumer goods of all sorts which are replaced many times a year – food, clothing, production goods. Coal after it comes out of the ground becomes capital. Grain, yarn, oil, computer chips, paper before it goes into your newspaper, basic supplies that we produce in a civilization. That is a picture of the reservoir in Central Park which I walk around every morning when I can, weather allowing. And Con Ed. and steam. Con Ed supplies steam to the various buildings. A few years ago it blew up killing a few people, but that is what we live with. Gas, oil for

cars. These are the things that keep us going and are replaced regularly that make our modern lives functional and supplies of them are erratic and subject to being cut off in third world countries. In the first world country it is always there and we just take it for granted.

The function of working capital is what I call a bridge over time which allows us to survive until we complete whatever project we are working on. We have to have it stored up in order to get to from now until then. The oldest kind of capital, obviously, is stored food to get us from harvest to harvest. The reservoir provides water. Gasoline in our tanks – we have fuel; well, it takes a long time to get gas for the gas tanks because you have got to go explore for oil, drill for oil, pump it up, refine it, transport it. It takes a long time; you have got to have a good stock of gasoline available to keep an economy running. Those of you who were there in 1973 during the oil crisis when there were lines of cars around the block know what it is like to have a shortage of gasoline. I was living in San Francisco at the time and I quit driving altogether. I just took public transportation, as did a lot of us.

Something else that takes a very long time is lumber for construction. Trees grow for 40-50 years, and then we cut them and slice them up and transport them, and it takes time to have a stock of lumber on hand during that period when the tree starts to grow and we can harvest the lumber.

Another characteristic, and you see this throughout Mason's writing about circulation of capital, that it is made, produced, sold, used and replaced again. That is why classical economists call working capital circulating capital.

There are different cycles again. Wheat is produced on an annual cycle. Cattle pretty much the same thing, you have spring calves. Quarterly – fashion designs. Daily, food on a cart or newspapers. Or continually, as water in reservoir.

Mason loves to make examples of food carts. Hot dog vendors are seen all over the streets in Manhattan. They buy their hot dogs and buns in the morning and they sell them out during the day and they go home and the next morning they buy another supply of hot dogs and buns and then trundle out into the streets again. So this is real working capital replaced daily. You will see these vendors in Mason's articles. (continued on page 7)

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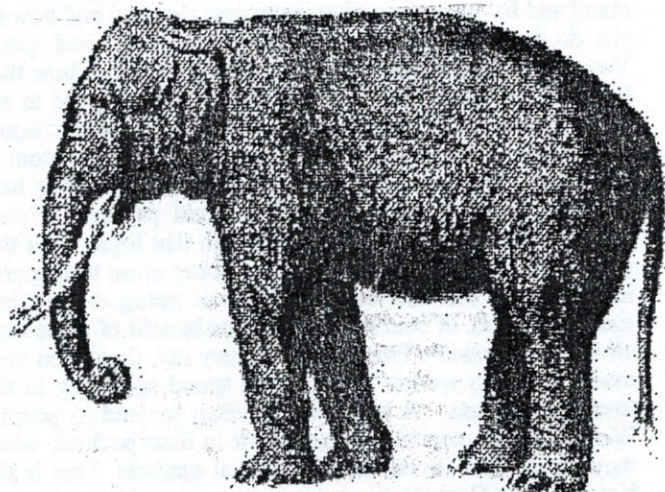
Another point you will see throughout Mason's writings is the importance of shortening the cycle because if you can produce more on the same land to speed up the cycle you will gain more production, less waste, and more jobs off the same land. And you can shorten the cycle. The Japanese are experts on this partly because they have a dense population and they have got to make the best of what little land they have and they have multiple and mixed crops on the same land. You can grow spring wheat and fall wheat or whatever crop. You can have multiple shifts in a factory to run at night as well as during the day. The Japanese are experts at just in time production which means they don't keep an inventory to produce components as needed and replace them very quickly. The Japanese total quality control is the same thing. Again, make sure that that you don't have any waste by checking each component as you go; the Japanese system runs off more labor which is a good thing because the more labor you have on the land the more production. This is the cycle of working capital – more labor and less land.

Working capital: we are in big trouble when working capital runs low. You can think about the Bengal famine, various famines are due to the weather, floods, wars, mismanagement like Venezuela; the working capital runs out. When you think of Venezuela they are sitting on one of the greatest oil supplies in the world, and yet people are running out of food, they are running out of gasoline, and they are running out of electricity. Things are right for a coup. That is what happens when you run out of real working capital.

Flint, Mich. ran out, or at least its managers decided to replace the water supply with one totally polluted. This picture from the New York Times is of a widow in her home in Greece while Greece is suffering from drastic austerity. Greece is out of real working capital and what real working capital they can round up they ship off to Germany. Greece's largest export is oil. That is the picture of life when you are running out of real working capital.

This is how David Ricardo blew it and somewhat led Georgists astray. Ricardo was great friends with Malthus and we know about Malthus and subsistence wages. Malthus said, at least for the workers, workers are reduced to starvation wages because they breed too fast. At the same time the classical economists – like Ricardo and Mills and the rest -- realized that this stock of grain went mainly to pay wages, and Mills' name for the stock was the wages fund. George throws out the wages fund; it is a terrible idea, because of course, what Ricardo did was get it backwards. He concluded that dividing the wages fund by the number of workers would give you the wage and that is how you could figure out what the wage was. George said, no, this is nonsense. And he dumped the whole concept of the wages fund. George figured out what determines the wage. It is what a man can earn for himself working on marginal land. George figured out what determines the wage by essentially applying Ricardo's model of rent to wages. Why Ricardo didn't figure this out for himself is beyond me. George got the wage theory right. He realized that Malthus was wrong. So he threw out the whole wage fund; this is Malthusian nonsense. Unfortunately in the process George missed a yet further good case for land value taxation. Land value taxation speeds up the circulation of working capital. We will see a lot of those things in Mason's writings. In any case, George threw out the baby with the

bath water.



Now I am going to talk about elephants. And there are lots of elephants besides Mason. One of the elephants is, of course, the elephant that the six blind men of Indostan went to see. One said the elephant is like a spear, another said like a rope, etc. There are lots of theories about the boom and bust cycle but I am going to talk about three very conventional theories about the boom and bust cycle and then the elephant theory which is Mason's theory of the boom and bust cycle. I am simplifying so people get the basics.

The first one is the conservative Republican theory of overconsumption. People went out and splurged, they spent too much, and then you have a bust and this is reckoning and the family must tighten its belt. This is paternalistic, judgmental. And there is a lack of aggregate supply; and we have got to do something about that. The Republicans say cut public spending and especially on public services because all of those people out there consumed too much and now they need to tighten their belts. Cut big business regulations and taxes to stimulate production and, of course, they make no distinction between the different kinds of taxes; you know, all taxes are bad. They say keep interest rates low enough to keep land values up (and that is what the Federal Reserve is doing, trying to keep those interest rates low enough to keep up the land values up that are collateral for the big banks) but not so low as to cause inflation. It is sort of a balancing act. They want to keep the interest rates low to keep housing values up but not too low. That is the conservative Republican overconsumption theory.

Here is the Keynesian or Democratic underconsumption theory. They (continued on page 8)

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say the nation is not like a family because the government can control public spending and monetary policy. Furthermore, due to too much spending, there is now a lack of aggregate demand. Even Stiglitz who is mostly on our side with the land tax still talks about the lack of aggregate demand and having to stimulate aggregate demand and how do you do that? You get the government to go out and spend. You don't really worry about how they spend it, or how they finance what they spend, but get out there and spend to rev up the economy. That is sort of the conventional wisdom these days. The other part of the conventional wisdom is you keep interest rates very, very low, this time not to help property owners but to help debtors and property buyers. There are all sorts of things wrong with that logic. But this is why we have the Federal Reserve doing close to negative interest rates, the idea being that this is going to stimulate spending. And, of course, who gets the benefit of those negative interest rates? The banks, and they say, thank you very much and then we are going to go spend splurging in the financial markets. It is too much effort to lend to people. We give them money and they put it in their pockets, when they go out and invest in the financial markets. That is the Keynesian or Democratic under consumption theory.

Now to the Libertarian or Austrian theory. The Libertarian Austrian malinvestment theory says that due to overly low interest rates at central bank, there is too much spending on land and too much heavy fixed and large investment. And there is too much consumption due to the wealth illusion. That is when people are rich or feel richer they spend more and invest less. In particular, there is not enough investment in real working capital so inventories drop and eventually start to run out. And the Austrian Libertarian theory is that is what helps produce the collapse after a bubble. This is why the Liberals and Conservatives don't take the Libertarians seriously because they recommend what I would call austerity on steroids. Eliminate debt. Return to the Gold standard. And be really strict on those over-spending people out there.

These are the three theories. And like the elephant, I think there is some truth in each of them. Now this is Mason's genius to pick from each of these theories the good parts and throw out the bad parts. The Conservative Republican theory is right in that there is a lack of supply and if there is no devaluation or bankruptcy or land value taxation as in Greece or Puerto Rico, there is no escaping austerity. (The answer for Greece is land value taxation but they don't have a decent cadastral system. So Stiglitz says you have the government declare everyone has to report the value of their property. The government will have the right to buy it at 125% of what they say it is worth and that will make them scramble to fix the property lines and straighten everything out.) That is the Conservative Republican theory. There is a lack of supply. In the Keynesian Democratic theory there is a lack of demand. Some government spending, the right kind of government spending can, in effect, stimulate the economy. The problem is the lack of focus on what kind of spending or how it is financed. The Libertarian Austrian theory is right in that booms produce malinvestment, leading

to a shortage of real working capital – and that is what drags down the economy. This is how Mason puts these pieces together.

This picture is of the big elephant in the room that all of these conventional theories ignore. They all ignore distribution of wealth and distribution of land ownership in particular. They ignore the fact, even more so today than 40-50 years ago, that big landowners, the 1% or the .001% buy up all the good land and similar resources like the broadcast spectrum and the like. And they use it lightly and inefficiently and they replace working capital slowly. They are sitting on stuff and it is too much trouble to manage it and they are not managing resources efficiently. The big banks issue mortgages to homeowners and credit to small businesses based on collateral – if you don't have collateral, sorry folks, you don't get a loan. And they rip off customers with fees. So the big elephant in the room that is finally beginning to emerge is inequality and this is partly what is wrong with neoclassical economics. There is no place for inequality in neoclassical economics. Classical economists, yeah, you have landowners, capitalists and workers, and the landowners who have most of the land, they inherited it, they conquered it, it was a gift to them from the king. In modern economics there is no place for inequality. So that is a very big elephant in the room.

Now we look at Mason's theory of the boom and bust cycle. Irrational exuberance, it is not just the banks, it is everybody gets all excited. They all start to project land values will increase indefinitely and we have got to buy more land and it becomes kind of a mania. I have been reading Behavioral Economics, and behavioral economists who do experiments and labs and this is what happens to people; they get carried away, even if they know the experiment has to end. Nonetheless, people become sort of a herd. Irrational exuberance makes interest rates too low; the banks lend too much too carelessly, and there is a lot of fraud in the process especially with the mortgage bubble, like the lending bubble leading up to 2008.

The .001% start buying up peripheral land. The land they have is not giving a very good return; let's go buy some more, maybe there is better returns out there, so they start buying up land; they start with the central land and then they buy the peripheral land. And they start extravagant construction projects and housing developments all over the place, and ordinary people start borrowing against their homes to consume more. Small businesses say things are going great and let's expand and so they will take out loans to expand. And local governments are part of this racket. As you know, this is part of urban sprawl and they extend utilities to the speculative developments out on the fringes, and in the meantime they are starving the central areas and at the expense of the central areas of the town. Fraud is rampant as we saw in 2008. Government agencies are overwhelmed. Everything is so exciting, who cares? (continued on page 12)

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This is what goes on in a boom. What doesn't get noticed during the boom and the thing that Mason points to is labor gets diverted to new construction, sometimes at the expense of routine maintenance on both private property and public property. Real working capital inventories start to fall but nobody notices. There is higher consumption. Remember, all these people are getting mortgages on their houses and consuming, instead of maintaining, instead of reinvesting, so there is reduced investment. This is an important quote from Mason that sort of tells the story: "It is as though grocers ate up part of their own wares, instead of selling and replacing them, leaving some shelves empty." This is what is going on and people aren't noticing it. Because as long as there is some supply out there and everybody feels rich, so the prices of consumer goods are going up, I am rich, I can afford it. Who cares? And people don't recognize what is going on.

Then somewhere it tips over to the bust. You don't quite know when it is going to happen but the moment somebody can't get that higher price that they expect, or somebody stops paying a mortgage, real working capital gets scarce, and interest rates start to rise and really spike at the end of a bubble. I remember reading about the crash of 1929 when the Fed finally realized that something was going on and tried to crank up interest rates to astronomical levels but people would still keep borrowing to buy more stocks on margin. It was totally crazy. It turns into a mania. Credit cards start going through the roof and new projects start to fail and new projects stop paying on their loans, and they lay off employees, and now the banks are not getting payments on their loans, so they stop rolling over existing loans, and they stop lending and rolling over loans to good customers who may be totally innocent victims who always made their payments.

The banks are running out of capital to roll over. Some small banks fail, and as we know now, big banks get bailed out by government and lending is cut back even on the best customers. Then it takes a while for things to recover. It takes a while for people to build up working capital again. It takes a while for the property markets to get working again. All this property has been bought up in one form or another by large property owners, large corporations.

And the thing that large corporations and rich people are best at doing is waiting. They sit there and they wait for the property values to come up. It may take years for the property values to come back or years for them to realize they aren't coming back and they may have to sell. So they wait, and the banks are waiting. At the moment, the banks are still up to here with bad loans. They own a whole passel of houses; they don't want to recognize that those houses aren't worth anything like the mortgages on them because that destroys the capital value of the banks. The Fed is in the conspiracy of the property owners and the banks to keep those property values up so that the banks don't have to recognize on paper their real losses.

This is a summary of the Gaffney elephant theory

which is there has been overinvestment in peripheral land. Ditto big banks. When banks are buying mortgages on bad property what are they doing? They are also investing in a form of land ownership as well. We sometimes forget that making a loan against collateral is also a form of buying land and both the big companies and the big banks have been engaged in buying lower quality land than the stuff they are usually comfortable with. This is part of what drives out the working capital because they can't manage it or continue to manage it.

Mason's policy proposals are land value taxation and where in the foreseeable future we can't get land value taxation we need to make the income tax back into a progressive income tax as it was originally designed by the Georgists who crafted it which is just a tax on the very rich and I realize that is not going to be easy. But somebody has got to do it. In the meantime don't borrow from the 1%, reduce the national debt by taxes rather than borrowing from the 1% and spend money on services to people – education, pensions, etc. – rather than on the military or bridges to nowhere.

(Dr. Polly Cleveland is a long time Georgist, whose first activism was with Nader's Raiders. She met Mason Gaffney shortly thereafter. She served as a Schalkenbach Foundation Board member. She is Director of the Association for Georgist Studies. Her Econamici blog is at www.mccleveland.org/blog. Her website is at www.mccleveland.org. She is an adjunct Professor in Environmental Economics at Columbia University School of International and Public Affairs. She may be emailed at mccleveland20@gmail.com) <<

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