Real Working Capital
& The Elephant in the Boom and Bust Cycle

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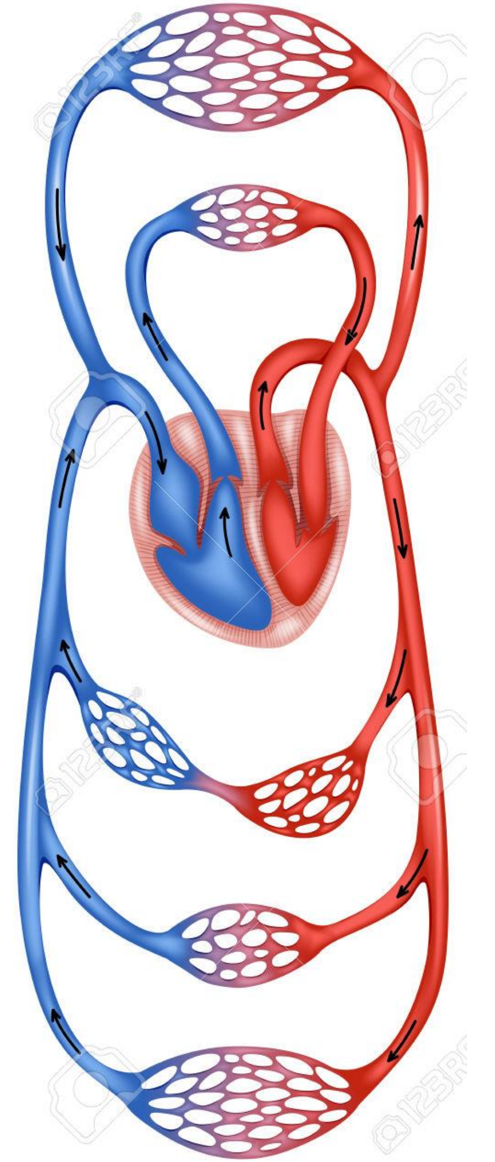
Friday August 19, 2016

Henry George on the Boom and Bust Cycle

- George recognized that land speculation causes the boom and bust cycle
- Money is not a primary cause
- Neither are overconsumption nor underconsumption
- Land taxation will remedy the cycle
- George couldn't come up with a good mechanism—his metaphor of the pyramid is just that, a metaphor
- He drops the subject in *The Science of Political Economy*

Mason Gaffney Solves the Riddle

- Gaffney points to something so obvious and ordinary that conventional economists miss it:
- It's not land that becomes scarce in a bubble, it's real working capital
- In "How to Thaw Credit, Now and Forever" (October 2008), he writes,
  - "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."

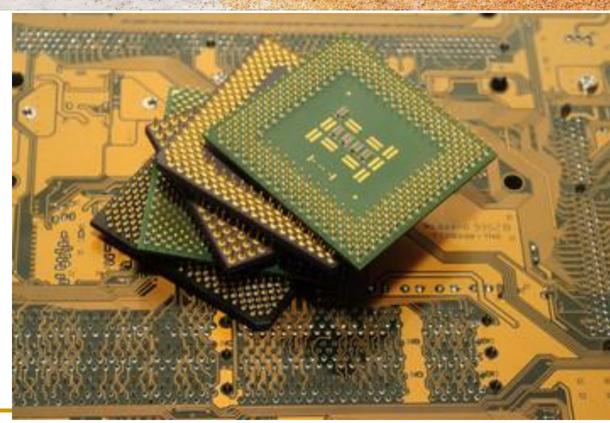


What is Real Working Capital?

- It's inventories of consumer goods:

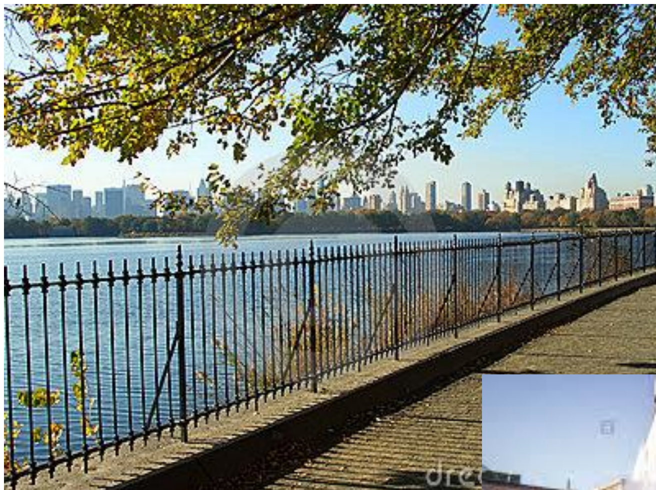
What is Real Working Capital?

- It's inventories of production goods:



What is Real Working Capital?

- It’s supplies of clean water and energy on demand:



Real Working Capital is a Bridge Over Time

- It allows us to survive until projects are complete
  - Stocks of grain give us food until the next harvest
  - Reservoir provides water until the next rain
  - Gasoline in tanks gives us fuel until new oil is found, pumped, refined and transported
  - Stocks of lumber give us building materials until new trees grow, are harvested, transported and sawn up

Real Working Capital Circulates

- It's produced, sold or used, and replaced on a cycle
  - Annually—wheat, cattle, new cars
  - Quarterly—new clothing designs
  - Daily—food on a cart, newspapers
  - Continually—water in a reservoir
- That's why classical economists called it "circulating capital".

A Shorter Cycle Means More Production, Less Waste, & More Jobs on the Same Land

- How to shorten the cycle
  - Multiple and mixed crops on farmland
  - Multiple shifts at a factory
  - Japanese just-in-time production
  - Japanese total quality control production

- Use more labor and less land

We're in Big Trouble When Real Working Capital Runs Low

- Gaffney writes of today's economy:
  - the economic blood is drained down, and what's left is slushy.

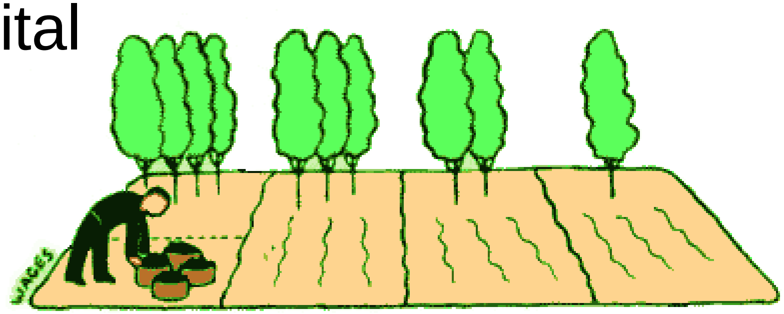
[Sidebar] David Ricardo’s Very Big Mistake

- Malthus said workers’ “subsistence” wage must be just enough to survive and reproduce, because workers tend to breed faster than food can be increased
- Classical economists recognized that the stock of grain must feed the population until the next harvest
- Mill called this stock of real capital the “wages-fund”
- Ricardo concluded that dividing the “wages-fund” by the number of workers gives you the wage—i.e. the supply of working capital at any moment determines the wage



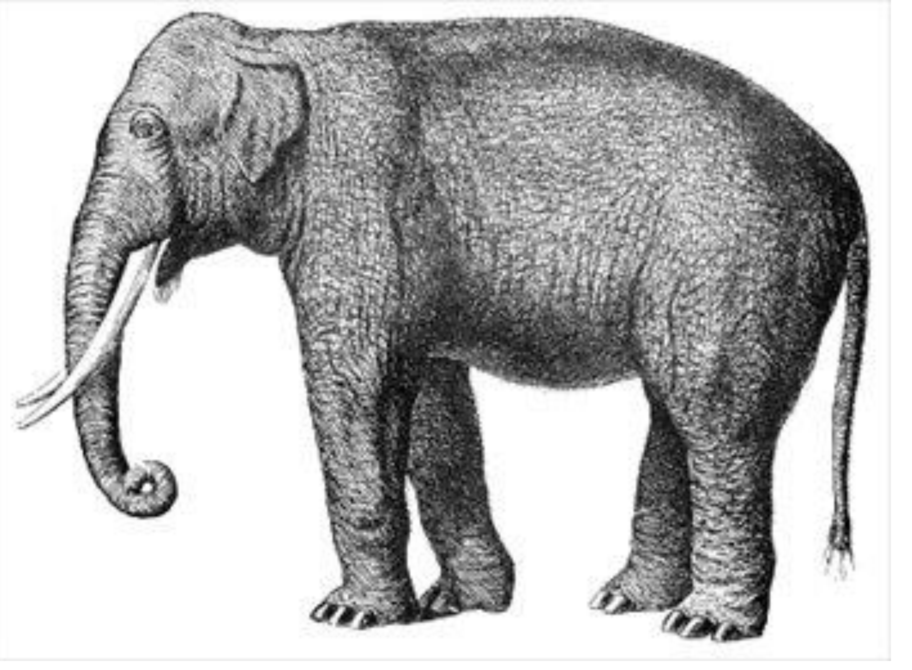

[Sidebar] George Threw Out the Baby with the Bathwater

- Ricardo had it backwards: the amount of wheat farmers *plan* to produce depends on wages
- George got wage theory right: wage depends on what a man can earn working for himself on marginal land.
- He rejected the Malthusian interpretation of the wages-fund, but also threw out the wages-fund itself
- He missed an additional case for LVT: by forcing good land into more intensive use, LVT speeds up circulation of working capital



The Elephant in the Boom and Bust Cycle

- Four theories
  - Conservative/Republican
  - Keynesian/Democratic
  - Libertarian/Austrian
  - Elephant/Gaffney



The Blind Men and the Elephant
(**John Godfrey Saxe** (1816-1887)

It was six men of Indostan
To learning much inclined,
Who went to see the Elephant
(Though all of them were blind),
That each by observation
Might satisfy his mind.

Three Accepted Theories of the Boom and Bust Cycle

- Conservative/Republican overconsumption theory
  - A nation is like a family that's borrowed and spent too much
  - The bust is a "reckoning"; the family must "tighten its belt"
  - There's a lack of "aggregate supply"
- Policy recommendations:
  - Cut public spending, especially on social services
  - Cut business regulations & taxes, to stimulate production
  - Keep interest rates low enough to keep land values up (but not so low as to cause inflation)

Three Accepted Theories of the Boom and Bust Cycle

- Keynesian Democratic underconsumption theory
  - A nation is not like a family because government can control public spending and monetary policy
  - Due to too much spending and debt, there's now too much saving and a lack of "aggregate demand"
- Policy recommendations:
  - Government must fill demand gap with public spending, no matter on what or how financed
  - Central bank should keep interest rates very low to help debtors and property buyers

Three Accepted Theories of the Boom and Bust Cycle

- The Libertarian Austrian malinvestment theory
  - Due to overly low interest rates at central bank, too much spending on land and other very durable items (Wicksell)
  - Too much consumption due to “wealth” illusion
  - Not enough investment in producing real working capital, so that inventories drop, eventually bursting the bubble
- Policy recommendations:
  - Austerity on steroids
  - Eliminate deficits
  - Return to gold standard to control central bank

Partial Truths in Three Accepted Theories

- Conservative Republican theory is right
  - There's a lack of supply
  - Absent devaluation or bankruptcy (or LVT)—as in Greece or Puerto Rico—austerity becomes inevitable
- Keynesian Democratic theory is right
  - There's a lack of demand
  - Government spending (the right kind) can stimulate the economy
- Libertarian Austrian theory is right
  - Booms produce malinvestment, leading to a shortage of real working capital—that's what drags down the economy

Big Elephant in the Room: Inequality

- All three theories ignore unequal distribution
- Big landholders, corporate & individual: The One Percent
  - Buy up and hold good land to keep it from other landholders
  - Use land lightly and inefficiently
  - Replace working capital slowly
- Big Banks
  - Issue mortgages to homeowners & credit to small businesses—depending on collateral
  - Rip off poorer customers with fees

What Happens in a Boom?

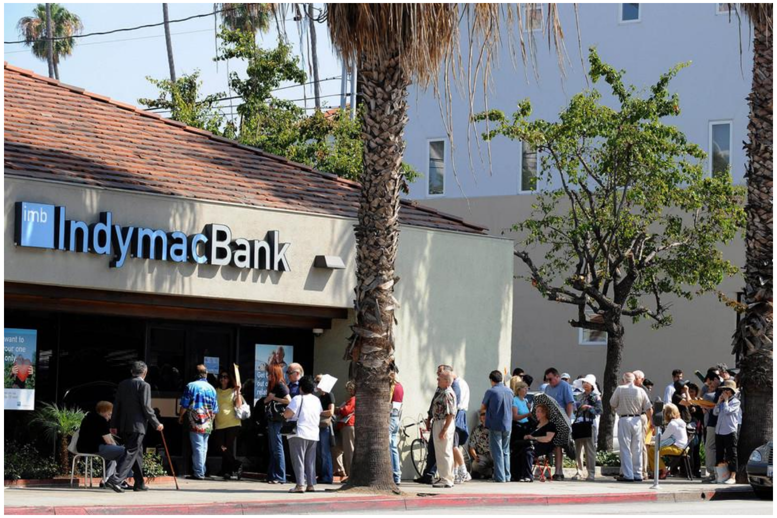
- "Irrational exuberance" makes interest rates too low
  - Banks lend too much too carelessly
- The One Percent (People & Business)
  - Binge on peripheral land
  - Start extravagant construction projects
- Ordinary people
  - Borrow against homes to consume more
- Small businesses
  - Borrow to expand
- Local governments
  - Extend utilities to speculative developments on the fringes
- Government agencies ignore rampant fraud

What Goes Unnoticed During a Boom?

- Labor is diverted to new construction
  - Routine maintenance fails on private property and public infrastructure
- Real working capital inventories fall
  - Higher consumption
  - Reduced investment

- As Mason Gaffney puts it:
  - "It is as though grocers ate up part of their own wares, instead of selling and replacing them, leaving some shelves empty."

What Happens in a Bust?



- Working capital gets scarce
  - Interest rates rise
  - Credit card rates skyrocket
- New projects fail
  - Stop loan payments
  - Lay off employees
- Ordinary people
  - Stop paying mortgages
- Banks
  - Small banks fail
  - Big banks get bailed out by government
  - Lending cut back even to good customers

Elephant/Gaffney Theory of Boom & Bust

- Elephant/Gaffney Theory
  - Overinvestment in peripheral land by One Percent
  - Overinvestment in (bad) loans by Big Banks
    - (Mortgages are a form of land ownership)
  - Drying up of real working capital

- Policy proposals
  - Tax land, state and local
  - Tax rent through progressive income tax
    - Eliminate land loopholes
  - Don't borrow from 1%—reduce national debt
  - Spend money on services to people—healthcare, education, pensions, urban infrastructure, science
  - Not on land-grabbing military and bridges to nowhere

Thank you!