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The Financial Character of Today's Crisis and Why Economists Avoid Confronting It

Economists are the last people one should ask to explain today's crisis. Although they say their discipline is about how to allocate scarce resources among competing ends, they refer only to small marginal movements within the existing set of institutional relationships, tax laws and loopholes, political alignments—and peoples' gullibility. There is no free lunch, unearned income or exploitation in this textbook world, and hence no need for government regulation or economic reform. "Free market" advocates seem always to be shocked, shocked to hear that there is insider dealing, fraud and deception going on. Gambling, perhaps, but only to hedge against risk and stabilize markets, never to crash them.

This paradigm excludes reality as an anomaly. The recent Bubble Economy should have rendered its logic obsolete by showing it to depict a fictitious parallel universe that never really existed. If its post-classical tunnel vision survives, there must be strong vested interests supporting its happy-face ideology and benefiting from today's economic mess.

Rent-seekers and their bankers claim that if governments agree to step aside and stop regulating and taxing, economies will settle naturally at a stable and fair equilibrium. Automatic stabilizers will maintain full employment to run economies optimally, while price and income adjustments ensure that everyone's income and wealth reflects their productive contribution to economic growth. This is why they call it a crisis when resources or money get scarce and debts cannot be paid—and blame it on disturbances from outside the economy. Presumably an accident that won't happen again, not a systemic problem.

The refusal to recognize unproductive grabbing of unjustified income is subsidized by powerful interests that benefit by deterring economic reform, opposing public regulation and blocking progressive taxation of predatory income skimmed off without adding to production or the economic surplus but carved out of it. This revenue—which classical writers called economic rent—is extracted from business cash flow and appropriates the productivity gains that were supposed to raise living standards. At least that was the promise back in 1945 when World War II ended and productivity breakthroughs began to soar.

This rosy pro-*rentier* view of how a "free market" operates opens the gates for the frauds, insider dealing and unproductive predatory finance that are assumed not to exist. It is as if economies are not polarizing between creditors and debtors, culminating in foreclosure time and financial austerity. If the world really worked in the way that opponents of public regulation tell the story, there would be no need for fiscal and financial reform. But the reality is that economies polarize and shrink when they are stripped of the checks and balances put in place by the classical economists and Progressive Era reformers.

That is the problem the world faces today. It is the result of the financial sector loading down economies with loans without any idea of just how debtors are to pay out of their normal earnings. Banks and other creditors use their receipt of interest and fees to make yet more loans that further increase the debt overhead.

What has confused populations in recent years is that this debt creation appears to "create wealth" when credit is lent in a way that inflates prices for real estate, stocks and bonds. Asset-price inflation is what fueled the post-1980 stock market takeover boom, the dot.com bubble, and the enormous 30-year bond market rally from 1980 to 2011. Interest rates fell almost steadily as the Federal Reserve flooded the U.S. banking system with credit, raising the prices of existing bonds and increasing the multiplier by which banks could capitalize a given flow of real estate rent or business income into a loan. Property and financial securities are worth whatever banks will lend to new buyers or corporate raiders—and credit standards were lowered steadily, capped by the 2001–08 real estate bubble.

Until 2008, prices for housing or rewards for staging a corporate raid rose faster than carrying charges on the debt, so balance sheets reported rising net worth. But these were only "paper gains"—balance sheet net worth, not real wealth. Tangible capital investment slowed, and wages and disposable personal income were flat, or even falling if one takes into account FICA wage withholding and other taxes, rising debt service and housing costs. Many families were able to maintain their living standards only by borrowing. The idea was that once they got onto the "home ownership on credit" treadmill, they could simply take out home equity loans against the rising price of their property, treating it like the proverbial piggy bank. This is the kind of wealth creation that Federal Reserve Chairman Alan Greenspan celebrated. The secret of perpetual motion seemed to have been discovered, at least in the financial universe if not in the physical world. It was a godsend to bank loan officers whose product is debt, after all.

Just as a Bubble Economy is financial and usually reflects the failure of public checks and balances to protect the economy from debt creation grow

aster than the ability to pay, so most crises are resolved by public giveaways to the banks and other *rentier* interests, as if the alternative to the resulting asset grab and polarization of wealth would be economic collapse. Creditors buy up real estate, infrastructure and debt-strapped companies on the cheap.

The underlying debt dynamic is masked by the fact that crises typically are triggered by fraud or embezzlement. Blame for the crash of September 2008, for example, has focused on junk mortgage loans to NINJA borrowers (with No Income, No Job and no Assets) and fictitious property valuations given unwarranted credit ratings. But these are only the outcroppings of the basic imbalance between the debt overhead and the ability to pay.

Mainstream economics shies from dealing with this tendency for debt service to absorb more and more of the economic surplus. Instead of treating the financial sector as acting in extractive and outright parasitic ways as it becomes autonomous from production, bank-friendly economists depict it as part of the "real" economy. National income statistics recognize the symbiosis of finance with insurance and real estate (FIRE) by grouping them together, but treat their interest, fees and rents as earnings for providing real services.

Economic models stop short of acknowledging how "free markets" are shaped by high finance using part of its gains to capture governments and their regulatory agencies, starting with the central bank and the criminal justice system so as to neutralize their checks and balances against predatory finance. Wall Street backs politicians, public relations "think tanks" and business schools that provide a logic (or at least a cover story) for shifting taxes off interest and rent onto labor and industry. When this ends up shrinking the economy and causing debt defaults, financial lobbyists demand that the central bank and Treasury issue new public debt to bail out banks, brokerage houses and hedge funds for loans gone bad.

In his 1987–2006 tenure as Federal Reserve Chairman, Mr. Greenspan promoted debt leveraging as the paradigmatic form of "wealth creation." The "wealth" in this case is balance-sheet net worth, inflated by easier lending terms extended to a widening range of borrowers at rising risk. Bank balance sheets become increasingly fictitious, and when reality raises its ugly head and the debt bubble bursts, asset prices plunge—but the debts remain in place, bringing foreclosures that transfer property from debtors to creditors. Even government assets are privatized, creating yet a new category of lending for banks to finance on credit.

This financial turmoil makes little appearance in mainstream economic models. The monetarist Chicago School reflects a view popular since David Ricardo's day, describing the economy as operating on barter beneath "the

veil of money," without debt problems. What passes for macroeconomics these days takes national aggregates without layering them into the top 1 or 10 percent vis-à-vis the bottom 99 or 90 percent. The private sector is described homogeneously as "households," without segregating the McMansions and lordly estates from the pueblos and middle class row houses. Wealth acquired by "capital gains" on credit—mostly on real estate, corporate raids and in the hedge fund casinos—are deemed as socially positive as wealth acquired by investing in tangible capital to employ labor to produce goods and necessary services.

It is as if finance capitalism is part of industrial capitalism, not as having given way to casino capitalism quickly collapsing into a negative equity economy leading to debt peonage. Instead of bailing out the "real" production and consumption economy (the "bottom 99%") by writing down debts to reflect the ability to pay, governments are acting as debt enforcers. Claiming to support "price stability," they insist that this can be maintained only by keeping unemployment high. So even as credit-inflated asset prices soar for real estate, stocks and bonds, the prices on which monetarists and central bankers focus are consumer prices and wages. Debt deflation is permitted in the Bubble Economy's wake, but not rising wages or social spending.

The economic theory used to justify this policy is a highly selective portrayal ("model") of how society works. Depicting interest and rent as "earnings" on a par with profits on tangible capital investment gives the impression that the FIRE sector produces a surplus instead of being what France's Physiocrats called sterile, or even worse: a deadweight eating parasitically into the economy. As bank loans turn land rent, monopoly privileges and infrastructure access fees into a flow of interest payments, they use some of this revenue to throw their lobbying power behind these rent extractors. The idea is to advocate lower taxes on *rentier* revenue so as to leave more available to pay interest. Land rent, monopoly privileges and patent rights are capitalized into bank loans, becoming the backing for today's financial sector and the economy's savings.

This creates a symbiosis among the economy's rent-yielding sectors. Some 80 percent of bank loans are real estate mortgages, and the balance of loans are to buy financial securities already issued or to take over companies, or consumer loans to be paid out of revenue earned in the normal course of employment, not by investing the bank credit productively. Even in the case of U.S. student loans (whose volume now exceeds that of credit card debt), this lending has not enabled many students to earn enough return on their education to pay their creditors. As debt deflation shrinks the economy, there are few employ-

ment opportunities for new graduates. Lacking jobs, they are obliged to live at home with their parents. Arrears on their student debts mount up, immune from the prospect of being wiped out in bankruptcy proceedings. The government has guaranteed these high-profit loans to the banks, yet the loans cannot be paid without polarizing the economy between creditors and debtors.

Vested interests defend tax favoritism and public guarantees backing this *rentier* behavior and sponsor a self-serving economics denying that debts need to be written down to reflect the ability of debtors to pay. This approach rejects the classical contrast between cost-value (what is technologically and socially necessary to produce a good or service) and economic rent ("unearned" income, including capital gains). Rejecting the distinction between earned and unearned income and wealth, the value of financial securities and other assets is assumed to capitalize revenue streams reflecting real effort and enterprise.

Also rejected is the idea that reform can make economies more efficient by minimizing unearned income and unproductive credit. Post-classical (that is, pro-*rentier*) models reason as if the economy is imprinted with the existing political and institutional structures, somewhat like patterns on a balloon. It can be inflated by credit creation or deflated by debt service, but keeps its basic proportions. Keynesian fine tuning aims at injecting enough purchasing power to maintain full employment, and the Fed sets an interest rate intended to supply just the right amount of credit—without changing the economy's institutional structure, tax system or political relationships. It is as if prices for goods and services, real estate, stocks and bonds are affected symmetrically and proportionally across the board. Under this assumption, any change is deemed to be "exogenous." So economic reform is not a topic in this discussion. There is no recognition of a free lunch or special privilege polarizing the distribution of income and wealth, to say nothing of being regulated or even fully taxed. Just the opposite: Public regulation, taxation and public investment are accused of being distortions, and indeed the road to serfdom. From the vantage point of the free lunchers, the past eight centuries of reforms appear as a distortion. Only their own extraction of income is deemed to be distortion-free.

This attitude explains why new public debt is issued (as in the Federal Reserve's post-2008 "cash for trash" swaps and taking Fannie Mae and Freddie Mac onto the government's balance sheet) to bail out bankers and speculators from having to take a loss, but the "real" economy is not being rescued. A bad-debt crisis is inevitable, because no exponential growth of credit can be sustained for long. Politicians rationalize bailouts by claiming that they are selecting priorities—and that economy's payments system will collapse if debts are written off. But keeping them on the books enables creditors at the top of

the pyramid to steadily increase their share of wealth and income. Retail banking could have been rescued while folding up Citibank and Bank of America. But the financial sector seeks to convince politicians to accept the tunnel vision that Margaret Thatcher summarized in her intellectually and socially deadening slogan: "There is no alternative" (TINA). More blatantly, the bankers waive their final weapon: the threat to plunge the economy into chaos if they don't get their way.

This tunnel vision—and the debt overhead it has facilitated—is the economic tragedy of our time. It is tragic not only because the financial system bases its operations on extractive rather than productive lending, but because this is so unnecessary. It doesn't have to be this way! There is an alternative. That in fact is what classical political economy was all about.

The financial problem ultimately is rooted in fiscal policy. This makes it political. If classical political economy had succeeded in its reform program of taxing the land's site value (created not by the landowner's own efforts but by local transportation and other infrastructure investment and the level of general prosperity), this revenue would not have been available to be capitalized into bank loans and paid out as interest. This would have held down debt-leveraged housing prices, while saving governments from having to tax labor and productive business.

This was the logic underlying the classical program to make economies more fair and equitable as well as more competitive by minimizing their cost structure. Taxing economic rent and regulating monopoly pricing was seen as the alternative to taxing productive labor and tangible capital. Progressive Era economists hoped to invest this revenue in infrastructure. If governments had kept basic infrastructure in the public domain, prices for its services would not reflect the privatizers' interest charges and other financial fees for loans taken

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out to buy it, or the exorbitant salaries and bonuses that have accompanied the
sale of these assets on credit. The public option would provide essential serv-
ices (transportation, communications, etc.) at cost or on a subsidized basis, or
as freely as roads and sidewalks. The aim was to minimize the cost of living and
doing business. This is the logic by which a public option for banking and reg-
ulations against casino-capitalist gambling, collateralized debt swaps and extor-
tionate gouging by credit card companies would have helped avert today's
polarization between *rentiers* and the productive economy.

But post-classical economic models neglect the distinction between neces-
sary production costs and unnecessary "watered" costs. Income distribution is
discussed without taking into account capital gains from real estate and stock
market bubbles. There is almost no recognition that for real estate, finance and
globalized investment today, the name of the game is capital gains, fueled by
asset-price inflation. Wealthy individuals try not to earn (or at least to declare)
taxable income, thanks to the fact that interest is tax deductible while capital
gains and *rentier* revenue are replete with special loopholes and taxed at much
lower rates than "earned income" in the form of wages and normal business
profits.

This tax favoritism for debt financing as opposed to equity investment leads
the debt overhead to reach a critical mass. The only way to avoid a crash is to
lend debtors the credit to pay interest and even the amortization falling due.
This is what U.S. banks did when they wrote "negative interest" mortgages
that simply added the interest onto the debt balance, until it reached 125 per-
cent or some other specified proportion of the original principal. The effect
was an exponentially growing debt curve—the "magic of compound interest,"
society's paradigmatic free lunch. It can be sustained only by lending larger
and larger amounts against collateral that is rising in price. An equivalent effect
is achieved by channeling credit into the purchase of assets to raise their price
at a high enough exponential rate to cover the accrual of interest, so that banks
can rewrite their loans at the collateral's higher, debt-inflated price.

Lower interest rates enable a given stream of revenue to be capitalized into
a larger loan principal. Under Mr. Greenspan's stewardship, the Federal
Reserve supplied enough credit by 2008 to drive down interest rates to as low
as they seemed likely to go. (To be sure, long-term rates were driven down even
further by 2011 as banks tried to revive the plunging housing market.) Lower
amortization rates also reduced carrying charges. Many mortgage debts were
made perpetual, covering only the interest payments instead of being self-
amortizing. Finally, banks were able to make larger loans by requiring lower
down payments. Whereas 30 percent equity was normal prior to the 1990s,

banks were making 100 percent loans by the early 2000s—indeed, even 105 percent loans to enable borrowers to pay fees to the mortgage originators and title insurers who were Wall Street's partners in crime.

The reality is that perpetual motion no more can be created in economies than in physical nature. As asset-price inflation raises the price of buying a retirement income (because higher stock and bond prices reduce the dividend and interest yield), pension funds cannot support retirees at the typically 8 per cent rate assumed for annual returns (compounded annually to pay enormous sums out of "capital" gains. Reality imposes itself on "mark-to-model" calculations that are stock in trade of the GIGO (garbage in, garbage out) toolkit used by financial fraudsters.

By 2006 an estimated one-sixth of new U.S. homebuyers were speculators. Rents fell as these buyers sought tenants to carry as much of the mortgage as possible while waiting for prices to rise by enough to pay off the bank loan with interest and still leave the hoped-for capital gain. The fantasy was to pay off their debts out of these gains, not out of operating revenue. The plan was to buy property whose carrying charges that cover the debt service—as long as the rate of price gain remained higher than the rate of interest. But the economy was not expanding and rents did not keep pace as debt deflation diverted spending away from goods and services. When rents fell, buyers had to make up the shortfall from other revenue or by drawing down their own savings—or by borrowing yet more from the banks. Seeing the economy growing top-heavy with debt, wise investors cashed out. Prices stopped rising. Foreclosure time arrived.

Treating money and credit simply as a veil misses this drive for asset-price gains to obtain balance-sheet wealth by debt leveraging. The "value-free" neoliberal approach assumes that competition will keep prices in line with technologically necessary production costs, but does not take account of rent seeking on credit. It must fail as a business plan in the end, because adding financial costs to family and business budgets increases break-even prices beyond necessary cost-value. This enables other economies to undersell debt-ridden ones.

Yet fortunes are still made most easily today by obtaining financial claims on existing wealth, not by increasing production. To the extent that free lunches are obtained this way, they are a quid without quo—revenue without a corresponding real cost of production. Yet the recent Bubble Economy has not deterred the textbook assumption that economies will "return" to equilibrium and fair income distribution when disturbed. Why then are there so many riots?

Throughout most of history the largest fortunes have been carved out of the public domain or achieved by insider dealings. A historically based reality-based economics thus should focus on the military conquests that created Europe's landed aristocracy, land grants in its colonies, the real estate give-aways to America's 19th-century railroad barons, and the recent financial give-aways to recipients of the $13 trillion in post-2008 U.S. financial bailouts that have endowed a power elite to rule the 21st century.

Ricardo's Theory of Economic Rent Leading to a Crisis of British Industry

The leading theories of crisis were formulated as warnings of what would happen if economies failed to reform themselves by freeing markets from the special financial and property privileges inherited from Europe's feudal epoch—landlordship, banking and the monopolies that medieval Europe bequeathed to industrial capitalism. Northern conquerors carved landlordship out of territories they defeated levying groundrent and monopoly rent as the primordial forms of tribute. In due course Italian bankers emerged out of Church orders to lend kingdoms the funds to pay tribute to Rome, and then to wage wars.

Prior to 1815, Britain's landed interest and industrial capital both feared the overgrowth of debt owed to bondholders, especially to the Dutch who owned much government debt and stock in the Crown monopolies. But as normal trade resumed after the Napoleonic Wars ended, industry and banking formed an alliance of against the landed interest. In 1846 they succeeded in repealing Britain its protectionist Corn Laws, negotiating free trade to make Britain the "workshop of the world"—and also the world's banker, making profits by financing foreign trade, mainly foreign raw materials for British manufactures.

The 19th century saw two major lines of theorizing about of how industrial capitalism would experience a crisis. The first was David Ricardo's warning against landlords seeking protectionist trade policy to promote national self-sufficiency in food production—at rising prices and hence land rents. Assuming that diminishing returns would push up food prices at the margin of cultivation. Unless the rising cost of producing food at home was checked by importing lower-priced crops from abroad, the landlords' rising receipt of groundrent would absorb the entire surplus. Industrialists would have to pay labor a higher wage to cover the cost of higher-priced food, ending capital profitability and thus stifling further progress.

This logic was based on technological nonsense. It assumed diminishing returns in agriculture—just as the revolution in soil chemistry (the use of fertilizers, pesticides), new seed varieties and mechanized farm production pow-

ered a century of remarkable productivity gains. Ricardo's pessimistic approach denied that fertilizers or capital improvements could change the "original and indestructible powers of the soil" in the form of natural fertility.

This focus on diminishing returns distracted attention from earlier worries about financial crisis stemming from public debts imposing heavy carrying charges paid by a proliferation of excise taxes. At the time Ricardo wrote his *Principles of Political Economy and Taxation* in 1817, three-quarters of British government's budget was spent on debt service, mainly as a result of its centuries of warfare with France. His labor theory of value (and its logical complement, his definition of economic rent as the margin of market price over actual costs of production ultimately reducible to the cost of labor) treated income and wealth in "real" terms, reducible to labor time and wages. It was as if economies operated on a barter basis, with money and credit (and hence, debt) being only a veil. There was no monetary and financial dimension, no debt service eating into income, no "capital transfer" problem of paying foreign debts.

As Britain's Parliamentary spokesman for its banking industry (today we would say lobbyist), Ricardo based his price theory on Malthus's ideas of population growth forcing resort to poorer soils, increasing the cost of producing food. Rising crop prices would provide a windfall gain—economic rent—for landlords on the better lands cultivated first. The increase in land rents would grind industrial capitalism to a halt, at least in Britain, as long as it relied on domestic agriculture to feed its work force. Rising prices for subsistence would price the economy's manufacturers out of world markets and shift industrial power to less densely populated countries with better soils and hence (so Ricardo assumed) lower prices.

Adam Smith's *Wealth of Nations* had denounced the policy of shifting the fiscal burden onto labor and industry by a proliferation of sales taxes and other excise taxes. Ricardo used his labor theory of cost-value (including the labor embodied in making capital goods) and market price (reflecting the excess of economic rent over and above the cost of production on well situated land) to oppose tariff protection for agriculture. British industry could retain its global dominance by abolishing the protectionist Corn Laws (introduced in 1798 during the Napoleonic Wars with France) so as to buy food in the cheapest markets it could find—mainly in North America. Free trade in grain would enable industrialists to feed their labor force as inexpensively as foreign manufacturers could. Given Britain's industrial head start, it could remain the workshop of the world.

After the revolutions of 1848 drew the middle classes and labor back industrial and finance capital in the drive for democratic political reform, the consensus ideology of the Industrial Revolution was to free economies from the legacy of special privilege and hereditary favoritism. It was left to John Stuart Mill and subsequent "Ricardian socialists" to advocate taxing land rent. That became the great political fight in Britain from 1848 to World War I, highlighted by the Budget Crisis of 1909–11. It required electoral reform and an extension of the franchise to reduce the landed interest's control over Parliament. Reformers throughout Europe and America sought to re-establish banking, basic infrastructure and land ownership (or at least the land's rent) in the public domain. Evolution seemed to favor nations that invested the economic surplus in tangible public and private capital formation rather than unproductively to extract land rent and monopoly rent with borrowed credit at interest.

The American School's Technological Optimism as an Alternative to Ricardian Pessimism

Britain's free trade negotiations after 1846 offered other countries tariff-free access to its agricultural markets if they would give British industry access to their own domestic markets. This revived the tariff debate in the United States. Henry Clay had coined the term "American System" in the 1840s for the Whig program of protective tariffs, internal improvements and a national bank. Henry Carey and his followers such as E. Peshine Smith soon pointed out that thanks to the progress of science and technology, increasing returns characterized agriculture as well as industry and transportation. By the 1850s a distinctly American School of political economy developed with regard to how increasing returns would transform economies, above all as a result of rising energy usage per worker.

To obtain such productivity gains, they argued, U.S. manufacturers needed to be protected from Britain's industrial head start. This logic was embodied in the Republican Party's founding program in 1853, and guided U.S. development after it won the 1860 presidential election behind Abraham Lincoln. Smith went into the State Department with his long-time Rochester, New York law partner, William Seward. In the 1870s, Seward arranged for Smith to go to Japan as advisor to the Mikado to guide that nation's protectionist industrialization.

By the end of the 19th century the American School developed in a number of directions. In contrast to theorizing that assumed wages to be able to fall without reducing labor productivity, the Economy of High Wages theory held that better paid labor was more productive labor as a result of being better

fed, better clothed and above all, better educated. All this cost money, but it enabled high-wage economic such as the United States to undersell low-wage economies.

The economic problem was expected to be more sociological than one of scarcity. Simon Patten, the first economics professor at the major early business school, the Wharton School at the University of Pennsylvania, described a high productivity Economy of Abundance in which the temptation to overconsume would challenge the traditional morality of stalwart altruism inherited from subsistence societies.

Many of Patten's students became sociologists or social workers. His student Rexford Tugwell became a member of Franklin Roosevelt's Brains Trust and was appointed governor of Puerto Rico, later teaching at the University of Chicago as an institutionalist in the days before Chicago went hard-line monetarist. But despite the American School's influence on U.S. economic policy for a century, protectionists and institutionalist ideas have been stripped from mainstream histories of economic thought. A censorial post-classical economics shifted the focus, traumatized by how Marx and other reformers mobilized classical economics to counter the *rentier* sector's special privileges and continue the restructuring process initiated by France's Physiocrats.

Marxian Socialism

Writing within the tradition of classical value theory but from the vantage point of labor, Marx viewed the essential crisis under capitalism as political. Capitalism would avoid stagnation by evolving into socialism. The transition would save it from underconsumption and economic polarization resulting from financial and industrial capital impoverishing labor.

Whereas Ricardo saw profits declining as a result of a rising share of income going to landlords, Marx saw profits falling as a proportion of the industrialist's cash flow as what today is called depreciation and amortization increased—the return of capital, as well as the return to capital (profit). As production became more capital-intensive in its drive to raise productivity, capital/output ratios and capital investment per worker would increase. This meant that industrialists would have to recapture the original cost of their capital investment, in addition to making a profit. And like Adam Smith, Marx assumed a 50:50 share of debt and equity in his numerical examples. Assuming a steady interest rate, it followed that as production became more capital-intensive, financial charges would rise. But the political force of industrial capitalism would modernize finance and industrialize it, he optimistically believed.

Given the progress of science over the past few centuries, it is only natural that most technological views of the future are optimistic. Rising productivity has been a long-term trend, even in food production and mining. Despite the Ricardian assumption of diminishing returns that still characterizes textbook models, and despite Club of Rome limits-to-growth campaigning and peak-oil warnings, crises have stemmed not from the production sector but from the financial sector—and behind it, from the concentration of wealth in the hands of *rentiers*, monopolists and privatizers that have carved special privileges and property rights out of the public domain.

Like the American protectionists, Marx was a technological optimist. Describing agriculture as becoming industrialized, lowering food prices by raising productivity, he saw technological innovation as constantly lowering costs, making much industrial capital obsolete before it physically wore out. To the extent that the pace of technological innovation gained momentum, obsolescent high-cost capital would have to be written off and replaced even though the physical lifetime of the machinery was not yet worn out. This rising productivity was unlikely to cause a chronic over-production crisis under capitalism, he wrote, because more labor would be employed in the capital goods sector as production became more capital-intensive.

Marx's followers have focused on the relationship between industrial capital and labor, and on the internal contradictions of capitalism that Josef Schumpeter later elaborated as "creative destruction" within the capitalist class as innovators invested to undersell competitors by lowering production costs. But Marx also re-introduced the pre-Ricardian emphasis on finance and debt. In his draft notes for Volume III of *Capital* and Book III of *Theories of Surplus Value* he discussed how the purely mathematical growth of finance capital at exponential rates caused financial imbalance—the "magic of compound interest." The excessive autonomous buildup of finance capital formed the core of his theory of the business cycle. But these cyclical mini-crises were not the existential theory that Ricardo forecast in what Marx characterized as the Armageddon of industrial capitalism. He optimistically expected finance to become industrialized, on its way ultimately to becoming socialized.

Yet despite the fact that Ricardo's technological assumptions of diminishing returns was so wrongheaded and anachronistic even in its own day—not to mention his special-interest pleading for the banking industry—subsequent mainstream economics remains focused on his ideas rather than pursuing the more realistic development of classical political economy at the hands of Marx or those of the American School of technology theorists, institutionalists and Progressive Era social reformers. The explanation lies in the fact that

Ricardo's pleading for the financial sector appeals to the major backers of today's academic economics. Realistic analysis showing the problems of financial overhead and extractive rent-seeking is precisely what led to its rejection, in accordance with the time-honored criterion for acceptability by vested *rentier* interests: "If the eye offends thee, pluck it out."

Post-classical Theorizing Defends the rentiers *as Productive, in Proportion to Their Wealth*

In criticizing the strictly Ricardian views of the American anti-socialist journalist Henry George, Marx wrote that industrial capital always had a visceral hatred of landlords. The historical task of industrial capitalism, after all, was to purify society of the carry-over from feudalism's landed aristocracy—not only its land ownership and groundrent but also its control of the upper house of legislatures, by which it managed to block reform in many countries. In Britain the political struggle came to a head in 1909–10, when the House of Commons sought to pass a revenue bill based on a land tax. A constitutional crisis ensued, resulting in a ruling that the House of Lords never again could block a House of Commons revenue bill.

But by the time World War I broke out in 1914 the momentum for taxing landed property had passed. Finance capital was in the ascendant. And whereas in Ricardo's day it had thrown its political support behind manufacturing industry—seeing international trade as the major private-sector market for banking, as it had been since the 13th century—by the 20th century urban real estate was becoming much more valuable important than agricultural land. Britain's wealthiest individuals were still the post-feudal families holding groundrent on Kensington and other high-value London neighborhoods, but home ownership and commercial real estate was well on its way to becoming democratized—on credit. Given the high price of real estate relative to income, it could be bought only by borrowing from the banks. Some 80 percent of bank lending in most English-speaking countries now takes the form of real estate mortgages. This has led the banking and financial sector to reverse its earlier attack on the landlord class—above all the post-Ricardian thrust of John Stuart Mill and other "Ricardian socialists" to fully tax groundrent or nationalize the land outright.

Today's ultimate recipients of land rent are not the hereditary owners as was the landlord class in Ricardo's day; they are the banks. No 19th-century economic writer expected this. From Britain to the United States, the great political fight was to socialize land rent either by taxing it or by nationalizing it. The thrust of classical value and price theory was to distinguish between

earned income (wages and profits on industrial capital investment) and unearned income: economic rent, paradigmatically by landlords but also, by logical extension, monopoly rent, interest and other returns to privilege. The most important privilege today is the banking system's privilege of creating credit.

After the Great War's aftermath derailed the path of development toward which the Progressive Era seemed to have been leading. The vested financial and property interests mounted an ideological counter-attack, and a major arena was economic theory. The new theory's political aim — its value system, price theory, monetary theory and the tax policy this theorizing implied — reflected the shift in alliances between finance capital, real estate and industry. Instead of continuing to oppose the landed interest, the 20th century's democratization of property ownership — on credit — led to a symbiosis of finance, insurance and real estate (FIRE). To the extent that finance interfaces with industry, it has been to financialize industrial companies, not to industrialize the financial system as seemed to be occurring in the late 19th century from Germany and Central Europe to Japan. And to the extent that finance interfaces with government, it is first of all to finance the public construction of capital infrastructure, and then to force its sell-off — at prices far below the original cost — to buyers on credit, permitting them to factor in a proliferation of financial charges into the access fees they extract from the population. The result is the opposite direction of evolution from which 19th-century economic Darwinians expected. Instead of lowering a nation's cost structure to make it more internationally competitive, financialization increases prices across the board.

As noted above, the definition of "free markets" has been turned upside down. Instead of freeing markets from rent-seeking, taxing groundrent and keeping major infrastructure monopolies in the public domain, economies were deregulated to "free" finance to load industry and government with debts, turning profits and disposable personal income into interest charges. Taxes have been shifted off real estate and finance onto labor and industry, while the post-1980 New Enclosure movement has increasingly privatized the public domain. And to cap matters, under the slogan of "free markets" as the antithesis to "the Road to Serfdom" (defined for all practical purposes as public regulation of the FIRE sector) planning has been centralized in the financial centers, from Wall Street to the City of London, the Paris Bourse and Frankfurt.

It thus seems ironic that governments have become the major sponsors of private finance capital. Lenin was the most astute in applying Marx's theory of finance capital to the eruption of the Great War, in Imperialism. At the time he wrote it in 1916, it was natural to focus on private finance capital. But what the war did was create an entirely new dynamic (or "synthesis," as Marx-

ists would say): inter-governmental debt, headed by the U.S. demands for Inter-Ally arms debts that led the Allies to demand German reparations to cover their payments of debt service to the United States. Wall Street organized a triangular flow of U.S. purchases of German state and local bonds, providing the Reichsbank with dollars to pay the Allies to pay the United States. And after World War II, the International Monetary Fund, World Bank and most recently the European Central Bank have acted as executive committees on behalf of international finance (mainly Wall Street, thanks to the Washington Consensus that dominates these creditor institutions). The result is an international imposition of financial and fiscal austerity on debtor countries, starting with Third World countries in the 1960s and culminating in the asset stripping of Iceland and Greece today (2011).

The financial sector's attempt to turn the economic surplus into debt claims threatens to leave economies in poverty by collateralizing wealth to pay interest rather than invest in tangible capital formation, rising living standards or environmental preservation. And the vested interests threaten to plunge economies into crisis if governments move to check their interest by reviving the Progressive Era's policy to check the power unearned wealth, finance and monopolies.

That is the essence of today's global crisis. Yet the financial and other *rentier* interests are capturing the public debate, mass media and academic economics. Inverting classical economics, they have re-defined "free markets" in a way diametrically opposed to what was meant a century ago. Instead of meaning markets free of economic rent, interest and monopoly power, the term now means markets free for predatory finance and kindred *rentiers* to dismantle public regulation and free themselves from taxation. Such an economy "frees" the new financial oligarchy to reverse democracy, stifle growth and stop living standards from rising.

The resulting dominance of the financial sector over industrial capital, real estate and commerce (and increasingly over family budgets) threatens to absorb the economic surplus today, bringing on precisely the form of economic Armageddon that Ricardo forecast landlords would create in the absence of free trade in grain, and which Mill, Henry George and other critics of landlord said would create economic crisis of the public sector failed to collect the land rent created by no effort of capital investment of landlords themselves.

The world economy is being thrown into a financial crisis based largely on mortgage debt so large that it not only absorbs all the land rent, but requires payment from wages and salaries as well as industrial profits. Ricardo's barter-based, bank-free and debt-free economic theory did not recognize this kind of financial crisis. And all economic logic of the 19th and early 20th century

assumed the rule of law. But today, junk mortgage lending and outright fraud are proliferating on an unprecedented scale, beyond the ability of the courts or criminal prosecutors to cope with. And in contrast to the effect of 19th-century Parliamentary and Congressional reform in promoting democracy politically, governments throughout the world are becoming subordinated not to the landed aristocracy this time around, but to financial *rentiers*. It is they to whom John Maynard Keynes referred in 1936 in his gentle term "euthanasia of the *rentier*," by which he meant a rationalization of the financial system.

Instead of such rationalization occurring, the *rentiers* have fought back, joining in an alliance of finance capital with real estate to create the symbiotic FIRE sector. The national income and product accounts often are unable to distinguish financial from real estate earnings in today's epoch of vertical integration between banks, real estate brokers and appraisers. By 2008, Wall Street investment bankers were packaging junk mortgages into loans, and "casino capitalist" institutions placed bets on how long it would take for this "toxic waste" to explode, bringing down the economy in a convulsion of bankruptcy.

So in retrospect, the 19th century's warnings of how the crisis of capitalism would unfold turned out to be too optimistic. They did not anticipate how the *rentier* interests would mount a counter-attack to block governments from industrializing (to say nothing of socializing) banking and insurance systems. The "independence of the central bank" is applauded as the "hallmark of democracy" rather than seeing it as a victory for the new financial oligarchy. The financial system has disabled the U.S. legal system by buying the right to name the heads of Congressional committees dealing with banking, and backing the political campaigns of judges committed to applying the law in the interests of their financial supporters.

Summary of Part I

Whereas Ricardo's view of class war was between industrial capital and the landed aristocracy, Marx's shifted the focus to industrial capital vis-à-vis labor—assuming that industrial capital was well on its way to winning its war against the landed aristocracy. And as for finance capital, Marx assumed that it would become subordinate to industrial capital.

But the seeming servant has become the master. Instead of banking becoming industrialized as seemed to be happening at least in central European banking prior to World War I, industry has been financialized. The shift gained momentum in the 1980s, as central banks first in the United States and then in Western Europe and Japan became free of the foreign exchange and gold bullion convertibility constraints that had existed prior to 1971. Corpo-

rate raiders now raise credit to take over industry, paying out cash flow as interest and dividends instead of investing in fixed capital formation or longer-term research and development.

Only a reduction in debt and higher wages can spur real recovery. But this is blocked by austerity policies that impose debt deflation. The solution needed for today's broad economic downturn is easier bankruptcy, especially for educational loans, and for mortgages to be brought in line with today's lower market prices and affordability. But when the financial sector gains control of policy, its prime objective is to protect creditors from taking major losses on loans gone bad and gambles against bettors unable to pay (*e.g.*, Lehman Bros. and A.I.G. after September 2008). Something has to give—and the financial sector has achieved sufficient power to sacrifice general prosperity in order to squeeze out debt service. So new capital investment and hiring shrink, and economies fall into depression—leading to yet more bankruptcies and foreclosures in the private sector, and privatization sell-offs by debt-strapped governments.

The Role of Governments in Sponsoring Financial Exploitation

Saving used to mean putting money away out of earnings to be able to spend. But today, "saving" in the national income statistics takes the form mainly of paying down debts taken on in times past. Current earnings are not available for spending; they are earmarked to pay the banks for credit cards, to pay the mortgage, to pay student loans, auto loans, retail store credit. The era of free choice is over—the choice being offered is, "Your money or your life."

The term "debt deflation" was popularized by Irving Fisher writing in the Great Depression of the 1930s. Markets collapsed under the weight of Inter-Ally debts and German reparations stemming from World War I, and speculative credit as the U.S. Federal Reserve flooded financial markets to enable American banks and investors to lend Germany the money to pay reparations to the Allies to pay their debts to the United States. Lenin had written that wars were inevitable because finance capitalists in leading creditor nations would be unable to reach market-sharing agreements as to how to carve up the world amongst themselves and their leading industrial, mining and other clients. But what turned out to be most intransigent were U.S. Government claims on the Allied Powers for payment for arms supplied prior to U.S. entry into the Great War. Keynes blamed this claim on the Allied governments turning on Germany to pay them the money being demanded by the U.S. Government.

The amount demanded exceeded the reasonable amount that could be paid, making breakdown inevitable, first in 1929 and then finally in 1931 when standstill agreements were reached among the governments. It was too late to save Western economies from the Great Depression that recovered only as a result of the new public spending peaking in World War II.

After 1945 the international economy was reorganized along creditor-oriented lines sponsored by the United States as major global creditor, with nearly 80 percent of the world's monetary gold stock. But starting with the Korean War, military spending pushed the U.S. balance of payments into deficit in the 1960s, forcing the dollar off gold in August 1971. August seems to have become the traditional time of international crisis, from the guns of August 1914 to closing the London Gold Pool in 1971 to the financial crisis of August 2011 that saw gold jump once again in response to a flight out of financial debt claims.)

The Eurozone is re-creating a similar inter-governmental debt tangle today against its own members. This time the aim is not to pay for military war as in the 1920s, but to wage a 21st-century mode of financial warfare by creditors against debtor economies. First Ireland and Greece and then Italy, Spain and Portugal were directed to bail out their insolvent banking systems by imposing austerity and letting the banks "earn their way out of debt" by creating credit to lend to private buyers of the land and public domain that debt-burdened governments were to sell off. So instead of the Ricardian socialism directed against landlords and monopolists or Marxian socialism aimed at raising living standards and rationalizing industrial organization, the world is threatened with a lapse back into neofeudal *rentier* power.

This financial aggression is similar to military asset grabs. Just as in overt warfare, creditors seek the land and other real estate, public infrastructure and other assets from debtors in Ireland and Greece, and now Portugal, Italy and Spain as well. In place of tribute as such, they demand debt service. And the way to achieve this is by creating crisis, using their control of the payments and credit system as leverage to stifle economies that do not obey their demands. This is why today's global financial system is in crisis once again, largely because of inter-governmental debt overwhelming private-sector capital movements, and because of international financial institutions (headed by the multinational but U.S.-dominated International Monetary Fund and World Bank, the European Central Bank and the U.S. Federal Reserve system) seeking to impose austerity and heavy taxation for what has metamorphosed from military warfare to financial warfare—in this case, against debtor economies.

Part II

Inflated Debt and Debt Deflation

"I was never able to explain to the American people in a way in which they understood it why these rescues were for them and for their benefit, not for Wall Street."

Henry M. Paulson Jr., the former Treasury secretary, to the Financial Crisis Inquiry Commission in May 2010. Quoted in Gretchen Morgenson, "The Rescue That Missed Main Street," *The New York Times*, August 27, 2011.

7

A Property Is Worth Whatever a Bank Will Lend

Never before have so many Americans gone so deeply into debt so willingly. Housing prices have swollen to the point that we have taken to calling a mortgage—by far the largest debt most of us will ever incur—an "investment." Sure, the thinking goes, $ 100 000 borrowed today will cost more than $200 000 to pay back over the next thirty years, but land, which they are not making any more of, will appreciate even faster. In the odd logic of the real estate bubble, debt has come to equal wealth.

And not only wealth but freedom—an even stranger paradox. After all, debt throughout most of history has been little more than a slight variation on slavery. Debtors were medieval peons or Indians bonded to Spanish plantations or the sharecropping children of slaves in the postbellum South. Few Americans today would volunteer for such an arrangement, and therefore would-be lords and barons have been forced to develop more sophisticated enticements.

The solution they found is brilliant, and although it is complex, it can be reduced to a single word: rent. Not the rent that apartment dwellers pay the landlord but economic rent, which is the profit one earns simply by owning something. Economic rent can take the form of licensing fees for the radio spectrum, interest on a savings account, dividends from a stock, or the capital gain from selling a home or vacant lot. The distinguishing characteristic of economic rent is that earning it requires no effort whatsoever. Indeed, the regular rent tenants pay landlords becomes economic rent only after subtracting whatever amount the landlord actually spent to keep the place standing.

Most members of the rentier class are very rich. One might like to join that class. And so our paradox (seemingly) is resolved. With the real estate boom, the great mass of Americans can take on colossal debt today and realize colossal capital gains—and the concomitant *rentier* life of leisure—tomorrow. If you have the wherewithal to fill out a mortgage application, then you need never work again. What could be more inviting—or, for that matter, more egalitarian? That is the pitch, anyway. The reality is that, although home ownership may be a wise choice for many people, this particular real estate bubble has been carefully engineered to lure home buyers into circumstances detri-

mental to their own best interests. The bait is easy money. The trap is a modern equivalent to peonage, a lifetime spent working to pay off debt on an asset of rapidly dwindling value.

Most everyone involved in the real estate bubble thus far has made at least a few dollars. But that is about to change. The bubble will burst, and when it does, the people who thought they would be living the easy life of a landlord will soon find that what they really signed up for was the hard servitude of debt serfdom.

The new road to serfdom begins with a loan. Since 2003, mortgages have made up more than half of the total bank loans in America—more than $300 billion in 2005 alone. Without that growing demand, banks would have seen almost no net loan growth in recent years.

Why is the demand for mortgage debt so high? There are several reasons, but all of them have to do with the fact that banks encourage people to think of mortgage debt in terms of how much they can afford to pay in a given month—how far they can stretch their pay checks—rather than in terms of the total amount of the loan. A given monthly payment can carry radically different amounts of debt, depending on the rate of interest and how long those payments last. The purchasing power of a $1,000 monthly payment, for instance, nearly triples as the debt lingers and the interest rate declines.

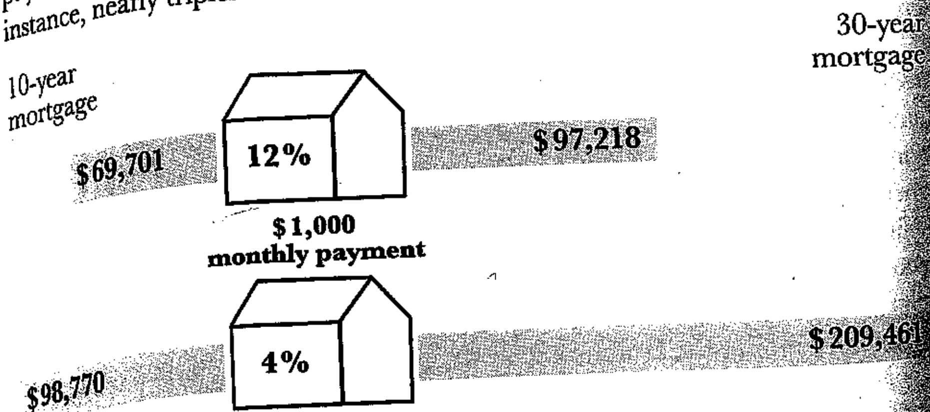


Fig. 1: A monthly $1,000 payment can carry different levels of debt

As it happens, banks are increasingly unhurried about repayment. Nearly half the people buying their first homes last year were allowed to do so with no money down, and many of them took out so-called interest-only loans, for which payment of the actual debt—amortization—was delayed by several years. A few even took on "negative amortization" loans, which dispense entirely with payments on the principal and require only partial payment of the

interest itself: the extra interest owed is simply added to the total debt, which can grow indefinitely. The Federal Reserve, meanwhile, has been pushing interest rates down for more than two decades.

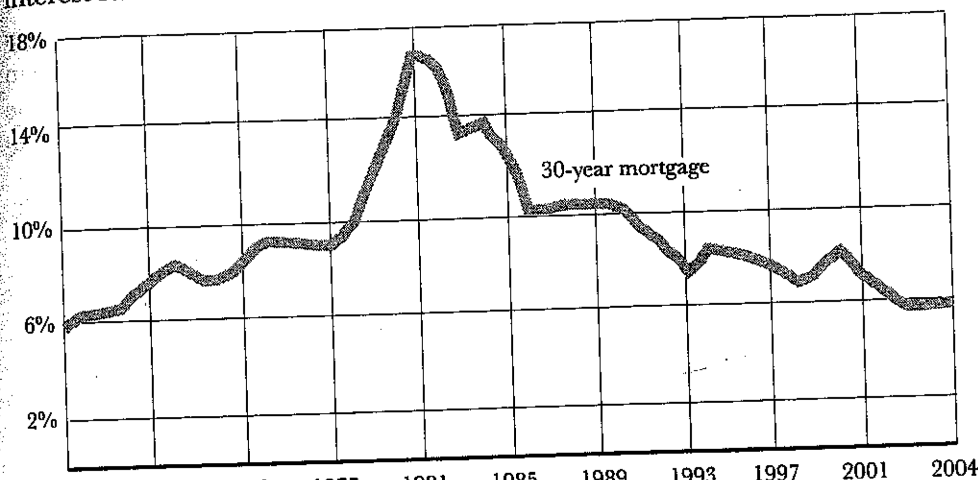


Fig. 2: Interest rates have been falling since 1981

The IRS has helped create demand for debt as well by allowing tax breaks —the well-known home-mortgage deduction, for instance—that can transform a loan into an attractive tax shelter. Indeed, commercial real estate investors hide most of their economic rent in "depreciation" write-offs for their buildings, even as those buildings gain market value. The pretense is that buildings wear out or become obsolete just like any other industrial investment. The reality is that buildings can be depreciated again and again, even as the property's market value increases.

Local and state governments have done their share too, by shifting the tax burden from property to labor and consumption, in the form of income and sales taxes. Since 1929, the proportion of tax burden has almost completel reversed itself.

In recent years, though, the biggest incentive to home ownership has not been owning a home per se, or even avoiding taxes, but rather the eternal hope of getting ahead. If the price of a $200,000 house shoots up 15 percent in a given year, the owner will realize a $30,000 capital gain. Many such owners are spending tomorrow's capital gain today by taking out home-equity loans. For families whose real wages are stagnant or falling, borrowing against higher property prices seems almost like taking money from a bank account that has earned dividends. In a study last year, Alan Greenspan and James Kennedy found that new home-equity loans added $200 billion to the U.S. economy in 2004 alone.

It is also worth noting that capital gains—economic rent "earned" without any actual labor or industrial investment—are increasingly untaxed.

All of these factors have combined to lure record numbers of buyers into the real estate market, and home prices are climbing accordingly. The median price of a home has more than doubled in the last decade, from $109,000 in 1995 to a peak of more than $206,000 in 2005. That growth far outpaces the consumer price index, and yet housing affordability—the measure of those month-to-month housing costs—has remained about the same.

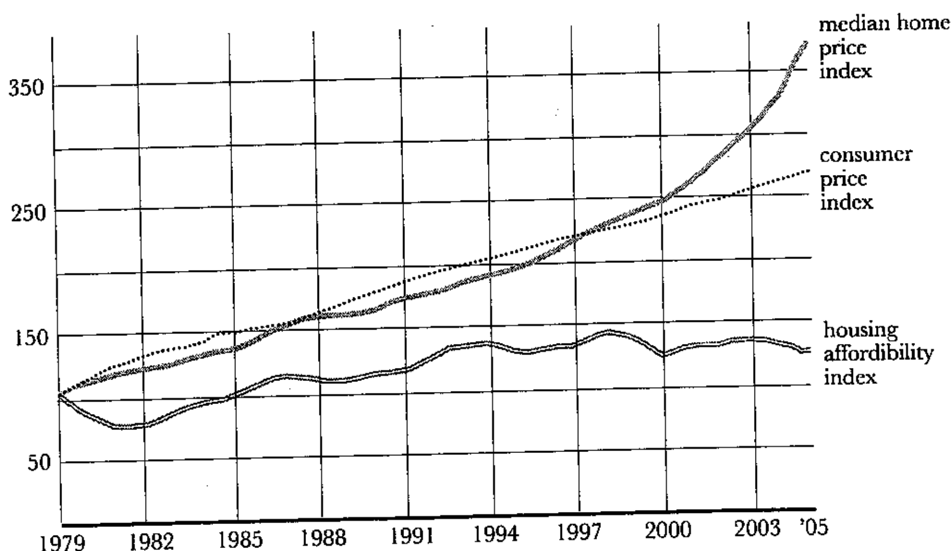
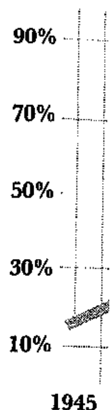


Fig. 3: Housing prices have far outpaced consumer prices even as monthly payment remain affordable

That sounds like good news. But those rising prices also mean that more people owe more money to banks than at any other time in history. And that's not just in terms of dollar—$11.8 trillion in outstanding mortgages—but also as a proportion of the national economy. This debt is now on track to surpass the size of America's entire gross domestic product by the end of the decade.

Even that huge debt might not seem so bad, what with those huge capital gains beckoning from out there in the future. But the boom, alas, cannot last forever. And when the growth ceases, the market will collapse. Understanding why, though, requires a quick detour into economic theory. We often think of "the economy" as no more than a closed loop between producers and consumers. Employers hire workers, the workers create goods and services, the employers pay them, and the workers use that money to buy the goods and services they created.



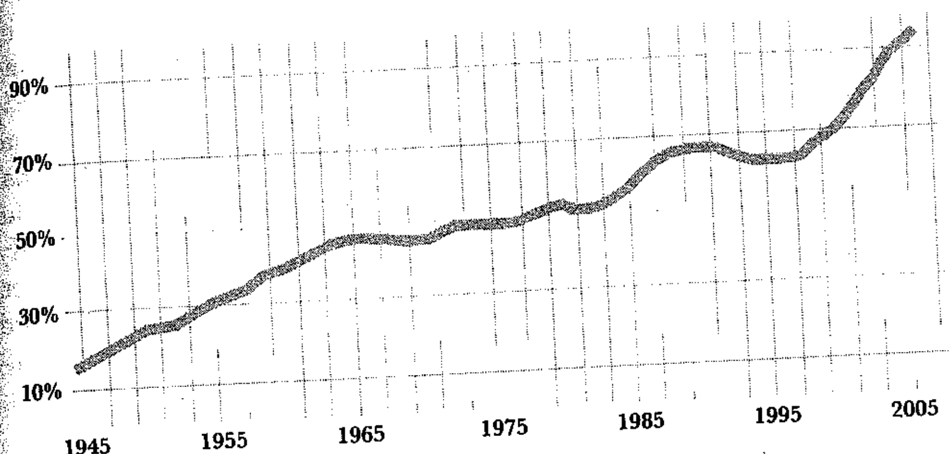


Fig. 4: Mortgage debt is rising as a proportion of GDP

As we have seen, though, the government also plays a significant role in the economy. Tax hikes drain cash from the circular flow of payments between producers and consumers, slowing down overheated economies. Deficit spending pumps more income into that flow, helping pull stalled economies out of recession. This is the classical policy model associated with John Maynard Keynes.

A third actor also influences the nation's fortune. Economists call it the FIRE sector, short for finance, insurance, and real estate. These industries are so symbiotic that the Commerce Department reports their earnings as a composite. (Banks require mortgage holders to insure their properties even as the banks reach out to absorb insurance companies. Meanwhile, real estate companies are organizing themselves as stock companies in the form of real estate investment trusts, or REITs—which in turn are underwritten by investment bankers.) The main product of these industries is credit. The FIRE sector pumps credit into the economy even as it withdraws interest and other charges.

The FIRE sector has two significant advantages over the production/consumption and government sectors. The first is that interest wealth grows exponentially. That means that as interest compounds over time, the debt doubles and then doubles again. Theeighteenth-century philosopher Richard Price identified this miracle of compound interest and observed, somewhat ruefully, that had he been able to go back to the day Jesus was born and save a single penny—at 5 percent interest,compounded annually—he would have earned himself a solid gold sphere 150 million times bigger than Earth.

The FIRE sector's other advantage is that interest payments can quickly be recycled into more debt. The more interest paid, the more banks lend. And those new loans in turn can further drive up demand for real estate—thereby allowing homeowners to take out even more loans in anticipation of future capital gains. Some call this perpetual-motion machine a "post-industrial economy," but it might more accurately be called a rentier economy. The dream is that the FIRE sector will expand to embrace the fortune of every American—that we need not work or produce anything, or, for that matter, invest in new technology or infrastructure for the nation. We certainly need not pay taxes. We need only participate in the boom itself. The miracle of compound interest will allow every one of us to be a rentier, feasting on interest, dividends, and capital gains.

In reality, alas, we can't all be rentiers. Just as, in Voltaire's phrase, the rich require an abundant supply of the poor, so too does the rentier class require an abundant supply of debtors. There is no other way. In fact, the vast majority of Americans have seen their share of the rental pie decrease over the last two decades, even as the real estate pie as a whole has expanded. Everyone got a little richer, but rich people got much, much richer.

We will be hard-pressed to maintain even this semi-blissful state. Like any living organism, real economies don't grow exponentially, or even in a straight line. They taper off into an S-curve, the victim of their own successes. When business is good, the demand for labor, raw materials, and credit increases, which leads to large jumps in wages, prices, and interest rates, which in turn act to depress the economy. That is where the miracle of compound interest founders. Although many people did save money at interest two thousand years ago, nobody has yet obtained even a single Earth-volume of gold. The reason is that when a business cycle turns down, debtors cannot pay, and so their debts are wiped out in a wave of bankruptcy along with all the savings invested in these bad loans.

Japan learned this lesson in the Nineties. As the price of land went up, banks lent more money than people could afford to pay interest on. Eventually, no one could afford to buy any more land, demand fell off, and prices dropped accordingly. But the debt remained in place. People owed billions of Yen on homes worth half that—homes they could not sell. Many commercial owners simply went into foreclosure, leaving the banks not only with "nonperforming loans" that were in fact dead losses but also with houses no one wanted—or could afford—to buy. And that lack of incoming interest also meant that banks had no more reserves to lend, which furthered the downward spiral. Britain's similarly debt-burdened economy inspired a dry witticism: "Sorry you lost your job. I hope you made a killing on your house."

We have already reached our own peak. As of last fall, even Alan Greenspan had detected "signs of froth" in the housing market. Home prices had "risen to unsustainable levels" in some places, he said, and would have exceeded the reach of many Americans long ago if not for "the dramatic increase in the prevalence of interest-only loans" and "other, more exotic forms of adjustable-rate mortgages" that "enable marginally qualified, highly leveraged borrowers to purchase homes at inflated prices." If the trend continues, homeowners and banks alike "could be exposed to signifi- cant losses." Interest rates, meanwhile, have begun to creep up.

So: America holds record mortgage debt in a declining housing market. Even that at first might seem okay—we can just weather the storm in our nice new houses. And in fact things will be okay for homeowners who bought long ago and have seen the price of their homes double and then double again. But for more recent homebuyers, who bought at the top and who now face decades of payments on houses that soon will be worth less than they paid for them, serious trouble is brewing. And they are not an insignificant bunch.

The problem for recent homebuyers is not just that prices are falling; it's that prices are falling even as the buyers' total mort- gage remains the same or even increases. Eventually the price of the house will fall below what homeowners owe, a state that economists call negative equity. Homeowners with nega- tive equity are trapped. They can't sell—the declining market price won't cover what they owe the bank—but they still have to make those (often growing) monthly payments. Their only "choice" is to cut back spending in other areas or lose the house—and everything they paid for it—in foreclosure.

Free markets are based on choice. But more and more homeowners are discovering that what they got for their money is fewer and fewerchoices. A real estate boom that began with the promise of "economic freedom" almost certainly will end with a growing number of workerslocked in to a lifetime of debt service that absorbs every spare penny. Indeed, a study by The Conference Board found that the proportion of households with any discretionary income whatsoever had already declined between 1997and 2002, from 53 percent to 52 percent. Rising interest rates, rising fuel costs,and declining wages will only tighten the squeeze on debtors. But homeowners are not the only ones who will pay. The overall economy likely will shrink as well. That $200 billion that flowed into the "real"economy in 2004 is already spent, with no future capital gains in the works to fuel more such easy money. Rising debt-service payments will further divert income from new con- sumer spending. Taken together, these factors will further shrink the "real" economy, drive down those already declining real wages, and push our debt- ridden economy intoJapan-style stagnation or worse. Then only the debt itself will remain, a bitter monument to our love of easy freedom.