Why the Economic Crisis Won't Go Away

It didn't take an economic genius to see this economic crisis coming. In fact, if you are an economic genius you were more likely not to see it coming because conventional economics was and is focused on the wrong indicators of economic health. Stock prices, interest rates, and even mean income do not give a good picture of our economic health.

Look, capitalism is not a difficult concept to understand. The invisible hand that Adam Smith wrote about 250 years ago is based on two simple components: consumers and choice. What about the capitalists you say? They did not play a large role in Adam Smith's accounting. He figured capitalists would take care of themselves. They didn't need any coddling, incentives, or tax breaks. They could look after their own self-interest.

What capitalists did need was constant surveillance, and yes, even government intervention if necessary, in order to maintain the choice side of the equation. He once said that the biggest threat to capitalism is the capitalists themselves, because they do not like to compete for consumers. He was well aware of the potential for capitalism to devolve into monopoly and thereby lack of choice. Remember, choice is one of the two *requirements* for capitalism to survive.

Adam Smith also drew a sharp line between self-interest and greed. He despised greed because it was a threat to capitalism. He also knew that capitalists left to their own devices would invariably slip across that line and lose all perspective on the difference between self-interest and greed. Why did he not like greed? Probably because he saw that in order to have consumers, the wealth could not be pooled. Greed tends to pool wealth and thereby greatly diminish the pool of consumers. This in turn weakens the other *requirement* for capitalism, consumers.

Since Adam Smith's time we have accumulated a few data points that support his hypotheses on capitalism. We might have more if more economists had focused on indicators of these two primary principles behind capitalism, *consumers and choice*, rather than indicators of how well the capitalists are doing. In 1929 one percent of the U.S. population controlled 23 percent of the wealth. The only time the pooling of wealth has come anywhere near this level since then was when one percent of the population controlled 20 percent of the wealth. That was… oh yeah, right now!

So what indicators would have given economists a heads up that this crisis was coming? One is the jobless rate. Over the past eight years we have been shedding jobs like crazy. And many of those who lost their jobs were older workers who had been making good incomes, and also had equity in their homes. A coupled indicator is median income. Note I said median, not the mean income economists traditionally look at. Why? Look at it this way. For each person that makes one hundred million dollars more this year, ten thousand middle-income people can make one thousand dollars less and the mean income stays exactly the same.

The way unemployment figures are generally interpreted also glosses over the health of the consumer impact on capitalist equation. The impact on consumer health has been masked by two major factors. First, many of the unemployed have either taken jobs at half (or sometimes less) than they were making in their old jobs, or they have become self-employed consultants making half of what they did before. Or, they may have just stopped looking for a job. All these conditions take them off the unemployment roles, but in all these cases they are no longer the strong consumers they were when they were making a lot more money. The second factor became the direct cause of the current financial crisis. Since many of these newly income-diminished people had equity in their homes, they were able to maintain a semblance of their previous life style by borrowing against that equity. This propped up the system short term, and allowed the pooling of money to continue. But when the housing bubble burst the consumers were left in debt and under employed. In short, they were left in worse shape than when they first lost their jobs.

Shoring up the banks and financial institutions is not going to fix the major breakdown in capitalism, because it doesn't address the real problems. Even if the banks start lending money, who is going to borrow it? Consumers cannot continue to buy things on borrowed money if they don't have the income to pay it back. *We have violated both tenants of Adam Smith's capitalism*, allowing the system to reduce consumer choices then allowing the wealth to pool and severely weaken the consumer base.

Bringing back consumers (middle class wealth) is the only thing that is going to solve this crisis. That means that rather than unclogging the financial markets to spur lending, we instead should be looking at how we are going to unpool the wealth to get money back into broader consumer circulation. That is likely going to be a tougher problem.

Raising taxes on wealthier people and corporations may be the only way to do that. To those who say that tax cuts are the only way to create new jobs I issue this challenge. WHERE ARE THE DATA THAT SUPPORT THIS VIEW?

If we look back over the 20th Century the data show that every time we had tax "relief" for the wealthiest individuals, the overall economy did worse, not better. In recent times we have seen the biggest experiments with this approach resulting in perhaps the most definitive results. Ronald Reagan pushed through tax "relief" for the wealthiest in 1980, and by the end of his term the wealth was beginning to pool in ever-smaller circles, the middle class was losing ground economically, the jobless rate was increasing, and the country was in a recession. After a decade of prosperity in the 1990s George W. Bush tried it again, on a grander scale, in 2000. The current economic disaster is the result.

What would Adam Smith, the father of capitalism, say? I suspect he would not be surprised that we have seen the recessions and depressions that track the pooling of wealth. He also would not be surprised that tax cuts for the wealthiest individuals lead to this result. Unlike the American capitalist mythology of today, he makes it clear in his writings that he believes in taxes. He also appears to believe in progressive taxes stating that those who benefit the most from capitalism have a duty to support the health of the system that allowed them to accrue those benefits. That system is one that puts as its highest economic priority the economic health of large numbers of consumers and the maintenance of real alternatives in their consumption.

Steven Telleen - October 2008