

The background of the cover is a photograph of a wide river, likely the Mississippi, with a forested cliff in the distance. The sky is blue with some clouds. The text is centered over the image.

ANALYSIS OF THE FLAW IN LAISSEZ FAIRE CAPITALISM

Duard L Pruitt

Analysis
of
The Flaw
In
Laissez Faire Capitalism

By Duard L Pruitt

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The Flaw in Laissez Faire Capitalism

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Our ongoing, never ending, national financial problem is that Laissez Faire Capitalism is unstable and is also a sort of cheating mechanism which robs from the poor and middle classes and automatically transfers the loot to the ultra wealthy. In effect, a low tax Laissez Faire system automatically and handsomely rewards those already ultra rich which simultaneously (and also automatically) penalizes the poor. How does it work?

First, since the ultra wealthy own most of the national investment wealth, most of corporate profits and other investment income goes to them automatically. Note that the ultra wealthy, via our political system, have instructed the Congress to take it easy on investment income, with ultra-low or even zero tax rates on such income. Unrealized capital gains are not taxed at all, and some bond interest is not taxed. Corporations are famous for evading taxes they supposedly owe (legal evasion of course!). Some of the largest and most profitable corporations have managed to pay very low or even zero tax in recent years. At the same time, a wage earner (with little or no investment income), has his (or her) entire income subjected to a significant "pay roll tax". Most corporate income goes to the ultra wealthy because the ultra wealthy own most of the investment property. The after tax income is re-invested, giving the owner an even larger share in the next time period. Note that there is no upper limit to the resulting accumulations of wealth.

The other method is via large salaries: ultra wealthy and influential business owners will award the most lucrative jobs to themselves, and will (of course) use their "influence" to make the salaries as high as the companies can afford. For example, at this point in time, an average company CEO receives about \$11 million annually in salary and benefits (ABC news, 7-3-2011). And these well paid CEOs make sure that the company workers are paid as little as possible: currently an average industrial worker receives about \$40,000 annually in wages (same ABC news reference).

With a current GDP running at an annual rate of about \$15 trillion (including capital replacement cost of about \$2 trillion), and with approximately 117 million households out there, the average share of GDP per household works out to approximately \$110,000. per annum after capital replacement. (This is not meant to imply that all household incomes should be equal; it is just to point out that, on average, we are still a rather prosperous nation, even in the middle of a severe recession.)

The result is a build up (over many years) of a very high concentration of wealth (and therefore also income) in a few of our wealthiest households. The numbers

constantly change, but the overall problem remains stubbornly in place through good times and bad. As observed in recent years, the results are as follows:

■ Share of investment wealth owned by wealthiest 10% of households:

Over 80%.

■ Share of investment wealth owned by wealthiest 1% of households:

Over 40%.

■ Annual Income of poorest household:

About zero.

■ Annual Income of poorest 5% of households:

Less than \$10,000.

■ Annual Income of poorest 25% of households:

Less than \$30,000.

■ Annual Income of 50th percentile household:

About \$55,000.

■ Annual Income of 90th percentile household:

About \$110,000.

■ Annual Income of 99th percentile household:

About \$400,000.

■ Annual Income of 100th percentile household:

Unknown, but known to be in the \$Billions.

If you don't see it immediately, integrating the available data shows conclusively that the richest few percent, and especially the richest one percent of the households, "capture" such a large share of the total national income (of about \$15 trillion) that they can live opulent life styles, if they wish, and still have most of their large incomes left over. That richest 1% is intent on mostly reinvesting their huge incomes so that they will have an even larger share next year. The inevitable result, which happens over and over and over again, is that retail sales falter from lack of "economic" demand (the workers don't have enough total income to buy the available finished products). Production is cut back, workers are laid off, and of course the "economic" demand then becomes even less: recession, or worse. The "recovery" typically leaves a few percent of the population on the economic sidelines: chronically unemployed or under employed.

Note that the average CEO (about \$11 million annual income) has the potential to become an ultra wealthy multi-millionaire in just one year, though he (or she), of course, was probably already a multi-millionaire before he (or she) became a CEO. Also, there is some upward mobility. Note that a super sports star or entertainer (football, basketball, baseball, TV, movies, etc.) can become a multi-millionaire in just one season if he (or she) is just a little bit careful with his (or her) spending. Even congressmen (or congresswomen) can evolve into multi-millionaires if they play their cards right (books, speeches, "sweetheart" business deals). Small wonder that more than a few congress people seem to value the interests of the ultra wealthy over the interests of the workers. A large number of these congressmen (or congresswomen) are ultra wealthy themselves. In fact, more than a few were ultra wealthy even before they ran for congress: being famous and/or beautiful can attract votes whatever your political views. "The rich get richer and the poor get poorer", is not just a joke: it is happening continuously. The poor are also getting to be more numerous.

Is there any way to fix this horrendous problem? Yes. Many people have figured this all out, and some of them have been working to try to enlighten the voters (mostly without success). Check the views of Robert Reich on robertreich.org. Or keep reading this booklet.

The Business Cycle

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A "boom" period sows the seeds of its own destruction by a number of real and psychological factors:

(1) Almost everyone gets over optimistic, from the poorest car or home buyer to the wealthiest banker. In the absence of effective regulations and controls, many over extend themselves financially. In some cases, there may be an actual excess of federal taxes over expenditures. Instead of paying off some of the national debt, Congress typically reacts to fuel the boom by lowering taxes. We have developed a national attitude that responds to this irresponsible action (lowering taxes) by applauding. Almost everyone optimistically assumes that the boom is going to last forever, in spite of our history that booms have always ended in a recession or depression.

(2) The operation of "Laissez Faire Capitalism" automatically further enriches the wealthy few, at the expense of almost everybody else: the "poor" and middle classes. This happens automatically because a small percentage of the population owns most of the "investment wealth" and therefore captures most of the investment income. This small group of wealthy are also in a position to demand and get astronomical salaries in addition to their investment income. The rich get richer, everybody else struggles to hold their own, and the very poor actually get poorer.

(3) At some point, the poor and middle classes lose their ability to cope with the situation by such strategies as multiple jobs per household, and buying things on credit. They necessarily begin to buy less, resulting in sluggish demand for goods and services. Production bosses notice the reduction in demand, and lower production (laying off a few ordinary workers, further lowering demand). A downward spiral develops into a recession or perhaps even a "depression".

(4) The breakdown typically happens fairly quickly, and, even though it is a common occurrence, having happened repeatedly in the past, it seems to almost always catch almost everybody in a disbelieving surprise. Recovery is likely to be slow and painful, involving bankruptcies, foreclosures, loss of wealth, and some actual starving and freezing among the very poor. Official unemployment figures peak up, and may not fully recover even after the recession is officially declared to be "over".

(5) As pointed out in the above paragraphs, this sort of undesired business cycle is inevitable in our traditional, "conservative", low tax, low regulation, "rugged individualist", Laissez Faire type of Capitalism. That this is true can be confirmed by merely reviewing our financial history.

(6) Can anything be done about this? A true Conservative will, of course, say no. To him (or her) it is just an inevitable and normal part of business. It always recovers after a while, they say. Unfortunate that some of the poorest people have to starve and freeze every time, but that's just the way things are.

(7) A more careful analysis of the history leads to different conclusions. The great depression of the 1930s, for example, showed no sign of complete recovery until the onset of WWII provided the impetus and the conditions needed to snap out of the depression. Although all of the conditions for prosperity were not met in the WWII and post WWII experience, enough conditions were satisfied (e.g., relatively high progressive personal income tax, social security, unemployment payments, welfare) to provide a period of relative prosperity which lasted for almost 35 years before some of the safeguards started to be dismantled and things started to fail again.

(8) The secrets of prosperity, as pointed out and explained in other essays and even in books, include high progressive taxation ala WWII for personal income, corporate profits, large gifts and bequests, and estates; massive federal government stimulus projects (e.g., upgrade infrastructure and public transportation and power generation); and simultaneously pay off the national debt and never borrow again. An engineer can easily point out how this could be made to be a self-correcting system with no more recessions or depressions. This would have to be a never-ending policy to be effective and self-correcting: i.e., permanent high progressive taxes, permanent federal stimulus programs (such as universal health care and social security coupled with continuous public infrastructure repair and upgrade).

Correlations

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The economic history of the past hundred years shows that:

(1) The ideology of "reagonomics" (minimal federal taxation coupled with little or no governmental services) naturally and automatically enriches only the already rich; impoverishes almost everyone else; and leads to an inevitable depression.

And

(2) That the opposite ideology (very high progressive taxation coupled with massive federal stimulus spending) led to the most prosperous period our country has ever known (about 1940 to about 1965).

The graphs of Figures 1 and 2 cover approximately the last hundred years, ending in the year 2010.

Figure 1 shows the percentage of national "money income" captured by the wealthiest 10% of us since 1917. This graph is taken from an article by Emmanuel Saez: Summary for the broader public "Striking it Richer: The Evolution of Top Incomes in the United States", updated March 2012), which in turn is based on an article by Piketty & Saez ("Income Inequality in the United States, 1913-1998" with Thomas Piketty, Quarterly Journal of Economics, 118(1), 2003, 1-39). For the original articles, see the URL <http://elsa.berkeley.edu/~saez/> .

Figure 2 is a graph I plotted showing a variety of economic data for the past hundred years. The key data is the red curve, maximum income tax rate on the maximum tax bracket. This red curve clearly shows when one or the other of the two ideologies (Reagonomics, or high taxation with federal stimulus) was dominant, and indicates the transition periods. The "income capture" curve of Fig. 1 (including realized capital gains) is also shown as the green curve of Fig. 2.

Figure 4 (shown in section "C" of chapter 5, "Dysfunctional USA Politics") illustrates the ridiculous concentration of income in the wealthiest one percent of the USA households. The distribution is skewed so badly that the poorest few percent of households have no significant income at the same time that the very wealthiest households have literally billions of dollars of annual after tax income. Careful analysis of the other two figures (Fig 1 and Fig 2) shows that this extreme maldistribution is an automatic result of the normal operation of Laissez Faire Capitalism.

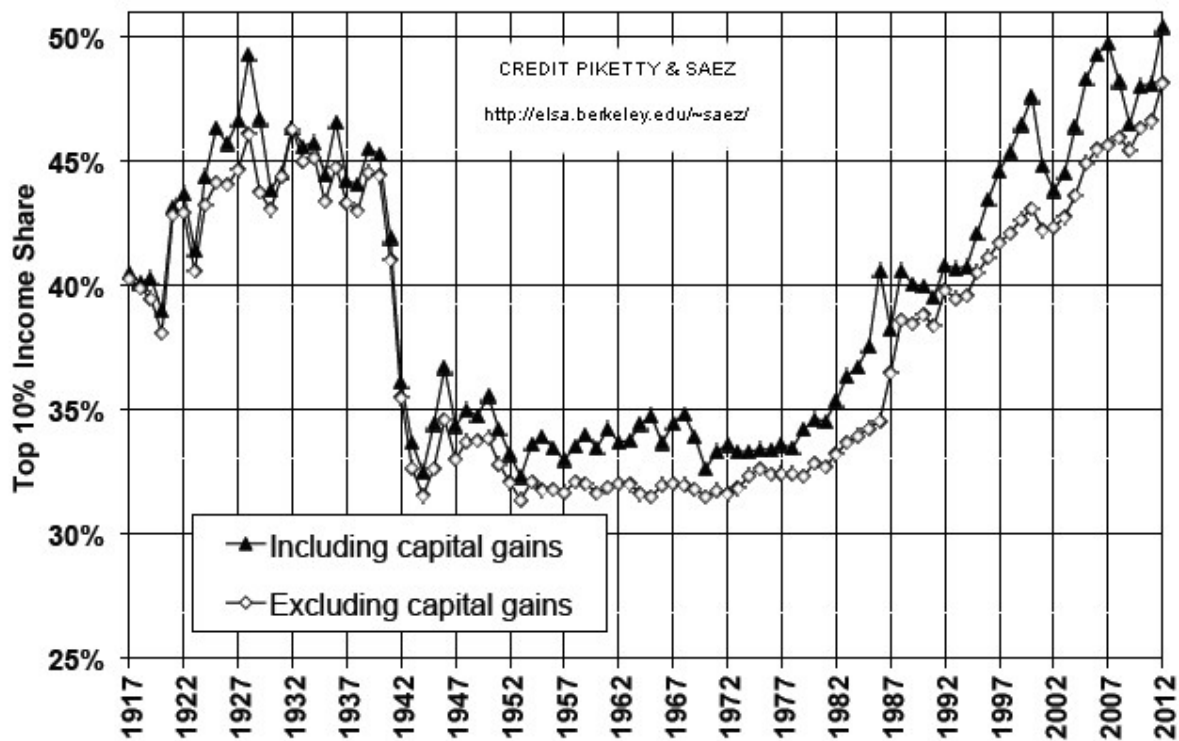
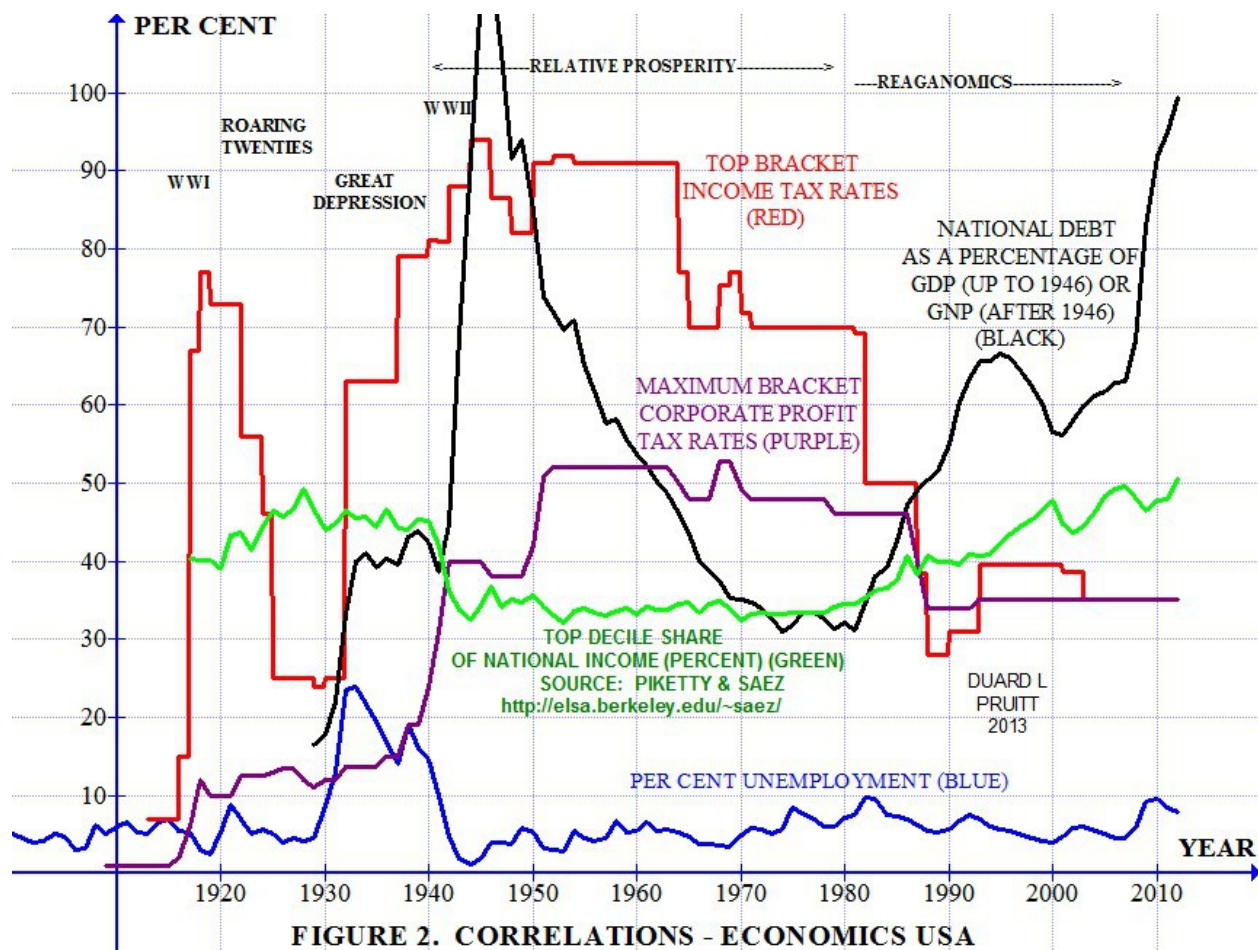


FIGURE 1
 The Top Decile Income Share, 1917-2012

Starting with Figure 1 (or the green curve of Fig. 2), note that the first data point in 1917 showed that the wealthiest 10% of us was "capturing" about 40% of the national "money income" in 1917. This value didn't change very much for a few years (probably an effect from WWI). Then, correlating with the low tax rates of the roaring 1920s, it starts a "noisy" (volatile) climb to a value near 50% capture of national money income in 1928. This peak signaled the start of system instability, culminating in the stock market crash of 1929 and the start of the "Great Depression", which constituted the first documented catastrophic failure of Reagonomics, even before Reagonomics had a name. At this point, the wealthy "capture" rate drops back to a "noisy" (volatile) value near 45%, where it remains for the rest of the Great Depression. Looking back at the tax rate curves of Figure 2, the Great Depression period correlates with intermediate tax rates (income and corporate taxes too low to solve the problem), and therefore with inadequate, only partially effective, federal stimulus programs. The Great Depression was "ameliorated", but did not go away. Then, WWII reared its ugly head.



Terrible as this time was, it contained a lesson which we sorely needed, but promptly forgot even before the war was over. In a nutshell, the message was that really massive government stimulus programs (adopted to cope with WWII), coupled with really high progressive taxes, are incompatible with a depression. The depression loses and very quickly disappears. The graphs show the lesson clearly: the "top decile" "capture" of national "money income" (green curve) fell steeply to a final value of about one-third (about 33%). The unemployment percentage fell to less than 1%. And the red curve shows that the max bracket income tax rate was (bi-partisanly) raised to a high of 94%. High as this was, the corporate (especially) and individual tax rates combined were not high enough to completely stabilize the system: the national debt rose to a value greater than GNP. The resources required to prosecute the war were there, as is proven by the fact that the national debt money was supplied from the income of the countries citizens, primarily the wealthy citizens. Overall score: one short period of massive federal government stimulus resulted in one rip roaring success: Great Depression banished, and a relatively prosperous USA for more than a quarter of a century.

Please note that the USA was not the only country to experience this phenomenon. The Great Depression was a world wide depression, which a number of other countries escaped in the same way.

First, Japan wasn't badly effected by the Great Depression, because Japan was in war mode all of the time. Italy recovered by going to a dictatorship: Mussolini "made the trains run on time", among other things. (He also had a war, incorporating Ethiopia into the Italian Empire). Germany promoted Hitler to dictator, and he quickly started building things like the autobahn (and also secretly preparing for war). As I have noted somewhere else, these "miraculous" recoveries from a deep depression were at least a part of the reason that Mussolini and Hitler were initially very popular in their respective countries. Sure enough, none of the western democracies fully recovered until they were finally fully involved in the war.

After WWII, there was a brief move to reduce the income tax rates, but they were returned to 91% maximum in 1950 (Korean War). The "upper 10%" wealthy segment "income capture" stabilized around a value of about one third. The large WWII national debt was being sharply reduced for about 20 years. Under both Democratic and Republican Administrations, the max bracket income tax rate was kept above 90% (a peak of 92% under the Eisenhower Administration). This was a "relatively prosperous" period, which may be unique in our economic history.

Then in 1964-1965 the Johnson administration lowered the income tax rates sharply in two stages. Reduction of the national debt became slower, and then ground to a halt in the mid 1970s.

1980 was a tipping point. The Reagan Administration sharply reduced tax rates, which became a very bad habit during the Reagan and Busch Administrations. The national debt immediately started to climb steeply, and it is still climbing, after a brief stabilization during the Clinton Administration. The percentage of "money income" captured by the upper decile started a steady rise in about 1980, reaching a bad, noisy, value near 50% in 2007, similar to the noisy 1928 peak. And, just like in 1929, economic collapse hit in 2008, completing a second documented catastrophic failure of "Reaganomics" (Laissez Faire Capitalism). As of 2012, although the "Great" Recession has been officially declared to be over, we are in reality still in this recession period, known by some economists as "The Great Recession".

And the prime correlations we observe are:

(1) When the federal tax rates are low enough (as in the 1920s and in the 1980 to 2010 time periods), a Depression can be expected. The timing of the depression is uncertain, but the factors to cause it are in place. The 2008 "Great Recession" took several times as long to set up as the 1929 "Great Depression" for several observable reasons. These included the fact that we were closer to the depression in 1920 (upper decile "money income capture" was already about 40% in 1920). Also there were no public safety nets in place in 1920 to 1930. By contrast, in the

latter period (1980 to 2010) we started from an upper decile "money income capture" of about 33% (farther to go for instability), and we had some social security payments, some medicare payments, and some unemployment payments to provide a little spending demand and thus slow the process down.

(2) When the federal tax rates are high enough (similar to WWII levels), and the federal spending stimulus is also high enough (as in the 1940 to 1946 period) full employment and prosperity either exist or can be expected to occur quickly.

Given these obvious insights, why in the world do about 50% of us consistently vote for those policies that cause widespread poverty, rather than the more desirable widespread prosperity? (In our Congress, a majority of greater than 60% is required in the Senate to get anything done).

Wealth & Income (mal)Distribution in the USA

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Figure 3 below, WEALTH & ANNUAL INCOME DISTRIBUTION (USA), clearly shows our national economic problem with just a minimum of study.

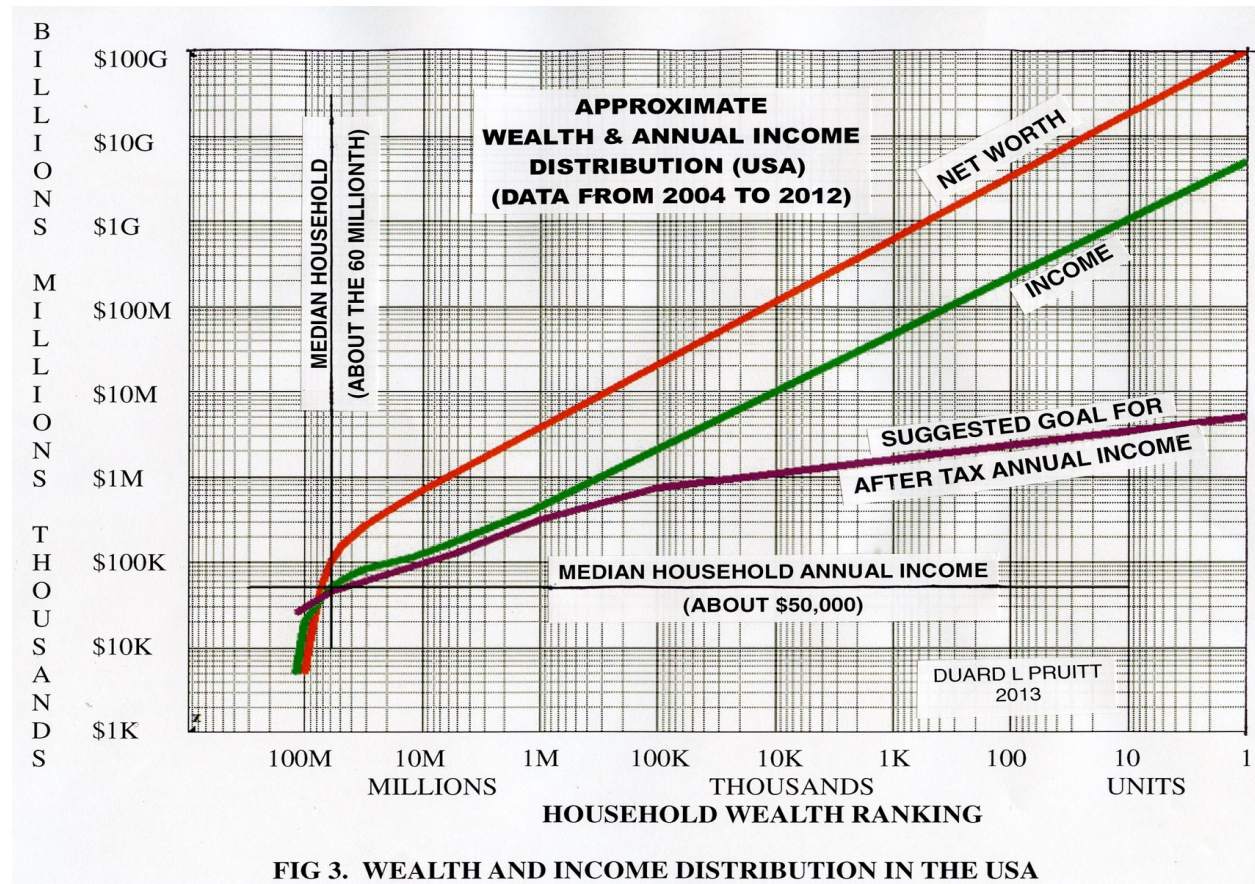


FIG 3. WEALTH AND INCOME DISTRIBUTION IN THE USA

The right hand 2/3 of the chart shows that about one percent of the households (about 1.2 million households) have a household net worth of about three million dollars or more, ranging up to about sixty billion dollars per household. The annual income (before taxes) of this top one percent ranges from about 400 thousand dollars to several billion dollars per household. This is the portion of the population that lives a rather luxurious life style (compared to most of the remaining 99%), and still has funds left over to invest. With very few exceptions, this group grows richer every year. Over time, this group acquires ownership over a larger and larger portion of the US economy. The effect varies over this 1% group: at the low end, the growth may be relatively modest, but as we approach the high end of the range, the growth becomes a Biblical flood. Reflect that, over the past 40 years, the average growth rate per year of the top two billionaires has been greater than one billion dollars per year after taxes! Finally, there is no limit to this growth, and the current tax codes actually encourages this astronomical growth: the tax rates on investment income are actually lower than the rates on

low paid worker's wages. This is the trickle up effect that this top 1% must certainly fully understand, and yet they (the wealthiest 1%) are determined to keep the rules just like they are now, thank you. (Correction: the top 1% are actually engaged in a policy of austerity: further reduce taxes and eliminate federal programs such as social security and medicare, so that their wealth capture rates will actually increase). Note that the national debt doesn't really bother the wealthy segment; they own most of it themselves, and thus collect most of the interest paid on the debt by the national government.

By contrast, the households in the lower portion of the wealth curve, especially those at or below the median level (about the 60,000,000th household), have been losing ground the past 40 years or so. With a significant and apparently permanent unemployment rate since just after WWII, wages are *small*. No bargaining power for the wage earner: he (or she) has to just take the small wage that is offered. Since capitalism is a zero sum game, those small wages automatically equate to higher profits for the owners, which will, of course, be taxed primarily at the low rates for investment income. As the factories modernize and automate, fewer workers are required, making the high unemployment rate a chronic problem. The profits from the automated factories all go to the owners and the unemployed workers are out of luck. You can understand why the wealthiest 1% believes that all of this is fine and dandy.

The recurrent problem is that capitalism *is* a zero sum game: i.e., for every wealthy household that receives tens, hundreds, or even thousands of times an average share of income, there must be even more wage earner households with a fraction (in many cases even a small fraction) of a share. The wage squeezed workers will resort to actions such as multiple wage earners per household and buying goods on credit. Multiple jobs per household puts abnormal stress on the family, and buying on credit is a self defeating policy: the money wasted on interest reduces the ability to buy the goods for sale. The normal result is an intolerable buildup of household debt, eventually ending in enforced reduction in buying and a resulting recession or depression. As “conservatives” may point out, after some period of “hard times” the recession will ease up, except that the high unemployment rate has been a chronic and permanent feature of our economy since just after WWII. If you look carefully, the wealthy segment may have recovered from a recession, but a portion of the citizenry has fallen into a chronic and apparently permanent status of unemployment or underemployment.

"The Moral Equivalent of War"

(Quote used by Jimmy Carter)

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The United States, and the World, is grappling with the worst problems ever to confront a civilization. Serious over population strains our natural resources, which are running out, and causing the environment to deteriorate. Oil, the base of our global economy, is about half used up world wide, and the second half will disappear much faster than the first half because global demand just keeps rising. Burning our fossil fuels is causing the Earth's temperature to increase significantly, leading to climate change, ocean level rise, and species die offs (some people still deny that this is happening, but scientists agree that the evidence is overwhelming). Our global financial systems (mostly Laissez Faire Capitalism), automatically and naturally enrich a very small percentage of the population, and just as automatically penalizes almost everyone else, with an increasing percentage of impoverished unemployed and underemployed world wide, including the United States.

Is there any way to halt the slide into chaos? Let us consider the financial system first, since just about all else hinges on keeping as much of the population as possible fed, housed, and clothed.

(1) Examine the history of our "Great Depression" and WWII. After almost a decade of wrestling with the Great Depression without really solving the problem, the onset of WWII stopped the depression in its tracks very quickly and completely. We failed miserably to analyze why at the time, but about 70 years of history and financial experience has provided some hind sight which makes it clear what happened. Briefly, the key was putting everybody back to work (in the war effort in the case of WWII), and mostly paying for the effort by raising the personal income tax to high rates for the top brackets of a progressive structure.

(2) As noted by someone else in his memoirs, a good question is why were we unable to accomplish this feat in peace time, but did it very quickly in the pursuit of a destructive war?

(3) And the answer of course, using 70 years of 20-20 hindsight, is that we could have abolished the depression in peace time, but we didn't because of a lack of political will. Most voters were unable to understand the problems, resulting in disagreements, opposition, indecision, and lack of adequate appropriate action. Then WWII came along and supplied the impetus to do what needed to be done: (a) Massive federal government stimulus programs put everybody back to work, and (b) Pay for the effort with very high and very progressive personal income taxes. We still have that problem today (2011). In the midst of global turmoil, the

United States is concentrating on reducing personal income tax rates to as near zero as possible, while the corporations use loopholes and special provisions to avoid paying any significant corporate tax. At the same time, instead of putting people back to work, we are proposing to trash social security and medicare and are laying off teachers and public servants, on the grounds that there is no money to pay the bills. Obviously, we didn't learn the lessons supplied by WWII.

(4) The global crisis that we are now facing requires the equivalent of a "PEACE TIME WAR EFFORT" if we are to have any chance of terminating the financial crisis and saving our planet. In short, this could be:

"THE MORAL EQUIVALENT OF WAR"

I know, this isn't my quote. I got it from a famous President (Jimmy Carter), who suggested such an approach to the oil problem a few decades ago. We don't have to actually go to war, we could make peace time infrastructure instead of war materials, and we should not actually "overspend". We should actually start repaying the national debt as a part of the effort.

Fortuitously, the actions required to stop the looming depression can fit right in with minimizing the effects of global warming and overpopulation. Suitable stimulus programs could include border patrol duty, electrifying the national railway system, developing small electrical automobiles for short range use, converting our electricity generating system into a post oil age "green" system, renewing our aging infrastructure in general, upgrading our national parks, and a probably near endless list of useful projects.

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