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The Transition from Industrial Capitalism to a Financialized Bubble Economy

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ABSTRACT

For the past decade, the U.S. economy has been driven not by industrial investment but by a real estate bubble. Although the United States may seem to be the leading example of industrial capitalism, its economy is no longer based mainly on investing in capital goods to employ labor to produce output to sell at a profit. The largest sector remains real estate, whose cash flow (EBITDA, or earnings before interest, taxes, depreciation, and amortization) accounts for over a quarter of national income. Financially, mortgages account for 70 percent of the U.S. economy's interest payments, reflecting the fact that real estate is the financial system's major customer.

As the economy's largest asset category, real estate generates most of the economy's capital gains. The gains are the aim of real investors, as the real estate sector normally operates without declaring any profit. Investors agree to pay their net rental income to their mortgage banker, hoping to sell the property at a capital gain (mainly a land-price gain).

The tax system encourages this debt pyramiding. Interest and depreciation absorb most of the cash flow, leaving no income tax due for most of the post-1945 period. States and localities have shifted their tax base off property onto labor via income and sales taxes. Most important, capital gains are taxed at a much lower rate than are current earnings. Investors do not have to pay any capital gains tax at all as long as they invest their gains in the purchase of new property.

This tax favoritism toward real estate—and behind it, toward bankers as mortgage lenders—has spurred a shift in U.S. investment away from industry and toward speculation, mainly in real estate but also in the stock and bond markets. A postindustrial economy is thus largely a financialized economy that carries its debt burden by borrowing against capital gains to pay the interest and taxes falling due.

Keywords: Real Estate; Financialization; Capital Gains; Land Rent; Land Value; National Income Accounting; Bubble Economy

JEL Classifications: G1, N2

From St. Simon's followers in France to Marx and other reformers prior to World War I, nearly all financial observers expected banking to become the economy's industrial planning agency, alongside government. But contrary to their expectation that banking would become industrialized, the opposite has occurred: Industry has been financialized. Companies are being turned from means of production into vehicles to extract interest, generate banking fees and register stock market gains for the banking and financial sector.

Capital formation today is financed mainly out of retained business earnings. The stock market also was supposed to supply investment funding, but since the 1980s it has been turned into a vehicle for corporate raiding. By permitting interest to be tax-deductible and taxing capital gains at low rates (and often not at all), the tax code favors replacing equity with debt. The effect is to make asset-price inflation the quickest mode of "wealth creation" – buying real estate, monopolies and financial securities on credit, and hoping to emerge with a "capital" gain.

This is true above all for real estate, which remains the largest asset in every economy and hence the banking sector's largest customer. Some 70 percent of bank loans in the United States, Britain and Australia are real estate mortgages. This paramount role of land and buildings as recipients of credit creation has created what national income accountants call the FIRE sector – an acronym for finance, insurance and real estate.

This symbiotic sector is political as well as economic. Translating its economic power into political control, bankers support real estate owners in lobbying to roll back property taxes, slash income taxes on higher wealth brackets and dismantle public bank regulation. This policy is guided by the realization that whatever revenue the tax collector relinquishes will be "free" to be capitalized into mortgages and other loans, and paid as interest – to be recycled into new loans to bid up property prices further, justifying yet further new lending.

From antiquity down through medieval times, land provided the main source of taxes. But starting with the Revolt of the Barons in England in 1258-65, its owners used their control of Parliament to shift the fiscal burden onto the rest of the economy. The thrust of classical economic reform was to make land once again the basic source of public revenue. Seeking to free labor and capital from the burden of rent and interest, Progressive Era reformers sought to fully tax the land's rent or nationalize it outright.

It is natural for land prices to increase over time as a result of infrastructure spending, the general level of prosperity, and property tax cuts. Governments invest in transportation, public schools and other infrastructure (water and sewer services, gas and electricity) and give rezoning permits providing valuable development privileges. All this raises the rental value of sites as populations grow and become more prosperous. But what turns out to be mainly responsible for the rising price of land today is mortgage credit. A property today is worth as much as banks will lend against it. As the volume of credit has grown exponentially, banks have lowered their credit standards to the point where most rental value (or its equivalent value to homeowners) is paid out as interest.

New homebuyers are obliged to take on a lifetime of debt to obtain housing as property prices have soared. The irony is that this "democratization" of housing is called the bulwark of the middle class rather than debt peonage. As real estate bubbles burst and leave debts in their place, owners with negative equity (mortgages in excess of plunging market prices) are unable to sell, frozen into their homes, the result is not unlike medieval serfs tied to their land. Today's post-industrial society is coming more and more to look like a regression to debt peonage.

Until recently, buying property was much like buying a bond. In fact, the original meaning of *rente* (a French word) was an interest-bearing government bond, later extended to include land receiving a regular periodic payment. Land was priced at "so many years purchase" of its rent. A property's worth was calculated by discounting its flow of rental income (or equivalent value, for homeowners) at the going rate of interest: Price = rent/interest. A lower interest rate in the denominator gave a higher multiple. A $10,000 annual income can be capitalized into a $2 million price at 5% interest (20 years purchase) or $2.5 million at 4%, but only $1 million at a high interest rate of 10% (10 years purchase).[1]

What additionally is factored in today is the expected price rise.[2] Buyers acquire property on credit, planning to pay off their debt by refinancing their mortgages (or "cashing out") as asset prices are inflated. Hyman Minsky described this phenomenon as culminating in the Ponzi stage of the financial cycle[3]: Debts are carried simply by adding the interest onto the principal, creating a rising upsweep of indebtedness – "the miracle of compound interest."

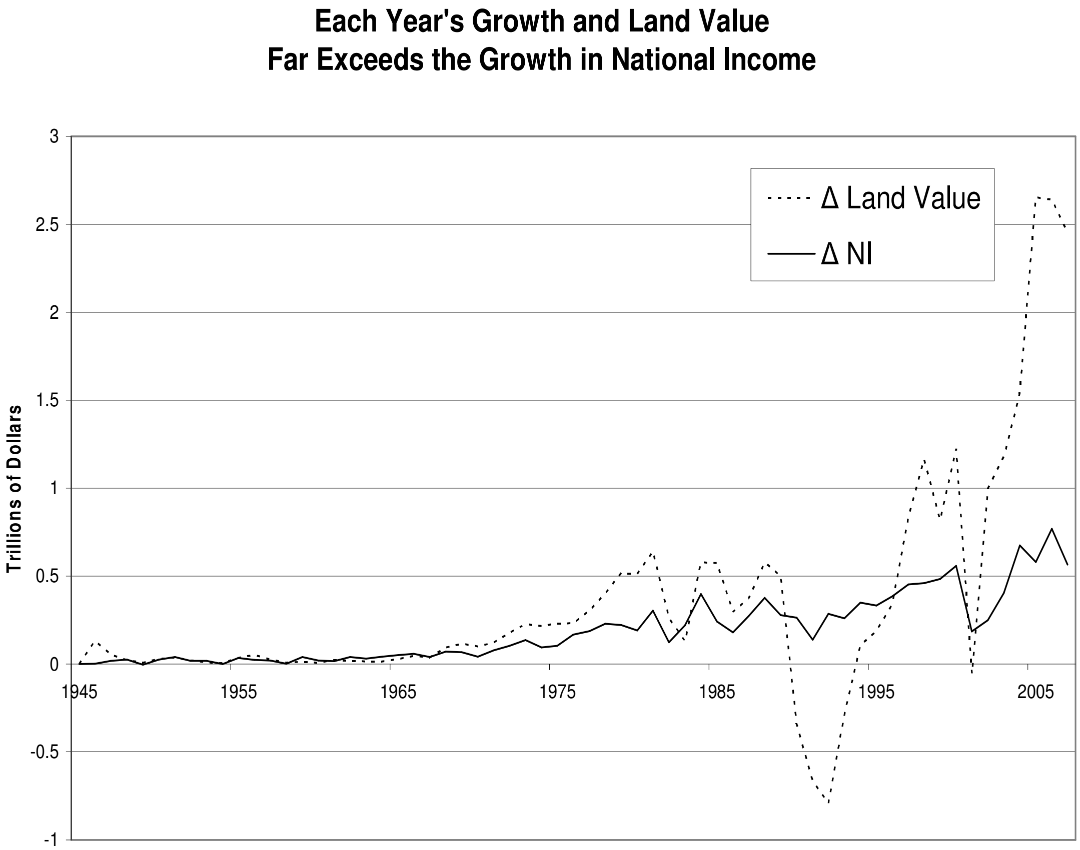
A Bubble Economy is based on debt leveraging in search of "capital" gains. Inasmuch as real estate is the economy's largest sector and land its largest component, these gains are headed by rising site value. The annual rise in land prices has far outstripped growth in national income since the late 1960s, becoming the driving force in today's financialized mode of "wealth creation."

[1] William Petty, *Treatise of Taxes and Contributions* (London 1662), p. 26: "Having found the Rent or value of the *usus fructus* per annum, the question is, how many years purchase … is the Fee simple naturally worth?" Marx (*History of Economic Theories*, tr. Terence McCarthy [New York: 1952], p. 5) notes that Petty deduces the rate of interest from rent "as the general form of surplus value."

[2] Price = (rent + ΔP)/interest

[3] Hyman P. Minsky, *The Financial Instability Hypothesis*, Working Paper No. 74, May 1992 (The Levy Economics Institute of Bard College). Prepared for *Handbook of Radical Political Economy*, ed. Philip Arestis and Malcolm Sawyer (Edward Elgar: Aldershot, 1993).

Chart 1: Annual Land-Value Gains compared to Growth in National Income

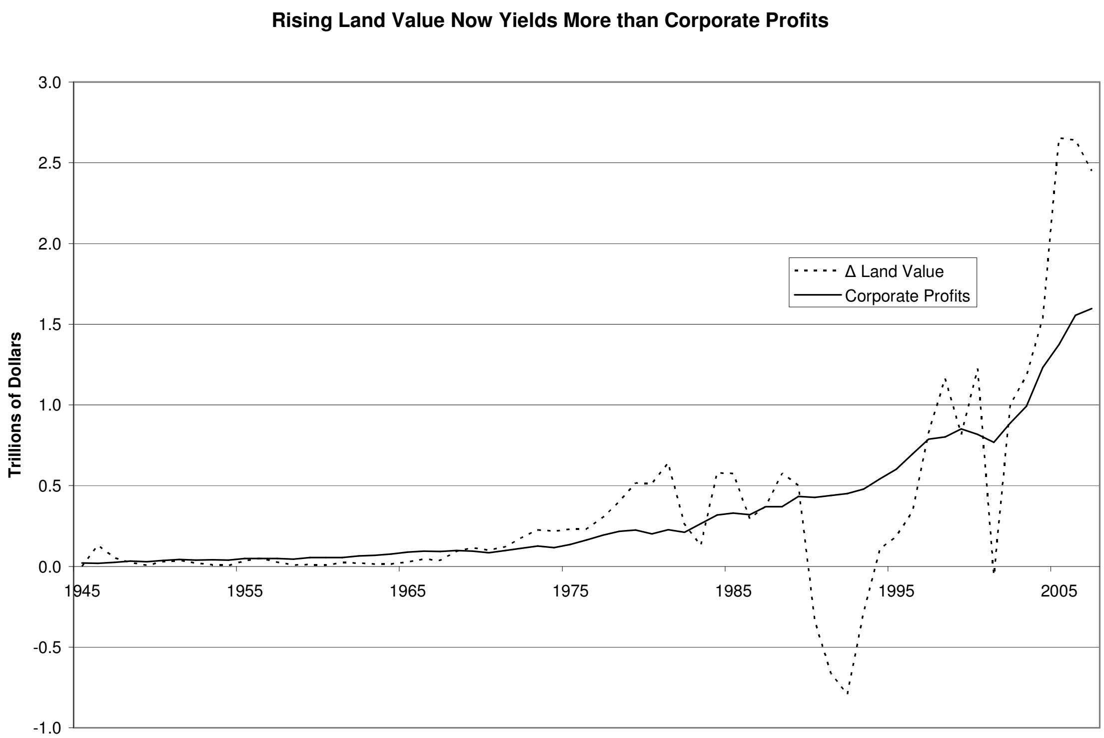


Under Alan Greenspan's chairmanship of the Federal Reserve Board (1988-2006), the government sought to enable debtors to carry their obligations by borrowing the interest against the rising market price of their property. Current income plays a declining role as property buyers aim at maximizing "total returns," defined as income plus capital gains – especially the latter. The policy to keep the financial bubble expanding is asset-price inflation sufficient to keep increasing real estate prices by enough to enable debtors to refinance their mortgages and other loans. Applying the maxim that "Rent is for paying interest," real estate investors are willing to pledge the net rental income to mortgage bankers in order to get a chance to make a capital gain. Asset-price gains become the key, not saving out of earnings or direct investment and enterprise. As the Federal Reserve's 2004 *Survey of Consumer Finances* noted: "Changes in the values of assets such as stock, real estate, and businesses are a key determinant of changes in families' net worth."[4]

[4] "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, 2006, pp. A1-A38.

This creates a symbiosis between finance, insurance and real estate – the FIRE sector at the core of the Bubble Economy. Its basic dynamic is a feedback between bank credit and asset prices. The more credit and the easier the terms on which it is available – the lower the interest rate, the lower the amortization rate, and the lower the down payment required – the larger the loan can be made. And as debt leveraging increases, it is easier to go into debt to ride the wave of asset-price inflation than to earn profits by investing in industry. Why invest money in an industrial factory or other company that takes years to organize production and mount a marketing program to develop sales on which to make a profit that is taxed at 30 percent, when you can buy land and simply sit back and make capital gains that exceed profit rates and are taxed at only half as much?

Chart 2: Annual Increase in Land Prices vs. Corporate Profits



Yet the national income and product accounts (NIPA) do not count capital gains. These occasionally are surveyed by the Internal Revenue Service's *Statistics on Income*, but the only regular estimate of such gains is the Federal Reserve's flow-of-funds statistic for land prices. The Fed estimates that price for the nation's raw land rose by $2.5 trillion for 2007. (I find $3.5 to $4 trillion to be more realistic, for reasons discussed below.) At over 20 percent of U.S. national income, this land-price gain was four times than the amount by which national income grew, and two-thirds more than total U.S. corporate profit (much of which itself derived from mortgage financing and brokerage). So today's "postindustrial" economy turns out to be mainly about real estate. If it is a "service economy," the services in question are mainly those of the FIRE sector.

From asset-price inflation to debt deflation

Inflated asset prices have made fortunes for investors, and also for many homeowners who saw the market value of their homes rise by more than they were able to earn in a year. Financial promoters hawked a dream that people could maintain their life styles and get rich by capital gains rather than by what they could earn and save. Families who found that their wages and salaries were not enough to make ends meet were tempted to sustain their living standards by taking out home-equity loans. Banks appeared to have created a postindustrial mode of wealth creation by issuing enough credit to keep bidding up property prices – and to keep the boom going by lending yet more against collateral rising in value. Not to play this game was to be left behind as the affordability of housing rose further and further beyond the means of most families to pay without cutting back their expenditure elsewhere.

The problem with such bubbles is that once underway, asset-price inflation becomes the only way to sustain the debt burden. Debt-financed speculation must accelerate or else end in a wave of bankruptcy. The problem is that carrying charges on this debt divert income away from being spent on consumption and investment. Using debt leverage to bid up property prices loads the economy down with interest and amortization commitments to pay creditors. Prospective buyers must devote more and more of their working life to pay off the debts needed to buy a home, automobile, education or health care. That is the essence of debt deflation.

The policy of lowering property taxes has subsidized speculation, by enabling more income to be paid as interest. The banks gain, capitalizing the proceeds of property tax cuts into yet larger loans. This raises the carrying costs of real estate (and business) financed on credit, while forcing taxes to be levied elsewhere to stabilize public revenue. If public spending is not cut back in response to foregone tax receipts, the shortfall must be made up by borrowing, by taxing non-property income at a higher rate, or by selling off the public domain.

This is not how matters were supposed to work out. The Progressive Era a century ago advocated that taxes should fall mainly on rent and other property returns. The aim was to free economies from rent and interest, so that prices would only reflect necessary costs of production – wages and profits for labor and capital. But governments have pursued the opposite fiscal philosophy since World War I, and especially since 1980. They have lowered property taxes and refrained from imposing a resource-rent tax on minerals, fuels or the broadcasting spectrum. They also have deregulated monopoly prices rather than kept them in line with production costs, and cut capital-gains taxes to just half the rate levied on wages and profits.

On the logic that capital gains built up net worth just as saving did America's original 1913 tax code treated them as regular income. As Treasury Secretary Andrew Mellon explained:

> The fairness of taxing more lightly income from wages, salaries or from investments is beyond question. In the first case, the income is uncertain and limited in duration; sickness or death destroys it and old age diminishes it; in the other, the source of income continues; the income may be disposed of during a man's life and it descends to his heirs.
>
> Surely we can afford to make a distinction between the people whose only capital is their mental and physical energy and the people whose income is derived from investments.[5]

This logic is applicable to today's Bubble Economy. After a real estate bubble bursts, "total returns" no longer drive balance sheets. What Alan Greenspan lauded as "wealth creation" in the form of rising property prices has the opposite effect from tangible capital investment. Instead of lowering production costs, seeking gains from debt leveraging builds interest charges into the cost of living and doing business. This slows economic growth, by diverting income to pay creditors instead of to spend on production and consumption.

The financial sector's symbiosis with real estate: Driving homebuyers into debt peonage

Ever since the United States enacted its first modern income tax in 1913 the financial sector has thrown its weight behind real estate and sought to shift the burden off property. This is quite a turnabout from David Ricardo's day, when finance backed repeal of Britain's high agricultural tariffs and land rents. At that time it seemed that industry and foreign trade would become the largest market for banks. But as matters have turned out, real estate has achieved this position.

The financialization of real estate is a distinctly 20th-century phenomenon, going hand in hand with the democratization of property ownership. Long after the end of feudalism, landlords remained the wealthiest and most liquid class. But the 19th and 20th centuries saw banks finance the spread of home ownership. In the early decades of the 19th century, residential mortgage lending was left mainly to local savings banks. Many of banks were set up to help immigrants or workingmen save up small change each week, as reflected in the names for some of the largest New York savings banks: Seamans, Emigrant, the Bowery and Dime Savings Banks. But banking since World War I has focused on real estate mortgage lending as property throughout the world has become increasingly democratized, American-style.

By the 1930s, savings and loan associations (S&Ls) were formed to aim at middle-class depositors and homebuyers. After the return to peace after 1945 the construction boom and suburbanization created a thriving mortgage market. Since the 1980s, most savings banks and S&Ls have been converted into commercial banks.

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[5] Andrew Mellon, *Taxation: The People's Business* (1924).

As this has occurred, interest payments have expanded to absorb most of the rental value of commercial properties and owner-occupied housing. And as property became more widely owned and democratized, it was fairly easy for the largest investors – and mortgage bankers – to stir up popular opposition to real estate taxation. But homeowners are not much better off. What formerly was paid to the tax collector is now paid to bankers as interest.

This is the opposite of what the classical economists recommended. Nobody a century ago expected land rent to be paid out as mortgage interest to such a high degree – or that heavily mortgaged real estate would become the backing for the banking system. Banks were supposed to finance industrial capital formation, not create credit merely to bid up prices for land sites supplied by nature, rent-extracting monopoly and property rights and to buy companies already in place.

Debt expansion for such purposes may seem self-justifying as long as asset prices are rising steadily. This price run-up is euphemized as "wealth creation" by focusing on the inflation of financial and property prices, even as disposable personal income and living and working conditions are eroded. The problem is that rising price/rent multiples and price/earnings ratios for debt-financed properties, stocks and bonds oblige wage earners to go deeper into debt, devoting more years of their working life to pay for housing and to buy income-yielding stocks and bonds for their retirement. Homeowners thus do not gain by this higher market "equilibrium" price for housing. Higher prices simply mean more debt overhead.

A simple example should make the problem clear. Suppose Mary Smith owns a \$100,000 home free and clear of any debt. Suppose Jane Doe later buys the same exact home, but the price has risen to \$250,000. To buy it, Jane needs to take out a \$100,000 mortgage.

Who is in a better financial position? On paper, Jane has a \$50,000 equity advantage (\$150,000, as compared to Mary's \$100,000). But she only owns 60 percent of the home's value, and must pay her bank \$600 a month – payments that Mary does not have to make.

Prior to the real estate bubble Mary's house has \$100,000 equity with low taxes and no interest charges. By the time Jane buys the house, she must go into debt to outbid other potential buyers. The land area hasn't increased (nature is not making any more), and buildings slowly depreciate, but the debt overhead rises, leaving less income available for consumption or saving.

Mortgage credit inflates property prices (for a while), but is such "paper wealth" worth the carrying charge? Families a century ago dreamed of owning their home free and clear. They stayed out of debt to avoid worrying about losing the homestead. But these days the only way for many families to get a home is to borrow enough to pay prices set by buyers willing to pay the entire rental value to the bank for a loan to buy it, in the hope of selling out later for a capital gain. In the above example, for instance, matters are aggravated if Jane tries to make ends meet by borrowing against the higher market price of her home. When real estate prices fall back, her debts and their carrying charges will remain in place, threatening to leave her with negative equity. This is the condition into which a quarter of U.S. real estate was estimated to have fallen by autumn 2009.

Investors are tempted to believe they are better off as long as asset prices rise faster than debt, improving their balance sheet. But by absorbing rents, business profits and disposable personal income, the debt overhead entails future clean-up costs. The credit that bid up prices to "create wealth" during the Bubble Economy's run-up leaves "debt pollution" in its wake after asset prices collapse. Living standards, business investment and new construction must be cut back to pay the bill for pumping up asset prices that have receded. Higher real estate and other asset prices provide no more economic benefit than do higher consumer prices. One party's income or gain is another party's expense.

Real estate bubbles are a symptom of debt creation, shaped and sponsored by governments cutting property taxes and thus leaving more revenue to be pledged to bankers as debt service. Modern debt peonage obliges families to take on a lifetime of debt to gain access to housing, an education and health care. The class war takes on a decidedly financial dimension, as Alan Greenspan explained to Congress: Rising mortgage debt has made employees afraid to go on strike or even to complain about working conditions. Employees become more docile in a world where they are only one paycheck or so away from homelessness or, what threatens to become almost the same thing, missing a mortgage payment. This is the point at which they find themselves hooked on debt dependency.

What has been lost along the way is the economy's traditional set of proportions. From 1945 to 2000, for example, the value of U.S. real estate remained a fairly stable (about 250%) proportion of national income. The dot.com bubble of the 1990s inflated stock market prices, but real estate resumed its dominant role as the Federal Reserve flooded financial markets with credit after the market downturn of 2000. Fueled by rising debt ratios, real estate prices soared to the unprecedented levels of 325% of national income.

Debt pyramiding was encouraged by looser terms for bank lending – low, zero or even negative down payments, while unprecedented fraud by mortgage brokers and local banks exaggerated the income and hence debt-carrying power of homebuyers, making soaring mortgage loans appear to be affordable. However, adjustable-rate mortgages (ARMs) guaranteed that loans affordable at low "teaser" rates of interest would become unaffordable when their carrying charges re-set at higher rates, forcing homebuyers into the "Ponzi" stage of having to borrow the interest. Defaults that initially were thought to be a known risk turned out to be an inevitability.

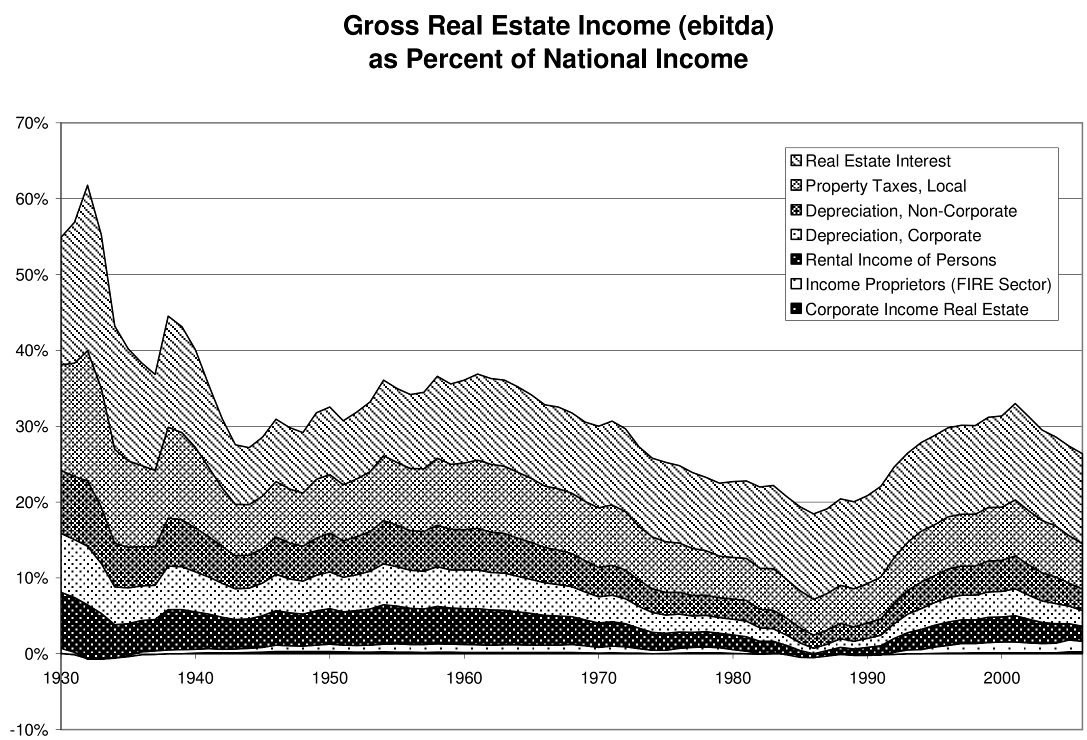
The magnitude of real estate revenue, and its increasing payout as interest

The National Income and Product Accounts (NIPA) depict the entire economy as if every activity were organized as a business – even owner-occupied housing. The word "rent" appears in only one line (Table 2.1, line 12). It is not a rent that actually is paid, but an imputed "as if" estimate of what homeowners would pay if they rented out their dwellings to themselves. This typically amounts to only 1 or 2 percent of national income.

Commercial and residential property income is reported as "real estate earnings," corporate and non-corporate. Most property investment is organized as partnerships, so most rental revenue accrues to non-corporate real estate. So closely intertwined are the real estate and financial sectors that for many years the NIPA were unable to separate their earnings.

Owners pay some of these earnings in taxes, but pass on most to their bankers. The relevant cash-flow concept is EBITDA: earnings before interest, taxes, depreciation and amortization. This can be compiled by adding real estate earnings (non-corporate and corporate, Tables 6.12 and 6.17), interest (Table 6.15) taxes paid at the state and local level (Table 3.3) plus federal taxes, capped by the most remarkable category in which EBITDA is buried: depreciation (Tables 6.13 and 6.22 respectively for non-corporate and corporate real estate depreciation).

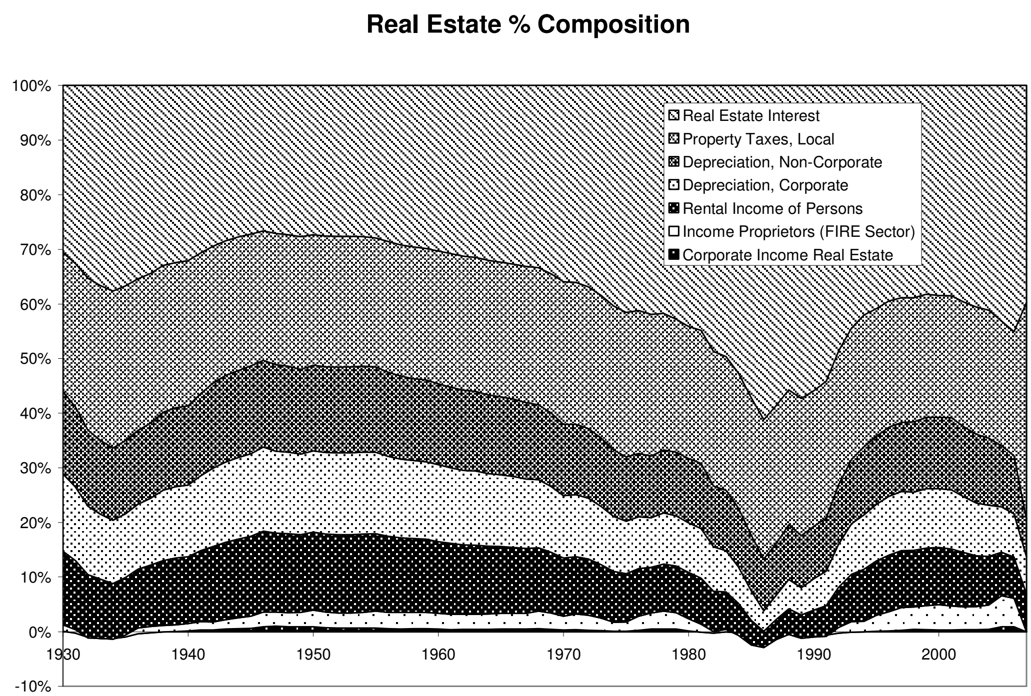
Chart 3: Real estate EBITDA as a percentage of national income, 1930-2007



Real estate EBITDA (including the rental value of owner-occupied homes) topped 60 percent of national income when the U.S. economy entered the Great Depression in the 1930s. This ratio fell by half by the time World War II ended, to just 28 percent, reflecting the shrinkage in personal income available after defraying other living costs.

Homeowners' "rental equivalent" and commercial cash flow rose from 1945 until 1960 as the postwar economy grew wealthier and more income was available to spend on homes and office space, whose location traditionally has been the major factor defining social status. But for the next twenty years the rest of the economy grew more rapidly than real estate. That sector's cash flow fell back under 25 percent of national income through the mid-1980s – until the watershed 1981 tax subsidy reversed matters. Real estate EBITDA accelerated sharply after 1985, recovering to nearly a third of national income by 2000.

Chart 4: Composition of real estate EBITDA, 1930-2007

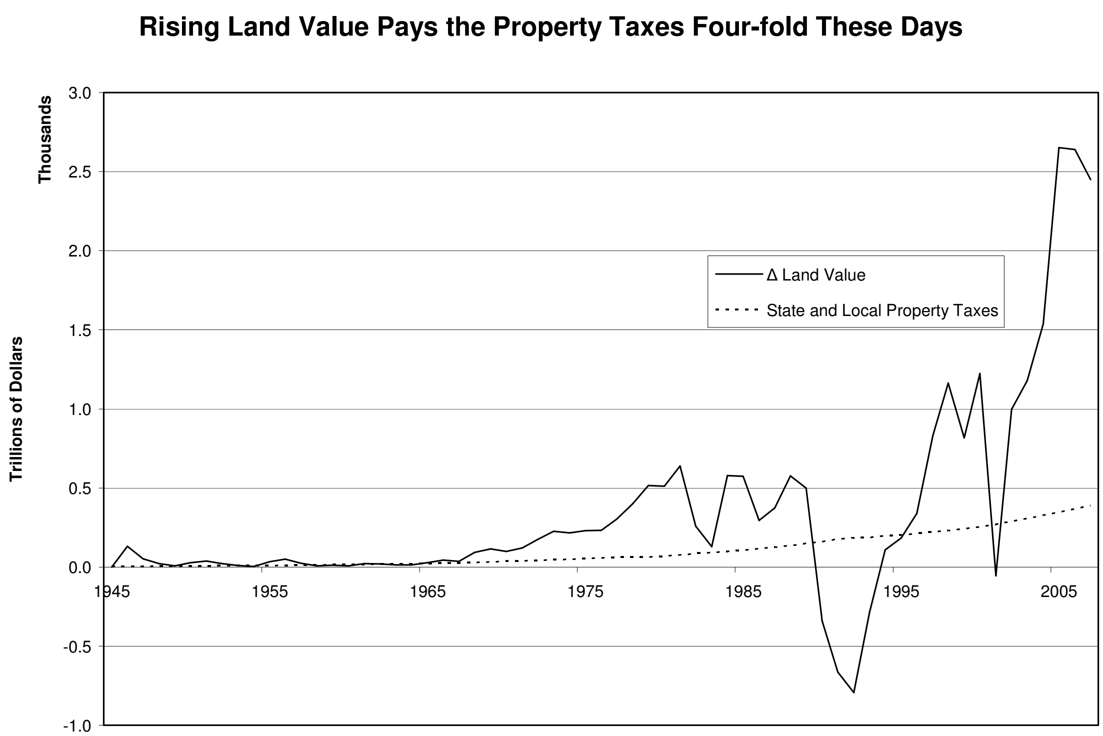


As noted above, classical writers expected land prices to rise as population increased and economies grew more prosperous and urbanized. The intention was to tax real estate's rising rental value, but two tax breaks have prevented this from happening. First is the tax deductibility of interest charges, which have absorbed most real estate cash flow since 1945. Nobody anticipated that so much interest would be paid out as to leave scarcely any income to be reported to the tax authorities. A second tax pretense permits landlords to over-depreciate buildings as if they are losing book value even while their market price is rising. The result is that despite the real estate boom, property pays an ever-shrinking share of local and federal taxes.

Shifting state and local taxes off property onto consumers

The well-known phrase of real estate agents to explain pricing – location, location and location – refers mainly to the proximity of transportation and good schools, which the United States historically has financed ms by taxing property. Localities could recapture the cost of this infrastructure spending by taxing the market value it adds to real estate sites. Instead, tax favoritism for real estate obliges federal, state and local budgets to look elsewhere for financing – mainly to tax sales and consumer income, and to borrow from the wealthy who have been un-taxed. The result is that property owners enjoy rising prices substantially in excess of what they pay in taxes.

Chart 5: Annual rise in land prices, compared to property taxes

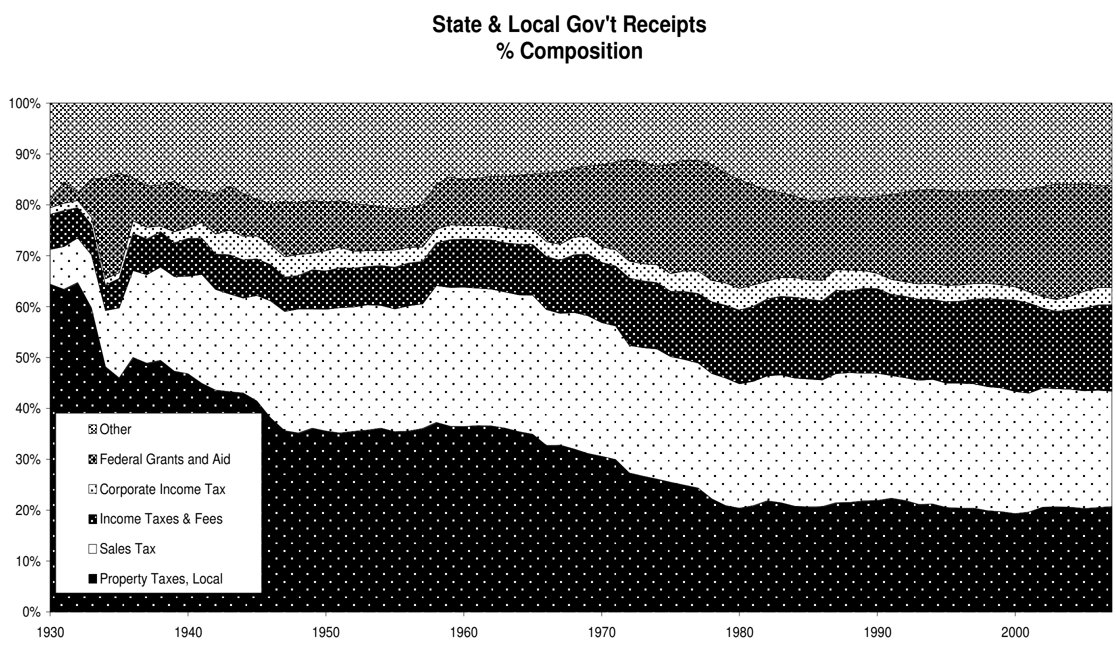


Prior to the 1930s property taxes accounted for about two-thirds of state and local government receipts. But the Great Depression obliged localities to look to sales taxes as property values shrank – and to income taxes in recent decades. Despite the postwar rise in property prices, states and localities have shifted taxes off property owners onto wage earners and consumers almost steadily, so that property taxes now make up only about 20 percent of state and local revenues (Chart 8). This is less than a third of their proportion ninety years ago.

Real estate downturns prompt property owners to campaign for their taxes to be reduced to save them from defaulting on their mortgages. Today's "negative equity" squeeze on mortgage debtors no doubt will increase political pressure for further tax shifts off property, avidly supported by bank lobbyists. The rhetoric is anti-government, but it mainly benefits bankers and large commercial owners.

The national tax shift off real estate has been even more regressive than the local tax shift. Finance and real estate have obtained "small print" tax breaks so enormous that only a modest proportion of their gains – which represents most of the economy's wealth –is counted as taxable income. Lobbyists have persuaded lawmakers to define taxable income in ways that leave property owners with no earnings to declare after deducting interest and a basically fictitious bookkeeping charge for depreciation. Landlords are allowed to pretend that their property is losing money as buildings are "used up." This tax ruling promotes a Bubble Economy by making it most economic for investors to put as little of their own money down as possible, using debt to a maximum degree. It also encourages investors to sell their property every few years, after depreciating their buildings so that new buyers can start depreciating them all over again.

Chart 6: Property taxes, as a percent of overall state and local revenues, 1930-2007.



This fiscal favoritism for property is a major factor polarizing wealth ownership in the United States. The effect is to wage a war on the middle class, despite the political values and seeming self-interest of most Americans in a more progressive tax system.

Over-depreciation of buildings

It took until the mid-19th century for economists to recognize depreciation as an element of value. Surprising as it may seem, it was Marx who first established it as a necessary charge in pricing commodities. In his critique of the French Physiocrats, he pointed out that when Francois Quesnay produced his national income account for France, the *Tableau Économique*, in 1759, he overlooked the need to replenish seed, inventory and capital stock.[6] In addition to covering their basic expenses, buying tools and raw materials and paying rent and taxes, cultivators need to set aside seed grain to plant the next season's crop. This seed is not available to be sold.

Just as bondholders get paid back their principal as well as interest, investors are permitted to recoup their original capital outlay without it being taxed as income. The recoupment period is spread over the expected lifetime of machinery, patent rights or other assets. Failure to acknowledge the need for this replacement out of sales revenue would give an overly optimistic picture of how well the economy is operating. Not to renew seed and capital investment would result in asset stripping – paying out revenue without maintaining a viable capital stock.

Economists recognize that depreciation results as much from technological obsolescence as from physical wearing out. Technology is continually improving, raising productivity and cutting costs. Rivals' innovation forces factories to modernize or be priced out of the market, sometimes obliging machinery to be sold as scrap metal before it actually wears out. But most depreciation statistically occurs where one might least expect it – in real estate.

This seems strange, because landlords rarely let their buildings wear out. They typically spend 5 to 10 percent of their rental income on maintenance and repairs, and periodically replace their plumbing and heating systems, electric wiring and windows. Buildings constructed prior to World War II – already a few lifetimes in the Internal Revenue Service's depreciation schedule – sell at a premium because they tend to occupy prime locations and are better built than their modern counterparts. Contractors have cut construction standards each decade, replacing "4 by 4" beams and copper plumbing with cheaper materials such as 2-by-4s and plastic, and making walls of aluminum siding tacked onto soft insulation.

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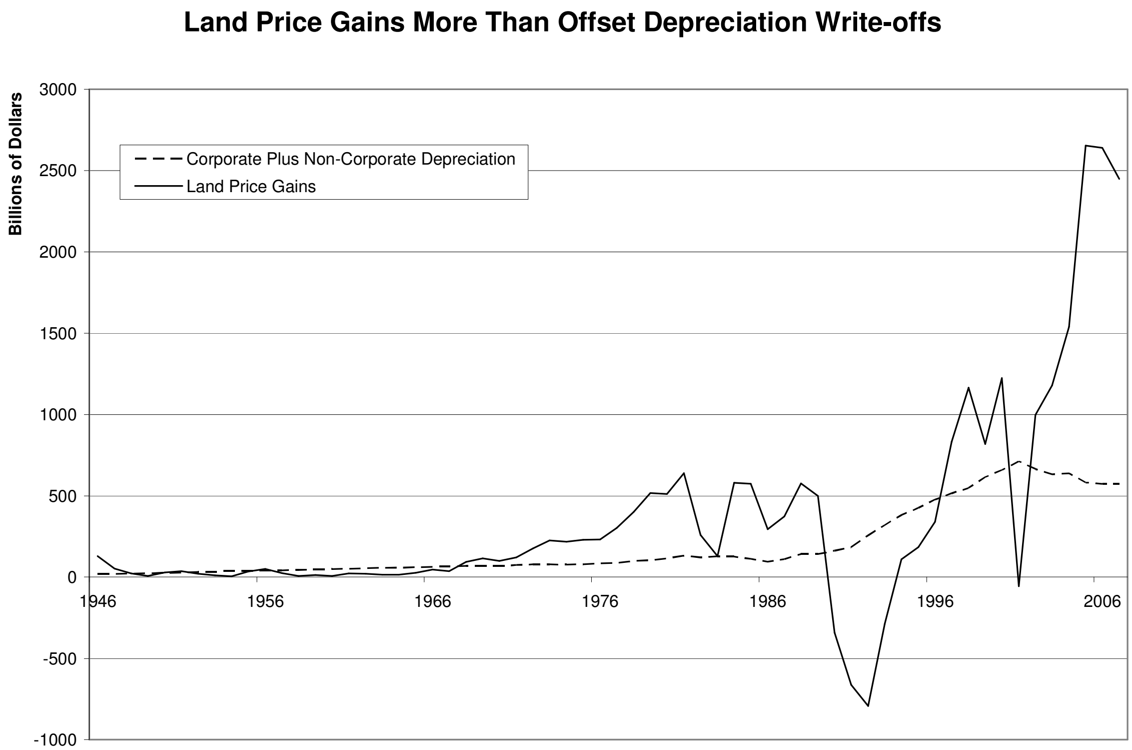
[6] The Wall Street analyst Terence McCarthy observed that Marx's analysis of the Economic Theory of Depreciation was so complete that, "if *Capital* has been called the bible of the working class, the *History* [he is referring to *Theories of Surplus Value*] might well be called the bible of the Society of Cost Accountants. … Over the whole society, failure to provide adequate depreciation reserves is, Marx implies, to negate economic progress and to begin consumption of that portion of the value of the product which Marx believes belongs neither to the laborers in industry, nor to their employers, but to the economy itself, as something which must be 'restored' to it if the economic process is to continue." Marx, *A History of Economic Doctrines* (New York 1952:xv). This was the first English language translation of Marx's *Theories of Surplus Value.*

The fact that most buildings are kept in good repair has led many countries not to permit landlords to depreciate them. It would be logical for landlords to depreciate their buildings only if they "bled" them by letting them run down. This would violate many commercial leases and is even against the law in many cities for residential buildings. But that has not prevented lobbyists in the United States from turning the depreciation allowance into a stratagem to shelter rental income from taxation. *Instead of depreciating in the way that industrial capital does, real estate accrues capital gains* as land prices tend to rise far in excess of the rate at which buildings "wear out." Most properties are sold and resold, wish new landlords able to start depreciating buildings anew with each sale – at the higher sales price.

Chart 7: land-price gains compared to depreciation write-offs



Land is not depreciable. Being supplied by nature, it has no cost of production. It is not used up in the process of yielding a revenue, nor does it become technologically obsolete. Yet most property assessors pro-rate each sales price so that the value of buildings appears to rise proportionally to the overall gain. After buildings have been depreciated once, they can be resold and depreciation write-offs can start all over again, without limit, at so high a rate as to offset a large portion of the new landlord's erstwhile taxable income.

This poses a logical problem: How can buildings gain in assessed valuation if they are supposed to be depreciating? Indeed, how can the economy's most sustained capital gain – that of real estate – reasonably be depicted as operating at a loss for years on end?

The explanation is to be found in the ability of lobbyists to find lawmakers willing to distort the tax code's "small print" in a way that makes owning real estate much like owning an oil well in the heady days of the oil-depletion allowance. No profit appears in this "Hollywood accounting." From the 1954 tax act through its sequels in 1972, 1979 and the Economic Recovery Tax Act of 1981, the depreciation treatment became increasingly generous to real estate investors. The 1981 tax code assumed a short 15-year lifetime for buildings – and let property owners write off the assessed value of their buildings at *twice* this rate by using a convoluted "double declining balance" method. Owners could deduct twice the permitted 1/15th of the purchase price of a building in the first year (that is, 14 percent as a "non-cash" expense), as if it would last just 7½ years. The accounting schedule stretched out the remaining depreciation period by one year in each successive year – to 16 years in year two, 17 years in year three, and so forth. This meant that in the second year the owner could write off twice 1/16th (or another 12½ percent) on the remaining balance, and recover 55 percent of the building's valuation in just five years.

The 1986 tax reform stretched out the depreciation rate on residential buildings to 27½ years (and nonresidential buildings to 31½ years), but grandfathered in new buildings if they had obtained a certificate of occupancy for rental. The resulting depreciation write-offs for the real estate sector as a whole were large enough to leave no net taxable income to declare during the 1989-92 downturn. This pretense enabled investors to keep on earning rental income free of taxation, as if nothing "really" was being earned. Economic fiction became a fiscal reality, even to the point of being confirmed by seemingly empirical national accounting data.[7]

When one finds a statistical distortion at work, a special interest is almost sure to be involved. Misrepresentation and a false empiricism becomes a highly professionalized part of the economics of deception. The result is junk statistics. Unlike investment in machinery, property tends to rise in price, thanks to the land's rising site value. The deception that buildings are depreciating results in a fictitiously high ratio of ostensible building valuation to land. Precisely because the land site ostensibly cannot be depreciated, the tax privilege of depreciating buildings provides a motive for maximizing their valuation.

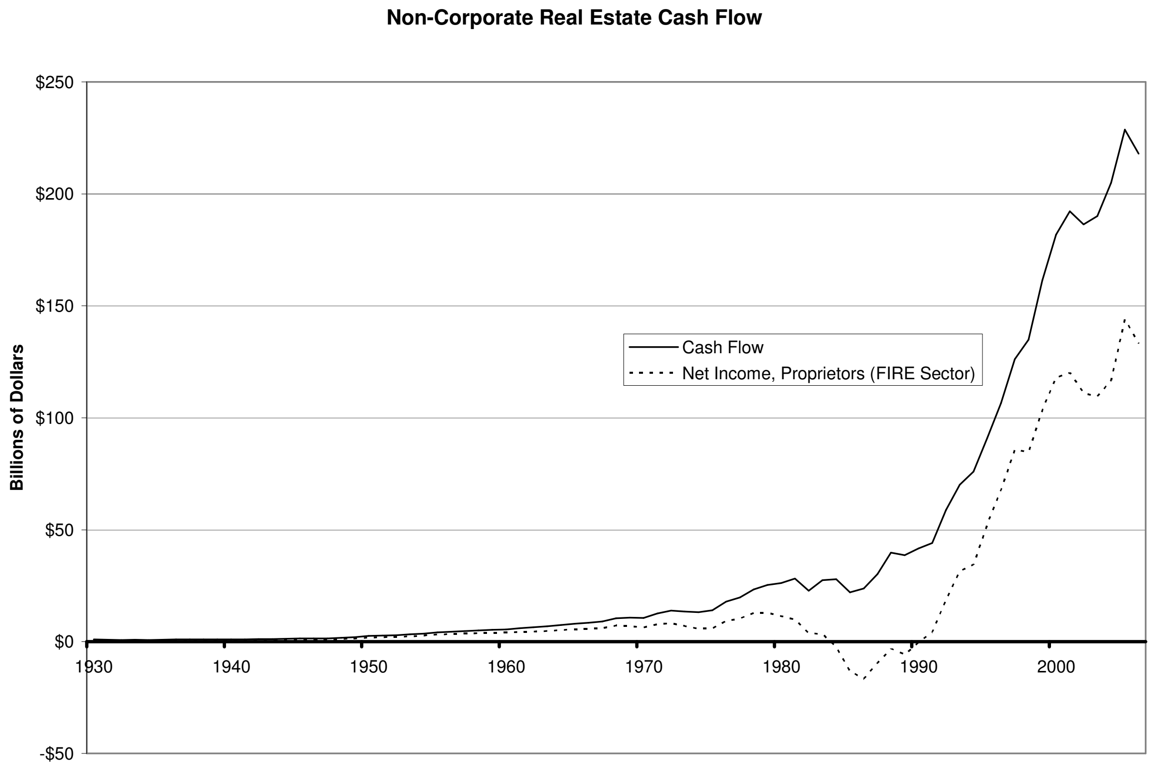
[7] This phenomenon has far-reaching implications for the so-called declining rate of profit. Marx attributed this to the rising organic composition of capital – and hence, an increasing rate of capital consumption (depreciation) relative to profit. However, his point of reference was industrial capital, not real estate. The latter's dominant economic role requires that it be segregated from the industrial economy's statistics. Otherwise, the rate of return on capital investment would be considerably understated.

Despite the reported net $5.1 billion pretax loss, $5.9 billion after-tax loss and $1.2 billion negative cash flow in 1990, real estate corporations paid $3.9 billion in dividends and were the largest source of interest for banks, maintaining the almost steady rise during the postwar period. Yet the NIPA show it often not to be earning any income and paying almost no income tax.

The effect is to encourage commercial property to change owners every few years, keeping it in perpetual motion to minimize its tax liability. Owners typically sell property when a building has been largely depreciated, and the new landlord can start depreciating it anew. In this way a building that already has been depreciated by its former owner achieves a new life. Like cats, a building seemingly has nine lives and can be written off again and again, turning real estate and its depreciation allowance into the economy's largest tax shelter. This explains why a sector that seems chronically to be losing money enjoys soaring investment and dividend payouts. While real estate investors pretend that their property is losing value as their buildings wear out, the site's locational value rises to more than compensate. Replacement-cost accounting likewise assumes a higher value for buildings, and hence a higher write-off each time a new buyer plays the game.

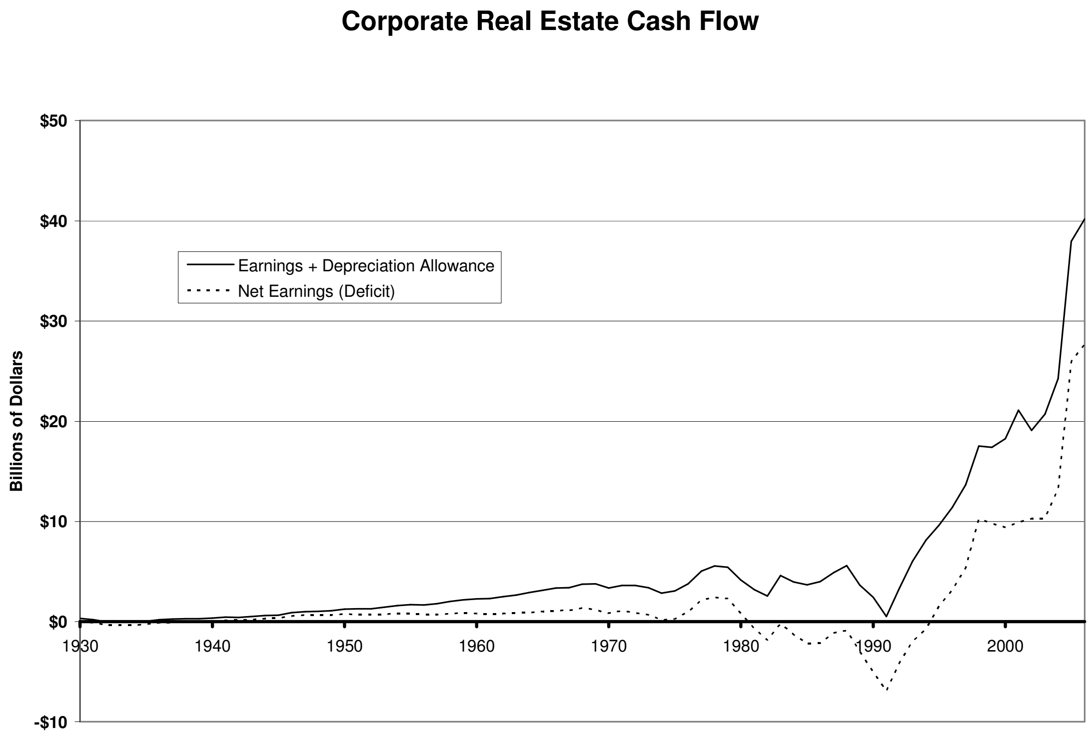
From 1981 through 1995 real estate investment trusts (REITs) and other corporate real estate the depreciation write-off was so large as to produce fictitious accounting losses for tax purposes, despite their rising cash flow and dividend payouts. By buying real estate, investors acquired so large a tax deduction that they often have been able to use it as a charge against other sources of income.

Chart 8: Non-Corporate Real Estate Cash Flow



Most commercial investment is organized as partnerships to obtain the financial benefits of incorporation while taking "book losses" as credits against the personal income of property investors. Like corporate real estate, these partnerships enjoyed freedom from income taxation during the second half of the 1980s, although the explosive take-off in rents rendered more income taxable over the two decades stretching from the mid-1980s through 2005 (Chart 8). Property prices soared as buyers earned income in excess of carrying charges and come out with a capital gain – and a tax write-off to boot.

Chart 9: Corporate Real Estate Cash Flow



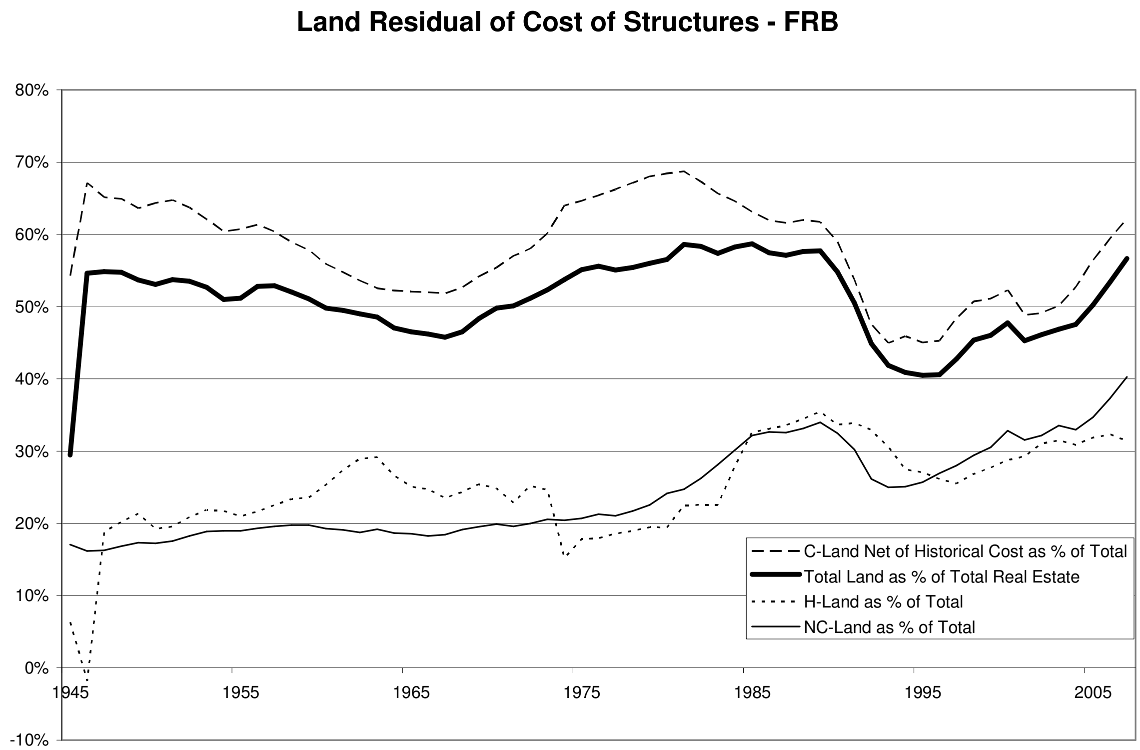
Homeowners are not able to make this depreciation pretense, only absentee owners. But even without being able to take a depreciation write-off against their wages and salaries, they have ridden the wave of asset-price inflation to build up their net worth. Applauded as ushering in an era of postindustrial prosperity, tax-subsidized debt pyramiding became a new mode of wealth creation – a seemingly permanent capital-gains economy.

How the Fed's appraisal philosophy attributes land values to buildings

Assessors in most U.S. cities estimate land at 40 to 60 percent of real estate value, tending toward the higher ratio. Federal Reserve statistics also show that land represents the largest element of real estate's market price, despite the fact that their methodology substantially undervalues land relative to buildings. Fed statisticians treat land as a residual left over after valuing buildings at their reproduction cost, including capital gains that reflecting rising construction costs.

The problem with this land-residual methodology is that it leaves an unrealistically low residual for land – so low that earlier Federal Reserve estimates produced a negative $4 billion number for corporately owned land in 1994. (The Fed has since reorganized its categories to moderate this irrationally low calculation, but continues to defend its methodology.)

Chart 10: Land residual cost of structures. (Source: FRB, Flow of Funds)



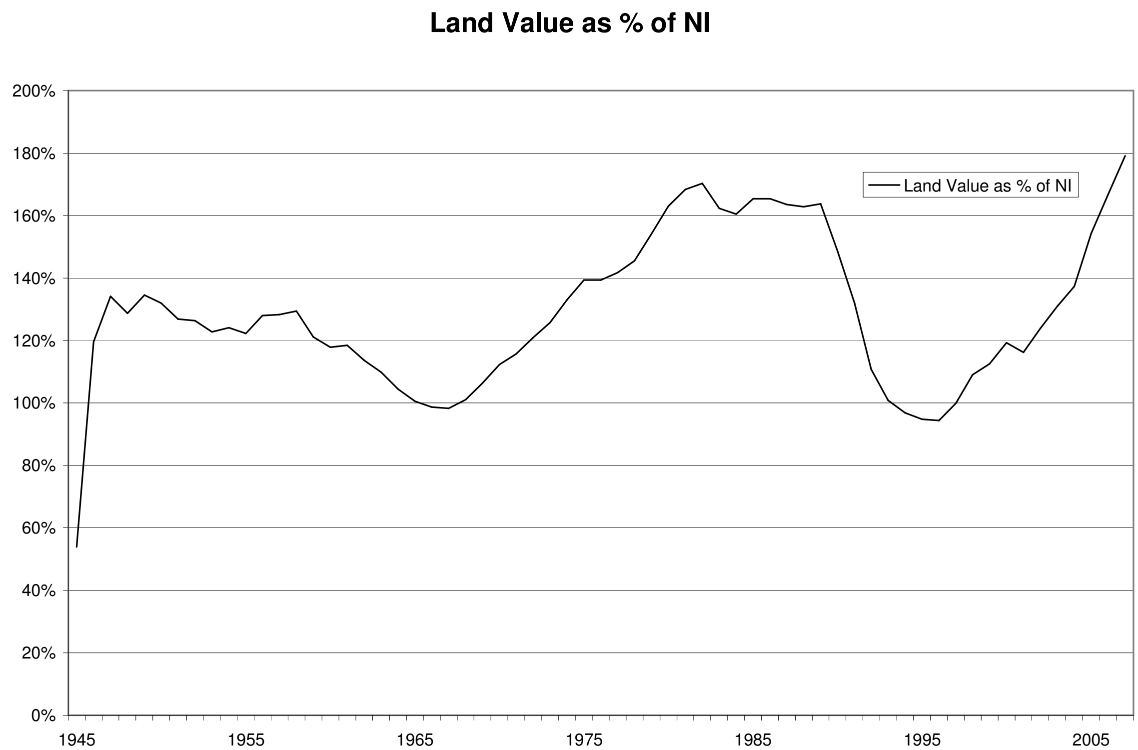
C: Corporate sector; H = Household Sector; NC = Non-corp.

Treating land sites as a residual (after over-estimating the value of buildings at replacement cost) makes land prices appear more volatile than overall real estate. The seeming fallback after 1990 in the land's residual value as a proportion of national income (Chart 13) is largely a statistical illusion as the pace of construction-price inflation increased the Federal Reserve's calculation for the replacement cost of buildings, leaving less residual for land, where the real market value lies. The steep rise in land valuation from 1995 to 2007 reflects the reduction of interest rates engineered by the Federal Reserve flooding the economy with liquidity to promote "wealth creation."

The inflation of land prices has been the driving force in real estate's dominant role in the U.S. economy. The Fed helped inflate real estate prices by lowering interest rates (enabling bankers to capitalize rental income at a higher multiple) and flooding the banking system with enough credit to enable prospective buyers to bid up prices. Fed Chairman Greenspan lauded the "wealth effect" for raising consumption levels on the way up, especially as homeowners took out home equity loans to sustain their living standards, while refraining from regulating lending to keep it honest.

It should be clear from the foregoing analysis that real estate is doing much better than appears at first statistical glance. Buildings are not really deteriorating, thanks to their ongoing repair and maintenance. Although the NIPA depict real estate as operating at a loss, investors actually are getting rich through asset-price inflation creating capital gains.

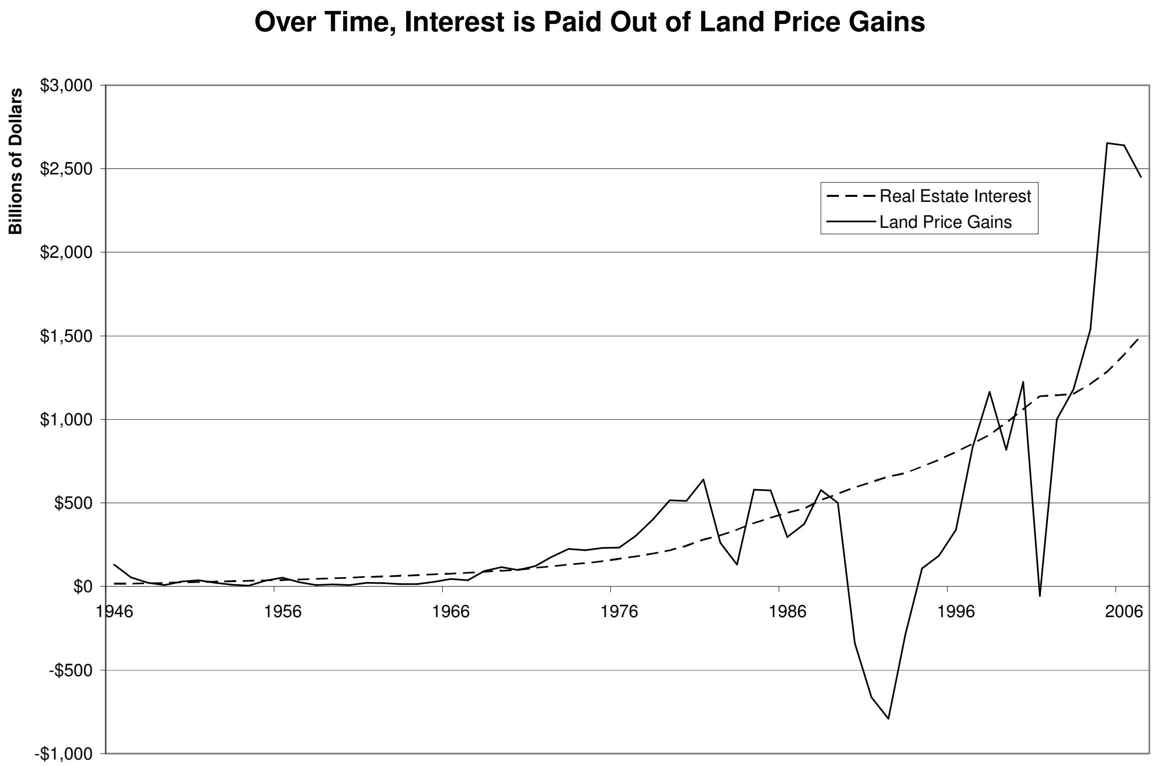
Chart 11: Land-Residual Valuation, as Percentage of National Income



So this poses an important policy question: Is it socially useful to increase real estate prices by providing tax breaks for running up mortgage debt and for absentee building owners? This might be argued if the reason why property owners are going deeper and deeper into debt is that rising construction costs increase the cost of buildings and other capital improvements. But if higher prices (and hence, larger mortgage loans necessary to buy real estate) simply reflect higher prices for land sites that have no cost of production, then to actively support property prices merely makes new buyers pay more – and specifically, pay more debt service to mortgage bankers. Higher land prices simply increase the cost of providing homes, office buildings and industrial plant. Taxing the land's rising rental value would not reduce its supply (nor would taxing the rising reproduction cost of buildings already in place lead to their removal from the market) but taxing the construction of new buildings would do so.

The more real estate growth consists of investing in capital improvements, the more it can be argued that rising property prices elicit more investment in the form of construction activity. But this argument cannot be made if what is being bid up is simply the land's access price. Higher site prices do not induce more land to be supplied, because it is provided freely by nature. The only way to increase site values is to provide more transportation access. It has long been argued that the public sector should recover the cost of this infrastructure by taxing the increase in rental and site values along the route.

Chart 12: Land-price gains compared to mortgage interest.



Tax favoritism for capital gains

When owners sell their real estate, they are supposed to report the recovery of past depreciation write-offs as a capital gain – the sales price minus the depreciated book value. But capital gains are taxed at a much lower rate than "earned" income – if at all! The tax code permits investors to avoid paying a tax at the point of sale if they build up of wealth by reinvesting their sales proceeds to buy new property of equal or greater cost.

The hypocrisy behind this tax logic is revealed by the Federal Reserve's own statistical treatment that estimates building values as rising. Using a construction price index that assigns an annual cost increase to buildings, the Fed subtracts their hypothetical replacement cost from its overall property valuation based on Census Department figures. The residual is assigned to the land. The faster building costs rise, the slower land sites seem to appreciate – sometimes not much at all. Missing the logic that guides Bubble Economy investors and homeowners, the NIPA do not take account of soaring land prices or other asset-price gains. Like the tax filings on which they are based, these national accounts look much more pessimistic than how investors view matters. They report merely that real estate often goes many years on end without earning an income.

Investors are just as happy to see these gains left out of the public accounts, because there is less pressure to tax them, in contrast to the late 19th century when the classical reformers focused attention on them. The less political pressure is brought to bear to tax or even take note of capital gains, the larger loans borrowers will take on, making mortgage lenders the ultimate beneficiaries of the fiscal giveaway.

Owners argue that they deserve to have their investment "keep up with inflation" – the rising cost of a new building to replace the one they are selling (after having sheltered its income by depreciating it). The Fed's logic serves to justify this claim – and hence, the land-price gains that John Stuart Mill described as a passive, unearned increment that should be taxed away. But if the driving forces behind rising real estate prices are credit, public transport spending and other infrastructure – and the overall level of prosperity – why are landlords allowed to write off their cost as if their investment is being eaten away?

No other part of the economy is inflation-indexed. Wage earners do not receive higher paychecks to reflect inflation. Landlords can avoid paying an income tax on their cash flow while industrial companies and their employees are obliged to save out of the income left *after* paying taxes. Real estate investors thus are given a tax break based on a concept of economic fairness that they alone are permitted to enjoy in claiming merely to be "breaking even" with inflation as construction costs rise – while at the same time pretending that depreciation is consuming their capital. This helps explain why most people no longer try to save by putting earnings in the bank.

Chart 13: Comparison of capital-gains tax rate with normal income-tax rates, 1913-present

	Maximum Capital Gains Tax Rate (%)		Top Marginal Income Tax Rate	
	Individuals	Corporations	Individuals	Corporations
1942-43	25%	25%	88%	40%
1944-45	25	25	94	40
1946-50	25	25	91	38
1951	25	25	87.2	50.8
1952-53	26	26	88	52
1954	26	26	87	52
1955-63	25	25	87	52
1964	25	25	77	50
1965-67	25	25	70	48
1968-69	25	27.5	70	48
1970	29.5	28	70	48
1971	32.5	30	70	48
1972-78 (Oct)	35	30	70	48
1978 (Nov)-June '81	28	28	70	46
June '81-86	20	28	50	46
1987	28	34	38.5	40
1988-89	33	34	33	34
1990-92	28	34	31	34
1993-95	28	35	39.6	35

Source: Joint Committee on Taxation (1995), "Tax Treatment of Capital Gains and Losses," JCS-4-95, February 13, 1995, and Office of the Secretary of the Treasury, Office of Tax Analysis (1985), "Report to Congress on the Capital Gains Tax Reductions of 1978."

Most families – and businesses – now seek to build up their net worth mainly via capital gains, buying homes and other assets whose price is expected to rise. Subsequent personal saving takes the form of paying down debts taken on to buy property.

Paying out real estate rental income as interest

Reflecting real estate's status is the U.S. economy's largest asset, by far the most interest is paid on mortgage debt (Charts 14, 15 and 16). Rising property prices oblige new buyers turn over most of its rental cash flow or value to mortgage lenders. As long as the Bubble Economy creates land-price ("capital") gains by enough to cover the interest payments, real estate owners are willing to pay out current income as debt service. But this arrangement cannot last, because adding the interest onto the debt balance year after year entails more and more charges.

As interest rates rose after 1945 to their high of about 15% in 1980, the volume of interest payments increased from just 1 percent of national income to 12 percent in the mid-1980s. As mortgage interest rates receded, the ratio of interest payments to national income fell below 8 percent in 2001, but then resumed its upward trend as new debt markets were developed, headed by subprime lending and the derivatives trade. Falling interest rates since 2000 offset the rising debt burden as the Federal Reserve flooded the U.S. economy with credit, but carrying charges now threaten to skyrocket if interest rates rise back to "normal" levels.

The composition of interest on the economy-wide level has remained basically stable. By far most interest is paid on mortgage debt, whose growth is subsidized by making interest payments tax deductible. The higher the degree of subsidy, the more debt can be afforded. And conversely, ending tax deductibility would reduce the amount of debt that a homebuyer can afford to take on. This would lower the equilibrium price that could be afforded. What seems at first glance to be an economic benefit to homebuyers – making their interest payments tax deductible – thus turns out to be largely illusory. The subsidy ends up being passed on to the banks. *Giving homeowners and property investors a tax subsidy, while maintaining the rule of thumb that mortgage payments should equal 25 percent or some such ratio of personal income, merely replaces the cost of tax payment with an interest payment to bankers*.

Adam Smith suggested as a rule of thumb that interest rates tend to be about half the profit rate. For a commercial or industrial enterprise financed entirely on credit, interest would absorb half the gross profit. But since the 1980s the ratio has risen as debt leveraging has

Chart 14: Interest in the U.S. Economy

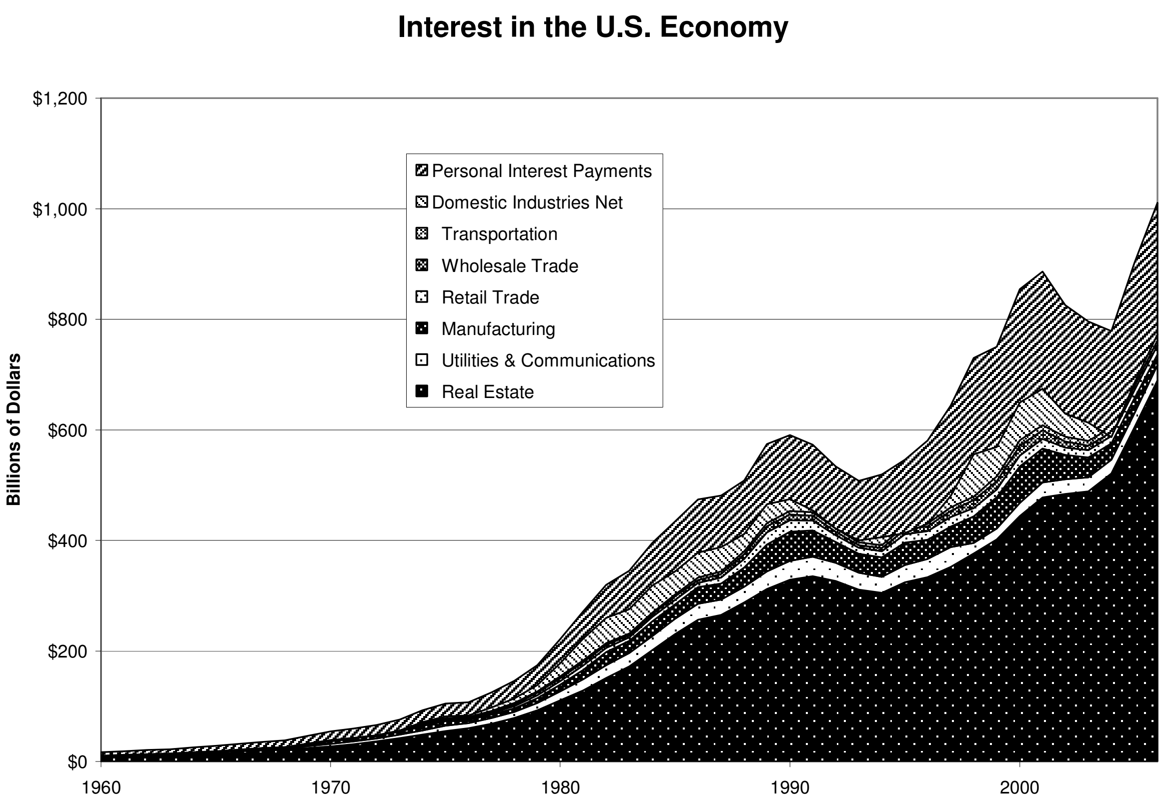


Chart 15: Interest Payments as a Percentage of U.S. National Income

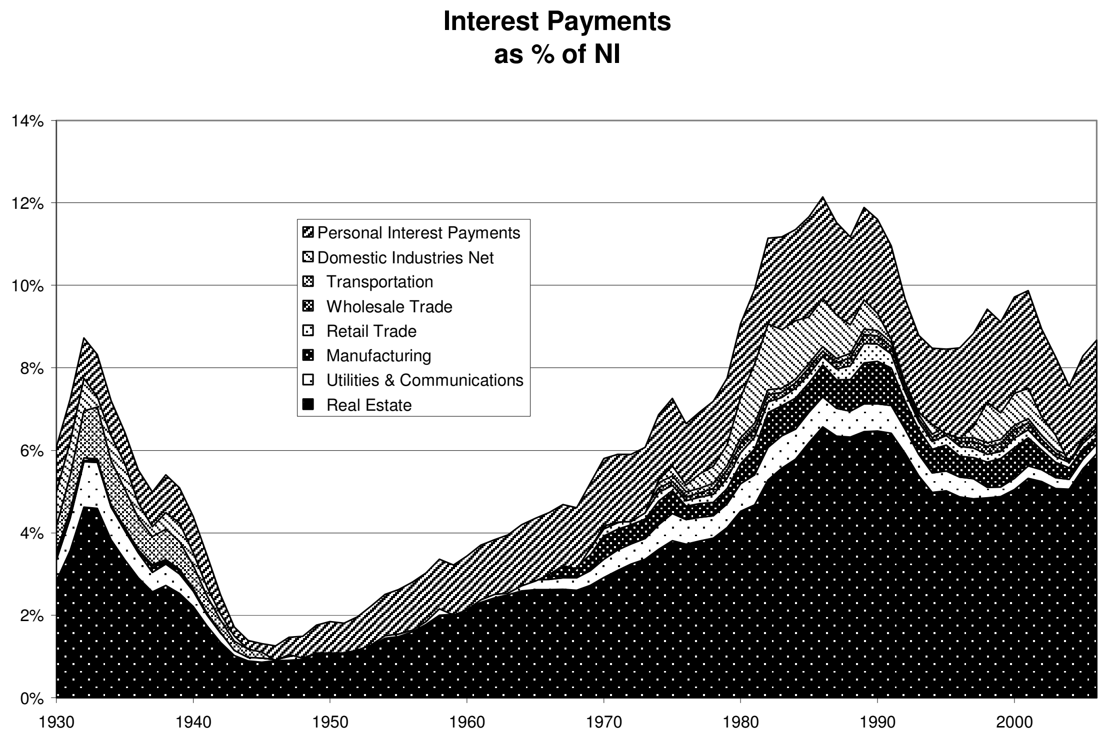
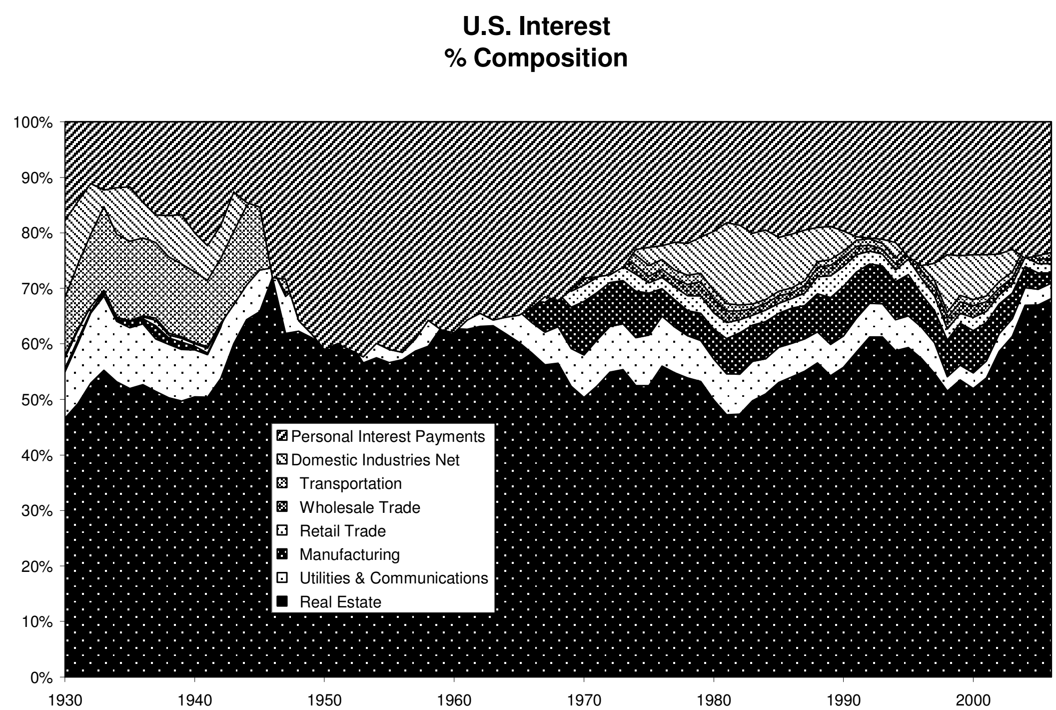


Chart 16: U.S. Interest: Percentage Composition



spread throughout the economy. "Shareholder activists" (the euphemism for corporate raiders) are financializing industry along much the same lines as real estate with its high debt/equity leveraging, turning profits and cash flow into interest via buyouts leveraged with high-interest "junk" bonds.

For commercial investors the choice of whether to buy a rent-yielding property on credit to use one's own money is a business decision shaped by prospects for after-tax returns. Debt financing is not a necessary operating cost but a business choice by investors to buy property with loans instead of using their own money. The government alters the investment equation by making such payments tax-deductible as if they were a necessary cost of doing business. The effect is that interest payments expand to absorb the revenue hitherto paid out as taxes, and the tendency is to absorb whatever is un-taxed. Making interest tax-deductible encourages debt pyramiding. This in turn leads to political pressure for tax cuts when investors suffer the inevitable debt squeeze as the economy shrinks in response to debt deflation.

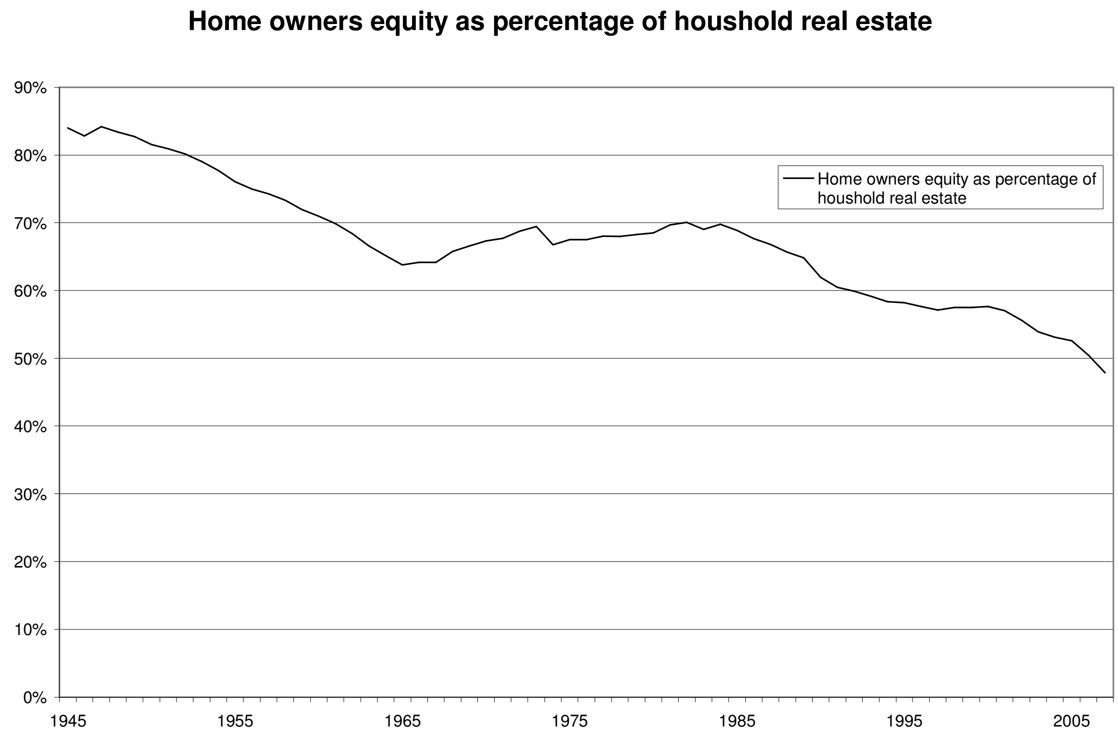
From asset-price inflation to debt peonage

Today, banks and other mortgage holders have become the major parties in U.S. real estate. Overall U.S. homeowners' equity has fallen from 70 to under 50 percent of property values as the United States shifts from an ownership to a debtor economy.

In contrast to industrial capitalism, financialization squeezes out an economic surplus not by employing labor to produce commodities for sale at a markup but by getting labor and industry into debt. It extracts a financial surplus in the form of interest, not profits on production and sales. And finance capitalism uses this surplus to extend yet new interest-bearing loans, not to invest in tangible capital formation. When income is insufficient to pay bondholders, financial managers extract revenue by carving up and selling off assets. Such zero-sum (or even negative-sum) transfer payments do not promote growth but polarize the distribution of wealth in ways that dry up the domestic market for consumer goods and investment goods.

Financialization also acquires wealth from governments by appropriating the public domain or monopoly rights in settlement of debt. In the United States the railroad barons became land barons with a stroke of the privatization pen – along with the emerging mining and timber oligarchy. By this time real estate, mining and forestry were becoming part of the FIRE sector, dominated by finance. In America this meant Wall Street; in England, the City of London.

Chart 17: Homeowners' equity as percentage of household real estate. (Source: FRB)



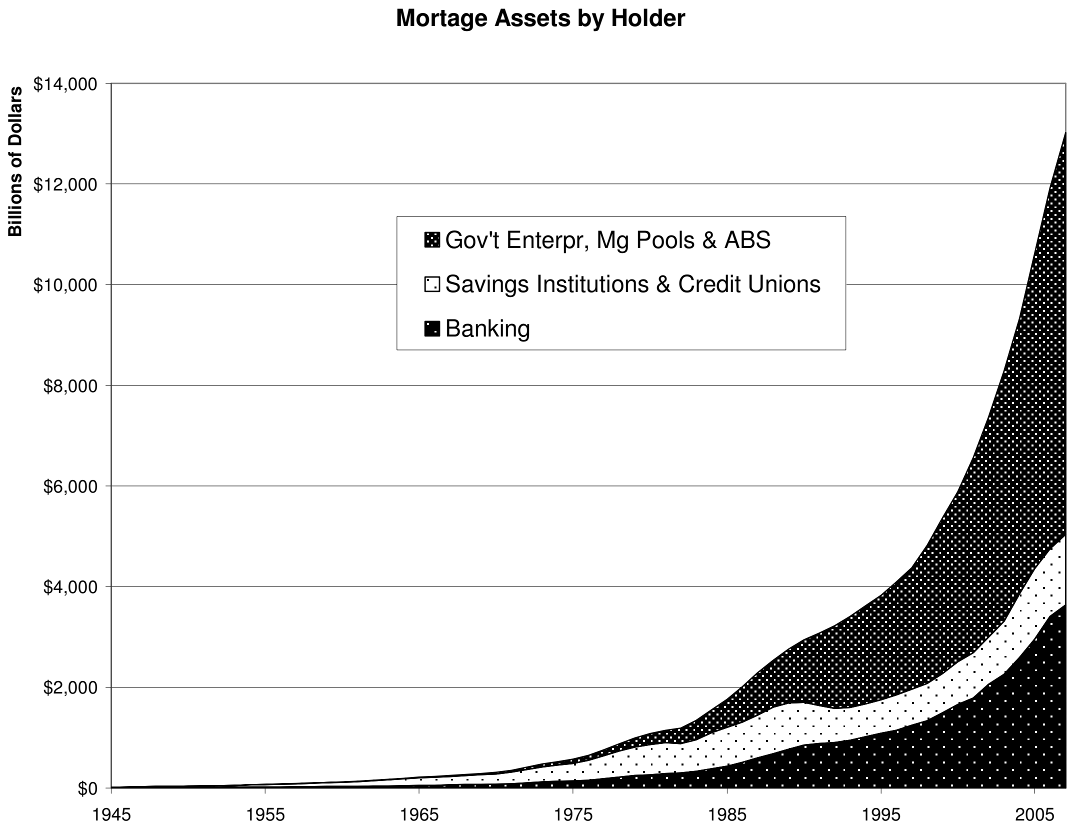
It often is overlooked that inequality of wealth far exceeds that of income. This is because the wealthiest 10 percent of families prefer to take their returns not as income but in the form of the much less highly taxed capital gains. And while the population's bottom 90 percent hope to catch up by going into debt to buy homes and other property, the insatiable growth in debt needed to keep a real estate and finance bubble expanding imposes financial charges that polarize wealth ownership. These debt charges grow so heavy that debtors are able to pay only by borrowing the interest. They do this increasingly by pledging real estate or other assets whose prices are being inflated by a combination of central bank policy and Treasury tax concessions. The problem is that in addition to going further into debt, the policy of un-taxing property and financial wealth forces labor and tangible industrial capital to pick up the fiscal slack.

Governments have become the property bubble's ultimate enablers. Ostensibly created simply to give liquidity to mortgages (which traditionally were held by the banks that originated them), the semi-public Federal Home Administration (FHA), Federal National Mortgage Association (FNMA) and Freddie Mac became the largest buyers, packagers and ultimate guarantors of U.S. mortgages, buying them up as fast as banks and mortgage brokers could issue them – some two-thirds of all U.S. home mortgages. These government-sponsored agencies then sold bonds backed by these mortgage holdings to institutional buyers who trusted that the government would stand behind them regardless of how poor the underlying quality of mortgages were. This was analogous to the Federal S&L Insurance Corp. (FSLIC) bailing out risk-taking institutional depositors in S&Ls two decades earlier, in the 1980s. FNMA and Freddie Mac bonds amounted to $5.3 trillion, as much as the entire publicly held U.S. Government debt.

Accounting fraud by FNMA managers helped create a false sense of confidence by buyers unfamiliar with how crooked the U.S. financial sector was becoming as deregulation let banks run wild. When the collateral value backing their mortgage-backed securities plunged, the FHA, FNMA and Freddie Mac duly reported losses and called for public bailouts – of themselves and their institutional clients, not for defaulting homeowners. But by July 2008 it was reported that under "fair value" accounting rules the mortgages failed to cover obligations by over $5 billion, share prices for the two semi-public agencies had fallen by 90 percent from 2007 to 2008. A *Wall Street Journal* editorial commented that: "The double irony amid the current credit crunch is that our politicians have been promoting Fannie and Freddie as mortgage saviors even as their risk of insolvency has grown. Chuck Schumer, Chris Dodd and many others have encouraged the duo to take on even greater mortgage risk as the housing slump has unfolded. They're the arsonists posing as firemen while putting more dry tinder around the blaze."[8] Rather than letting bad debts go under, Congress set about trying to re-inflate the home mortgage market so as to enable homeowners suffering negative equity to raise the money to pay their debts – debts owed almost entirely to large institutional investors and ultimately to the population's wealthiest 10%.

[8] James Politi and Ben White, "Freddie and Fannie in turmoil," *Financial Times*, July 11, 2008, and "The Price of Fannie Mae," *Wall Street Jo*urnal editorial, July 10, 2008.

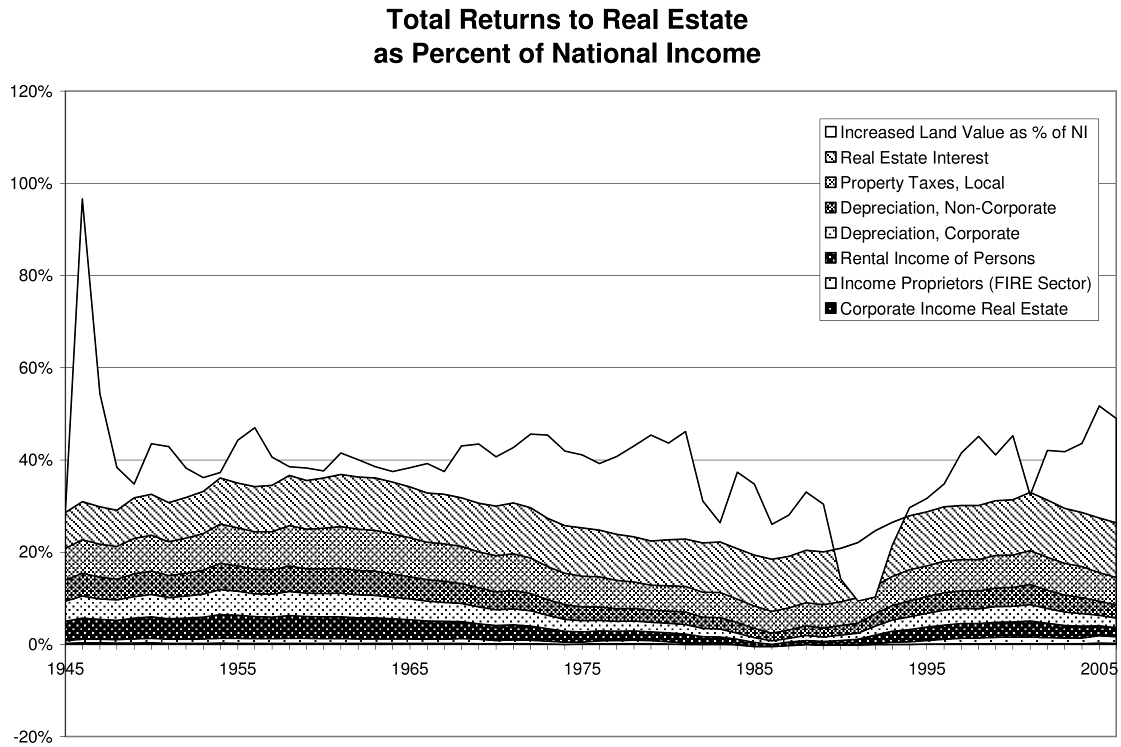
Chart 18: FNMA and Freddie Mac have become the largest Mortgage Holders



Real estate in a debt-leveraged economy

The fact that land-price gains have long overshadowed real estate cash flow (EBITDA) has made property investors willing to pledge their rental income to bankers as interest. Rather than seeking current income (or for homeowners, rental value) the aim is to ride the wave of asset-price inflation. So the fact that overall real estate net cash flow (EBITDA) is about a third of national income, this was by no means the whole story. In terms of total returns – cash flow plus asset-price gains – real estate generated an amount that rose as high as half of reported U.S. national income in 2005. That year's $2.5 trillion in higher land prices amounted to about 20 percent of reported national income, while real estate cash flow (EBITDA) added even more ($3 trillion). And this still leaves another trillion dollars or so for the Fed's calculation of capital gains for buildings' "replacement cost" which actually should be treated as site value.

Chart 19: Adding land-price gains to National Income provides a measure of Total Return



Conclusion: The larger the tax giveaway, the more the mortgage debt grows

Tax favoritism for real estate, corporate raiders and ultimately for their creditors has freed income to be pledged to carry more debt. Mortgage lenders consider that a "virtuous circle" is created when the right to deduct interest paid on debt leveraging "frees" income to be pledged for larger bank loans. But this credit has been used to fuel asset-price inflation, raising the entry price of home ownership and the cost of buying corporate stocks and bonds to yield a retirement income. But it does not increase production and output. Families get off the rent treadmill only to get onto the debt treadmill. Rental income hitherto paid as taxes is now paid as interest on credit extended to new buyers, while taxes on consumer income and sales also rise.

The idea is that shifting taxes off property and finance promotes a "free market." What it actually does is favor the debt-leveraged buying and selling of real estate, stocks and bonds, distorting markets in ways that de-industrialize the economy.

This is the tragedy of our financial system today. Credit creation, saving and investment are not being mobilized to increase new direct investment or raise living standards, but to bid up prices for real estate and other assets already in place, and for financial securities (stocks and bonds) already issued. The effect is to load down the economy with debt without putting in place the means to pay it off, except by further and even more rapid asset-price inflation – and sale or forfeiture of property from debtors to creditors.

This kind of economic distortion is largely the result of relinquishing planning and the structuring of markets to large banks and other financial institutions. In the name of "free markets" the economics profession has celebrated the shift of planning and tax policy to the financial sector, whose lobbyists have rewritten the tax code and sponsored deregulation of the checks and balances put in place in the Progressive Era a century ago.

At that time it seemed that banking and finance would be industrialized, while landed wealth and monopolies would become more socialized and their "free lunch" (economic rent) fully taxed. Rather than real estate prices rising as we are seeing today, this "free lunch" (what John Stuart Mill called the "unearned increment") would provide the basic source of public finance, including the financing of public infrastructure.

The classical policy of basing tax policy on the land's rising rental value was intended to have two positive effects. First, it would free labor and industry from the tax burden as this was shifted back onto property. Second, paying this rental value to the government would make it unavailable to pledge to mortgage lenders as interest and capitalized into larger bank loans to bid up real estate prices. This would prevent rent-extraction from becoming the objective of new credit, absorbed as interest by the banks.

But the vested interests have fought back. Financial lobbyists have extracted fiscal favors for real estate and pressed for deregulation of monopolies as the major source of interest and collateral for bank loans and bonds. The largest gains of all are made by privatizing enterprises from the public domain, most notably in the post-Soviet kleptocracies but also from debt-strapped Western governments.

This is a travesty of the "free markets" that lobbyists for the banks and the wealthy in general claim to advocate. If the revenue currently used for interest and depreciation were paid property taxes, this would free an equivalent sum from having to be raised in the form of income and sales taxes. This was the classical idea of free markets.

Financial and real estate lobbyists encourage the popular misconception that higher property taxes squeeze homeowners and wage earners. The reality is that taxing the land's rental value would reduce interest charges by an amount equal to the tax. Real estate prices would become more affordable as the interest now paid to banks to support a high debt overhead would go to lowering the income- and sales-tax burden. This would reduce the cost of production and living proportionally, by about 16 percent of national income.

Prices and rents for housing and office space are set by the market place. Interest and taxes are paid out of this rental value. This means that homeowners and renters would pay the same amount as they now do, but the public sector would recapture the expense of building transportation and other basic infrastructure out of the higher rental value this spending creates. The tax system would be based on user fees for property, falling on owners in a way that collects the rising value of their property resulting from the rent of location, enhanced by public transportation and other infrastructure, and from the general level of prosperity, for which landlords are not responsible but merely are the passive beneficiaries under current practice.

In sum, fiscal policy would aim at recapturing the land's site value created by public infrastructure spending, schooling and the general level of prosperity. The economy's debt pyramid would be much lower as savings take the form of equity investment once again, rather than a minority position in a debt pyramiding operation. Slower growth of debt, housing and office prices, and lower taxes on income and sales would make the economy more competitive internationally.

But as matters stand, a Bubble Economy weakens the national fiscal position as well as burdening industry and the nation's competitive position. International equilibrium can be maintained only if all other economies are financialized in a symmetrical fashion – a proliferation of the debt burden that in fact has become a distinguishing characteristic of today's globalization.