

**NORTHWOOD UNIVERSITY WHITE PAPER ON
U.S. FINANCIAL CRISIS, FALL 2008**

American History, Capitalism and the Crisis on Wall Street

By Dr. Timothy G. Nash and Dr. Debasish Chakraborty

I. Overview

Almost 232 years ago, on December 23, 1776, American statesman Thomas Paine's American Crisis Volume I was published. The work opens with his now famous words, "These are the times that try men's souls. The summer soldier and the sunshine patriot will, in this crisis, shrink from the service of their country, but he that stands now, deserves the love and thanks of man and woman." Also during this time, Paine authored a series of pamphlets entitled, Common Sense, through which the American colonists and the Continental Army could in clear and thoughtful terms understand the issues and difficulties facing a new nation just into revolution. Perhaps our current crisis on Wall Street (and the impending financial meltdown some have predicted) is not yet "trying our souls" but certainly it is a time that calls for "common sense" and for clear and thoughtful reasoning, justification, statesmanship and a long-term solution.

One simply needs to watch the Sunday news shows on television or read a wide range of internet, newspaper or magazine articles to find that there is no "common sense" agreed to explanation for the root cause of the "crisis" burdening Wall Street. There are numerous alleged unfounded 'causes' including the many explanations that point to the failure of capitalism or even more disturbing pronouncements that capitalism has simply run its course in economic history. To this we stand as a clear and dissenting voice in opposition to this uninformed and misguided logic.

Capitalism is not nor has it ever been positioned to be a perfect economic system. It is simply the best that humankind has been able to devise to date. According to Nobel Laureate Friedrich von Hayek, "I very seriously believe that capitalism is not only a better form of organizing human activity

than any deliberate design, any attempt to organize it to satisfy particular preferences, to aim at what people regard as beautiful or pleasant order, but it is also the indispensable condition for just keeping that population alive which exists already in the world. I regard the preservation of what is known as the capitalist system, of the system of free markets and the private ownership of the means of production, as an essential condition of the very survival of mankind." Capitalism (1776 AD to date) is an ethical economic system based on private ownership of and responsibility for the means of production with the allocation of goods, services, and assets taking place through a voluntary, free market pricing system. Capitalism as an economic system has been responsible for the greatest leap forward in global human progress in the history of the world. Capitalism has also been the "intellectual godfather" of the decline of Communism in Eastern Europe and China and has guided the United States from infancy to an economic position that has been the envy of the world.

What is often lacking in students of history, and in many of those trying to frame the debate over today's financial crisis, is the knowledge that government, well-intended as it usually is, has often been the source of economic instability and hardship in American history. Also absent is the knowledge that markets are efficient and self-correcting when left alone.

The purpose of this paper is to provide: a) a brief history of government intervention in the U.S. economy as well as the negative economic impact said intervention often creates and prolongs within a capitalist system, b) support for capitalism and the market economy, c) specific issues that need to be addressed and debated during these trying times and d) a list of problems that must be solved if America is to remain the beacon of economic and political freedom around the world.

II. United States Economic History and Government Intervention

A. The American Revolution

The Continental Congress of the United States decided to develop a currency to foster economic stability and to more effectively attain needed supplies to feed and pay the troops who were to fight the British if war broke out and the American Revolution began. Students learn in basic economics that there are three ways to finance government; taxation, borrowing and/or inflation (excess printing of money). Inflation, which often creates distrust and chaos between consumers and producers, is not well understood in terms of root cause. From 1776 to 1781, the Continental Congress decided it would greatly reduce the tie of the Continental currency, the 'Greenback' (paper dollar), to gold and silver so as to allow for more printing of Greenbacks to fund the war effort. The belief was that the purchasing power of the currency would stay constant and the war effort could be more effectively funded through additional printing. Just the opposite was true. In an article in The Canadian Journal of Economics and Political Science (November 1952), it was noted that the inflation rate for the 'Greenback' went from roughly 6 percent before the American Revolution to roughly 2,000% in 1781. The currency became nearly worthless and officials began to barter commodities and trade gold and silver to attain the supplies necessary to fight the war. Farmers and merchants often refused to accept the almost valueless "greenback" as legal tender often leaving the Continental Army in a deficient position. It was largely the result of a complex barter system, a partial shoring up of the currency with gold and silver to combat the hyperinflation, a war tax, and the bravery and heroism of the Continental Army that turned the tide and allowed for colonial victory in 1783.

B. The Great Depression 1929-1941

Many people today accept the view that it was the failure of capitalism that caused The Great Depression. As a result, they cling to the unsubstantiated myth that government intervention lightened the consequences of and eventually ended The Great Depression. Nothing could be further from the truth.

A series of misdirected government policies caused and then lengthened the U.S. Great Depression. In his book, America's Great Depression, Murray Rothbard notes the Federal Reserve increased the money supply by more than 60% from mid-1921 to mid-1929, driving up the stock market and fueling the "Roaring Twenties". In the book, A Monetary History of the United States: 1867-1960, Nobel Laureate Milton Friedman and his co-author, Anna Schwartz, proved conclusively that the money supply then contracted by 33% from mid-1929 to early 1933. The inflationary bubble and deflationary bust were clearly the result of erratic and wrong-headed government monetary policy which caused malinvestment, wide-scale bankruptcy and unemployment. By 1933, the Dow Jones Industrial Average had lost 90% of its 1929 value, and the U.S. unemployment rate stood at nearly 25%. Lawrence W. Reed, in "The Great Myths of The Great Depression", notes irrational monetary policy was exacerbated by the Smoot-Hawley Tariff of 1930, which almost closed the U.S. borders to foreign goods and ignited a vicious international trade war. Reed notes tariffs went from 20 to 34% on agricultural products, 36 to 47% on wines and spirits, and from 50 to 60% on woolen products. Foreign nations reciprocated with trade barriers on U.S. exports compounding the error of high U.S. tariffs and deflationary monetary policy. Next, the U.S. Congress passed and President Hoover signed into law the Revenue Act of 1932. According to Reed, the Revenue Act of 1932 was the largest tax increase in U.S. peace time history to that point. It doubled the income tax with the top tax bracket increasing from 24% to 63%. It should also be noted that tax exemptions were lowered, the earned income tax credit was abolished, corporate and estate taxes were raised, new gift, gasoline, and auto taxes were imposed, and postal rates were sharply increased.

Subsequently, each time market forces tried to bring the economy out of its downturn, additional government policies made it difficult if not impossible for the market to function. President Roosevelt's New Deal, much of which would be declared unconstitutional by the U.S. Supreme Court,

added costly regulations that handcuffed business. The Wagner Act (1935) created an extremely difficult labor environment for business by 1938. In a 1939 American Institute of Public Opinion's national poll, almost 70% of Americans surveyed said the Roosevelt administration's attitude toward business was delaying the recovery. The Great Depression did not end until the U.S. entered World War II.

C. Tax Cuts and Budget Deficits

It is often argued that tax cuts on individuals and/or corporations lead to budget deficits. According to the National Center for Policy Analysis, the Joint Economic Committee of the Congress of the United States, and a study published in the July 1986 edition of The Journal of Business and Economic Statistics, this was not true at least relative to the Kennedy and Reagan tax cuts. In both cases, while tax cuts resulted in higher tax revenue to the federal government, larger increases in government spending resulted in increased deficits. Tax revenue grew by 56 percent from 1981 to 1989 (despite a severe recession in 1982), while government spending increased by 69 percent during the same time frame.

In an April 1996 Joint Economic Committee of the Congress (JEC) of the United States report, Christopher Frenze, Chief Economist and the Vice Chairman of the JEC, notes high marginal tax rates discourage work, saving, and investment, while promoting tax avoidance and evasion. A reduction in high marginal tax rates will boost long term economic growth, and reduce the attractiveness of tax shelters and other forms of tax avoidance. The report also noted that economic benefits of the Reagan tax cuts were summarized by President Clinton's Council of Economic Advisers in 1994: "It is undeniable that the sharp reduction in taxes in the early 1980s was a strong impetus to economic growth."

From 1994 to 1996 the JEC provided information about the impact of the tax cuts of the 1980s.

The JEC has published IRS data on federal tax payments of the top 1 percent, top 5 percent, top 10 percent, and other taxpayers. This data shows after the high marginal tax rates of 1981 were cut, tax payments and the share of the tax burden borne by the top 1 percent climbed sharply. For example, in 1981 the top 1 percent paid 17.6 percent of all personal income taxes, but by 1988 their share had jumped to 27.5 percent, a 10 percentage point increase.

The 1996 report also points out the share of the income tax burden borne by the top 10 percent of taxpayers increased from 48.0 percent in 1981 to 57.2 percent in 1988. Meanwhile, the report shows the share of income taxes paid by the bottom 50 percent of taxpayers dropped from 7.5 percent in 1981 to 5.7 percent in 1988.

Frenze's report concludes the Reagan tax cuts, like similar measures enacted in the 1920s and 1960s, show reducing excessive tax rates stimulates growth, reduces tax avoidance, and can increase the amount and share of tax payments generated by the rich. High top tax rates can induce counterproductive behavior and reduced revenues, variables usually missed or understated in many government reports depicting static revenue flows.

III. Recent Problems on Wall Street and the Role of Government

Recent problems on Wall Street have reignited the debate over the role of government in the U.S. economy. A dispassionate analysis of the issues points to a complex situation meriting serious reflection and reliance on sound economics and statesmanship... not populist partisanship.

The first issue deserving critical analysis is the extent of the severity of this problem. Should we take "experts" at their words, most of whom have been consistently wrong? It was just a few months ago when many on Wall Street and in Washington assured us that the fundamentals of the economy and our financial markets were strong and there was no need to worry. Is it possible they are wrong

again and are seriously overestimating or underestimating the extent of this problem? If they are, then this rescue package is either unnecessary or inadequate. If they are wrong, they will come back with more requests or perhaps will have committed almost \$1.8 trillion unnecessarily. The problem on Wall Street is two- fold: there is a problem of solvency and there is a problem of liquidity. The problem of solvency is partly addressed in the bailout, where the government has pledged to use tax payer money to bail out securities that are losing “market” value. Once the bad “assets” are removed from the balance sheets, banks or non-bank financial institutions would become more solvent. That belief is only partially true. It is entirely possible the extent of these bad “assets” are still unknown or unrevealed to date. So it is entirely possible these pledges of the federal government may not “go far enough.” Then will we need a new round of bailouts? That scenario would definitely be worse than no bail out at all. We should not forget that panicked reactions always lead to short run fixes for a problem that is essentially long run in nature. The problem of liquidity is not addressed in this bailout package. When the President of The United States warns of an impending recession or an economic calamity unless Congress passes a massive bailout, people often have asymmetric reactions to such a dire prediction. Investors do not necessarily believe Congress has the right solution for the problem (why should they, when government has allowed this crisis to continue so long), but they seem to believe that a recession is imminent or here. So they do what most rational economic agents would do. They lose confidence in the financial system and they start withdrawing their bank deposits. This is what happened with Washington Mutual Bank, even when it was certain that some version of the bailout package would be passed. This is exactly what could have happened to Wachovia this week if Citibank had not stepped in. So the bailout package has failed to soothe consumer anxiety over the perceived impending failure of the financial system. The call is now for the government to guarantee all financial deposits and transactions even beyond what the FDIC is currently doing. This is a true problem that the bailout package fails to address to date.

The second issue needing serious attention is whether government should be in the business of bailing out or subsidizing any business. Should government feed into this “moral hazard” problem by using tax payer money to bail out businesses that made risky investments? What the government is essentially doing is privatizing corporate profit and socializing corporate losses. Is this a path we want American business and the U.S. government to travel together? We think not. We have to remember that Treasury secretary Paulson is the former CEO of Goldman Sachs. Without implying anything about his motive, it can be safely assumed he is trained to think events on Wall Street shape events on Main Street rather than the other way around. The actual truth may be that the events on Wall Street have a marginal impact on Main Street. What we need is serious thinking on how the fundamentals of the overall American Economy can be strengthened. The last thing we should do to strengthen the fundamentals of the economy is to reward unproductive, inefficient and perhaps criminal behavior on the part of a small number of Wall Street movers and shakers. The moral hazard issue is amplified significantly if we allow backdoor negotiations among the rich and powerful to steer the largest transfer of tax revenue in U.S. history to private coffers with a simultaneous “takeover” of many private businesses by the federal government.

The third issue meriting serious discussion is what happens if the government refuses to bail out Wall Street? What will be the extent of the damage? Will a complete meltdown of the market result or is the market smart enough to factor such losses in its deliberation so that the extent of the loss will be much less than forecasted. The fundamental rationale behind this bailout is that most of these assets the government intends to buy are inherently sound, and if there is an investor who is patient and has the capacity to wait before selling (like the federal government can) it will regain its value. However, that is what the market does best. While the decline of the price of an asset is grave from the perspective of the supplier of those assets, it is actually very good news for the investor who wants to

buy those assets. Thus, bargain hunters often put the market back on track without any government intervention. In fact, if history is any guide, government intervention often extenuates the problem by sending the wrong price signal to the market. In his initial proposal, Secretary Paulson planned to pay more for some assets than the current market value. His argument was the market is currently assessing them lower than it should. How did he decide what the current market value should be? He believes that he knows better. We do not think so. This is reminiscent of the old socialist planning models, where the price signal was always suppressed, because the planners knew better. What a remarkable transformation in our thought process! We are willing to sacrifice the basic tenets of capitalism, the power of the market and replace it with failed socialist style planning? This is profound. We are not talking about regulating the market, we are talking about eliminating the market. The idea behind Secretary Paulson's proposal is to deal with capitalism in an asymmetric way. Let us reap the benefits of the market, but when market calls for painful adjustment we should shun it in favor of central planning. The Federal bailout included BearStern, AIG, Fannie Mae and Freddie Mac, but did not include Lehman Brothers. So the Federal Government is now picking winners and losers. This is industrial policy at its core and also uniquely un-American.

The fourth issue deserving serious analysis is the fallout from this government bailout. When government gets involved, it usually comes with a price tag. The price tag, in this case, will be increased regulation. This bailout will reward inefficient, incompetent, and perhaps a few corrupt corporations, but hamstringing smart, ethical and innovative businesses with overregulation. This will interfere with what famed Harvard economist Joseph Schumpeter called the process of "creative destruction." This process allows inefficient or wrong minded businesses to fail and be replaced by innovative and forward thinking competitors. What is even more disconcerting is the fact that these regulations are designed for twentieth century financial instruments. Today, financial markets are highly integrated internationally

and what a foreign business does is often more impactful to the domestic financial market than that of another domestic firm. How are we supposed to reign in foreign corporations with American regulation? This global market requires regulation much more fluid in nature than currently exists. Our government lacks a fundamental understanding as to what these regulations might and/or should look like. In a rush fueled by political expediency the government will substitute poorly thought out arcane regulation for sound economic thinking, thereby potentially killing future financial innovation? Secretary Paulson recommended Congress increase the debt ceiling to approximately \$11.4 trillion dollars. The U.S. debt to GDP ratio is astronomically high and some might argue unsustainable. This high debt to GDP ratio can have two significant impacts on the US economy. On one hand, it will raise the cost of capital both in the domestic and international markets making productive investment very expensive, thereby reducing it. Simultaneously it will make the dollar strong against other currencies, reducing our exports, increasing our imports and thereby worsening our current account deficit. But that is the good news. The other likely scenario is our creditors decide this debt is unsustainable and refuse to lend us more money. Americans have been living beyond their means for a long time. This will mean that the party is over. The impact on the dollar and whether or not it can continue as the world's major reserve currency will be in doubt. Both are likely scenarios and not confidence enhancing for the U.S.

The fifth and perhaps most important issue is the role of government in the cause or causes of our current problems on Wall Street. We must carefully examine the role of the Clinton and Bush Administration regulatory authorities at all levels throughout our financial system. Were they negligent in their responsibilities? If so, why? Did monetary authorities, largely Mr. Greenspan, over shoot interest rate targets allowing for excessively low interest rates in the recent past triggering the malinvestment we see today? We must investigate charges that the noble intentions of the Community Reinvestment Act led to a reckless surge in mortgage lending pushing much of our financial system to

the brink of chaos. We must investigate the role of Fannie Mae and Freddie Mac in the explosion of the subprime housing market. What was/is the role of government in funding these loans that ordinarily would not have been made based on long-held underwriting standards that historically call for: a) a down payment, b) a ratio of income to purchase price, and c) a payment history indicating credit worthiness? Was this proper public policy? How could subprime lending grow 2,757% from \$34 billion in 1994 to a total of nearly \$1 trillion by 2007 without any major intervention over 14 years and two administrations? What happened to proposed 2005 Senate legislation designed to reform Fannie Mae and Freddie Mac due to concerns voiced three years ago? And finally, is the government mandated “mark to market” method of valuing assets good and proper or is it a contributing factor in the financial crisis? Is “mark to economic value” a more logical methodology?

A sixth issue or concern is the extent to which the prospect of the bailout is interfering with the market adjustments and spreading panic. How many people reacted to President Bush’s speech by selling off their assets, buying gold or T-bills?

IV. Problems that must be solved

What is the proper and prudent response to this financial crisis? History shows new challenges can bring new opportunities if led by statesmen who desire to “fix” the problem for the long-term. This is a pivotal moment for our leaders to reach a national consensus on what the major long term structural problems are within the US economy and what the best solutions are to said problems. Let us suggest the following be addressed:

1. **High budget deficits and an unsustainable national debt.** After the proposed bailout, the United States will be the 13th most indebted country in the world as measured by public debt as a percent of GDP at 82.37% (just behind the country of Sri Lanka) with China ranked

102nd at 18.4%. In 2008 the U.S. budget deficit is projected to be \$500 billion which is larger than the entire GDP of the 20th largest economy in the world (Sweden). In 2008, interest on the U.S. National Debt will surpass \$230 billion which is slightly smaller than the total GDP of Ireland. The United States is the world's largest debtor nation with more than \$12.2 trillion in external debt as of the end of 2007.

2. **High corporate tax rate which makes business investment expensive in the U.S.** The United States currently has the second highest corporate tax rate in the industrialized world at 39.3%, trailing only Japan at 39.5%. In fact, nine members of the Organization of Economic Cooperation and Development (OECD) dropped their corporate tax rates last year to attract more investments (including Canada, Germany, and the UK). Sweden just recently announced its intention to reduce its top corporate tax rate from 28% down to 26.3% to attract additional investment, as well.
3. **Lack of a comprehensive energy policy.** See Dow CEO Andrew Liveris' recent speech to the members and guests of the Detroit Economic Club.
http://news.dow.com/dow_news/speeches/9-22-08_DEC_Final.pdf
4. **Two expensive wars we are unable or unwilling to finance using our own tax revenue**
5. **The belief high income earners can and somehow should pay an even higher percentage of federal individual income taxes than current law mandates.** In 2006, the top 1% of all income earners paid 39.89% of all federal income taxes, the top 5% of all income earners paid 60.14% of all federal income taxes, the top 25% of all income earners paid 86.27% of all federal income taxes, while the bottom 50% of all income earners paid 2.99% of all federal income taxes in 2006.

6. **The counterproductive idea we can balance the budget by taxing more and spending more.** The U.S. must come to a consensus. We need to adopt sensible fiscal policy to address the issue of deficit spending and its impact on the economy.

V. **Conclusion**

If we take a sensible approach to solve the economic problems facing the U.S., we will increase confidence in our economy and Wall Street will respond favorably. In the meantime, we favor an approach to this crisis forcing the market to adjust on its own. However, it is highly unlikely members of Congress will opt for such a solution and therefore they will likely choose from the options currently being debated. If a “bailout” occurs, the government would be smart to establish an insurance plan troubled financial institutions must purchase if they are to expect the government to acquire their questionable assets. We would also suggest private individuals and institutions be allowed to purchase ownership in said fund of weighted “depressed assets” as a mechanism to measure market confidence in the management and future of these investments. This would inject some much needed capital into the market without exposing tax payers to excessive bad debt risk.

Let us hope future generations will say with pride that in the fall of 2008 America took a principled and common sense stand averting a crisis and placing itself once again on the path to prosperity. It is our intention that this paper play a role in the debate.

About the Authors

Dr. Timothy G. Nash is Vice President of Graduate and Specialty Programs at Northwood University and Associate Professor of Business and Economics at the Richard DeVos Graduate School of Management. Dr. Debasish Chakraborty is a Professor of Economics at Central Michigan University.