August 17, 2011

"Systemic Poverty as a Cause of Recessions"

Robert Ashford

"Systemic Poverty as a Cause of Recessions"

Professor Robert Ashford
Syracuse University College of Law
Syracuse, New York 13244
(315) 677-4680
rhashford@aol.com

Abstract

This article argues that the failure to address and ameliorate systemic poverty is a major cause of recessions. Recessions occur (and sub-optimal employment and growth persist) when a critical mass of market participants come to believe that the distribution of future earning capacity is not sufficient to purchase what can be produced despite the physical and technological capacity to employ available labor and capital to produce more over the same period even at lower unit cost. The essence of systemic poverty is widespread inadequate earning capacity. In recessionary periods, with rising unemployment, the problem of inadequate earning capacity (which perennially plagues poor people even in good economic times) rises up through the middle class like rising flood waters. The mainstream approach to end recessions and to ameliorate poverty is to promote (1) capital acquisition mostly with the earnings of capital and primarily for well-capitalized people largely in proportion to their existing wealth and (2) primarily jobs and welfare for the rest of the population. This article argues that, poverty can be systemically reduced and recessions avoided if the same government-aided system of corporate finance that facilitates capital acquisition with the earnings of capital primarily in proportion to existing wealth is opened competitively to all people.

* * * * *

Analyses of the causes of the current economic crisis and the ways to achieve a sustainable economic recovery generally proceed on the widely-shared but tacit assumption that there is no substantial, first-order connection between recessions and the failure to address the problem of systemic poverty. Otherwise, the analysis of the causes of recessions, remedial policies, and the need to address the market processes that perpetuate systemic poverty would commonly be addressed in the same discussions; and they are not. This widely-shared tacit assumption is false. The longstanding failure to address the market processes that perpetuate systemic poverty *is* a fundamental cause of the current economic crisis.

Recessions occur (and sub-optimal employment and growth persist) when a critical mass of market participants come to believe that the distribution of future earning capacity is not sufficient to purchase what can be produced despite the physical and technological capacity to employ available labor and capital to produce more over the same period even at lower unit cost. Over the last half century, in the USA, both (1) the lay-offs, down-sizings, business failures, bursting of the dot.com and real-estate bubbles, stock-market plunge, and credit freeze that have occurred, and also (2) the government bail-outs, loans, guarantees, tax cuts, and spending, and the Federal Reserve monetization undertaken to prevent economic collapse and promote economic recovery can all be understood as forward looking responses to the widely perceived prospect of inadequate earning capacity of consumers and producers to purchase what can physically be produced and to repay existent and anticipated debt obligations – in short, the sustained prospect of inadequate earning capacity in the context unutilized productive capacity. Over the same time period, the market short-fall in the earning capacity of America's consumers has increasingly been financed with welfare distribution and consumer debt – practices that enable people to buy what they cannot earn to afford.

The essence of systemic poverty is widespread inadequate earning capacity. In recessionary periods, with rising unemployment, the problem of inadequate earning capacity (which perennially plagues poor people even in good economic times) rises up through the middle class like rising flood waters. Thus, rather than view Wall Street as too big to fail, it is more accurate to recognize that the responsibility to enhance the earning capacity of poor and middle class people is too big to ignore and must be made our highest economic priority

The idea that profitable mass production requires the earning capacity to support mass consumption is not new. Nor is the idea that profit incentives to employ labor and capital today require a bankable expectation of consumer demand tomorrow. Likewise, a reasonable expectation of sustainable economic recovery and growth today requires a reasonable expectation of increasing earning capacity tomorrow. However, the mainstream strategy for promoting economic recovery is a composite left- and right-wing mix of government policies that promote (1) capital acquisition with the earnings of capital (and also considerable government redistribution) primarily for major corporations and well-capitalized persons (generally in proportion to their existing wealth), and (2) primarily jobs (but by no means the best or highest paying jobs) and various forms of welfare redistribution for poor and middle class people.

Policies that promote jobs, including programs that provide people with the education, skills, and ancillary support to secure and maintain them, are certainly needed, as are various forms of welfare. But such policies at best address only the short and intermediate needs of poor and middle class people. They fail to provide them with the long-term market participation essential for the widespread, growing earning capacity necessary for sustainable economic growth.

The missing element in the mainstream strategies for enhancing the earning capacity of poor and middle class people is the recognition of the need to democratize "the right to acquire capital with the earnings of capital."[1] This right is not a "welfare right" (i.e., it is not a right to

---

[1] Although virtually never mentioned by law, economics, or business texts and articles, or by mainstream media, whether this right would remain privatized (as in Western-style economies) or outlawed (as in communist economies) was also a major issue (and certainly the major issue never specifically identified) at the root of the Cold War struggle of capitalism against communism that dominated much of the Twentieth Century. For a discussion of the relationship among, capitalism, freedom and the right to acquire capital with the earnings of capital see Robert Ashford, "Milton Friedman's Capitalism and Freedom: A Binary Economic Critique," 44 *Journal of Economic Issues* 533 (2010).

receive what others have produced). Rather it is a "contract right" (or a "market right") -- a right to participate in market transactions with other willing market participants. More specifically, it is the right of competitive access to the government-supported market processes whereby capital is acquired with the earnings of capital. It requires opening to poor and middle class people the same government supported institutions of corporate finance, banking, private insurance, government loans, guaranties, and reinsurance and favorable tax and monetary policy that are presently relied upon by the Federal Government to stimulate the economy and to facilitate capital acquisition with the earnings of capital primarily for well-capitalized people roughly in proportion to their existing wealth.

Although in theory, all people in a market economy have the right to acquire capital with the earnings of capital, the major determinant of the ability of individuals to acquire capital with the earnings of capital is the existing distribution of capital ownership. The practical inability of the existing market structures to distribute capital acquisition and earnings sufficient to support sustainable recovery and growth can be understood by considering America's three thousand largest credit-worthy companies. The financial capitalization of these companies comprises over 99% of America's equity market.[2] At diminishing unit costs, most of these companies can profitably produce much more of the goods and services that people would purchase if they had the earning capacity to do so; and if they could do so, the market value of the shares of these companies would increase.

Presently, almost all capital acquired by these corporations is acquired with the earnings of capital (not with the earnings of labor), and much of it is acquired with borrowed money.[3] (The primary purpose of corporate finance is to enable corporations to acquire capital assets *before* they have earned the money to pay for them and simultaneously to enable existing share owners to acquire capital with the earnings of capital.) At the same time, the ownership of this corporate wealth is highly concentrated: Approximately 1% of the people own 50% of the wealth and 10% own 90% of the wealth, leaving 90% owning little or none.[4] Thus, capital earns at a rate reflective of its long-term (suppressed) earning capacity as it earns primarily for a small minority of the population.

---

[2] http://www.russell.com/Indexes/data/US_Equity/Russell_US_equity_indexes.asp

[3] During the fifteen year period from 1989 through 2003, in the case of major American companies, the sources of funds for capital acquisition, in approximate terms, reveal that annually retained earnings accounted for at least 70% and more usually 80% of the capital acquisition. Borrowing accounted for almost all of the rest. Sale of stock as a source of funds capital acquisition never exceeded 5% and was negative in most years. See Richard A. Brealey & Stewart C. Myers, Franklin Allen *Principles of Corporate Finance* Chapter 14, pp 561-563 3rd edition, 2004).

[4] Edward N. Wolff, *Top Heavy: A Study of Increasing Inequality in America* (New York, Twentieth Century Fund, 1995) and Edward N. Wolff, "How the Pie is Sliced: America's Growing Concentration of Wealth," *The American Prospect*, No. 22, (Summer 1995), pp. 58-64. These statistics include the all the holdings in pension, stock ownership and profit sharing plans.

Because present demand for the employment of capital and labor is dependent on demand for consumer goods in a future period, a voluntary pattern of steadily broadening capital acquisition promises more production-based consumer demand in future years and therefore more demand for a fuller employment of labor and capital in earlier years. Thus, if the techniques of corporate finance (presently used to for the benefit corporations and their existing share owners to acquire capital with the earnings of capital) were opened competitively to all people then, the present demand for capital investment and employment would increase in anticipation of the broadening distribution of capital income to poor and working people with unsatisfied consumer needs and wants. Accordingly, a broader distribution of capital acquisition and income strengthens the promise of capital to pay for itself with its future earnings, makes profitable the employment of more capital and labor, and enhances the prospects of sustainable economic recovery and enhanced growth. It will also therefore increase the market value of well run corporations and their shareholders within the growing economy.

Underlying the analysis of this deeper cause of the economic meltdown, recessions generally, and chronic sub-optimal growth is the principle that a concentrated pattern of capital acquisition with the earnings of capital stifles growth and a broader pattern of capital acquisition with the earnings of capital promotes growth. Stated in other words, a broader distribution of capital acquisition with the earnings of capital will provide the greater incentives to profitably employ existing unutilized productive capacity and employ additional capacity than a narrower distribution of capital acquisition with the earnings of capital.

This principle (which is known as "the principle of binary growth") is a fact proposition. Factually, it is true, false, or indeterminate. Whether it is "good" or "bad" for capital to be more broadly acquired with the earnings of capital is a normative issue quite distinct from the factual issue raised by the proposition. For example, one might be a King Henry VIII desiring to own everything and have as his only regret the sadness that his subjects do not worship him the way ancient Egyptians worshiped the Pharaohs, and nevertheless begrudgingly admit that the broader distribution capital acquisition with the earnings of capital will promote growth by providing incentives to profitably employ existing unused capacity and invest in more capacity. However, if a present-day King Henry did understand this principle, he might do everything in his power to prevent and discourage it from being taught in universities, published in law, economics, and business journals, and acknowledged on television and radio programs and other electronic or print media.

A detailed description of the modest market reforms necessary to open to poor and middle class people the market processes whereby capital can be acquired with the earnings of capital is beyond the scope of this brief article, but can be found in other writings.[5] The system

---

5 Robert Ashford, "Broadening the Right to Acquire Capital with the Earnings of Capital: The Missing Link to Sustainable Economic Recovery and Growth," *39 Forum for Social Economics*. 89 (2010); *Binary Economics: the New Paradigm,* (1999) with Rodney Shakespeare (University Press of America); "Louis Kelso's Binary Economy," Volume 25 *Journal of Socio-Economics* 1 (1996) (available on westlaw.com in its jjsocecon data base); "The Binary Economics of Louis Kelso: A Democratic Private Property System for Growth and Justice," Chapter 6 in *Curing World Poverty: The New Role of Property,* (1994), John H. Miller, C.S.C., S.T.D., editor; "The Binary Economics of Louis Kelso: The Promise of Universal Capitalism,"

of ownership-broadening finance thereby authorized would be entirely voluntary as to market participants and would require no taxation, confiscation, redistribution, credit rationing, or government control of lending or investment decisions. The pattern and distribution of capital acquisition remains in private hands, but is more open as a practical matter to all people precisely because the profit incentives for voluntary exchange are greater as the pattern of capital acquisition broadens.

By opening to poor and middle class people the same government supported institutions of corporate finance, banking, private insurance, government loans, guaranties, and reinsurance and favorable tax and monetary policy (presently relied upon by the Federal Government to stimulate the economy and to facilitate capital acquisition with the earnings of capital for people primarily in portion to their existing wealth), poor and middle class people will also be able enhance their earning capacity by acquiring capital with the earnings of capital. A fairer and more competitive market foundation for the systemic reduction of poverty will thereby be established; and greatly enhanced prospects for greater and more broadly distributed economic opportunity, earning capacity, and sustainable growth can be reasonably expected and realized by all.

---

22 *Rutgers Law Journal* 3 (1990). These are based on the work of Louis Kelso, whose writings can be found at http://www.kelsoinstitute.org.