Saving the U.S. economy with “trickle-up” economics

By Rinaldo S. Brutoco, Founder and President, World Business Academy

STATUS: The federal TARP program and related bailout plans did not solve any underlying fundamental weakness in the economy. All they arguably did was buy us time, band-aid the bleeding if you will, so that we can rapidly address what is really wrong. Wrapping new layers of debt at the Federal level as additional leverage on the existing levels of private and public debt will only cause the economy greater permanent damage if we don’t use the time we bought to change the fundamentals, which created the meltdown in the first place.

The bad news: The economy as we have known it since World War II is so fundamentally broken that it cannot be fixed by fine tuning it in its present form no matter how much intervention the government engages in. The good news: Once we develop a dramatically different approach to the economy, what we are calling “trickle-up” economics, we will create a level of wealth in the U.S. (and ultimately abroad) that will be at least 10 times greater than the level of economic wealth created since World War II under the old economic system.

THE FIX: An economic recovery will require the country to recognize that the financial crisis cannot be solved without changing the underlying culture of debt and replacing “trickle-down” economics with “trickle-up economics.” We need, among other things, to immediately fund infrastructure repair projects on a massive ($50-100 billion/year) annual basis to create good paying jobs in the respective trades; radically slow down the rate of home foreclosures; freeze the Adjustable Rate Mortgage resets; freeze all interest rate increases on variable home owner equity lines of credit; and help average American workers attain affordable comprehensive health care and an affordable college education for their children as well as secure retirements through an intact and adequately funded Social Security system.

The following is a punch list of steps necessary for economic recovery.

1. Create the modern day equivalent of the Depression-era Home Owners Loan Corporation (HOLC), which bought up and renegotiated troubled mortgages and closed shop less than 20 years later after making a small profit for taxpayers. When the HOLC is re-authorized, it should have one of its former principal duties, providing free credit counseling to home borrowers. It should also have the power to negotiate on behalf of a mortgage holder who is otherwise unable to represent itself in such negotiations, such as when the mortgage has been chopped up and syndicated into a thousand pieces and no one entity, including the servicing agent, has the authority to speak for the mortgage holder. For a host of reasons, it would be wise to put the great bulk of the $700 billion in funds recently authorized by Congress into this modern day

1 Freezing Adjustable Rate Mortgage resets is less critical now than when we first published this commentary on October 10, 2008 because interest rates have fallen to historical lows. If rates rise, this step will again become critical.
Regrettably, since the time we first made this recommendation, Congress has not created a HOLC and required it to hold TARP funds, nor has the Treasury adequately administered the first $350 billion of TARP funds released. As a result, those funds have done little to arrest the dramatic downward spiral in the home mortgage market. We strongly recommend that when the remaining TARP funds are released, a significant portion be placed in a newly created HOLC.

See footnote 1. If the beginning of economic recovery is accompanied by a jump in interest rates, an interest rate freeze will be necessary to avoid a rising tide of mortgage defaults that could strangle the nascent recovery.

Congress should hold hearings to evaluate last year’s amendments to the Bankruptcy Code that make it more difficult for consumers to use bankruptcy to discharge credit card debt. The passage of time since the financial crisis began has underscored the importance of this recommendation. Defaults on consumer debt are rising faster each month partly because of the inflexibility of the Bankruptcy Code. Consumers need a judicial forum in which to lawfully re-structure their debt and get back on their financial feet, and the country needs a mechanism to deal with the coming avalanche of default on credit card debt.

Immediately get control of the unregulated market for Credit Default Swaps (CDS), and prohibit the issuance of any new swaps at least until a new law or SEC rule defines a CDS as a “security” within the meaning of the 1933 and 1934 Securities Acts if any material portion of the underlying insured obligation relates to a U.S.-based company or asset. Similar measures should be considered for derivatives of every sort but on

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a less urgent basis. Without this reform, it would be destabilizing to bail out the financial industry by buying up assets that cannot be sold on the private market because investors would still use swaps to hedge transactions they deemed to be unacceptably risky. If we do not immediately begin to bring the CDS market under control, trillions of dollars more of swaps will be created even as we try to deal with the damage caused by the tens of trillions of dollars in swaps already outstanding. The Depository Trust & Clearing Corporation reported in November that $33.6 trillion in swaps are still outstanding, but as recently as October the market was estimated to be at least $54 trillion.

5. Increase margin requirements for all stock purchases by 5% per month for each of the next five months so margin requirements are at least 25% higher than now, and impose subsequent monthly increases as necessary to reduce market purchases of equities, bonds and commodities on leveraged speculation. At some point, and Congress should immediately hold hearings on this issue, we will have raised margin requirements high enough to damp down speculation while still providing adequate liquidity for non-speculative, forward purchase-oriented transactions. Once we adopt the tax reform discussed in item 11 below, 401(k) plans, IRAs, and other investors will put more of their funds into healthy companies, and less-healthy companies will die off.

6. Re-evaluate short selling rules through Congressional hearings to determine whether short selling plays a necessary role in the markets, and if so, how it should be regulated and whether the “uptick” rule repealed in 2007 should be reinstated. That rule, part of the Securities Exchange Act of 1934, was designed to prevent short sellers from speeding up crisis-induced downward spirals in share prices. The rule prohibited any short sale that was not “higher than the last different price.” In other words, a seller could not short a stock unless the share price first ticked upward by a fraction of a point.

7. Restore a Glass-Steagall–like wall between commercial banking and investment banking. This is even more critical now that there are no pure investment banking houses of significance left on Wall Street. Goldman and Morgan Stanley have decided to enter retail banking, and the other big investment banks have either been acquired (Bear Stearns by Morgan Chase and Merrill by Bank of America) or liquidated (Lehman Brothers).

8. Launch an immediate project, in the $50-100 billion range annually for the next 5 years, to rebuild and expand American infrastructure, including bridges, roads, hospitals, sewers, public buildings, green transit, alternative energy projects, and broadband capacity. While the House version of the pending stimulus bill does a far better job than the Senate version in providing funds for necessary infrastructure improvements, it does not go far enough. We will need major supplemental appropriations for each of the next four years.

9. As fast as possible, zero out the $10 billion/month we spend on the Iraq war. Reduce annual defense spending to $600 billion, saving $100 billion annually, and redirect the savings to a crash green fuels program and other true stimulus projects.

10. Enact a universal health care system that provides affordable care to every American and relieves employers of the inordinate burden of providing such coverage. Employer healthcare costs make U.S. industry less competitive than other western industrialized countries where employers do not have to absorb such costs. This one reform would make U.S. industry immediately more competitive on world markets.

Require pharmaceutical companies that sell drug products in the U.S. to sell patent drugs to government health programs and private outlets at the lowest price they sell the same
product anywhere else in the world. This would leave drug companies with more than adequate profits while drastically reducing the nation’s healthcare bill. (No pharmaceutical company refuses to sell drugs in Europe where prices are up to 40% lower than in the U.S. for the very same brand drug.)

These healthcare proposals are vital to help save homeowners from bankruptcy due to their inability to pay for the skyrocketing costs of medical care and drugs in the absence of full insurance. These proposals will be particularly welcomed by senior citizens who are faced with a disproportionate burden of paying for our broken healthcare system even as their incomes are declining in retirement.

11. We must immediately increase the incentives for companies to pay dividends and reduce the incentives for them to assume excessive debt. Currently, a company’s interest payments on debt are tax-deductible but their dividend payments are not. We should amend the tax code so that a company’s dividend payments receive the same tax treatment as its interest payments on debt. This simple step will raise significant new revenue for the national treasury without increasing any tax rates. Tax rates on individual income, including in the form of dividend payments, are higher than the tax rates on retained corporate profits. A tax amendment that encourages corporations to pay dividends will increase the pool of income subject to the higher tax rate. This amendment to the tax code would also undercut Wall Street’s gambling tendencies, alter management’s quarter-to-quarter mentality, decrease chances for accounting manipulation of financials, and help transform the U.S. economy from a culture of debt to a culture of savings and equity.

This reform would begin to reverse companies’ quarter-to-quarter mentality because they would no longer be judged by a PE (Price Earnings) ratio that can be manipulated, but by a DE (Dividend Earnings) ratio that cannot. No accounting sleight of hand can hide how much a company actually pays out in dividends. This reform would allow the individual investor, 401(k) plan holder, IRA holder, and others to make investment decisions based on companies’ actual dividends and likely future dividends, rather than on some number that is subject to accounting manipulation.

12. To discourage speculative trading, and raise federal revenues, reinstate the federal .25% securities transfer tax like the one in effect in the U.S. from 1914-1966 and still in effect in the UK and other countries. A group of Democrats included such a provision in the “No Bailouts Act” introduced after the House voted down the first bailout plan. They estimated that it would raise $150 billion a year.

13. Ensure the effectiveness of the Congressional Oversight Panel created as part of the TARP program. A strong oversight panel is necessary to protect taxpayers, including by ensuring the fairness of the cost-basis contracts with the financial experts that the Treasury Department will need to manage the program. What must happen next is for the Treasury to write the rules it will play by, have Congress review those rules to ensure they provide for adequate oversight, and then have the rules take the full force of law. Under the leadership of Chair Elizabeth Warren, the Panel has already proven its effectiveness, including with its recent technical analyses of the Treasury’s largest transactions under the program. What we need are actual rules that the oversight committee can insist be followed.

14. Immediately create a bridge-financing fund for state, county, and city government entities to provide temporary relief from shortfalls caused by falling tax revenues as a result of the economic downturn. The entities should be required to guarantee repayment with a priority lien against future tax receipts on some equitable basis. The fund is not in-
tended to encourage governments’ deficit spending but to provide liquidity at a time when banks are unwilling to provide bridge financing. In addition, provide a governmental financing authority for state, county, and city entities until the market for revenue-backed municipal bonds and state financing of revenue-backed infrastructure projects normalizes.\(^4\)

In making the suggestions above, and the many more that are sure to follow as we continue to analyze the current financial crisis, the question that we will most frequently be asked is: “With all the costs of the bailout, won’t it mean the next President will have to reduce domestic spending to pay for everything?”

First, this question assumes that military spending could not be reduced to pay for the entire package and still leave the U.S. military with an extraordinarily high level of funding by historical standards. The American people must realize that even after the minor 10% cut recommended above, military spending would remain dramatically higher than when George W. Bush took office, and that we are so broke we can no longer afford to spend more on military matters than the rest of the world combined. We have been on a permanent wartime funding in this country since World War II and such funding, more than any other single item, has lead us to the brink of financial ruin. Like every other empire that has preceded us, we must understand that the cost of maintaining a global military presence exceeds its value to us and is not making us safer. The time has come for us to take our responsible role as one very powerful nation amongst a family of nations rather than continue to attempt to run the world at the expense of the American taxpayer. We can no longer afford to have hundreds of military bases around the world nor continue to procure weapons at the staggering rate we have for over 60 years. President Eisenhower warned us precisely of this danger in his Farewell Address at the completion of this second term. It is time we took his admonitions to heart.

The second reason why we need not concern ourselves with reducing our domestic spending is because it is precisely that domestic spending that will re-ignite our economy to levels as yet undreamed of. That is why President Roosevelt in similar circumstances created the Works Progress Administration, the Civil Conservation Corps and Social Security itself to name but a few. The only way we can ever pay off the massive federal deficit we have created is by re-creating our economy so that we generate far higher levels of wealth. This can be done by implementing each of the 14 points above. Due to the famous “multiplier effect,” doing so will actually create an economy that is dramatically larger and more efficient than anything most people can even envision.

The current economic crisis is actually a blessing. No amount of tinkering with the existing “trickle-down” approach to the economy could ever create the wealth necessary to re-build U.S. society. Because the culture of speculation has made us near-bankrupt, we have no other choice but to embrace a more sane culture of equity, savings, and liquidity based on the creation of real goods and services. There really is no other choice left to us.

We must remember Winston Churchill’s wartime observation, “The Americans can always be counted upon to do the right thing—after they have exhausted all other alternatives.” The current crisis makes it abundantly clear that we have exhausted all other alternatives. It is now time to embrace some old-fashioned Common Cents.

\(^4\) The conference committee on the stimulus package should keep the $40 billion in state aid that is in the House version, and should include provisions to encourage federal purchases of municipal, county, and state bond indebtedness.