CHAPTER 1

Introduction

THE INVISIBLE HAND OF CONFISCATION

In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value.

The financial policy of the welfare state requires that there be no way for the owners of wealth to protect themselves.

—Alan Greenspan, "Gold and Economic Freedom," *The Objectivist* (1966)

"Why have I lost my money? And who took it?" That's the theme of this book. Millions of once rich and well-off Americans have watched their assets disappear in the Great Recession. These Americans are unemployed, and after years of work many have lost their homes, and their once rock-solid retirement plans are in ruins. Was it based on stupid financial decisions? Probably. Was it based on making financial decisions without a high level of financial literacy? Probably. Was it greed? Probably. Was it based on actions over which they had no control? Probably. Many Americans have become poorer, and the rest are worried.

The "Probablies" are not the only answer to these questions. This book looks at specific political and financial events that put Americans into complex situations where they are required to make decisions that they are unskilled to make. On the surface these financial choices appeared simple. Buy a house. Sign a mortgage. Invest in stocks.

Yet signing a mortgage is a complex decision, and the forces and policies behind the financing are hidden. Oh, and we want to note at the beginning of this book: Stocks don't always go up.

Topics to be covered in this book include:

- What to do about the housing depression.
- Bank credit cards and uneducated borrowers—an interesting combination
- Making choices in fund investments
- Greenspan depression and the coming Recession
- 36 days of infamy in the 2000 Presidential election
- The federal debt bomb
- Collapsing educational systems
- What's going on with unemployment?

But first—Chapter 1 discusses four aspects of today's economy that have led to the financial pickle the United States and you are facing today. It begins with the fourth branch of government.

The Fourth Branch: K Street Government

Remember high school civics class? It was one of those groaning classes where a boring teacher talked about Congress, Justices, the prez, and, oh yeah, the founding of our democracy. Ooops—it's a republic. But what about the opposing groups in that republic? Are they equal to one another? Does one faction oppose and have the ability to override the interests of others?

Going back to the development of the United States and the Federalist Papers, James Madison (1787) wrote about strong groups who promote their interests over the rights of others and the public good. Among those he mentioned were those with resources and those without:

> But the most common and durable source of factions has been the various and unequal distribution of property. Those who hold and those who are without property have ever formed distinct interests in society. Those who are creditors, and those who are debtors, fall under a like discrimination. A landed interest, a manufacturing interest, a mercantile interest, a moneyed interest, with many lesser interests, grow up of necessity

> in civilized nations, and divide them into different classes, actuated by different sentiments and views.
>
> It is in vain to say that enlightened statesmen will be able to adjust these clashing interests, and render them all subservient to the public good. Enlightened statesmen will not always be at the helm.

Today, those factions Madison wrote about are alive and well. They are found largely on K Street in Washington, D.C. K Street consists of lobbying groups, various special interest committees, and their service providers. The sole purpose of these groups is to influence public policy and legislation using huge amounts of money they collect from corporations, foreign governments, and others. They have special access in our federal government, and in some cases, these groups have written legislation that has been introduced in Congress. Banks, investment banks, foreign governments, industry groups, cigarette manufacturers (hey, cigarettes did great for 100 years), even congressmen use these groups to change policies in the United States. Special interests and some in our Congress are paid to support those who pay them the cash.

Where's the Cash?

Randy "Duke" Cunningham, the California Republican congressman resigned on Monday after admitting he took $2.4 million in bribes ("A Culture of Bribery in Congress," *Christian Science Monitor*, December 2, 2005, www.csmonitor.com/2005/1202/p08s01-comv.html).

Former congressman William J. Jefferson was convicted of corruption charges Wednesday in a case made famous by the $90,000 in bribe money stuffed into his freezer (Jerry Markon and Brigid Schulte, "Jefferson Convicted in Bribery Scheme," *Washington Post*, August 6, 2009, www.washingtonpost.com/wp-dyn/content/article/2009/08/05/AR2009080503195.html).

Jack Abramoff, an influential Washington, D.C., lobbyist, was sentenced to a four-year prison term for fraud and corrupting public officials. Swept up in the fraud was Steve Griles, a coal industry lobbyist and deputy secretary at the Department of Interior, for obstruction of justice; 18th District Ohio Congressman Bob Ney, in a trade of political favors for gifts; David Safavian, former chief of staff in the General Services Administration; and

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nine others. In addition, Tom DeLay, although not currently convicted of wrongdoing, had to step down as House Majority Leader and left Congress.

Senator Ted Stevens was accused of taking $250,000 in gifts. The Department of Justice later dropped the case due to technicalities.

Tom DeLay, the former House Majority Leader, resigned his post and at the time of this writing his guilty verdict on money laundering is being appealed. He is accused of laundering $190,000 of corporate money to Texas politicians in 2002 (www.statesman.com).

Charlie Rangel is found guilty of 11 ethical violations by a congressional House ethics committee. The violations include influence peddling, hiding $600,000 in income, misuse of federal funds, inaccurate financial disclosure statements, and soliciting donations for the Rangel Center for Public Policy in a manner that led to questions of influence peddling (http://cbsnews.com and www.house.gov).

If easy mortgage loans support their clients' interest, special interests are pushing that policy into Congress for the "public interest." If these loans go bad, they are there pushing for a bailout, for the "public interest." Either side works.

Do you remember your civics teacher talking about checks and balances in the U.S. government? Well, that's mainly true about the three branches of government, but it is not true about the fourth branch. There are no checks on the power of lobbyists in our country.

Reason number 1 why you lost your money—there is an unauthorized fourth branch of the government. This branch is very organized, and it is stuffed full of money. The money is used to influence government policies, not just government legislation. The objective of that influence is to ensure that policies go into effect that protect certain groups or make them richer. If it's not about money, it's about getting favors.

More Income Tax and More Debt, Too

Let's take a look at that statement. Prior to the income tax, the U.S. government received a large share of its revenues from a tariff tax.

The 16th Amendment made it legal to tax individual income in 1913. Originally, in 1894, the Supreme Court had determined that a 2 percent tax on incomes over $4,000 was unconstitutional, but beginning in 1909 and extending over a four-year period, the states ratified the 16th Amendment to the Constitution. The 16th Amendment allowed the federal government to levy a 1 percent tax against people's income (i.e., those with high income), and there was no need to apportion the collected revenues among the states according to their populations. The idea was that those with large amounts of wealth should support the government. Initially, the tax applied only to 4 percent of the U.S. population. And so it began.

And Collections Gets Bigger

In its first year in operation, income taxes were responsible for raising less than 10 percent of federal revenues. By contrast, the income tax accounted for 45 percent of federal revenues in 1950 and nearly 73 percent in 1985 (Answers.com, www.answers.com/topic/federal-income-tax-of-1913; accessed October 30, 2010).

In 2008, corporate and individual income taxes represent approximately 50 percent of the federal government's revenues (www.taxpolicycenter.org/briefing-book/background/numbers/revenue.cfm; accessed October 30, 2010).

But what really began with an income tax?

The federal government's ability to generate significant revenues is what began in 1913, and with it the idea to spread the wealth of the nation. Remember, the percentage of U.S. citizens paying taxes is no longer 4 percent as when the 16th Amendment was originally passed. Today, more of us are involved in spreading the wealth due to wasteful government programs.

Government spending is unchecked. There appears to be no limit on the level of government spending, and, consequently, tax revenues can't cover the expenditures. So government borrows. Expenditures must be funded with debt. Forty cents of each dollar spent must be borrowed.

I Asked

I once asked a congressman at a public meeting where the money for the 2008 stimulus was going to come from and he laughed off the question and said, "We'll just borrow it." He was reelected in the November 2010 elections.

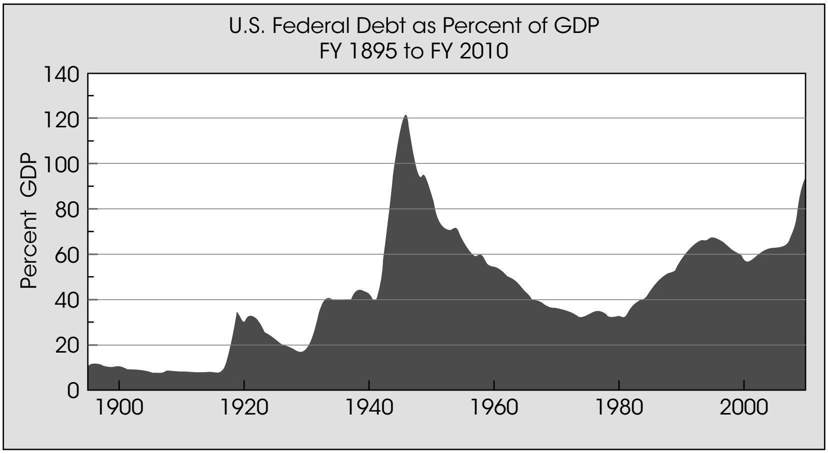

Figure 1.1 The Debt-to-GDP Ratio Chart
Source: usgovernmentspending.com, www.usgovernmentspending.com/federal_debt_chart.html.

When revenues become insufficient for government excessiveness, the government simply borrows based on its ability to generate tax revenues. Everyone knows from their own personal finances that the higher their income, the more they can borrow. As long as the income stream continues, the federal government can borrow. But when our salaries can no longer support our continued borrowing, we have to stop borrowing. The federal government doesn't. If the tax revenues are not enough, the government can simply print money down at the Treasury building.

Figure 1.1 shows the relationship between federal debt and gross domestic product (GDP). This information is the best way to compare net worth and debt for a government. As individuals, we can sign for a first and second mortgage on our homes. Yes, the government does have assets to mortgage, but, politically, the federal government can't mortgage the Washington Monument—at least not yet. But who knows, maybe the Chinese are looking for a good investment. So for a government the debt-to-GDP ratio in Figure 1.1 is the closest comparison to an individual's net worth-to-debt ratio.

Notice the debt can be more than GDP, as it was in 1945 at the end of World War II. Also notice that the percentage relationship was around 15 percent until the passage of the 16th Amendment and the beginning of World War I. As the amount of income taxes collected from U.S. citizens increased to higher and higher dollar amounts, so did the government's debt level. Today, the percentage is approaching 100 percent. Basically, everything the government can hock has been hocked.

As Figure 1.1 is reviewed, several questions can be asked: Did the United States ever have a war before WWI? Oh, yes. "Remember the *Maine*" and the Spanish-American War? Did it raise the debt-to-GDP ratio above 15 percent? No. Even during the Civil War, it was not beyond 32 percent.

Looking at the debt-to-GDP ratio for the following selected time periods, we see how distorted it has become in 2010 (research .stlouisfed.org/fred2/series/GFDEGDQ188S).

During World War I:

Year	Debt-to-GDP
1914	7.98
1915	7.9
1916	7.28
1917	9.58
1918	19.25

During the Great Depression:

Year	Debt-to-GDP
1929	16.34
1930	17.75
1931	21.96
1932	33.2
1933	39.96
1934	40.99
1935	39.16
1936	40.31
1937	39.64

During World War II:

Year	Debt-to-GDP
1941	38.64
1942	44.73
1943	68.83
1944	91.45
1945	116

Past Eight Years:

Year	Debt-to-GDP
2005	62.77
2006	63.49
2007	63.99
2008	69.15
2009	83.29
2010	94.27
2011	95.2
2012	99.0

Looking at these time periods, it can be seen that our current debt-to-GDP ratio is out of whack with the political situation the United States is facing . . . we are not fighting WWII . . . we are just on a debt binge to fund special interests represented by the fourth branch of government. Additionally, the trend of the debt-to-GDP ratio should be seen as alarming.

Reason number 2: You are losing your wealth due to the collection of income taxes by the federal government. It is not because of the dollar totals collected. You are losing your wealth because of the effect those collections have on government's inability to adequately support this level of national debt. Without a stronger revenue base, the government's main choice to support this level of debt is to print money, and that leads to the next topic—the monetization of U.S. debt and increases in the cost of everything.

Monetization of the Debt: Say What?

This is a big monkey. This is the one that will be a killer. To get out from under a pile of debt, the government has to monetize it.

The Merriam-Webster dictionary (www.merriam-webster.com) describes the term *monetize* as the purchasing of public or private debt and thereby free for other uses moneys that would have been devoted to debt service. Well, that's not quite it.

Monetization of the debt occurs when the Federal Reserve buys back outstanding Treasury bonds. The holder of the Treasury bond receives a cash payment from the Fed. Where did the Fed get the money to buy back the bond? It prints money—one dollar after another. Thousands of these transactions occur, and the result is billions or trillions of U.S. dollars in the hands of everyone (especially banks). Although that doesn't sound bad, more money leads to more spending, but the effect can be a disaster.

First, with more money flowing around, everything becomes more expensive as inflation starts to kick in. On top of a surge in inflation, there is a drop in the value of the dollar compared to other currencies because there are just too many dollars floating around the world. The Fed wants this to occur so that the federal government can repay its debt with cheap dollars.

The consequence for U.S. citizens is an inability to buy certain products that are imported into the United States, like cars. Today, it is difficult to find a product that is completely manufactured in the United States. So get ready for a lower standard of living. Another consequence is an increase in interest rates, as the United States has to pay a higher rate on its debt as every creditor knows they are going to be paid back with cheaper dollars. Every borrower gets whacked with higher interest rates.

There are only three ways to pay off the enormous outstanding U.S. federal debt. One way is to default on the debt. Not a likely choice. A second alternative is to increase taxes to a high enough level to pay off the debt. Not possible given the debt burden.

I Asked

In my undergraduate economics course, I asked the professor if the United States could go bankrupt. With confidence, he replied that the United States can't go bankrupt because the government can tax you for everything that you have.

If I had been smarter, I would have asked: "Gee, don't you think someone would object?"

And the third and most viable choice is to inflate your way out of the debt.

The Fed is currently on the road to creating inflation so that debt obligations can be repaid with money that has less value. Possibly good for the government, but bad for us. Those of us who have worked and saved and put money aside for our retirement will find that the $1 million nest egg that your investment adviser told you was needed for a comfortable retirement won't do now. You are likely to need around $3 million after the effects of coming inflation and money printing work their way through the financial system.

Again, the government is not confiscating assets by taxing you at a higher rate—after all, they said they wouldn't raise taxes, and a promise is a promise. Rather, they are taking your money away by making any saved dollars in your possession worth less. Remember the old communists begging on the street corners of Moscow? They were still receiving the pensions they had been promised. Pass the vodka!

Well, maybe not. With the right level of inflation and drop in purchasing power, a bottle of vodka may be only for the rich. In five years, an imported bottle of vodka could cost $81 when the drop in the value of the dollar and the inflation rate shown in Table 1.1 are taken into account.

Reason number 3: So, who took my money? You are losing your wealth because the government is printing money and trying to inflate its way out of debt. Any monies that you saved or are scheduled to receive will be worth less and less. But no one increased your taxes. Hurray, we are lucky! Let's vote the incumbents in again.

Table 1.1 The Printing of Money, Inflation, and the Cost of a Bottle of Vodka

Today 2010		After 1 Year: 2011*	After 5 Years: 2015
Cost of a bottle of vodka	$40	$52	$81

*Assume the following:

	Year 1	Year 2	Year 3	Year 4	Year 5
Drop in value of the dollar	20%	5%	2%	1%	1%
Inflation rate	4%	8%	10%	10%	8%

The Last Biggie: Repeal of Glass-Steagall and Gamblers Gone Wild

The Glass-Steagall Act, passed in 1933, was a major banking revision act. It was enacted because of the fraud, margin trading, and investment excesses that occurred in banks before the 1929 market crash and depression. Prior to the 1929 market crash, all banks were involved in speculative investments. After the crash, it was apparent that local banks were involved in stock market investment activities in which they had little understanding of the risk or even the exact nature of their investments. The Act separated banks into two different types.

Commercial banks are those banks where individual depositors keep their checking and savings accounts and buy certificates of deposit. This is what I call a "Peoria bank" or a limited risk bank. Investment banks are the typical Wall Street banks that are organized to create mergers and acquisitions, issue bonds backed by mortgage loans, organize buyouts, trade derivatives, and underwrite stock issuances by large companies. These banks develop new and esoteric investment products for rich investors. This is what I call a "Las Vegas bank" or a high-roller bank.

The Glass-Steagall Act separated banks into commercial and investment banks. It walled off speculative activities from commercial banking. The objective was to limit risky capital investment activities to investment banks and depositor activities to commercial banks. Well, banks sought to find loopholes in the law and they paid the fourth branch of government—that is, the lobbyists—to change the law. The reason: More money can be made outside of commercial banking.

From 1933 to 1999, commercial and investment banks were separated from one another. During this period, the local town banks began to be merged into larger and larger banks. In 1934, there were 14,146 FDIC-insured commercial banks in the United States. In 1984, the high-water mark for these banks, there were 14,496 such banks. In 2009, the number was 6,839, which is more than a 50 percent drop in 25 years. Today, in many small towns and cities the only evidence of these former busy commercial banks are old vacant bank buildings which once bustled with customers. Figure 1.2 shows the decline in independent commercial banks.

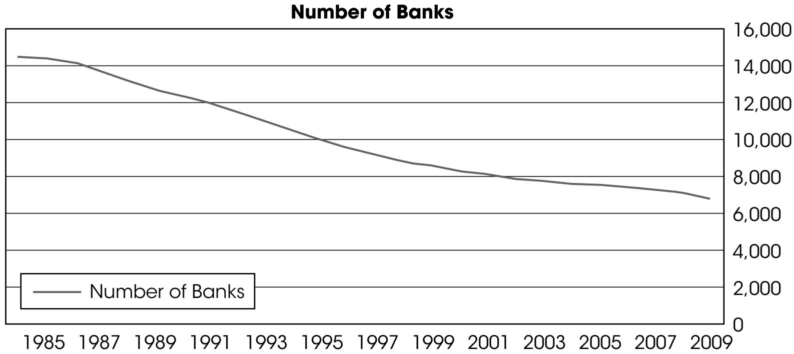

Figure 1.2 Number of Commercial Banks in the United States
Source: FDIC, www2.fdic.gov/hsob/hsobRpt.asp.

In 1999, the Glass-Steagall Act was repealed with the passage of Gramm-Leach-Bliley (GLB) Act. This new act repealed the separation of banking activities that had been in place for 66 years. The consequence of the repeal was that commercial banks could become investment banks. So could insurance companies. Everyone could bet on everything.

And that's why many of you lost money. Peoria banks became Las Vegas gamblers.

In 1987, a reason for separating risky operations from the commercial operations was noted.

> Securities activities can be risky, leading to enormous losses. Such losses could threaten the integrity of deposits. In turn, the Government insures deposits and could be required to pay large sums if depository institutions were to collapse as the result of securities losses.
>
> —Jackson, 2010, p. 3

Gee! You think? Is $750 billion a lot of money? How about another $600 billion?

Less than 10 years after the repeal of the Glass-Steagall Act, a financial crisis occurred in the United States that affected countries and financial institutions around the world.

The effect of the financial crisis of 2008 has left many financial institutions in ruins. GLB allowed commercial banks, investment banks, and insurance companies to become one. The unperceived investment risk for these institutions rose into the stratosphere. The number of failed banks in 2009 was 140, which was 2 percent of all commercial banks.

And the consolidations continued—until the institutions became too big to fail.

Recently, the congressionally enacted Dodd-Frank Act has back-pedaled on some of the cowboy financing and trading that occurred after the repeal of Glass-Steagall. Now there is a requirement for the disclosure of information about some derivatives, and there will be a council of "systematic risk oversight" created. The council's job is to analyze the risk in the financial system, especially banking, to determine if risk levels are reaching a point where extreme events could cause the whole system to collapse. Further, the law restricts investments in hedge funds by banks and the use of bank assets in risky trading ventures. The exact meaning of the legislation is being worked out by the government agencies tasked with the law's enforcement.

Now all that's left to do is for banks to find the loopholes in Dodd-Frank or delay its implementation while lobbying to lift certain unfavorable restrictions in the new legislation.

Reason number 4: Although a gambling casino looks like it is the place where the biggest bets are made, it's not. Bigger and more risky bets are placed at banks. When losses are incurred in a casino, it is the responsibility of the individual. Las Vegas has more suicides than any other similar-sized city. When banks lose their bets, it is the responsibility of the taxpayer. The taxpayer pays either one way or the other. And that's the fourth reason you are losing your wealth: paying for the bank's mistakes.

Summary

So what is the government doing in the background of your everyday life that is causing your money and net worth to disappear?

The government is:

- Strongly influenced by the fourth branch—the special interests.
- Issuing unsustainable amounts of debt.
- Monetizing the debt and creating the scenario for inflation by printing money.
- Allowing for high levels of financial failure risk to exist in the banking system.

As you get your morning coffee, the federal government is borrowing more money from China. By the time you get to work, the government has printed millions of dollars to put into the financial system. During your workday, the fourth branch is plying congressmen and senators with gifts and money to get access and influence so that their clients are better off than you.

In this book, areas of financial danger will be analyzed, and suggestions will be made to help prevent the invisible hand of confiscation from grabbing you.

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