Constitutional Capitalism

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This papers covers the following:

- Capitalism is an inherent human trait, necessary for freedom from bondage.
- The private market system of storage of hard-earned capital–legally protected by the government–has failed to win the trust of humans.
- The most successful American presidents like Lincoln and Roosevelt were as confounded as the Americans about modern economics' invisible hand (god) causing periodic financial depressions. The foundation of modern economics was laid by Adam Smith's *Wealth of Nations*, which was published in the same year (1776) in which U.S.A. gained independence. Modern economics has shaped the notion of capitalist economy which U.S.A. embraced as soon as it became independent. Modern economics even now relies on god for causing periodic financial calamities. But modern economic fails to define god rationally.[1] The Financial Crisis Inquiry Commission, appointed by the U.S. Congress, rejected the economic experts' blaming of god in its report of 2011. The FCIC rather found that the 2008 financial crisis was manmade and avoidable.
- My research corrects four profoundly false dogmas, which have not only shaped the academy of finance/economics and financial markets, but also jeopardized the economy. These corrections will help adopt a new economic paradigm–Constitutional Capitalism–founded on first-best efficient governance of capital markets to provide a trustworthy system of storage of hard-earned capitals of individuals (firms and households) which is necessary for individual freedom from manmade (avoidable) financial bondage.

A. Constitutional Capitalism

Capitalism is rooted in capital, which means net-worth, equal to assets minus liabilities, of an individual household or a firm. Individuals consider net assets as necessary for freedom from bondage. Freedom is common human longing. Capitalism is, thus, a necessary act of accumulation and preservation of net assets to attain freedom from bondage. Individuals cannot abandon an act (capitalism) which is vital for their freedom. What has then failed in the financial catastrophe of

[1]For a rational portrayal of god, see Acharya, S. (2012), "A Unifying Philosophy of Governance [Universal Religion and God," Journal of Governance and Regulation, and available http://pro-prosperity.com/A-Unifying-Philosophy-of-Governance.html

2008?

1. The system of storage of hard-earned capital of individuals crashed in 2008.
2. Capital is stored in various units of credits, like dollars and units of stocks and bonds and their values in dollars. The system of storage of capital busted in 2008.
3. Credit means trust. Individuals had trusted the prevailing system for preservation of their accumulated credits. The financial crisis of 2008 eroded this trust.
4. Individuals can concentrate on work to attain their potential incomes as long as their surplus savings are invested in a trustworthy system for accumulation of credits. A trustworthy system is, thus, the pillar of capitalism. This pillar cracked in 2008.

The capitalist act of accumulation of credits for attainment of individual freedom from bondage has not been dented, however, by the 2008 crisis. Individuals kept their money under their pillows in the wake of the banking crisis of 1907. Since the financial catastrophe of 2008, they are increasingly storing their accumulated credits in government treasury securities. Their trust in the private market system of storage of capital eroded due to the 2008 financial catastrophe.

What is in the private market system of storage of capital in which individuals lost trust? It is the capital market shenanigans which cause surreptitious usurpation of hard-earned and accumulated capitals of individuals. These shenanigans are directly and indirectly legalized by requisite laws, acts, policies and procedures. The legally protected capital market shenanigans constitute <u>second-best governance</u>.[2]

A <u>first-best efficient system of governance</u>, which averts usurpation and preserves trust, exists in equilibrium.[3]

To fulfill their common longing for freedom, individuals want my first-best efficient, trustworthy system for storage of their accumulated capital. This necessitates replacement of the current second-best system with my first-best efficient system.

The first-best efficient system of governance is crucial to restore individual trust, freedom, and prosperity amid stability, which is mandated by the constitution. This system voids all the shenanigans which facilitate usurpation, even surreptitiously, of the hard-earned, accumulated capitals of individuals. Only the first-best efficient system of governance can preserve trust or credit or capital. My research shows that the first-best efficient system is constitutional and stable, while the current system is not. I call the first-best efficient governance <u>Constitutional Capitalism</u>.

B. Four Profoundly <u>False</u> Dogmas of Modern Economics

Adam Smith's Wealth of Nations (1776) founded modern economics and the American capitalistic

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[2] See Acharya, S. (2012), "First-best Management Academy," for a detailed discussion of first-best and second-best concepts, available at http://pro-prosperity.com/Research/First-best%20Management%20Academy.pdf

[3] See Acharya, S. (2012), "Arbitrage Pricing of Total Risk of Assets and First-best Governance of Financial Markets," unpublished mimeo available at http://pro-prosperity.com/Research/moralhazardliberty.pdf; and Acharya, S. (2012), "Constitutional System of Money and Finance," forthcoming in the Journal of Financial Transformation, and available at http://pro-prosperity.com/Research/Constitutional-Monetary-Finance-System.pdf

economy. Modern economics paints capital market crashes as slaps by some invisible hand (god) without defining god rationally.

My research[4] corrects four profoundly false dogmas/theorems/propositions/assertions, which have not only shaped the academy of finance/economics and financial markets, but also jeopardized the economy:

1. Data generated by the current system of money and finance–which has been proved by my research to be economically inefficient, unstable, unsustainable and unconstitutional–can be consistently used to test for efficiency and stability of the system by presuming that the financial industry honchos are self-disciplined to not precipitate systemic crises. In several memos earlier, I have detailed the inconsistency and falsity of this claim.

2. Financial panics are caused by liquidity shocks foisted by some undefined god:

    a. Any economic proposition or theorem which depends on some unspecified god cannot be rational.
    b. For instance, the proposition of Doug Diamond and Phil Dybvig that a federal guarantee of bank deposits is necessary for equilibrium depends on liquidity shocks caused by a tacitly latent but unspecified god present in their model.
    c. The Diamond-Dybvig proposition is as good as a statement that god makes a federal guarantee of bank deposits necessary for an economy. Such a statement is obviously irrational because it is founded on god not defined rationally.
    d. The academy of finance and economics has, however, taken the above irrational statement as gospel.
    e. The government has shaped banks and capital markets based on an irrational gospel.
    f. The Federal Reserve recently reproduced the Diamond-Dybvig paper to broadcast the gospel as an 'explanation' of the financial crisis of 2008.
    g. Gary Gorton at Yale has formally told through a book published by the Oxford U Press that financial catastrophes of the type erupted in 1907 or 2008 are slaps by some invisible hand (god) which he does not define rationally.
    h. Many experts including the current Fed Chief, Ben Bernanke, Doug Diamond and other prominent finance and economics professors have publicly extolled and recommended Gary Gorton's book to those interested in the causes of the 2008 financial crisis.
    i. Top academic experts, industry honchos and government regulators have basically blamed god for the financial crisis of 2008.
    j. On one hand, the academic experts assert that the current manmade system is invincible or that the Masters of the Universe (financial industry honchos trained by the finance and economics experts in the academy) have the self-discipline and power to prevent even god

[4] Acharya, S. (2012), "Arbitrage Pricing of Total Risk of Assets and First-best Governance of Financial Markets," available at http://pro-prosperity.com/Research/moralhazardliberty.pdf

from destroying the manmade system of money and finance. On the other hand, when their established system crashes, they contradictorily blame god for causing the crises.

3. Only a second-best efficient equilibrium is feasible when agents have privilege of control over welfare of principals. The authors who have stamped the academy with such a claim include Milt Harris, Arthur Raviv, Bengt Holmstorm, Paul Milgrom, Joe Stiglitz and many others in the extant literature on adverse selection and moral hazard.[5] In plain English, the privilege of controlling principals' welfare allows agents to enjoy first-best status by subjecting principals to second-best sustenance:

    a. The extant literature hides a profound truth that principals may withdraw the privilege if doing so can attain first-best efficiency. Whether or not agents can have privilege should be determined in equilibrium, as opposed to the presumption made in the extant literature that agents are ordained (by god latent in the extant model) to enjoy privilege.
    b. My dynamic general equilibrium model–with net-worth maximizing stakeholders of leveraged firms (banks and nonbanks), not-for-profit government minimizing cost to taxpayers, and markets pricing securities by arbitrage–obtains first-best efficiency in equilibrium in which agents enjoy no privilege.
    c. In particular, agents (mega bankers who control the system of money and finance) have no privilege within my first-best efficient equilibrium. In my model, privilege or no-privilege is an outcome of equilibrium, as opposed to a restrictive assumption made in the extant literature.
    d. By presuming that the agents are ordained by god to have privilege, the extant literature basically assumes as true a dogmatic proposition that first-best efficiency is not attainable in equilibrium. The established system of governance of financial markets has been supported by such assumption as gospel, by hiding a profound truth (obtained in my model) that a first-best efficient equilibrium with no privilege is attainable.
    e. During the first presidential debate on October 3, 2012, Governor Romney challenged President Obama to end the privilege ('blank checks') given to mega banks in the Dodd-Frank Act of 2010. My research and memos submitted to the US Presidents, presidential candidates and members of Congress since 2003 have pursued for elimination of the ordained privilege with a view to attaining first-best level of prosperity and stability for principals (citizens).

4. Only a part of the total risk of an asset is priced in equilibrium. This extant claim/wisdom of the academy does not hold true within a more general dynamic general equilibrium model of microeconomics developed in my paper, where the total risk of an asset is priced.[6] The

[5] See Acharya, S. (2012), "Arbitrage Pricing of Total Risk of Assets and First-best Governance of Financial Markets," unpublished mimeo available at http://pro-prosperity.com/Research/moralhazardliberty.pdf, for the cited research.

[6] See Acharya, S. (2012), "Arbitrage Pricing of Total Risk of Assets and First-best Governance of Financial

decision to not update this extant academic wisdom by refusing to review research on first-best efficient governance entails devastating, unrecoverable economic calamities:

a. If economic stability (equilibrium in my model) is centered at pricing of total risk of assets, but the real-world is brainwashed by the extant academic wisdom to trade based on valuation of partial risks of assets, instability marked by catastrophic market crash (of the type observed in 2008) will ensue and be deemed by people's representatives to be manmade (not ordained by some undefined god).
b. A few privileged mega banks (facing no risk of their failure by law) profit enormously from trading by valuing total risk of assets against pension plans and mutual funds which follow the academic doctrine of partial risk pricing.
c. With privileged mega bankers, the markets have become a vastly negative sum game, which can cause catastrophic unrecoverable destruction of capital of the type we saw in 2008.[7]
d. The top journal and book publishers in the academy of finance and economics which control updating of wisdom are financially controlled by the privileged mega banks. The editors and reviewers often occupy top endowed banking chairs.
e. The academy of finance and economics thus faces serious moral hazard and attains only second-best wisdom, which can be corrected by publication of research on first-best efficient governance being embraced by the principals (citizens) and their representatives.
f. Impact factors of academic journals are based on citations of the papers published. But any number of citations of papers in these journals which failed to presage the financial catastrophe (let alone conceive of research to discover policies to avert crises preemptively) is not a rational indicator of the true impact of research on principals and the economy which prop the academy.
g. Google ranks many of my research papers at the top of hundreds of millions of websites based on search for such profound generic subjects as system of money and finance, first best management, first best governance, unifying philosophy of governance, constitutional capitalism, safe banking policy, etc.[8]

In the best interest of the academy and economy, top journals in the academy should obtain responses from the authors cited in this memo and in my papers, rather than adopt a second-best strategy of denying reviews.

C. Anxiety of People and their Elected Representatives

The anxiety of elected leaders now is as serious as it was during the American Civil War of 1860's,

Markets," unpublished mimeo available at http://pro-prosperity.com/Research/moralhazardliberty.pdf, for the cited research.

[7] Acharya, S. (2012), "Economic Inefficiency and Unconstitutionality of Short Selling and Privileged Private Market Clearing," Journal of Investment Management and Financial Innovation; and Acharya, S. (2012), "Constitutional System of Money and Finance," forthcoming in the Journal of Financial Transformation.

[8] http://pro-prosperity.com/Pro-Prosperity-ranking.pdf

when the markets crashed and people agitated. Das Kapital (1867) by Karl Marx (1818-1883) then emerged as an alternative economic paradigm for people to work in communes at equal pay. But communism failed because it could not induce able people to attain their potential to make their nation prosperous and secure. Political leaders are now as worried about the failure of private market system of preserving hard-earned capital as their counterparts were during the Civil War and Great Depression.

Americans may remember Abraham Lincoln for uniting them and for eradicating slavery. But as someone who came to USA to search for new knowledge, I see that Lincoln's acts represented a methodical transformation of the prevailing economic dogma. He reformed the dogma that physically bonded labor enhanced agricultural productivity. He reformed the wisdom that only elite private universities reserved the right to create and disseminate new knowledge. Common people could not get proper education as a result. Lincoln established land-grant universities for common people to achieve economic parity based on their enhanced education and productivity. He pursued a risky Civil War to achieve greater economic freedom based on unified, as opposed to segregated, diligence. Lincoln's actions collectively indicate that he inherently strived for enhancement of prosperity of common people, by redressing the Marxist criticisms of the privileged system of usurping hard-earned capitals.

Lincoln could not perhaps fathom how the second-best system of governance could continually destroy hard-earned wealth for bondage of even the most productive people irrespective of color, race, religion, national origin. He could not decipher see how capital market players employed shenanigans to usurped wealth by massive destruction of capitals accumulated by the vast majority and engaged elite experts to blame some undefined god for the destruction. The Great Depression of 1930's and the Great Recession of 2008 (termed by the Fed as worse than the Great Depression) destroyed a vast amount of hard-earned wealth because of the second-best system of governance. In fact, the Congress for the first time blamed the experts and their promoted second-best system for the 2008 financial catastrophe.

President Franklin D. Roosevelt made the U.S. a welfare state by taxing disproportionately the private market players responsible for causing deprivation due to manmade destruction of wealth. His welfare state could not, however, get the deprived people out of the Great Depression. An extolled guru of the second-best system, Maynard Keynes, advocated for printing money to fund welfare and increase government spending. New money kept the inherently inefficient second-best system oiled for some time. But it did not help people to recover from the depression to trust the system. The economy improved only after the US entered WW-II and defeated the most productive nations at that time (Japan and Germany) to make the latter toil for American defense machinery.

The equitable state created by Lincoln, economic security offered by Roosevelt and the winning of a justified war induced talents from all over the world to immigrate to a truly victorious nation, USA. The American economy thereafter gained its preeminence.

Even the most successful presidents could not, however, root out the true cause of periodic capital destructions, as reminded by the 2008 financial catastrophe:

1. The second-best system of governance of private capital markets cause concentration of credit

among a few who indolently enjoy the fruits of labor of the vast majority that perseveres to create, innovate and produce globally competitive goods and services needed to secure the nation and prop the currency.

2. The persevering people lose the incentive (after they find themselves bonded financially in the wake of decimation of their hard-earned capital) to work hard to produce, innovate and create as much as needed to keep the nation secure and the currency strong.
3. The economy then enters a prolonged state of economic depression.

The Keynesian philosophy of sprinkling newly created money in the economy did not work during the Great Depression. [Reference] Neither will it work now. About 93% of income growth during the last four years has gone to the top 1%, even after the US sprinkling $2.5 trillion of new money created by the Fed and $4 trillion borrowed by the US. Ironically, those who are opposed to welfare subsidies are the net creditors funding the government for such programs. It shows their fear that their accumulated credits will not be honored if they did not fund the government. This situation mirrors the aftermath of the banking panics of 1907. The few who concentrated all the credits of the economy (lent as debt to the rest) were afraid then of the protection of their credits. They engaged their front men–the 13 Robber Barons–to meet in secret in Jekyll Island to craft and foist the Federal Reserve Act of 1913 by which the Fed would create new money on the back of the financially eviscerated and bonded people to let the financial institutions honor the credit obligations of only a few individuals, not that of the vast majority. During the latest financial catastrophe, the public observed how the FRA protected a few creditors.

D. Conclusion

It is necessary to replace the second-best system of governance with a first-best system to preserve capitalism, attain individual freedom, and enhance economic prosperity amid stability mandated in the constitution The first-best efficient system of governance is characterized by the absence of all shenanigans which facilitate usurpation, even surreptitiously, of hard-earned, accumulated capitals of individuals. Only first-best efficient governance can preserve the trust or credit or capital accumulated by persevering individuals. I call the capital-preserving first-best system of governance Constitutional Capitalism.

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