

3 Decades of Economic Diversity

*Essays on Labour, Technology and Monetary Economics
in honour of prof. dr. Joan Muysken*

ISBN 9789056814205

© 2013 Huub Meijers & Tom van Veen

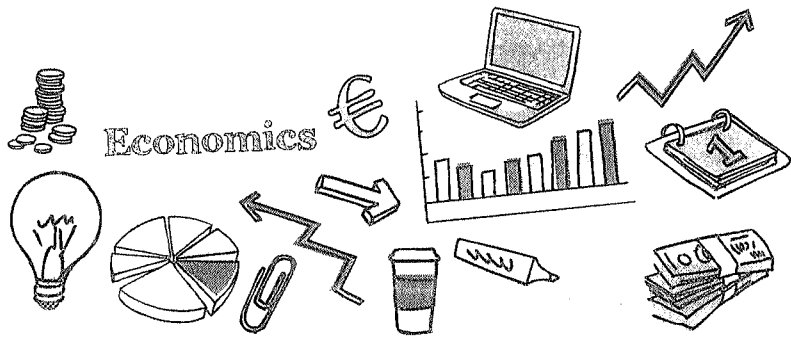
huub.meijers@maastrichtuniversity.nl

t.vanveen@maastrichtuniversity.nl

CBS 9106 Design & Print Canon Business Services, Maastricht

Full Employment Abandoned: the Triumph of Ideology over Evidence

William Mitchell



Chapter 4

Full Employment Abandoned: the Triumph of Ideology over Evidence

William Mitchell (bill.mitchell@newcastle.edu.au)

Preface

I first encountered Joan in 1989 after he agreed as head of department to host my study leave visit at Maastricht. He had been recommended to me by Jean-Phillipe Lambert as a person with research interests similar to my own. That assessment was correct and so started a collaboration that has endured to this day. My first encounter was interesting. I had spent a lot of time in Belgium in the past racing bikes and knew several Johans. The “h” in the middle defined gender, or so I thought. When J-PL recommended “Joan” to me, in that pre-Google world, I imagined Joan was a she not a he. After all, my mother was a Joan! I didn’t give it another thought and when I turned up in Maastricht one (rare) sunny day, I located Joan’s room number on the board and proceeded to the designated room. I knocked on the door, entered when invited and there was Joan. A moment’s shock, a laugh, and there began our working relationship, which continues to this day.

It hasn’t been an easy collaboration given the tyranny of geographical distance, and, at times, quite different approaches to knowledge generation. But in the same way that I have become a “bit Dutch” as a result of annual visits to Maastricht, Joan has also become a “bit Aussie” as a result of his annual visits to Newcastle. Moreover, the professional relationship, which culminated in the publication of our book - *Full Employment Abandoned: Shifting Sands and Policy Failures* - has become a life-long friendship, which has also embraced our respective families. I have watched Joan’s children grow up and prosper and he has been very involved in my family dynamics. It is a relationship I value greatly. And, if you can believe it, the Joan of old, who claimed he didn’t want to get involved with E-mail or the Internet, now Skypes us in Australia and sends photos of his grandchildren by E-mail to keep us updated. A toast to my mate - een kopje Droom van Maastricht, zwart maar zwak.

1. Introduction

The global economic crisis exposed the neo-liberal promise - that markets can self-regulate and deliver sustained prosperity for all - as a lie. But that doesn’t seem to have registered with governments, which have, without exception, built their responses to the crisis on a series of myths - the same myths that caused the crisis.

The crisis was the culmination of three decades of policy choices made by governments infested with this neo-liberal lie. The Great Depression showed that markets fail badly

if left unregulated and that governments have a strong role to play as an employer and a spender. Unfortunately, in the 1980s, governments abandoned these responsibilities and introduced widespread deregulation. This unleashed the destructive dynamics of capitalism, which mixed greed, criminality (for example, Enron, Libor scandal) and incompetence into a lethal cocktail, and, ultimately manifested as the crisis.

Now with millions unemployed, youth jobless rates in excess of 55 per cent in some advanced nations, inequality and poverty rates rising, and massive daily losses of national income being endured, governments have claimed that there is no alternative but to impose austerity by cutting budget deficits. In most nations - whether in government or opposition - the unquestioned dominance of neoliberal ideology has not only homogenised the political debate but also obscured the only credible route to recovery. A correct assessment of the current state indicates that budget deficits have to increase. Austerity is exactly the opposite policy response that is required. All the evidence is telling us that. But as Lakatos (1970) noted, the dominance of degenerating paradigms is not easily challenged.

The extraordinary events in world financial markets in 2007, which undermined the basis of monetary capitalism initially led to massive injections of public spending. The stimulus packages promoted early recovery, which negated the claims by mainstream economists that fiscal policy (public spending minus taxes) was ineffective. The glaring defects of mainstream macroeconomic theory were clear.

However, the neo-liberals soon began to reassert their dominance and what began as a problem of unsustainable private debt growth, driven by an out-of-control financial sector aided and abetted by government deregulation, has now mysteriously been reconstructed as an alleged sovereign debt crisis. Now conservatives, some of whom were direct beneficiaries of bailout packages in the early days of the crisis, tell us that our governments are bankrupt, that our grandchildren are being enslaved by rising public debt burdens and that hyperinflation is imminent. Governments are being pressured to cut deficits despite strong evidence that public stimulus has been the major source of economic growth during the crisis and that private spending remains subdued.

The crisis was created by a lie and the current solution - fiscal austerity - is making matters worse, because it is built on the same lie. Public deficits do not cause inflation, nor do they impose crippling debt burdens on our children and grandchildren. Deficits do not cause interest rates to rise, choking private spending. Governments cannot run out of money. The greatest lie - endlessly repeated by neo-liberal economists and uncritically echoed by the mainstream media - is the claim that if governments cut their spending, the private sector will "crowd in" to fill the gap.

In April 2013 some shoddy spreadsheet work by two high-profile American economists was discovered. These economists had promoted the famous 90 per cent threshold on public debt, beyond which they erroneously claimed growth would contract. Policy makers used this threshold to justify harsh cutbacks in public spending, which, in turn, have caused economic ruin. Together with the weight of empirical evidence, this simple exposure has highlighted that fact that there are no credible grounds for the disastrous

austerity that the IMF and the OECD have promoted and which many advanced nations have implemented.

The fact that some shoddy spreadsheet analysis became so influential among policy makers and the financial journalists helps us to understand why the crisis occurred and why many nations are still enduring massive daily output losses and rising unemployment. It is a triumph of ideology over evidence.

A sustained recovery requires a categorical rejection of mainstream macroeconomic theory and practice. Economists should seek to understand how the monetary system actually works, not how they might wish it to work. Modern Monetary Theory (MMT), which is ground in the operational realities of the system, not only predicted the crisis but also provides credible recovery strategies that reject the austerity paradigm.

This paper traces the demise of the commitment to full employment (Sections 2 and 3), considers the origins of the crisis (Section 4) and outlines the MMT framework and some of its key policy proposals (Sections 5 and 6).

2. The full employment era

The Great Depression taught us that without government intervention, capitalism is inherently unstable and prone to delivering lengthy periods of unemployment. The Hooverian and British Treasury orthodoxy of balanced budgets, tried during the 1930s, failed. Full employment came only with the onset of World War II, as governments used deficit spending to prosecute the war effort. The challenge was how to maintain this full employment during peacetime.

Unemployment was not only seen as wasteful but a violation of basic human rights. The 1945 Charter of the United Nations (Articles 55 and 56) enshrined the principle of employment as a basic human right and declared that governments were responsible for sustaining full employment. This was reinforced in the 1948 Universal Declaration of Human Rights (Article 23).

Western governments realised that with deficit spending supplementing private demand, they could ensure that all workers who wanted to work could find jobs. All political persuasions accepted this commitment to full employment as the collective responsibility of society (Beveridge, 1944). As a result, very low levels of unemployment in most Western nations persisted until the mid-1970s. While private employment growth was relatively strong during this period, governments not only were important employers in their own right but also maintained a buffer of jobs for the least-skilled workers. These jobs were found in the major utilities, the railways, local public services and major infrastructure functions of government. By absorbing workers who lost jobs when private investment declined, governments acted as an economic safety valve.

Ormerod (1994: 203) notes that the economies that avoided high unemployment in the 1970s maintained a '... sector of the economy which effectively functions as an employer of last resort, which absorbs the shocks which occur from time to time, and more generally makes employment available to the less skilled, the less qualified.' Ormerod concluded that societies with a high degree of social cohesion (such as Japan, Austria, Norway) were willing to broaden their concept of costs and benefits of resource usage to ensure everyone has access to paid employment opportunities.

In addition, welfare systems provided income support and other public services (such as health and education) to citizens in need. While there were significant differences across nations in the scope of these systems, they all shared the view that the state had a role to play in providing economic security to citizens (Mitchell and Muysken, 2008).

3. The abandonment of full employment

The stability that came with the continuous full employment was always a source of dissatisfaction for the capitalist class because it led to more equitable shares of national income (Mitchell and Muysken, 2008). Conservative resistance to the use of budget deficits grew in the late 1960s, particularly in the United States, as inflationary pressures mounted because of spending associated with the Vietnam War. But the full-employment consensus didn't collapse until the escalating inflation that followed the OPEC oil-price hikes of the 1970s. This marked the beginning of the neo-liberal era, which has dominated the political debate ever since.

Governments around the world reacted with contractionary policies to quell inflation and unemployment rose giving birth to the era of stagflation. The economic dislocation that followed provoked a paradigm shift in macroeconomics (Thurow, 1983). With support from business and an uncritical media, the paradigm shift in the academy permeated the policy circles and governments relinquished the defining feature of the Post-War framework – the commitment to full employment. The Keynesian notion of full employment, defined by Vickrey (1993) as 'a situation where there are at least as many job openings as there are persons seeking employment', was abandoned in favour of the so-called 'natural rate of unemployment' (Friedman, 1968), or, as it later became known, the Non-Accelerating Inflation Rate of Unemployment (NAIRU). The NAIRU is a conceptual unemployment rate where inflation is stable. It is conceived as being solely determined by supply forces making it invariant to Keynesian demand-side policies. Despite the lack of robust empirical support, this concept remains a dominant policy construct.

It reintroduced the previously discredited Say's Law by alleging that free markets guarantee full employment and Keynesian attempts to drive unemployment below the NAIRU will ultimately be self-defeating and inflationary. The Keynesian notion that unemployment represents a macroeconomic failure that can be addressed by expansionary fiscal and/or monetary policy was rejected. Instead, mass unemployment was now depicted as an individual problem - poor work attitudes leading to a lack

of job-seeking - exacerbated by excessively generous welfare payments, trade unions with too much power, and job protection laws (OECD, 1994). Textbook versions of the natural rate hypothesis taught to students cast unemployment as a voluntary, optimising choice by individuals seeking to enjoy leisure.

These ideas were promoted vociferously by the emergence of conservative, free-market 'think tanks', which were liberally funded by business and other anti-government interests. Beder (1999) considered these institutions fine-tuned "the art of 'directed conclusions', tailoring their studies to suit their clients or donors" (Beder, 1999: 30). Politicians paraded their so-called 'independent' research findings as the authority needed to justify their deregulation agendas. Organisations such as the Peterson Foundation and the Cato Institute (US) and the Centre of Independent Studies (Australia), among many similar bodies, are still distorting the policy debates with their erroneous propaganda.

The new macroeconomic cult of Monetarism defined a sole policy objective - to control the money supply in order to manage inflation. Although various experiments at controlling the money supply failed dismally in the 1980s, the dominance of monetary policy in mainstream economics was complete. Fiscal policy was demonised as being inflationary and its use eschewed, depriving liberally inclined governments of the tools to advance a more progressive agenda. As governments began to adopt fiscal austerity and 'inflation-first' monetary policy strategies, unemployment accelerated and has never returned to the low levels that were the hallmark of the Keynesian period.

Rising welfare payments were then erroneously constructed as a threat to the fiscal viability of government. Conservative leaders such as Margaret Thatcher lecture us about how governments, like households, have to live within their means. They invoke emotional blackmail by claiming that to pay back budget deficits, governments would have to introduce onerous future tax burdens, which force our children and their children to pay for our profligacy. They claim that government borrowing (to "fund" the deficits) competes with the private sector for scarce available funds and thus drives up interest rates, which reduces private investment – the "crowding out" hypothesis. And because governments are not subject to market discipline, neo-liberals claim, public use of scarce resources is wasteful. Finally, they assert that deficits require printing money, which is inflationary. All of these myths were exported directly out of undergraduate macroeconomics textbooks that are used to indoctrinate students and perpetuate the hegemony of the conservative paradigm. None are applicable to the real world.

Policy-makers accepted the assertion that the only way they could reduce this 'naturally occurring rate of unemployment' was to further free up the labour market. If governments were unhappy about the level of unemployment, their only alternative was to make it harder for workers to get income support payments and to eliminate other 'barriers' to hiring and firing (for example, unfair dismissal regulations). Attacks on trade unions and statutory protections for workers began in earnest. Privatisation and outsourcing accompanied these policy shifts.

The hollowed out state became a servant of capital rather than a mediator in the capital-labour conflict. The Thatcher government attacks on the trade union movement in Britain in the 1980s exemplified the broader political ambitions of the neo-liberal era. These same ideas had driven the failed policies that led to and extended the Great Depression. However, history is conveniently forgotten when policy is strengthening the hegemony of the elites.

The 1994 OECD Jobs Study served as the bible for this new microeconomic reform agenda even though its evidence base was at the time questionable, and later, found to be unacceptable by conventional standards (Baker *et al.*, 2004; OECD, 2004, 2006). The OECD articulated the 'activist agenda', whereby the labour market role of government was reduced to one of ensuring individuals are employable with minimal income support being provided.

To establish legitimacy for cutting income support and the like, governments, aided by the urgings of the neo-liberal intellectuals in the media and in conservative think tanks, set about redefining the state's obligations towards its citizenry. The central notion of collective will, which underpinned the Post-War full employment commitment, was usurped by the primacy of the individual. The hallmark of the neo-liberal era is that individuals have to accept responsibility, be self-reliant, and fulfill their obligations to society (Giddens, 1998). Unemployment is now a problem of welfare dependence rather than a deficiency of jobs. To force individuals to become accountable for their own outcomes, the so-called reciprocal obligation was developed as a leading principle in several countries as a means of reintegrating the allegedly, welfare dependent underclass into the community (Cook *et al.*, 2003). Unfortunately, no reciprocal obligation was constructed for government to ensure that there are enough jobs for all those wanting work. Throughout this period there were less jobs available than those seeking them.

4. The origins of the crisis and the descent in neo-liberal miasma

4.1 The origins of the crisis

The tectonic shifts in policy under Monetarism caused higher unemployment, rising poverty and suppressed real wages, which ran counter to the rhetoric that the new free market approach would generate better outcomes. But the changes also started the countdown to the GFC.

It is not difficult to pin point the triggers for the current crisis. The dynamics began in the US with the collapse of their real estate boom. But the origins of the crisis can be traced to the decision of most Western governments to introduce policies, which unleashed the destructive dynamics of the capitalist system. The key elements of this policy shift were the denial that continuous budget deficits constituted the norm for most nations; the widespread deregulation of labour and financial markets; and the

reduction in oversight of what financial regulation remained. Governments created an economic structure that was ultimately unsustainable and it was only a matter of time before the system collapsed (Mitchell, 1998).

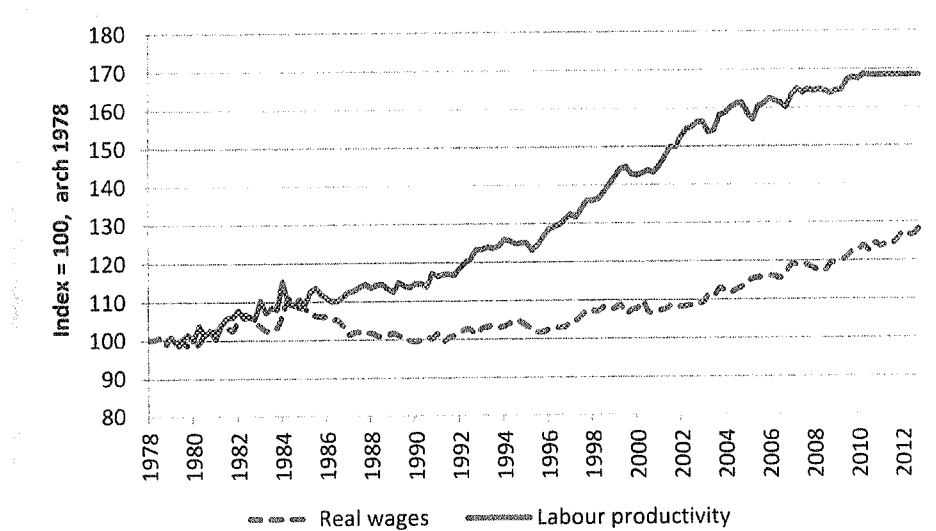
4.2 The shift in national income

The deregulation in the labour markets not only created increased job instability and persistently high unemployment but also led to large shifts in the distribution of national income from wages to profits. Figure 1 shows the relationship between real wages and productivity growth in Australia from 1978 to 2012. Stockhammer (2013) reports similar trends in other advanced OECD nations.

First, the wage share in national income has fallen significantly over the last 35 years in most nations. Second, in the Anglo nations, “a sharp polarisation of personal income distribution has occurred” (Stockhammer, 2013: 2), with the top percentile and decile of the personal income distribution substantially increasing their total shares. The munificence gained at the expense of lower-income workers manifested, in part, as the excessive executive pay deals that emerged in this period.

Up until the early 1980s, real wages and labour productivity typically moved together. As the attacks on the capacity of workers to secure wage increases intensified, a gap between the two opened and widened. The widening gap between real wages and productivity growth manifested as the rising profit share. In 1975, the Australian wage share was around 62.5 per cent of factor income. By the end of 2012, it was around 54 per cent. Australian government aided this redistribution in a number of ways: privatisation; outsourcing; harsh industrial relations legislation to reduce union power; National Competition Policy and such.

Figure 1: Real wages and productivity growth, Australia, 1978-2012



Source: ABS National Accounts, Labour Force, CPI. Labour productivity is measured as GDP per hour worked (market sector).

4.3 The rising dominance of the financial sector

Imbued with the, now discredited, efficient markets hypothesis, promoted by University of Chicago economists, policy makers bowed to pressures from the financial sector and introduced widespread financial deregulation and reduced their oversight on the banking sector. This not only led to a massive expansion of the financial sector, but also set the stage for the transformation of banks from safe deposit havens to global speculators carrying increasing, and ultimately, unknown risks. The massive redistribution of national income to profits provided the banks and hedge funds with the gambling chips to fuel the rapid expansion of the 'global financial casino'. Increasingly, the Gordon Gekkos strutted the stage as celebrities and were cast as important wealth generators. Private returns were high and the lemming rush unstoppable. But the reality was different. The vast majority of speculative transactions that occur every day in the financial markets are unproductive, in that they are unrelated to the real economy and advancing our welfare. A substantial portion of the "wealth" generated was illusory and we subsequently discovered that the socialised losses were enormous as the huge, unregulated gambling casino collapsed under its own hubris, criminality and incompetence.

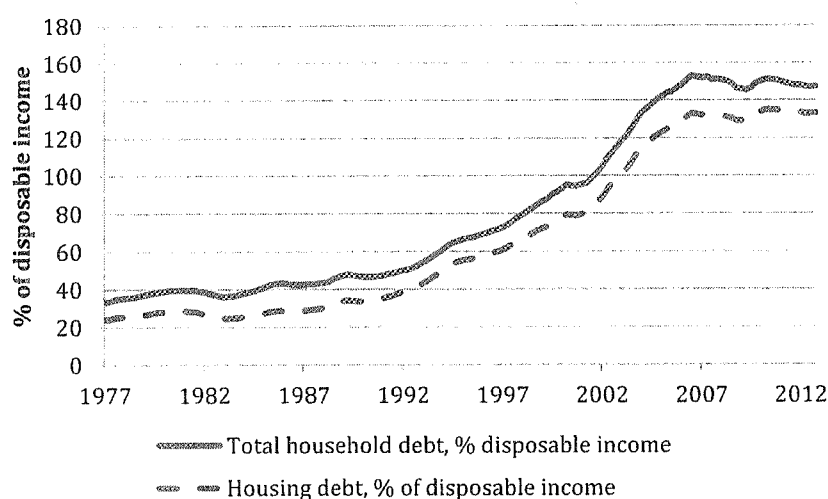
4.4 The explosion of private debt

The capitalist dilemma was that real wages had to typically grow in line with productivity to ensure that the goods produced were sold. So how does economic growth sustain itself when labour productivity growth outstrips the growth in capacity to purchase (the

real wage)? This was especially significant in the context of the increasing fiscal drag coming from the public surpluses, which squeezed private purchasing power in many nations during the 1990s and beyond. The neo-liberal period found a new way. The ‘solution’ was found in the rise of so-called ‘financial engineering’, which pushed ever increasing debt onto households and firms. The credit expansion not only sustained the workers’ purchasing power but also delivered an interest bonus to capital while real wages growth continued to be suppressed. Households, in particular, were enticed by lower interest rates and the vehement marketing strategies of the financial engineers. It seemed to good to be true and it was.

Figure 2 shows the increasing household indebtedness in Australia. The debt to disposable income ratio stood at 69.1 per cent in March 1996 and by September 2008 had risen to a staggering 153.1 per cent. Governments, their central banks, and so-called financial industry experts played down any sense of alarm during the pre-crisis period claiming that wealth was growing along with the debt. When the debt bubble burst, significant proportions of the ‘wealth’ vanished leaving many borrowers with massive debts but few assets.

Figure 2: Household debt, Australia, 1977-2013, % of Disposable Income



Source: Reserve Bank of Australia, *Household Finances - Selected Ratios - B21*

As debt levels rose, the financial planning industry fell prey to the urgency of capital and to increase their profits further, they penetrated into the riskier segments of the market – the so-called sub-prime loans. The credit-fuelled economic growth masked the growing precarious of the world economy. Such was the smugness of the economics profession, Chicago economist Robert Lucas pronounced during his 2003 Presidential Address to the American Economic Association “the central problem of depression-prevention has been solved, for all practical purposes” (Lucas, 2003). Economists declared the business cycle to be dead and applauded the gains of deregulation and terms such as the “great moderation” crept into the literature (Stock and Watson, 2002). International institutions such as the OECD and the IMF praised the progress towards

deregulation and urged more. Soon after, the housing price bubble burst and increasing numbers of borrowers faced negative equity, defaults and foreclosures rose dramatically. The extent of the exposure was at first unknown but we now know that many investment banks had borrowed huge amounts to purchase the mortgage-backed securities, which were derived from the initial unsound loans.

The massive volume of so-called credit-default swaps, akin to insurance contracts, were totally unregulated and provided the holder with a guarantee against loan default. Trillions of dollars of these swaps were written against risky mortgage loans. The problem was that once the loans soured, and the holder of the swaps started to seek their 'insurance payment', the many financial institutions that had issued them could not honour their obligations.

The banks themselves took advantage of the lax oversight and deregulation to become gamblers in their own right. Yet, despite claims by the efficient markets hypothesis, markets are not rational and efficient and the gaps in the information flows between the banks, investors, firm and household borrowers, providers of securitized assets to be used as collateral, providers of insurance for these assets, the credit rating agencies assessing levels of risk in relation to these assets (which include credit default swaps), and the parties in the "real sector" who are generating the actual IOU's that eventually become securitised were enormous (Mitchell and Juniper, 2008). Add greed and criminality to the mix and the collapse was inevitable.

When the interbank market dried up and banks struggled to fund their exposed positions, firms in the real economy were denied funds to finance their working capital. At that point the crisis spread to the real economy.

4.5 The fiscal squeeze

The fiscal conservatism pursued during this period compounded the problems caused by deregulation. Consider the national accounting identity for the three sectoral balances:

$$(S - I) \equiv (G - T) + (X - M)$$

Thus total private domestic savings (S) is equal to private domestic investment (I) plus the public deficit (spending, G minus taxes, T) plus net exports (exports (X) minus imports (M)), where net exports represent the net savings of non-residents. Thus, when an external deficit ($X - M < 0$) and public surplus ($G - T < 0$) coincide, there must be an overall private domestic deficit. While excessive private spending can persist for a time under these conditions using the net savings of the external sector, the increasingly indebtedness becomes unsustainable.

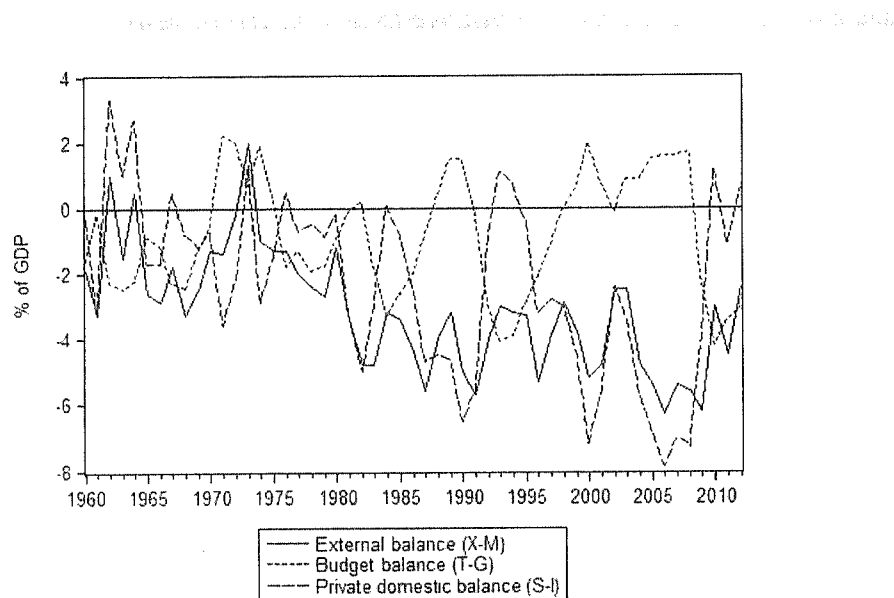
The sectoral balances framework allows us to understand the interaction between fiscal policy and private sector indebtedness. In a modern monetary economy where the government issues its own currency, it follows as a matter of national accounting, that the sovereign government deficit (surplus) equals the non-government surplus (deficit).

The failure to recognise this relationship is the major oversight of neo-liberal analysis. In aggregate, there can be no net savings of financial assets of the non-government sector without cumulative government deficit spending. Government (via deficits) is the only entity that can provide the non-government sector with net financial assets (net savings) and thereby simultaneously accommodate any net desire to save in the unit of account and hence eliminate unemployment. Additionally, and contrary to neo-liberal rhetoric, the systematic pursuit of government budget surpluses is necessarily manifested as systematic declines in non-government sector savings.

With an external deficit (current account) the only way that the economy can continue to grow, if the government sector is running surpluses, is if the private domestic sector undertakes increasing levels of indebtedness. The deteriorating debt to income ratios that result will eventually see the system succumb to ongoing demand-draining fiscal drag through a slow-down in real activity.

Figure 3 shows the sectoral balances for Australia for the period 1959-60 to 2011-12 as a percentage of GDP. The external deficit has increased slightly over time and fluctuates around the commodity price cycle. Accordingly, the dramatic shift from budget deficits to surpluses from the mid-90s onwards has been mirrored by a corresponding rise in private sector indebtedness; as the private domestic sector started to dis-save overall – that is, spend more than it was earning.

Figure 3: Sectoral balances, Australia, 1959-60 to 2011-12, per cent of GDP



Source: RBA Bulletin database and Commonwealth of Australia Budget Papers.

The Australian government was only able to run atypical surpluses between 1996 and 2007 because the private domestic sector's credit binge produced the growth maintained spending growth. But this was an unsustainable growth strategy because eventually

the build up of private debt became precarious. As the crisis hit, households and firms started to reduce their debt exposure and adopt more typical saving patterns (for example, household saving went from zero to around 10 per cent of disposable income). The facts are inescapable. The neo-liberal period of public surpluses and private deficits was atypical in our history. Similar trends occurred in most advanced nations over this period. The sectoral balances show us that when the private sector is deleveraging and a nation has an external deficit (of any size) then growth can only continue with budget deficits. That is the norm for most nations.

4.6 Rising income inequality

Not only did economies waste their precious labour resources during this period but there was also rising income and wealth inequality (see also Section 4.2). Terms such as ‘trickle down’ economics were one of many related neo-liberal fads during the 1980s and 1990s. The economics profession convinced governments that growth would be enhanced if they reduced the tax rates for top income earners, the so-called wealth generators. The evidence didn’t support these claims and even the IMF (Berg and Ostry, 2011: 3) recently admitted “that longer growth spells are robustly associated with more equality in the income distribution.” But the hallmark of the neo-liberal period is that income and wealth inequality rose after 1980 in most nations (Solt, 2009).

Table 1: Average household income and income shares, United States, 1979 and 2005

	1979		2005		Percentage Change in Average Income, 1979-2005
	\$US	Share	\$US	Share	
Lowest Quintile	14,400	5.8	15,300	4	6.3
Second Quintile	29,100	11.1	33,700	8.5	15.8
Middle Quintile	41,500	15.8	50,200	13.3	21.0
Fourth Quintile	54,300	22	70,300	19.8	29.5
81-90 Percentiles	68,800	15	96,100	14.2	39.7
91-95 Percentiles	82,900	9.8	125,500	9.9	51.4
96-99 Percentiles	117,400	11.4	200,500	13	70.8
99.0 - 99.5 Percentile	193,900	2.5	413,300	3.4	113.2
99.5 - 99.9 Percentile	296,500	3.3	830,100	5.6	180.0
99.9 - 99.99 Percentile	706,400	2	3,191,600	4.8	351.8
Top 0.01 Percentile	4,188,300	1.4	24,286,300	4.2	479.9
All households	46,400	100	67,400	100	45.3

Source: US Congressional Budget Office (2008), Table 3.

In the US, the contrast between rich and poor is now so stark that the income distribution looks like that from a less developing nation. Table 1 compares the distribution of average US household income between 1979 and 2005. There was barely any growth

in nominal income for the bottom 20 per cent (a real decline) and the gap between the top end of the distribution and the bottom has exploded. More recently, the crisis has eroded the incomes and wealth of the “middle class”. The Pew Research Center (2012: 1) concluded, “America’s middle class ... has endured a lost decade for economic well-being. Since 2000, the middle class has shrunk in size, fallen backward in income and wealth.” The claims that the massive debt explosion would generate wealth for all have proven to be illusory.

5. A modern monetary macroeconomic framework

Budget surpluses provide no greater capacity to governments to meet future needs, nor do budget deficits erode that capacity. Governments always have the capacity to spend in their own currencies. Why? Because they are the issuers of their own currencies, governments like Britain, the United States, Japan and Australia can never run out of money.

Most people are unaware that a major historical event occurred in 1971 when President Nixon abandoned what had been called the gold standard (or US-dollar standard). Under that monetary system, which had endured for eighty-odd years (with breaks for war), currencies were convertible into gold, exchange rates were fixed and governments could expand their spending only by increasing taxes or borrowing from the private sector. After 1971, governments issued their own currencies, by legislative fiat, which were not convertible into anything of value and were floated and traded freely in foreign currency markets. The flexible exchange rate frees monetary policy from defending some fixed parity and fiscal policy can then solely target the domestic spending gap to maintain high levels of employment. Most nations have operated ‘fiat monetary systems’ ever since, and as a result, national governments no longer have to ‘fund’ their spending. The level of liquidity in the system is not limited by gold stocks, or anything else.

Most of the analysis appearing in macroeconomics textbooks, which permeates into the public debate, is derived from ‘gold standard’ logic and is inapplicable to modern monetary systems. Economic policy ideas that dominate the current debate are artefacts from the old system and are similarly inapplicable to fiat monetary systems.

MMT describes how such a system actually works (see Mitchell, 1998; Mosler (1997-98); Wray, 1998; Mitchell and Muysken, 2008). First, the monetary unit (currency) has no intrinsic worth. The viability of the currency is guaranteed because it is the only unit acceptable for payment of taxes and other financial demands of the government. Second, the analogy neo-liberals draw between household budgets and government budgets is false. Households use the currency and must finance their spending. However, government issues the currency and must spend first (credit private bank accounts) before it can subsequently tax (debit bank accounts). The claim that governments have to tax or borrow to ‘finance’ its spending is false under a fiat currency system.

The euro nations are an exception. They surrendered currency sovereignty and thus have to borrow to cover deficits, which make them dependent on bond markets (in lieu of European Central Bank support) and exposes them to solvency risk. The current euro problem lies in the flawed design of its monetary system, which was a neo-liberal ploy to limit the capacity of these governments to borrow and spend.

The restrictions on government spending are the quantity of real goods and services available for sale in its own currency including all the unemployed labour. The neo-liberal claims that bond markets limit government spending is false. Despite the collapse of the convertible currency system, most fiat-currency issuing governments impose voluntary constraints on themselves that resemble the spending constraints under the gold standard. These ideologically motivated fiscal rules are designed to limit the capacity of government to run deficits and/or borrow from the non-government sector. They render fiscal policy subservient to monetary policy, which continues to echo the failed monetarist approach. The fiscal rules represent a denial of the opportunities that a fiat monetary system offers the elected government and are undemocratic (for example, making an unelected 'Budget Commission' responsible for fiscal policy).

A decision to restrict real public spending growth to 2 per cent might be suitable at some specific time given the need to ensure that nominal aggregate demand does not exceed real capacity and causes inflation. At other times, such a decision would be irresponsible (for example, when nominal demand is weak and unemployment is rising). Therefore, making it a fixed rule is not sensible practice.

What is often misunderstood is that the budget outcome is determined by the state of overall activity and is, largely, beyond the control of government. If private spending is weak then the budget deficit will typically rise as tax revenue declines irrespective of what government does. Thus by trying to operate within false thresholds and limits (for example, a 3 per cent deficit to GDP rule), governments are too easily seen to fail and the pressure for fiscal retrenchment increases. But when private spending collapses and the deficit rises, the correct response is to increase discretionary net public spending, not cut it. Typical fiscal rules create a bias towards spending restraint that damages public infrastructure development, reduces the volume and quality of public goods such as education and health, and maintains high rates of labour underutilisation. In the current crisis, they have resulted in pro-cyclical policy changes, which are the anathema of responsible fiscal management. Governments should not cut public spending when the economy is plummeting into recession.

Third, the sectoral balances show that, as a matter of national accounting, the national government deficit (surplus) equals the non-government surplus (deficit). Contrary to neo-liberal rhetoric, the systematic pursuit of government budget surpluses is necessarily manifested as systematic declines in non-government savings. Budget surpluses necessarily decrease net non-government savings, and with an external deficit, result in increasing private domestic sector debt levels.

The claim that surpluses represent "public saving", which can be used to fund future public expenditure, is a lie. Mitchell and Mosler (2002: 255) note that government

spends by crediting reserve accounts. That balance doesn't "come from anywhere", as, for example, gold coins would have had to come from somewhere. Likewise, payments to government reduce reserve balances. Those payments do not "go anywhere" but are merely accounted for. Budget surpluses either destroy private wealth by forcing the private sector to liquidate its wealth to get cash or destroy liquidity (debiting reserve accounts), which is deflationary.

Fourth, for aggregate output to be sold, total spending must equal total income. Unemployment occurs when the non-government sector, in aggregate, desires to spend less of the monetary unit of account than it earns and public spending fails to fill the gap. Thus, unemployment occurs when net government spending is too low to accommodate the need to pay taxes and the desire to net save (Tobin, 1963; Mitchell, 1998; Mitchell and Mosler, 2002, 2006; Mitchell and Muysken, 2008). The resulting unemployment is involuntary because the macroeconomic spending constraint renders an individual powerless to improve their employment circumstances. This conception is in contradistinction to the neo-liberal approach, which blames market rigidities or individual laziness for unemployment.

Wray (1998: 81) says, "Normally, taxes in aggregate will have to be less than total government spending due to preferences of the public to hold some reserves of fiat money." Thus, in general, deficit spending is necessary to ensure high levels of employment.

Fifth, governments do not have to issue debt to fund their spending. The main reason they issue debt, a hangover from the gold standard, is because of pressure placed on them by neo-liberals to restrict their spending. Conservatives know that rising public debt can be politically manipulated and demonised, and they do this to put a brake on government spending. But there is no operational necessity to issue debt in a fiat monetary system.

Interestingly, conservatives are schizoid on the question of public debt: public borrowing provides corporate welfare in the form of risk-free income flows to the rich because it allows them to safely park funds in bonds during uncertain times and provides a risk-free benchmark on which to price other, riskier financial products. The fact that bond yields have remained low throughout the latest economic crisis (reflecting strong demand for public debt) tells us that the bond markets do not buy the neo-liberal rhetoric. They know that currency-issuing governments face no solvency risk. Importantly, the source of funds that investors use to buy the bonds is derived from the deficit spending in the first place.

However, debt-issuance can also serve an interest-maintenance function by providing investors with an interest-bearing asset that drains the excess reserves in the banking system that result from deficit spending. If these reserves were not drained (that is, if the government did not borrow) then the spending would still occur but the overnight interest rate would plunge (due to competition by banks to rid themselves of the non-profitable reserves) and this may not be consistent with the stated intention of the central bank to maintain a particular target interest rate. However, the central bank can achieve the same outcome by paying a return on excess reserves, which most do.

Sixth, neo-liberals erroneously claim that deficits drive up interest rates. Deficits have risen sharply in recent years but interest rates have remained close to zero. Japan has been running large deficits since its property market collapsed in the early 1990s and has maintained zero interest rates and low inflation ever since. The neo-liberal lie forgets to mention that the central bank sets interest rates, not the market. Textbook models claim that government borrows from a finite supply of savings. The reality is that government deficits stimulate growth and savings rise with the higher incomes. Far from taking funds away from private investors, deficits expand the pool of available savings.

Finally, the claim that deficits ultimately cause hyperinflation is a lie. The reality is this: if the economy is operating at full capacity then attempts by the government to expand spending will cause inflation. But up to that point, governments can run deficits forever without causing inflation. By supporting spending in an economy not at capacity, deficits induce more production rather than higher prices, since companies will be happy to supply the growing demand.

6. Austerity is not the only alternative

MMT allows us to see the potential of government, which is suppressed by the neo-liberal lie. The major economies are suffering from a collapse of private spending and a massive overhang of private debt. Consumers won't spend if they fear unemployment; firms won't hire and produce if sales are flat. Persistently high unemployment means that our economies are forgoing massive production and income-earning opportunities. Unemployment also causes other problems, such as family breakdown, increased alcohol and substance abuse, increased crime rates and community dislocation.

As long as private spending is subdued, the greatest need is to expand budget deficits. That's the only way the advanced economies will drive growth fast enough to absorb the huge pool of unemployed. Inflation is low, and there is considerable slack in the economy, which can be brought back into productive use by further government stimulus. In advocating further fiscal stimulus, it would be useful to directly target job creation by introducing, as the first measure, an open-ended public employment program - a Job Guarantee - that offers a job at a living (minimum) wage to anyone who wants to work but cannot find employment. These jobs would 'hire off the bottom', in the sense that minimum wages are not in competition with the market-sector wage structure. By not competing with the private market, the Job Guarantee would avoid the inflationary tendencies of old-fashioned Keynesianism, which attempted to maintain full capacity utilisation by 'hiring off the top' (making purchases at market prices and competing for resources with all other demand elements).

Job Guarantee workers would enjoy stable incomes, and their increased spending would boost confidence throughout the economy and underpin a private-spending recovery. There is no reason the government could not afford this program. The labour is available for work, and the government can easily supply the jobs. There were no questions asked when the government, in the early days of the crisis, instantly provided billions for the

banks. To repeat: the government has no financial constraint on its spending and should immediately allocate funds to a massive job-creation program.

Currency-issuing government should refrain from public borrowing. Such borrowing is unnecessary to support the net spending (deficits) and contributes nothing positive in terms of advancing the primary goals of the national government and the issuance of Treasury bonds acts like corporate welfare for purchasers who are typically financial institutions and foreign governments. Why should they enjoy a risk-free government annuity? There is a range of financial and labour market reforms that are needed to force banks to be banks again; increase prudential oversight; and reduce inequality, which are beyond the scope of this paper.

7. Conclusion

In 2009, it was claimed that private sector spending would increase if deficits were cut. All the evidence showed that firms were pessimistic and were unwilling to expand employment and production until they saw stronger growth in demand for their products. Consumers were also pessimistic fearing unemployment. The massive private debt was also motivating increased saving. At that time, cutting public spending only deepened this pessimism.

The same goes for today. When private demand is subdued, the only way to increase growth is for government to spend, via deficits. Austerity just withdraws the lifeline that is required to keeping our economies growing while the private sector reduces its debt levels to more comfortable limits.

Harvard academic Richard Freeman (2010: 165) called the neo-liberal period “a giant experiment in laissez-faire capitalism”. The experiment failed but not without dramatic costs being inflicted. We can also conclude that the economic theory that supported the experiment is deeply flawed and inapplicable to a modern monetary economy.

The size of the deficit should never be the concern of policy. Fiscal sustainability is being defined by the austerity myth in terms of some arbitrary financial ratio. However, deficits should be whatever is required to maintain overall spending at the level consistent with full employment. No more, no less. Fiscal sustainability is about fulfilling the government’s responsibility to maintain an inclusive society in which everyone who wants to work can. Governments around the world that have deliberately introduced policies that force people into joblessness and poverty have lost their economic and moral compass.

References

- Baker, D., Glyn, A., Howell, D. and Schmitt, J. (2004) Labour Market Institutions and Unemployment, in Howell, D. (ed.), *Questioning Liberalization: Unemployment, Labour Markets, and the Welfare State*, Oxford, Oxford University Press.
- Beder, B. (1999) The Intellectual Sorcery of Think Tanks, *Arena Magazine* 41, June/July, 30-32.
- Berg, A.G. and Ostry, J.D. (2011) Inequality and Unsustainable Growth: Two Sides of the Same Coin?, *IMF Staff Discussion Note*, April 8, 2011.
- Beveridge, W. (1944) *Full employment in a free society*, London: Allen and Unwin.
- Cook, B., Dodds, C. and Mitchell, W.F. (2003) Social entrepreneurship: False premises and dangerous forebodings, *Australian Journal of Social Issues*, 38(1), 57-75.
- Freeman, R. (2010) Its Financialisation, *International Labour Review*, 149(2), 163-183.
- Friedman, M. (1968) The role of monetary policy, *American Economic Review*, 58, 1-17.
- Giddens, A. (1998) *The Third Way: The Renewal of Social Democracy*, Cambridge, Cambridge University Press.
- Lakatos, I. (1970) History of Science and Its Rational Reconstructions, PSA: Proceedings of the Biennial Meeting of the Philosophy of Science Association, Vol. 1970, 91-136.
- Lucas, R.E. Jr. (2003) Macroeconomic Priorities, *The American Economic Review*, 93(1), March, 1- 14.
- Mitchell, W.F. (1998), The Buffer Stock Employment Model – Full Employment without a NAIRU, *Journal of Economic Issues*, 32(2), 547-55.
- Mitchell, W.F. and Mosler, W.B. (2002) Fiscal policy and the Job Guarantee, *Australian Journal of Labour Economics*, 5(2), 243-60.
- Mitchell, W.F. and Mosler, W.B. (2006) Understanding the economic fallacies of the intergenerational debate, *Australian Journal of Social Issues*, 41(2), 159-170.
- Mitchell, W.F. and Juniper, J. (2008) There is no financial crisis so deep that cannot be dealt with by public spending, in Wrightson, G. (ed.), *Labour Underutilisation, Skills Shortages and Social Inclusion*. Proceedings of the 10th Path to Full Employment Conference/15th National Conference on Unemployment, December.
- Mitchell, W.F. and Muysken, J. (2008) *Full Employment abandoned: shifting sands and policy failures*, Aldershot, Edward Elgar.
- Mosler, W.B. (1997-98) Full employment and price stability, *Journal of Post Keynesian Economics*, 20(2), 167-182.
- OECD (1994) *Jobs Study*, Organisation for Economic Co-operation and Development, Paris.
- OECD (2004) *Employment Outlook*, Organisation for Economic Cooperation and Development, Paris.
- OECD (2006) *Employment Outlook: Boosting Jobs and Incomes*, Organisation for Economic Cooperation and Development, Paris.
- Ormerod, P. (1994) *The death of economics*, London, Faber and Faber.
- Pew Research Center (2012) *The Lost Decade of the Middle Class*, <http://www.pewsocialtrends.org/files/2012/08/pew-social-trends-lost-decade-of-the-middle-class.pdf>

- Solt, F. (2009) Standardizing the World Income Inequality Database., *Social Science Quarterly*, 90(2), 231-242.
- Stock, J. and Watson, M. (2002) Has the business cycle changed and why?, *NBER Macroeconomics Annual*, MIT Press, 159-218.
- Stockhammer, E. (2013) *Why have wage shares fallen? A panel analysis of the determinants of functional income distribution*, International Labour Office, Geneva.
- Thurow, L.C. (1983) *Dangerous currents: The state of economics*, Oxford: Oxford University Press.
- Tobin, J. (1963) Deficit, deficit, Who's Got the Deficit?, *New Republic*, January 19.
- US Congressional Budget Office (2008) *Historical Effective Federal Tax Rates: 1979 to 2005*, US Congress, Washington.
- Vickrey, W. (1993) Today's Task for Economists, *American Economic Review*, 83(1), 1-10.
- Wray, L.R. (1998) *Understanding Modern Money: The Key to Full Employment and Price Stability*, Edward Elgar, Cheltenham.

