**Scenarios for Recovery:**
**How to Write Down the Debts and Restructure the Financial System**

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(INET, Berlin, April 13, 2012)

## I. The Choice Before Us: Suffer debt deflation, or write down the debts

*The world faces a choice between trying to recover the Bubble Economy's debt-leveraged gains, or realizing that the financial sector has careened along an unsustainable path since 1980 and therefore that a fresh start has to be made.*

*The "business as usual" approach is to keep today's debt overhead on the books and bail out insolvent banks. This policy implies that financialization was a viable way to get rich in the first place. But the effect is to polarize economies further between creditors and debtors. Economies will shrink as a result of debt deflation, and falling tax revenues will push government budgets deeper into deficit – unless they cut back spending, which will make the downturn worse and threaten full-fledged depression. Unemployment will lead to emigration, the balance of payments will worsen and economies will be even less able to pay their debts.*

*The alternative is to see where this path is leading, and to write down debts sooner rather than later. This restores a more progressive distribution of wealth and income, and revives the economy's competitive position. The problem is that annulling debts also annuls financial claims on the "savings" side of the balance sheet. Creditors – led by the 1%, who have obtained most of the economic gains over the past thirty years – prefer to maintain their financial gains even at the cost of undercutting society's longer-term growth.*

*This opposition of interests obliges nations to choose between resuming prosperity or vesting a financial oligarchy to lord it over the remainder of the 21st century.*

### 1. *Trying to preserve today's debt overhead entails shrinking economies by imposing financial and fiscal austerity, and polarizing nations further between creditors and debtors*

It is intellectually uncomfortable to think that society has taken a seriously wrong path. It is even harder to reverse a path from which powerful interests are obtaining rich windfalls. The recent generation's drive to get rich by debt-leveraging has given banks, other financial institutions and the wealthiest 1% a dominant voice in government, the mass media and the academic curriculum that shapes how people think about the economy. This poses a political problem as well as a purely intellectual and scientific one when it comes to proposals to bring the economy's debt overhead back within the ability to pay.

The problem is that one party's debt is another's savings. More to the point, the debts of the 99% are the savings of the 1% (or at least the 10%). The past thirty years have seen an enormous transfer of income and wealth to creditors. Yet many people think it unfair that these savers should lose (even if they have quickly gotten much richer), or that "free riders" should benefit from having their debts forgiven. This view looks at the debt overhead from an individualistic vantage point, not in terms of the long-term economic consequences for how a neo-*rentier* society is being created – one in which rent and other monopoly fees are extracted from the broader economy, at the expense of capital investment and social progress.

Today's vested interests understandably want to avoid taking a loss on their bad loans, investments and financial gambles. But somebody must lose. The debt overhead cannot be kept on the books without a massive transfer of property to the financial sector and, via it, to the wealthiest 1%. Their rising share of wealth has taken the form primarily of creditor claims on the bottom 99%, or on governments that have taken bad bank loans and reckless gambles onto the public balance sheet, as in Ireland. So one way or another the 99% will suffer, either directly as debtors or indirectly as taxpayers.[1]

While the 99% have not yet put forth an alternative program, the 1% echo Margaret Thatcher's claim that "There Is No Alternative" (TINA). If this really is the case, then the Western economies are in deep trouble. Trying to keep today's high debt levels on the books imposes debt deflation and fiscal austerity, and hence shrinks the economy. And if the economy shrinks, more loans will go bad, in a deteriorating spiral. That is what happens in debt deflation.

The longer an alternative policy is delayed, the more the economy will polarize, making subsequent reforms even more difficult by bolstering the economic power of creditors to sustain today's home foreclosures, real estate defaults, property sales at distress prices, and spreading personal bankruptcy. It also will cause more corporate bankruptcy. This will raise the bargaining leverage of managers to replace defined-benefit pension plans with defined contribution plans (where employees have no idea of what they actually will receive upon retirement.)

On the public sector balance sheet matters are even worse – and more difficult to reverse. Tax receipts decline as economies shrink. Debt-strapped governments come under pressure to cut back their spending, starting with underfunding their pension plans. The end game is for cities, states and national governments to balance their budgets by selling off public infrastructure and other assets in the public domain.

Prospective buyers – and their bankers – depict privatization as a move toward efficiency and hence presumably lower prices. The opposite is more typically the case. The decision to pay bondholders rather than to write down or annul public debts enriches a set of rent-extracting interests adverse to those of the economy at large. Their business plan is to get richer by raising "tollbooth" fees on the infrastructure monopolies they have bought. This makes economies higher-cost, even as markets shrink for output produced by labor and industry. Privatization of the telephone sector from Mexico to the Baltics is a paradigmatic example.

[1] The U.S. Treasury and Federal Reserve have avoided raising taxes by simply monetizing the bad debts, creating new government money, bonds or Fed deposits in exchange for private sector claims. But most governments have not made use of this option for public money creation except in wartime, not to help the civilian non-financial economy grow, *e.g.* in the way advocated by Modern Monetary Theory (MMT).

2. *"Business as usual" means debt deflation*

This dynamic of credit expanding to divert the economic surplus away from public and private investment or rising living standards has occurred often in history, most notoriously in the way in which the Roman Republic and Empire collapsed. Yet it does not appear in economic models. That is part of the problem: *The narrow assumptions made by these models distract attention from the corrosive financial and other* rentier *dynamics that occur in the real world*.

The business-as-usual choice ("The debts must be paid!") threatens to derail attempts to recover, because income that is paid for debt service is not available for spending on goods and services. Diverting income to pay creditors dries up the domestic market and causes unemployment. This blocks financialized and debt-strapped economies from growing. And inasmuch as debt service is an element of price, it blocks debt-strapped economies from being able to export their way out of debt. This is why IMF-style austerity plans do not stabilize the balance of payments, but drive countries adopting such plans even deeper into debt.

What makes the post-2008 economic situation different from the crashes familiar from the 19$^{th}$ century through the Great Depression is that debts (and their counterpart financial claims or savings) were not wiped out. Governments have intervened to "save" financial markets from running the course followed in earlier times. The major creditors (but not employee contributors to pension funds) have been saved from loss by bailouts that have kept bad debts on the books, often by giving them public guarantees (as in U.S. mortgage debt and "toxic waste") or taking them directly onto the government's balance sheet as noted above.

The financial dynamic over the past thirty years has been for debts to mount up exponentially, at compound interest plus "free" electronic credit (debt) creation toward the point where they absorb the entire economic surplus – and then continue growing. Paying interest, amortization and penalties on this debt overhead shrinks the economy, plunging it into negative equity. A rising debt overhead prevents the economy from "growing its way out of debt," because corporate cash flow is used to pay creditors, and markets are not growing sufficiently to warrant new investment and hiring. And the economy certainly cannot "borrow its way out of debt." Over a quarter of U.S. real estate already is in negative equity and prices are still falling, so banks understandably have tightened their loan standards. The Federal Reserve's policy of lower interest rates for mortgage credit has not sufficed to overcome the continued unwinding of the real estate bubble. And its bursting has thrown state and local finances into deficit, forcing cutbacks in public service. The result is a cascade of lower spending.

Mathematically, the debt overhead tends to expand to the point where it absorbs the entire economic surplus (real estate rent, corporate cash flow, disposable personal income and government tax revenue), crowding out new capital investment, infrastructure investment and rising living standards. The "business as usual" scenario seeks to sustain this trend. Collapse of the Bubble Economy since 2008 has left the debt overhead on the books – while prices have plunged for real estate and other assets, reversing the rise in net worth that homeowners and retail investors thought was making them rich by taking on more and more debt.

The Federal Reserve has flooded the financial system with enough credit to re-inflate the balance sheets of debtors, and hence also of the banks and financial institutions holding mortgages and other claims. The problem is that trying to save the financial sector from loss in this way merely adds to the debt overhead. This implies a post-Bubble austerity, not recovery. New credit is debt, and it is being created not to finance new capital investment and employment, but simply to enable debtors to pay their creditors rather than writing down debts. The resulting debt service will divert consumer spending, corporate cash flow and government tax revenue (and new money creation) to sustain a debt overhead that has been decoupled from "real" economic growth (rising production and consumption).

3. *The alliance of banking with real estate and monopolies – and corporate takeover financing*

The policies chosen to resolve today's financial and tax problems will follow largely from the diagnosis of what has caused them. The first step therefore must be to describe how the financial system has loaded the economy down with debt, mainly unproductive debt that is a form of overhead rather than one that increases the economic surplus and ability to pay.

It does not do so in the way that most textbooks describe. The popular image (encouraged by the banks) is a world in which banks recycle the savings of depositors to finance new industrial investment and hiring. This was indeed the dream of bank reformers in the 19$^{th}$ century. But it does not characterize today's world. Industrial companies now bypass the banking system, borrowing by issuing their commercial paper directly, to investors who also bypass the banks.

From the 13$^{th}$ century down to Ricardo's day, banks found their major markets in international lending to finance export trade and related payments, including loans to governments to finance military spending abroad. This gave banks an interest in promoting a specialization of labor in which each country would produce what it was "best" at producing.

Britain's landed interests threatened this plan. After the Napoleonic Wars with France ended and trade resumed in 1815, rural landlords sought to block low-priced food imports. Lower prices would reduce the agricultural land rents that land lords received – rents that had risen in keeping with food prices during the decades of wartime isolation. So Parliament, dominated by the landed aristocracy, imposed agricultural tariffs – the Corn Laws.

Higher food prices increased the price that employers had to pay to cover labor's basic cost of living. The price of grain determined the price of bread, which most economists took as a proxy for wage levels. (Housing was nowhere near as large an element of the family budget as it has become today.) The Corn Laws thus threatened to impair Britain's attempt to undersell industrial competitors and become the workshop of the world.

To bankers, protectionism implied a world of largely self-sufficient balanced agricultural and industrial economies. That would not provide as great an opportunity for trade financing as specialization of labor would offer. Acting as the banking sector's major economic spokesman (and, in effect, lobbyist), David Ricardo's 1817 *Principles of Political Economy and Taxation* described how international specialization of production was more efficient than autarchy. Chapter 2, on economic rent, put forth a labor theory of value isolating land rent as the excess of market price over intrinsic cost-value, describing how the Corn Laws would increase prices and undercut competitiveness.

There was something ironic in using the concept of economic rent against landlords. The original distinction between cost-value and market price was discussed by the 13th-century Churchmen specifically with regard to what a Just Price would be for bankers to charge for converting foreign exchange (*agio*) and charging interest. But Ricardo's analysis left the financial sector out of account. Subsequent British political economy focused on returns to landlords, labor and capitalists receiving rent, wages and profits. But because money and credit were not viewed as "factors of production," its role in the economy remained indistinct. Credit was a *precondition* for the production and sale of goods, but was viewed simply as influencing price levels, not as debt requiring the economy to sustain interest payments.

The political upshot of Ricardian analysis (and indeed, that of the French Physiocrats, Adam Smith and other advocates of taxing landed wealth) was for British banking to support manufacturing against the landed interest. Parliament repealed the Corn Laws in 1846. On the continent of Europe, Germany and France also took the lead in steering banking increasingly to finance industry. And as the cities gained political power over the countryside, industry (and labor) gained power over the landed interest.

The past century has seen this alliance inverted. Instead of financing tangible capital formation to make profits by investing in plant and equipment, research and development, bankers have found their major market in lending against real estate. Whereas landed aristocracies in times past owned most of the land free and clear, property ownership has been democratized – on credit. Banks find their main business to be the financing of homeowners and commercial owners or absentee investors. The largest debt categories are real estate (mainly land) and basic infrastructure

– the economy's two largest asset categories. As rent-yielding assets, however, they (or at least, their economic rent) were widely expected to remain in the public domain.

The old landed fortunes have been transmuted into financial fortunes, receiving interest, dividends and financial gains in place of land rent. Finance is today's major source of wealth and recipient of economic rent. Buyers bid against each other for bank loans to buy property that formerly was held free and clear. The winner is whoever agrees to pay the most rental income to the banks. This financialization of land ownership ends up transferring the expected rent to the bankers – and recently some of the site's price gain as well.

The fact that some 80 percent of bank loans in the United States, Britain and Scandinavia are mortgage loans has created a symbiosis of the Finance, Insurance and Real Estate (FIRE) sectors. Banks have joined real estate lobbyists to minimize the property tax and related taxes– knowing full well that what the tax collector relinquishes will be available to be paid as interest. This campaign has rolled back property taxes from an average 70% for U.S. cities and states in 1930 to under 16% today.[2]

Pledging most real estate rent, natural resource rent and other economic rent as interest to bankers and bondholders means that it no longer is available to the tax collector. Contrary to what a century of classical economists recommended, the fiscal burden has been shifted onto labor and industry. This tax shift off the land, natural resources and monopolies is the opposite of basing the tax system on land rent as the Physiocrats, Adam Smith, John Stuart Mill and subsequent Progressive Era reformers urged. Their classical policy would have left untaxed and hence "free" to be capitalized into bank loans – and thereby would have held down prices for housing and infrastructure services.

The problem today is that any attempt to reverse course and move back to the classical ideal of taxing away rent as the major source of public revenue would cause a break in the chain of payments – because the rent already has been pledged to creditors as backing for most of the economy's savings and credit. Posing this quandary for the economy has convinced the banking sector that it has made its appropriation of rent away from government irreversible.

The stock market has not been much better in replacing debt with equity capital. The ideal developed by Saint-Simon and his followers in 19th-century France was for banks to take their returns as a share of profits, not as fixed debt payments. The idea was for financial returns to rise and fall in keeping with the ability of borrowers to pay, and that new stock issues would be used to fund new tangible investment. This is how most textbooks describe stock markets, as vehicles to raise shares in business earnings, *e.g.*, via Initial Public Offerings (IPOs).

[2] National Income and Product Accounts (NIPA), Table 3.3.

Since 1980, however, the net flow of funds has been increasingly *out* of the stock market. Drexel Burnham and other investment banks pioneered the use of high-interest "junk" bonds to buy out stockholders and "take companies private." The epoch of corporate raiding had arrived, and the tax laws subsidized replacing equity with bonds. At a 50% corporate tax rate, a company could pay out twice as much profit as tax-deductible interest to bondholders than it could as after-tax dividends to stockholders. So the financial return was doubled – leaving the tax collector with only half of what formerly was received.

When markets turn down and profits decline, companies cannot simply cut back payments to bankers or bondholders as they can with shareholders. Missing a debt payment means default and bankruptcy. Corporate managers use this fact as a threat to declare bankruptcy and wipe out employee pension funding unless the plans are renegotiated downward.

Instead of promoting the production of goods and services or spurring employment, the banking and tax systems have been distorted to promote the transfer of assets (mainly rent-extracting privileges) on credit – with interest being tax-deductible, as if banks deserved subsidy for playing a productive role rather than indebting industry, labor and privatized infrastructure to a point that threatens to drive many families, much industry and even governments into bankruptcy.

The term "socializing the losses" is not a good description of taking financial losses onto the public balance sheet. Today's governments are not socialist, or even "state socialist" as the term was applied to Bismarck's Germany with its subsidies for industry and agriculture. From America's $700 billion Troubled Asset Relief Program (TARP) in 2008 through the Federal Reserve's subsequent $2 trillion "cash for trash" swaps and bailouts of A.I.G., Citibank and other "Too Big to Fail" institutions, to Europe's bailouts of sovereign debt bondholders, new public credit and debts are being created not to revive economies but to preserve the financial claims of creditors at the top of the pyramid holding the rest of the economy in debt. These subsidies to the financial sector are unprecedented in magnitude. So a better term would be "oligarchizing" the losses as governments act on behalf of the new financial elite.

The game plan by the 1% to transfer the hard work and wealth of the 99% into their own pockets starts by cornering the market on obtaining credit from banks. Banks now lend mainly to other financial institutions, not the real economy. They then use debt leveraging for computerized casino gambling and to inflate the value of their real estate and securities. Homeowners also are advised to debt leverage and take out equity loans to make up the shortfall in living standards that their paychecks are not supporting. Alan Greenspan chimed in by informing the public that U.S. real estate is resilient against broad collapse, and that any problems were merely local.

When the bubble bursts, the strategy is to cry havoc and make sure that the government's monetary agencies – the Treasury and Federal Reserve – enable the bondholders, the 1%, to get their money back, while leaving owners of underwater real estate and toxic mortgage waste to absorb the losses. The crowning ploy is to have the Federal Reserve keep the large banks and financial institutions intact by buying their money-losing assets. This is what makes today's situation so different from the stock market crash in 1929, when the 1% lost their "paper gains" as the financial slate was wiped clean via bankruptcies and liquidations.

Even casual observers are now coming to recognize the hypocrisy of the 1% in pretending to be for "free markets" while insisting that the government bail them out and protect their booty to make their financial gains irreversible. Their cry of "There Is No Alternative" is the opposite of a free market policy**.** It aims to block discussion of where all this is leading.

4. *Mainstream remedies make the problem worse*

The world keeps on being given bad old economic medicine in new bottles. Today's neoliberal policies imposing austerity on Europe (leading to a capital and labor flight) are the same Washington Consensus policies that created the post-Soviet anti-labor tax philosophy, shock therapy and kleptocratic privatizations after 1991 (leading to a capital and labor flight), and before that the IMF austerity programs in the 1970s that led to the post-1982 Third World debt crisis (leading to a capital and labor flight). By the time the U.S.-European financial crisis hit in 2008, the IMF's former customers had rejected its financial philosophy while Russia was deploring the path that had reduced it to a raw-materials exporter with a shrinking population.

But the same "medicine" (like a medieval doctor bleeding his patient in the belief that this will "restore balance" rather than kill the patient) is being dictated today in an attempt to use the financial crisis as an opportunity to squeeze out enough tax revenue and debt service to keep the illusion that somehow the "financialization" path was a viable one, not ending in deadly economic shrinkage, falling tax revenues and deepening government budget deficits.

It is easy enough to see what steered today's economies into their financial *cul de sac*. Debt leveraging raises the cost of living and doing business, pricing financialized economies out of world markets. And by reducing taxable income, it contributes to the government's budget deficit – which the financial sector then uses as an opportunity to demand privatization and cutbacks in social spending. This adds fiscal austerity onto debt deflation.

Privatization has become the name of the new, non-military asset grab. While domestic markets for labor and goods are being shrunk, privatizers engage in rent extraction to erect tollbooths on the economy's key access and pressure points. Their business model is to raise the price of basic infrastructure services by building in interest and other financial charges, much higher executive salaries, and transfer payments to offshore tax-avoidance enclaves. Their rent extraction is tax-deductible because they have bought this infrastructure on credit, depriving governments even of user fees from sharply rising "tollbooth" charges for access to roads, railroads, ports and other transportation, education, water and sewer services, tourist sites, etc. This raises the cost of living and doing business even while the overall economy shrinks.

More of the above neoliberal policies are now being promoted as a *cure*. Economic theory (or at least, policy advocacy) has become much like a novel, with the author hoping that the reader can suspend disbelief long enough to follow the fictional world being created.

5. *International aspects of post-crash financial reform.*

Failure to resolve the debt problem will lead financialized economies to suffer deepening trade and payments deficits with less debt-ridden competitors. The problem is how to start reversing the financialization costs that have already been built into North American and European economies. As in the 1920s, the U.S. economy has become the most extreme example (outside of Latvia, that is). FIRE sector expenditures absorb as much as 75 percent of blue-collar family budgets in the United States. There is no way in which an economy with such a high monthly break-even "nut" can compete with less financialized ones.

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| Rent or home ownership costs: | 35 to 40% |
| FICA wage withholding (Social Security and Medicare): | 15% |
| Other debt service (credit cards, student loans, etc.): | 10% |
| Other taxes (income and sales taxes): | 10 to 15% |
| TOTAL: | 75% |

Only about a quarter of family budgets remains available for spending on current output. This is how financialization leads to debt deflation, even while prices rise as a result of higher banking and other economic rent charges that have no "real" cost basis.

The international effects of this fatal combination of debt deflation and rent extraction include capital flight and an emigration of labor in response to shrinking employment opportunities. The neoliberalized Baltic economies and bank-stricken Iceland are the most recent examples, and Greek emigration and capital flight also have picked up during the past year.

This dynamic is the opposite from what was expected a century ago. Instead of evolution favoring high-wage nations out-competing the old *rentier*-ridden post-feudal and post-colonial economies, wages and living standards are being scaled back under the political umbrella of financial emergency. Politically, power is being shifted from democratically elected governments to technocrats governing on behalf of international banks and financial institutions as international finance today achieves what armed conquest did in times past.

The effect of these policies is to centralize planning in the hands of financial managers. Their strategy is to privatize public enterprises and increase profits by de-unionizing formerly public sector labor, and to scale back Social Security, pension plans, health insurance and other social support programs. This is the treadmill on which financialized post-Bubble Eurozone social democracies are to be placed.

## II. **The remedies**

Fortunately, there is an alternative to letting economies be stifled by trying to pay debts at the cost of further economic growth. In fact there is an array of alternatives, and many dovetail into each other. Their common denominator is to restore the primacy of the "real" economy – labor and tangible capital on the asset side of the balance sheet – over financial and property claims on the liabilities side, and to restore balance between the public and private sectors. The aim is to minimize technologically unnecessary costs of living and production.

### 1. *The fraudulent conveyance principle*

A broad guideline for writing down debts was developed more than two centuries ago in the American colonies. British speculators and sharpies eyed the rich farmlands of upstate New York and refined the practice of making loans to farmers against their crops. Their strategy was to call in loans at an inconvenient time (*e.g.*, just before harvest), or simply to loan the farmer more than could realistically be repaid in the epoch's low-surplus economy. They then would foreclose.

To cope with this problem, the colony of New York passed the Fraudulent Conveyance law. This was retained when New York joined the United States, and remains on the books today. Its principle is that if a lender makes a loan that the borrower cannot reasonably be expected to pay off in the normal course of business – that is, without forfeiture of property – the loan should be declared null and void, and the debt cancelled. The legal assumption is that such a loan was a ploy to gain control of property pledged as collateral, over and above simply earning interest.

The aim is to keep debts within the ability to pay, by placing an obligation on bankers and other creditors to make viable loans rather than covert property grabs. This principle has two major implications for today's debt-strapped economies. It was cited in the 1980s as a defense against corporate raiders buying out stockholders with high-interest "junk" bonds. Victims of debt-leveraged buyouts claimed that there was no way that the loan could have been expected to be paid in the normal course of business and subject to existing employee contracts without selling off assets and, as noted above, downgrading their pension contracts with employees. The aim was to loot the company and leave it a bankrupt shell. The best-known recent case is the suit brought by Chicago Tribune employees against the real estate magnate Sam Zell who drove the company bankrupt and emptied out the Employee Stock Ownership Plan to pay his creditors. About half such ESOPs typically end up in bankruptcy through such financial sleight of hand.

The Fraudulent Conveyance principle may be applied to the public sector with regard to pressure brought on debt-strapped governments to sell off public enterprises to pay debtors. This situation is much like that of colonial farmers in upstate New York. Banks and bondholders have lent governments credit as if this were risk-free. This was done in the belief that if these governments have difficulty paying bondholders – especially in foreign currency – the IMF and other Washington Consensus institutions will step in and lend governments the foreign exchange to pay private-sector bankers, or simply strong-arm the sovereign debtor into paying, willy-nilly. Bondholders and banks are thus in the position of the British financial sharpies making ostensibly reckless loans in the belief that the local sheriff and other colonial officials would back up their property grab. The effect is to replace private-sector debt with debt to inter-governmental institutions and "hard currency" governments such as the United States or European Union.

As the breakdown of Inter-Ally debts and German reparations demonstrated in the 1920s, debts among governments are more difficult to write down than debts owed to private-sector banks and bondholders. Although governments are sovereign, they are subject to pressure to isolate them by the type of trade and financial sanctions imposed against Cuba and Iran. The tacit threat of such sanctions was used as an attempt to keep Argentina and other Latin American debtors in line for many years.

It has long been a basic principle of international finance not to take on debts in foreign currency. As Keynes explained in the 1920s, foreign debts add the "transfer problem" (running a trade and payments surplus to obtain foreign currency) to the domestic "budgetary problem" of governments taxing enough surplus to pay domestic-currency creditors. The global economy becomes "oligarchized" under conditions of increasing distress. (The word "distress" originally meant the property taken by creditors as collateral to ensure loan payment. Distraint is the act of seizing property to obtain payment for money owed.)

Just as the Allied Powers refused to acknowledge the transfer problem as distinct from the domestic budgetary problem with regard to World War I arms debts and German reparations in the 1920s, the IMF's "absorption" models likewise fail to draw this distinction.[3] They are the official equivalent of corporate raiders maintaining solvency with their creditors by downsizing and outsourcing, breaking up the assets and stiffing the smaller creditors (employees who agreed to lower wages in exchange for pension security) in the tradition of "big fish eat little fish."

[3] I provide a detailed review of discussions of the transfer problem from Ricardo through the 1920s to the IMF models in *Trade, Development and Foreign Debt* (new ed., 2009)

The basic principle of Fraudulent Conveyance is that loans which cannot be paid under normal conditions were made irresponsibly at best, and with predatory intentions at worst. In either case they should be written down. The ethical principle is that the debtor suffers less than the creditor, especially in a world where international credit is now created electronically on computer keyboards – while repayment of such credit polarizes and impoverishes debtor economies.

2. *Attempts to legislate reasonable ability to pay under normal conditions*

How should the courts define the reasonable ability to pay under normal conditions? Sheila Bair, head of the Federal Deposit Insurance Corp. (FDIC), suggested that mortgage-financed housing costs on new loans should be limited to 32% of the borrower's family income. This proportion is higher than the 25% rule of thumb applied by most banks before deregulation changed matters in the 1980s. But it is lower than current distress levels, which are in the neighborhood for 50% for many families, especially those with "exploding rate" variable-interest mortgages. This fact prompted Ms. Bair to propose that mortgage servicers should reset adjustable-rate mortgages back to the original rate so that the "exploding" interest rates would not cause defaults. "Avoiding foreclosure would protect neighboring properties and hasten the recovery."[4]

Another palliative would be to reduce mortgage debt service to the current rental equivalent of housing. Estimating a fair market price for real estate by capitalizing its rental value is how land prices were set in earlier centuries, when buying a property was like buying a government bond. Capitalizing the rent at the going rate of interest provided an equivalent current value. Fannie Mae has proposed a "deed for lease" program permitting defaulting mortgage debtors to remain in their homes for one year in exchange for paying the market rent – presumably much less than the existing mortgage terms. Democratic Arizona Congressman Raul Grijalva has proposed extending the homeowner's "right to rent" for five years, leaving the courts to estimate fair-market rent.

These solutions involve scaling back the value of nominal mortgage claims. Unwilling to compromise, intransigent bankers resist this – unless they are reimbursed in full. Despite public relations "jawboning" by Obama Administration regulatory agencies, banks have stonewalled against writing down mortgages. Their strategy has been to hold out for government reimbursement of any writedowns – so that the public sector ("taxpayers") will absorb the loss, not themselves. To pressure the government to capitulate (as the administration finally did in March 2012), financial institutions have held the economy hostage. Their position was that if they were not bailed out, they would destroy the real estate market.

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[4] Sheila C. Bair, "Fix Rates to Save Loans," *The New York Times*, October 19, 2007

This stance confronts governments with an all-or-nothing alternative. The banks' position is that debtors or the government must bear the entire burden of the unpayably high debts – debts that are the result of their own irresponsible and in many cases fraudulent loans. The financial sector's intransigence on this demand, and its power to threaten at least temporary economic collapse if it does not get its way and shift its loss onto "taxpayers," has upped the ante to force an all-or-nothing alternative – not a partial haircut, but a broad debt write-down.

3. *A public option for a credit infrastructure*

When Citibank, A.I.G., the Royal Bank of Scotland and Anglo-Irish Bank failed, governments became their *de facto* owners. U.S. authorities made a political decision to recognize claims by existing stockholders, bondholders and counterparties at public expense. For the economy at large, all countries kept the bad debt overhead on the books as far as debtors were concerned. Economies shrank as a result of debt deflation, the property bubble accordingly crashed, and much was simply abandoned.

Also lost was the opportunity for governments to provide a public option of banking and credit. These are in the character of basic infrastructure, after all. Instead of simply reselling these banks to new buyers – or in the case of Citibank and Bank of America, leaving their stockholders in place – the governments could have operated these institutions to provide credit cards and related services at cost rather than at a profit. Furthermore, a publicly run bank presumably would not write junk mortgages and create kindred toxic financial waste based on fraudulent "liars' loans," exploding interest-rate loans and other predatory practices that marked Citibank, Bank of America, Washington Mutual and other major offenders. The enormous public Post Office Savings Banks of Japan and Russia do not lend for such financial speculation.

The financial sector wielded sufficient political power to discourage governments from taking this option. The government did not fold up the banks or even wipe out A.I.G.'s counter-party speculators on their reckless credit default contracts. Sheila Bair argued in vain that there was no need to bail out the casino-capitalist gamblers. The FDIC could readily have taken over insolvent banks and saved insured depositors with their existing loan portfolios. This what the FDIC did when it wound down WaMu and other reckless lenders. "We have a resolution process that we've used for decades, and when we put a bank into receivership, we have the right to break all contracts, we can fire people, we can take away bonuses and we don't get into this kind of problem."[5]

[5] Joe Nocera, "Sheila Bair's Bank Shot," *The New York Times Magazine*: July 10, 2011.

A.I.G. had enough resources to maintain its "plain vanilla" insurance operations. The FDIC (and similar government agencies abroad) could have become major shareholders in the "systemically important" Too Big to Fail banks. After wiping out their superstructure of bad debt claims, it could have written down bad or outright fraudulent mortgages to realistic prices based on current rental values. But this would have caused losses for banks holding "second" mortgages and equity loans. To preserve their claims, they insisted that the economy be wrecked. Instead of representing the broad public interest, the Obama Administration went along with this demand.

In her interview with *New York Times* reporter Joe Nocera upon retiring from the FDIC, Ms. Bair emphasized: "Our job is to protect bank customers, not banks." But Wall Street institutions (the major contributors to both Democratic and Republican lawmakers, after all). Treasury Secretary Tim Geithner and other defenders of high finance told Ms. Bair: "'You have to do this or the system will go down.' If I heard that once, I heard it a thousand times. 'Citi is systemic, you have to do this.' No analysis, no meaningful discussion. It was very frustrating."

She blamed the Bush-Obama Administrations for acting to save the large investors rather than the overall economy when they bailed out the banks to save high-income investors from taking a loss. "It was all about the bondholders," she said. "They did not want to impose losses on bondholders, and we did. We kept saying: 'There is no insurance premium on bondholders,' you know? For the little guy on Main Street who has bank deposits, we charge the banks a premium for that, and it gets passed on to the customer. We don't have the same thing for bondholders." With this comment she put to rest the rhetoric refined by the 1% claiming that they believe in free markets untouched by government hands or free-lunch welfare.

Ultimately at issue is the belief that the asset side of the balance sheet needs the liabilities side to function. A further implication is that governments need to protect the banks not only from insolvency but losing their status as the economy's most profitable sector ("Where are the customers' yachts?") by keeping the existing debt overhead in place.

What was lost in the 2008 rush to act was an opportunity to achieve what Progressive Era reformers had spent a lifetime trying to promote: a public option for banking. The aim of public ownership historically has been to minimize the cost of living and doing business. Just as public roads, school systems and other basic infrastructure services are offered at cost or at subsidized prices – or freely – so the financial payments system is a basic public utility. A public option can offer less costly credit cards, savings and checking accounts than can private banks. But banks have gained control of the regulatory process and used it to disable government power to keep their charges in line with technologically necessary costs of production. They have made finance extractive – the bankers' equivalent of landlords rack-renting their tenants.

4. *An economy-wide debt cancellation (the "German Economic Miracle" option)*

The traditional path of least resistance has been to wipe out savings and debts together in a convulsion of bankruptcy. The 1929 and 1931 crashes led to the 1931 moratorium on German reparations and Inter-Ally debts. The Mexican and subsequent Latin American insolvencies led to the Brady Plan sovereign debt write-downs in the 1980s. But by far the most important example was the 1948 Allied Currency Reform in Germany. Savings over and above a basic amount were cancelled – on the logic that most belonged to members of the former Nazi regime. The main debts kept on the books were normal paycheck obligations owed by employers to their work force, and basic working bank balances. Rendering Germany free of a financial overhead, this catalyzed its Economic Miracle, making its experience a model modern Clean Slate.

Yet this prospect strikes most economists with horror in fear that it would disrupt the payments system. Monetary theory has ignored the role of money and credit as debt, as if it only affects prices – the "counters" for goods, services, sages and other payments. (Asset prices usually are left out of account, as noted above). As a mind expansion exercise it therefore is instructive to review the long history of how debt cancellations have preserved overall balance and restored prosperity rather than plunging economies into anarchy and poverty.

From the early third millennium BC in Sumer down through the Near East in Greek and Roman antiquity, societies proclaimed Clean Slates. When Sumerian, Babylonian and other Near Eastern rulers took the throne, or when droughts, floods or military disturbances made agrarian debts unpayable, rulers proclaimed "economic order": *amargi* in Sumerian, *misharum* and *andurarum* in Babylonian, and cognate terms in other Near Eastern languages extending down to *deror* in Judaism's Jubilee Year. This did not create economic disruption, but was a key to preventing widespread debt bondage and forfeiture of land rights.[6]

Such acts were relatively easy to proclaim in an epoch when most debts were owed to palace or temples collectors as in the ancient Near East, or placed at the center of Mosaic Law as in Judaism (Leviticus 25). What stopped the practice in classical Greece and Rome was the fact that debts were owed to private creditors – and unlike rulers, they found their interest to lie in reducing their debtors to a state of bondage and clientage. They did this despite the fact that this led to a flight of debtors from the land. That is why the prophet Isaiah denounced landlords and creditors who joined plot to plot and house to house until there was no more room left in the land for people.

An analogous condition exists today as creditors have imposed such extreme austerity on Iceland, Latvia and Greece that the youth must emigrate to find employment. Unemployment rate

[6] I provide a long survey and analysis in *Debt and Economic Renewal in the Ancient Near East* (ed. with Marc Van De Mieroop, CDL Press, Bethesda, 2002):7-58.

among young adults in Spain's is reported to be 50 percent, and the national rate 23 percent.[7] These countries are losing their most productive and highly educated labor. The most extreme experience is that of the former Soviet Union after neoliberals were given a free hand to financialize their economies into *rentier* rent-extraction opportunities after 1991. The moral is that unthinkable as debt writedowns may appear politically, the alternative is stagnation is worse.

All the major Roman historians – Livy, Plutarch, Diodorus, followed by modern writers such as Arnold Toynbee – blamed the decline and fall of the Roman Republic on creditor intransigence leading to a century-long Social War (133-29 BC) that polarized society between creditors and debtors. A quarter of the Empire's population was reduced to debt bondage and hereditary slavery, plunging economic life into a Dark Age. The dynamics of debt worked much like radioactive decay, ending at the point where economies finally stabilized in a leaden state of serfdom. Economic life reverted from cities to the countryside, centered largely on church estates, leaving only subsistence production throughout most of the land.

The relevance is that what blocks a reversal of toxic creditor power today – or even writedowns of more than a "haircut" – is that wiping out debts on the "liabilities" side of the balance sheet also wipes out savings on the "assets" side. The most politically problematic savings are those of the 1% that take the form of debts owed by the 99%. The 1% have achieved such great political influence in today's that they are able – and willing – to sacrifice the economy at large, and even to bring on depression rather than relinquish their financial claims.

This is what makes today's financial situation a political as well as economic crisis point in the global economy. Creditors never like to take a loss – and what makes the situation so different today is that they have achieved a political ability to drive the economy into depression in order to maintain their financial claims.

In the Great Depression, high finance and other investors lost fortunes (paper fortunes, to be sure) as stock market and real estate prices plunged and debtors defaulted. But there was a silver lining. The liquidations of wealth wiped out debts. This freed the economy from interest and principal obligations, enabling recovery to take place. But unlike the case in the 1930s, today's 1% are unwilling to absorb a loss. They have used government agencies originally created to regulate high finance to enforce harsh creditor terms and make the economy's nonfinancial sectors absorb the losses, partly by foreclosure and partly by taking bad debts onto the government's balance sheet ("taxpayers"). As a bonus, banks (most notoriously Bank of America) and A.I.G. received long-term tax credits that render them largely tax-free institutions.

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[7] http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Unemployment_statistics

Keeping these debts on the books blocks recovery, as described earlier. But the response of the bank lobbyists is blunt: "We don't care. Make us whole." It is in the character of private creditors to be more interested in their own wealth than in the survival of society. History attests to their willingness to see entire economies shrink. That is why a public checks and balances are needed – to subordinate financial dynamics to serve overall long-term welfare.

What has been lost is enlightened self-interest at the top of the economic pyramid. The financial sector's stars are *nouveaux riches* unschooled in the lessons of economic history and seemingly unfamiliar with the concept of *noblesse oblige*. Their lobbyists appear not to care that if the overall economy shrinks, wealth at the top must shrink too.

This attitude has characterized much of history. In many societies the 1% has cared more about its *relative* power over the 99% than about its own gains. It realizes that polarization widens as economies shrink and become poorer. One could only wish that the object lessons of history were taught as an integral part of how money, finance and debt interact with the overall economic and political system.

Shifting planning out of the hands of democratic government into those of Wall Street, the City of London and other financial centers has not created an enlightened despotism. The Roman model becomes relevant once again today: government acting on behalf of creditors to a point that reduces the population to debt dependency, dismantles the economy, empties out the cities, and replaces democracy with a Praetorian Guard. The Chicago Boys' applause of Pinochet's Chile as a "free market" experiment should stand as warning that a police state is the only way to keep this neo-feudalism in place and to make it so irreversible that (again, in Mrs. Thatcher's words) There Is No Alternative.

5. *Sovereign debt repudiation*

I understand that Arturo O'Connell on this panel will discuss the reasons why Argentina finally had no alternative to chronic depression and shrinkage but to revoke the foreign debts that global advisors had advised it to take on. The open question at this point is how soon Ireland, Iceland and other debt-strapped countries will face the pressures that led Argentina to save itself from being stripped by creditors. No sovereign nation should be obliged to pay foreign debts that cannot be paid in the normal course of business. It also should be a basic premise of international finance that debts should be denominated in one's own currency. All hyperinflations have stemmed from trying to pay foreign debts, not central banks monetizing domestic spending.

6. *Re-introduction of national usury laws and more creditor-oriented bankruptcy laws*

The rise of interest rates to over 20% in 1980 led to an abolition of usury laws in the United States. Creditors were able to sidestep state laws by locating in states that provided no protection to debtors. The rewritten U.S. bankruptcy laws in 2005 reversed an eight-century trend toward more humanitarian rules enabling debtors to make a fresh start. U.S. student loans are the capstone of creditor harshness. They cannot be wiped out by bankruptcy.

A related problem is the corporate bankruptcy practice putting employee claims behind those of wealthier financial creditors. The basic principle here is "Big fish eat little fish." Instead of using bankruptcy to restore overall economic balance, the practice reflects the power of bank and credit card lobbyists to rewrite the law in their own interest.

7. *A central bank to monetize government deficits*

From the Bank of England in 1694 through the U.S. Federal Reserve in 1913, the purpose of a central bank has been to create money to finance government deficits. But the European Union has blocked this option. The European Central Bank is restricted to lend only to banks, not to governments. This obliges governments to finance their deficits by selling interest-bearing debt to banks and bondholders rather than simply creating interest-free "greenbacks."

In practice, central banks have created money mainly in times of war. The U.S. Federal Reserve, however, created over $2 trillion after the 2008 financial crash to re-inflate the banking system, as an alternative to taking over and "socializing" insolvent banks. As noted above, this "oligarchizes" the losses to subsidize a new *rentier* elite.

Long before the post-2008 bailouts, wartime money creation showed how strong the power of governments is to create money when there is a will. But what if instead of creating this new money and public debt, the government had let a real "free market" wipe out the superstructure of debts? Governments could have turned the Too Big To Fail banks and other insolvent institutions into a public option to provide credit cards, bank loans and other credit to the economy. At the very least they could have separated "vanilla" banking operations from risky speculation.

A public option may be the most practical way to separate retail from wholesale banking – that is, staid credit operations from high-risk speculation. The big FDIC-insured banks fought proposals to block speculative gambling on derivatives, futures options and arbitrage loans. Their aim is to make the Clinton Administration's 1999 repeal of Glass-Steagall irreversible. Now that election campaigns have been "privatized," Wall Street contributors can buy the support of politicians to block attempts to legislate the "Volcker Rule" to re-separate the two types of banking. The big-bank ploy is to threaten a scorched earth "take it or leave it" attack on new attempts to regulate the financial system.

Their intransigence has left the line of least resistance to be sidestepping the Congressional blockage of bank reform is to create a public option out of the remnants of the failed giant banks. They could be operated in a similar way to how savings banks and S&Ls used to be run in the United States, before raiders financialized them into commercial banks.

The fear often is expressed that a public option might prove to be as prone to fraud and insider dealing as Bank of America, Citibank and other private-sector institutions. France's experience with "socializing" its banks – that is, turning management over to insiders – showed that this is indeed a danger. The Saint-Simonian Credit Mobilier founded in the 1850s as an alternative to commercial banking was undone by insider dealing under Napoleon III. The implication is that the same kind of checks and balances are needed for public banking that used to be applied to commercial banking before the neoliberal deregulators destroyed this balance. One need simply look at Iceland's privatization of public banking to see how much greater the danger of fraud and risk-taking is once public oversight is destroyed.

An under-appreciated advantage of this public option is that it is easier for governments to cancel debts owed to themselves than those owed to private-sector creditors. This is what explains the contrast between the Bronze Age Near East and subsequent Greek and Roman antiquity. The oligarchies that gained control of society (replacing kings either with Senates as in Rome, or with rulers beholden to the oligarchy) ended the tradition of debt cancellation, accelerating antiquity's financial polarization into debt bondage.

*Summary*: *Debts that can't be paid, won't be*

A common denominator runs throughout recorded history: a rising proportion of debts cannot be paid. Adam Smith remarked that no government ever had repaid its debt, and today the same can be said of the overall volume of private-sector debt. One way or another, there will be defaults – unless debts are paid in an illusory fashion, simply by adding the interest charges onto the debt balance until the sums finally grow to so fictitious a magnitude that the illusion of viability has to be dropped.

But freeing an economy from illusion may be a traumatic event. The great policy question therefore concerns just *how* the various types of debts won't be paid. The choice is between forfeiting property to foreclosing creditors, or writing debts down at least to the ability to pay, and possibly all the way down to make a fresh start. Somebody must lose, and their loss will appear on the other side of the balance sheet as another party's gain. Debtors lose when they have to forfeit their property or cut back other spending pay their debts. Creditors lose when the debts are written down or go bad.

The balance of gains and losses in such foreclosures depends – in narrow accounting terms – on the value of collateral being transferred. But from an economy-wide perspective the resolution of a debt overhead needs to be looked at as a long-term dynamic. Any such analysis turns on the role of specific classes of debtors and creditors within the economy – the 99% and the 1%, the "real" economy and the financial sector. It is not simply a matter of what contracts say ("A debt is a debt, and all debts must be paid.") The effect of debt on the economy's overall cost structure is most important – including the international dimension cited earlier with regard to the extent to which debt service and debt-leveraged housing prices and other output increase the cost of living and doing business.

Writing down debts reduces the overall economy's financial costs. Keeping debts on the books retains these costs. So when the financial sector (or the 1%) insists on maintaining the debts that have been run up – and supporting the debt-leveraged price of real estate pledged as collateral – securing its past "savings" gains are incompatible with maintaining a viable economy. The debt overhead becomes an expense that must be shed if the economy is not to shrink – and if it does shrink, more debts will go bad and a deteriorating spiral will set in.

Perception of this long-term macroeconomic dynamic is what has led the past few centuries of legal trends and political ideology to favor indebted labor and industry, and indebted governments as well. It explains why debtors' prisons have been closed, and bankruptcy laws become increasingly humanitarian to enable debtors to make a fresh start. This idea of clean slates is only recently being extended to the economy-wide scale, starting with government debts to global creditors.

Today's financial trend threatens to reverse this pro-debtor reform tendency. Without acknowledging the economic and social consequences, the "business as usual" approach is a euphemism for sacrificing economies to creditors. It seeks to legitimize the disproportionate gains of banks and their *rentier* partners who have monopolized the past generation's surplus. And it is to protect these accumulations that the FIRE sector has spent part of these gains to become the dominant voice in government, including the courts, as well as academia. The aim in practice is to impose austerity and economic shrinkage on the private sector, while the public sector sells off its assets in a voluntary pre-bankruptcy.

The internal contradiction in this policy is that austerity makes the debts even harder to pay. A shrinking economy yields less tax revenue and has less ability to create a surplus out of which to pay creditors. Debt repayment is not available for spending on current goods and services. So markets shrink more.

This is not an inevitable scenario. Governments are sovereign with regard to their creditors. They still posses the alternative power to wipe out the debts – along with the savings that are their counterpart on the opposite side of the balance sheet. The German Currency Reform of 1948 remains a model. But it calls for creditors to take a loss.

This has happened again and again in history for the past five thousand years. Until recently it was the normal result of financial crashes – the final stage of the business cycle, so to speak. But as economies have been financialized, creditors have gained political power – and also the power to disable realistic academic discussion of the debt problem. What they fear most of all are thoughts of how to avoid today's arrangements that have given them a free lunch at the rest of the economy's expense.

## III. **How to restructure the financial and tax system**

The economic tragedy of our time is the failure to mobilize saving and new credit creation to fund economic growth. Bank lending has sustained its growth by inflating prices for buying a home or a retirement income. Yet mainstream monetary theory relates the money supply only to commodity prices, not asset prices. It therefore misses the major dynamic polarizing economies and loading them down with debt.

A well-structured financial system should steer credit and saving productively – that is, into loans that provide the borrower with the means to pay. After a financial crash such as the West is experiencing today, the aim should be to help economies grow again – this time, in a way that will avoid a financial Bubble Economy from recurring as a result of unproductive lending and speculation.

At the broadest level the task is to prevent the "free lunch" tollbooth opportunities that classical economists sought either to tax away or to move into the public domain as subsidized infrastructure services. Nobody a century ago expected the financial sector to end up with this economic rent. It was expected to become the tax base. But financial lobbyists have promoted a slow but steady undermining of classical value and rent theory. Contrary to the classical reform program, the aim is to "free" economic rent and asset-price gains to serve as the basis for the economy's savings and credit creation.

To defend their appropriation of land rent, natural resource rent, monopoly rent and other returns to privilege, the financial sector has taken the lead in promoting an anti-government political ideology. Taxes on property and wealth are denounced – only to be replaced by interest charges capitalizing land rent and other property revenue into bank loans. This inversion of the classical reform program calls for a broad restructuring once today's debt rubble is cleared.

1. *Financial and fiscal reform need to go together*

Any economy is an overall system. Restructuring the financial sector and its debt overhead requires changes throughout the system – above all the tax system, because its distortions have aggravated and intensified today's financial malstructuring.

Contrary to what was expected in Ricardo's day, the major market for bank loans is not industry and commerce. Banks have found their major loan market in rent-extracting activities: real estate, insurance and monopolies. Mortgage lending accounts for some 80 percent of bank loans in the English-speaking economies. Other major bank customers are the oil and mining sectors (capitalizing their resource rents into bank loans and paying it out as interest), and corporate raiders as industry has become financialized to pay out cash flow as interest and dividends (and exorbitant executive salaries, bonuses and stock options). Industrial companies now bypass the banks and have developed their own direct access to credit markets.

The aim of classical political economy was to tax away "unearned income," defined as economic rent. From the Physiocrats and Adam Smith through John Stuart Mill and the Progressive Era reformers, the essence of free market theory was to tax the rental value of sites provided by (1) nature, (2) by public infrastructure investment in transportation, water and sewer systems, power distribution and communications, and (3) the level of general prosperity – all of which are extraneous to the landlord's own investment of capital and labor.

An associated virtue of a rent tax is its ability to recapture what kleptocrats and other privatizers have taken, especially in the post-Soviet economies. Ownership even can remain in private hands, as long as the government collects economic rent and windfall gains.

But when this rent has been capitalized into bank loans, it cannot be collected as the tax base – without causing loan defaults, because the same revenue cannot be paid to two different parties. The fact that the banks have aggressively over-lent and put their depositors (and government insurance agencies) at risk has convinced the financial sector that its appropriation of this rent is irreversible. An attempt to tax rent and asset-price gains today would raise the specter of financial crash that bank lobbyists wave as a red flag to get this way.

A political problem with having un-taxed economic rent is that governments must make up the fiscal shortfall by taxing labor and industry. The effect of income taxes and sales or excise taxes is to raise prices. A rent tax has the opposite effect. It leaves less "free income" available to be capitalized into bank loans to bid up real estate prices or shares of monopolies. This closes off the major stream of unproductive mortgage "overhead" debt. And inasmuch as asset prices are whatever a bank will lend to new buyers, a rent tax prevents the site value of housing, other real estate or monopolies from being capitalized into bank loans.

The public interest therefore lies in taxing land rent, natural resource rent and monopoly privilege – including extractive financial privileges – or keeping rent-yielding assets and activities in the public domain. But banks see their advantage to lie in un-taxing rent, as this has become their major loan market. Their interest thus lies in a policy that raises the economy's cost structure and makes it uncompetitive. The proper task of bank regulation thus should be to subordinate financial drives to serve the economy. But at present, matters are just the opposite: government policy aims at "freeing" as much of the economic surplus and property claims as possible to be pledged to the financial sector.

Taxes on monopoly rent have been averted in the United States by regulating the prices charged by public utilities, railroads and other privatized infrastructure, to keep them in line with necessary costs of production. Failure to regulate – as is occurring in economies privatizing their public domain with no regulatory authority in place – unleashes opportunities to extract "tollbooth" user fees, and for banks to develop a great financial market to capitalize this rent extraction into loans, whose interest is built into higher public user prices. The abuses of America's railroad barons and Gilded Age stock waterings should be an object lesson in the economics curriculum for how predatory finance carves out fortunes at the economy's expense – and how these fortunes remain intact to warp generation after generation of development, by defending themselves more and more at society's expense.

The link between financial reform and tax policy is completed by the fact that public money creation is given value by governments accepting it in payment for taxes. These taxes need not be deadweight if they prevent unproductive speculation and exploitation. The thrust of classical political economy was to show how socially desirable it is to collect economic rent. Failure to collect this "free lunch" revenue diverts saving and enterprise away from tangible capital accumulation into rent-extracting activities – and as noted above, leaves this rent to be built into the economy's cost structure as well as backing for its financial system. So the private sector is backed by the flow of rent that originally was supposed to back the public monetary system. This is part of the fatal tradeoff that anti-government "free market" ideology has backed.

2. *Remove the tax-deductibility of interest payments so as to favor equity over debt financing*.

As noted above, 19$^{th}$-century followers of Saint-Simon urged that financial systems be steered toward more productive capital formation by replacing debt with equity capital, taking bank returns as a share of profits. Today's tax system follows the opposite principle. It permits interest payments to be tax deductible (and executive salaries without limit), but not dividends or retained earnings re-invested in capital formation. This tax philosophy is largely responsible for the post-1980 conversion of stocks into bonds, equity investment into interest-bearing debt.

3. *De-financialize Social Security, pensions and health care*

Public finance is not like a family budget. Individuals have a reason to save for the future. If they do not do this, they will have less to spend. Their hope is for their savings to be invested productively and that they may get to share in the returns that are made.

That is not how public budgets work. Germany and other countries finance pensions, health care and other public programs on a pay-as-you-go basis out of current tax revenue – that is, on taxes that fall mainly on the higher income brackets, or by new money creation. This was the guiding principle of progressive tax philosophy until the neoliberal coups of the 1980s.

Matters changed in the United States in 1982. The Greenspan Commission advised an increase in Social Security funding by raising F.I.C.A. wage withholding (presently 12.4 percent for Social Security and 2.9 percent for Medicare, or 15.3 percent – which is higher than the 15 percent long term capital gains tax). Pre-saving to pay future Social Security turned the program into a steeply regressive tax. The cutoff point for the Social Security tax is currently at $110,100, so the wealthy do not pay anywhere near as high a rate to fund the plan as do blue-collar workers.

Taxing employers and employees to pre-save much larger amounts than previously changed the character of Social Security to a "user fee" rather than a public program financed largely out of the general budget. In fact, the Social Security Administration became a regressive way to pay for the general budget! The higher wage set-asides were used to buy Treasury bonds – enabling the government to slash taxes on property and the high tax brackets. The effect was a regressive tax shift – applauded as "balancing the budget" rather than denounced as an aggressive fiscal battle by the wealthy to avoid paying their way.

This was the beginning of the enormous increase in wealth held by the 1%, while disposable personal income for most people has not risen since the late 1970s. By the Clinton years (1993-2000), politicians were celebrating the high wage withholding for creating a budget surplus, as if this were a positive objective. But it meant that the government stopped providing a source of market demand to the private sector. That function passed to the commercial banking system – in the form of interest-bearing debt creation.

The interim until 2008 was applauded as the Great Moderation – Great because it led to unprecedented economic polarization between creditors and debtors, and Moderate because there was so little opposition from the non-financial classes having their taxes raised, their debts raised, their costs of education and housing raised, the price they paid for public utility services raised, and their social programs cut back.

The tax shift off property to employment and industry was worst in the post-Soviet states. Latvia imposes a 24 percent flat tax for Social Security on top of its 25 percent flat tax on employment (and further excise taxes that fall on labor). This diverts wages from being available for spending on the goods that labor produces – while making labor so high-cost as to be uncompetitive. Most post-Soviet property taxes have been less than 1 percent, fueling the world's steepest real estate boom since the mid-1990s – increasing the wage squeeze on labor by making housing much more expensive. The effect has been to impel emigration.

As in the case of Social Security's pre-saving, pension fund set-asides that are turned over to money managers for investment in the financial markets do not become a source of market demand. To the extent that financialization corrodes industrial capital formation (and hence employment), this undercuts future economic surpluses out of which to pay retirees – while leaving current labor with less to spend in the short run. The effect is regressive, not progressive.

The past half-century has seen an attempt to persuade pension-fund contributors to think of themselves as finance capitalists in miniature. Trying to convince the 99% to believe that their welfare is the same as that of the 1% is the game that General Pinochet and Margaret Thatcher called "labor capitalism." The reality, of course, is that the 99% are debtors *to* the 1%, while their savings are at risk. What employees believed to be their savings are being scaled down as employers replace defined-benefit pensions with amorphous defined contribution plans or simply annul such obligations in bankruptcy, turning the pot over to the 1%.

Small investors meanwhile have seen their savings stripped by the deregulation of high finance as Wall Street lobbyists have disabled the Securities and Exchange Commission and other regulatory bodies to the point where MF Global can appropriate client savings for its gambles without any criminal charges being brought. So the final stage of what was applauded a half-century as Pension Fund Capitalism (or even Pension Fund Socialism) turns out to be a decriminalized predatory financial system deteriorating into post-Bubble austerity.

4. *Restore classical value and rent theory, and apply it to the financial sector*

Imposing austerity on debt-strapped economies is a product of political lobbying to promote a false picture of reality, a distorted map that benefits the financial sector. Restructuring the economy therefore requires a better guide to how economies work. The task is inherently political, because wherever one finds a wrongheaded and seemingly dysfunctional analysis retained decade after decade, special interests are at work.

For the past century the main beneficiary has been the financial sector. In an alliance with real estate and monopolies, it has backed a reaction against classical economics, above all the distinctions between earned and unearned income, and between productive and extractive debt. The aim is to reject the idea of free markets held by the Physiocrats and Adam Smith, John Stuart Mill and subsequent Progressive Era reformers: markets free *from* unearned income and privilege, above all in the form of land and natural resource rent, monopoly rent, and financial charges resulting from the banks' privilege of credit creation.

To ensure the ideological dimension of TINA, the academic curriculum has dropped the history of economic thought, along with economic history. This blotting out of analytic knowledge has enabled today's "neoliberals" to turn the original liberal approach of Adam Smith and his successors inside out, by re-defining a "free market" as one that is free *for* rent extraction, free *from* government protection, price regulation and taxation of economic rent.

One must turn to novelists such as Honoré de Balzac to be reminded that behind most family fortunes is a great theft – often an undiscovered one, usually from the public domain. This is precisely why privatization receives such endorsement in high circles. Throughout history the largest fortunes have been obtained by such transactions, often by insider dealing. Seeking to lower a cloak of invisibility around the manner in which these fortune hunters or their forebears got rich, they claim that it was all from the free market, not from the public sector or by financial and legal sleight of hand. As another Frenchman, the poet Charles Baudelaire quipped, the devil wins at the point where the world believes he doesn't exist.

5. *Recalculate the National Income and Product Accounts (NIPA) to distinguish between wealth and overhead, and give a sense of proportion to "capital gains" and "total returns"*

Any statistical format applies the categories of economic theory. If the theory is off-center, the motto GIGO applies to how the numbers are filled in: Garbage In, Garbage Out. A more realistic accounting format would segregate the FIRE sector from the production-and-consumption economy. The aim should be to calculate the economic surplus and show where it is produced (focusing on the "real" economy's manufacturing, agricultural, mining, power production and transportation sectors) and who gets it (focusing on the *rentiers*).

The NIPA also should show the degree to which "total returns" are achieved by asset-price inflation ("capital" gains), as well as by rent extraction. Adding price-gains to real estate and financial cash flow shows sharp zigzagging changes from year to year, giving a truer picture of the economy. Quantifying asset-price gains also highlights the cost to society of providing today's tax favoritism to such speculation, steering savings and investment into a casino economy.

*An ideological synthesis*

Matters were not supposed to turn out like they have. Nothing like today's debt-leveraged economy channeling income and capital gains to a narrow financial layer (the 1%) was anticipated a century ago. Economic evolution was expected to favor the most egalitarian and democratic economies, thanks to the fact that higher productivity resulting from rising living standards enabled high-wage labor to undersell "pauper labor." Banking was expected to fund industrial capital formation, not load down the economy's assets with debt taken on by absentee owners and raiders on credit. A leisure economy appeared to be the wave of the future, not debt deflation and asset stripping.

Cassandras such as Michael Flürscheim, Thorstein Veblen and Frederick Soddy were dismissed because their warnings seemed so unlikely to materialize. A wave of cognitive dissonance set in with regard to the role of debt and credit creation by banks. Reality itself appeared as an anomaly to post-classical models.

Awareness of reality usually leads to new paradigms, although this may take a long time in coming. Since the late 1970s, rising labor productivity has not been reflected in higher wages. The surplus has been concentrated at the top of the economic pyramid. Instead of the anticipated leisure economy, families are working harder and longer under more oppressive employment conditions to carry their rising overhead of personal, educational, mortgage and other debts. The products they buy also have a rising element of debt, and the taxes they pay are for increasingly "financialized" public programs. And yet it will take at least a generation (or more likely, two) to reverse the financial power grab that has been implanted and rectify the junk economics that has been sponsored.

The longer that economies keep subsidizing the debt overhead, the more they will shrink. The cover story for keeping this overhead on the books is that writing it down will destroy savings and disrupt the economy. But recent growth in these savings has been monopolized by the 1%, and can be preserved only at the cost of imposing a fatal austerity on the economy. So shrinking disposable personal income is inevitable if the financial system is not restructured. Its present form threatens not only industrial capitalism and national self-determination but beyond that, the Enlightenment ideology of economic freedom and democracy.

It is a travesty to say that bailing out Citibank, Bank of America and A.I.G.'s counterparties was an exercise in a free market. It is not a free society to appoint "technocrats" acting as debt collectors to replace elected public officials in debt-strapped Greece and Italy. Imposing austerity ends up requiring a police state to enforce the maldistribution of wealth and political power. Some countries already are approaching this point as families lose their ability to provide an education or even food, or to retain their homes – or much hope for the future.

For the past century the path to rise into the middle class (and on upward) has been to buy a home, whose price rise has built up their net worth, and to get an education to qualify for higher-productivity, high-wage employment. But taking on a mortgage and a student loan has now become a road to debt peonage. Students face unemployment and must live at home with their parents. More than a quarter of U.S. homes are in negative equity, dragging down net worth rather than building it up. Student loan debt now exceeds a trillion dollars, even more than the credit-card debt that families have taken on just to keep their consumption standards from falling. All this threatens to turn the final stage of finance capitalism into debt-ridden austerity. That is what a neo-*rentier* economy means. Once entered into, it cannot be escaped from except by a violent political clash. The end game of finance capitalism will not be a pretty sight.