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Trade and Payments Theory in a Financialized Economy*

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ABSTRACT

Ricardian trade theory was based on the cost of labor at a time when grain and other consumer goods accounted for most subsistence spending. But today's budgets are dominated by payments to the finance, insurance, and real estate (FIRE) sector and to newly privatized monopolies. This has made FIRE the determining factor in trade competitiveness.

The major elements in US family budgets are housing (with prices bid up on credit), debt service, and health insurance—and wage withholding for financializing Social Security and Medicare. Industrial firms also have been financialized, using debt leverage to increase their return on equity. The effect is for interest to increase as a proportion of cash flow (earnings before interest, taxes, depreciation, and amortization, or EBITDA). Corporate raiders pay their high-interest bondholders, while financial managers also are using EBITDA for stock buybacks to increase share prices (and hence the value of their stock options).

Shifting taxes off property and onto employment and retail sales spurs the financialization of family and business budgets as tax cuts on property are capitalized into higher bank loans. Payments to government agencies for taxes and presaving for Social Security and Medicare absorb another 30 percent of family budgets. These transfer payments to the FIRE sector and government agencies have transformed international cost structures, absorbing roughly 75 percent of US family budgets. This helps explain the deteriorating US industrial trade balance as the economy has become financialized.

Keywords: International Trade Theory; Financialization

JEL Classifications: F3, F4, F10, F17, F18, F37, G12, G21, H21, J61

If trade theory is to be based on how economies work and relate to each other, it should focus on the financial overhead, capital movements, and tax policies that are the key to today's prices payments and exchange rates. Debt taken on to buy homes (with prices bid up on credit) and to obtain an education, and wage set-asides for pension funds, Social Security, and Medicare all raise the cost of living and doing business—and hence, make economies less competitive. So do debt-leveraged corporate buyouts.

Most trade and exchange rate models have neglected these financial, rental, and fiscal charges ever since David Ricardo analyzed costs as if economies operated on barter. He claimed that debt service and military spending could not create economic problems, insisting that they were automatically self-financing. This approach excluded recognition of how debt service adds to the cost of living and doing business, and depresses exchange rates. Capital transfers supposedly set in motion re-stabilizing "corrections" enabling debt or payment outflows to be paid without disrupting price and income structures.

What is remarkable is that debtor interests have accepted this "don't worry about debt" logic about "automatic stabilizers" for nearly two centuries. Forecasts promising that austerity will revive growth and that debt leveraging helps economies get richer faster rarely are innocent. They even get the direction of change wrong. When such theorizing is pursued generation after generation, the explanation is that special interests must be benefiting from its tunnel vision.

When it comes to minimizing the role of debt and credit, the financial sector's motivation is to distract attention from the problems caused by debts growing beyond the ability to be paid, disrupting economies and adding to the cost of living and doing business. This turns economics into a public relations lobbying effort for financial deregulation.

One cannot discuss the roles of finance and government without the concept of economic rent, because rent seeking is the largest category of bank lending—and also of tax favoritism. Today's academic mainstream rejects the classical idea of unearned income, defined as that which has no counterpart in socially necessary costs of production. But economic historians will recognize the concept of a free lunch as the centuries-long description of *rentiers*—bankers and landlords in the private sector. It is to this class that Keynes referred when he spoke of "euthanasia of the *rentier*" as the wave of social reform to avert future depressions.

Post-classical economics claims that there is no such thing as a free lunch—as if everyone earns and hence deserves whatever income and wealth they obtain, regardless of how they get it. This conflates transfer payments (including outright fraud and looting) with productive effort. All *rentier* income appears to be payment for providing economically helpful services, equal in value to the income paid to the financial, insurance, and real estate (FIRE) sector. This is the concept that underlies the national income and product accounts (NIPA).

The classical doctrine now swept under the academic rug began in the 13th century with the Schoolmen discussing Just Price, mainly to distinguish between fair and extortionate banking charges. The idea of unearned income came in time to be applied to land rent. The classical analysis of economic rent—whether in finance, insurance, or real estate, or even monopoly pricing—finds no room in today's curriculum. The concept is muddied by turning the tables to depict government officials as "rent-seeking" bureaucrats increasing public spending and regulation in ways that increase their own power, exclusively in unproductive ways that add to the economy's "deadweight" cost of doing business. Nothing about predatory FIRE-sector *rentiers* in this view!

EXCLUDING DEBT SERVICE FROM TRADE THEORY—AND FROM DOMESTIC PRICE AND INCOME THEORY

The financial sector historically has sought to make itself invisible. After all, what is not seen will not be criticized—or taxed. To paraphrase Charles Baudelaire's quip that the devil wins at the point where the public comes to believe that he doesn't exist, the financial sector's lobbying effort wins at the point where people believe that running into debt contributes to economic growth rather than burdens it, and that they will end up richer by acting as bank customers. Debt leveraging is depicted as the easiest and even the surest way to accumulate wealth—going into debt to buy assets whose prices are being inflated on credit, or to spend in the hope of paying out of rising and more easily earned future income.

But as the dust settles from 2008, most fortunes have been made by bankers and brokers, largely at the expense of their clients (and as it turns out, taxpayers as well). The banking system's product is debt, in a dynamic that ends with many debtors falling into

negative equity and forfeiting their property to foreclosing creditors. That is the legacy of the real estate bubble and debt-financed corporate takeovers. And internationally, debt-ridden economies are subject to pressure from intergovernmental institutions such as the International Monetary Fund (IMF) and European Central Bank (ECB) to impose fiscal austerity on their labor force, cut back public spending, and even sell off public enterprises.

This explains why the nonfinancial "barter" approach to trade and exchange rate theory pioneered by Ricardo, writing as Britain's leading bank spokesman, denies that foreign payments or credit cannot cause economic problems. Bankers are depicted merely as oiling the wheels of commerce, providing the "neutral" means of pricing goods and services (pretty much ignoring asset prices), not intruding into the circular flow between production and consumption by extracting debt service and lobbying for *rentier* privileges.

The public relations problem that Ricardo faced was that debt service in 1815 absorbed three-quarters of the British government's budget. Especially problematic was foreign debt taken on to finance military spending and subsidies to Britain's allies in its many centuries of wars against France. The Seven Years War (1756–63) and Napoleonic Wars (1787–1815) sharply increased the national debt and, as Adam Smith illustrated in Book V of *The Wealth of Nations*, new excise taxes to pay for each new borrowing. Confronted with popular criticism of the proliferation of excise taxes to pay interest to bondholders, the political task of bankers was to deny the problems caused by loading down economies with debt.

MOST MONEY AND CREDIT, WAGES, AND NATIONAL INCOME ARE SPENT ON THE FIRE SECTOR

The textbook formula MV = PT means money (M) times the velocity of turnover (V) equals the market price (P) of the economy's transactions (T). However, the "transactions" in question are limited to current production and consumption, and "price" refers only to consumer prices or those of other commodities—or wages. Yet by far most credit is spent on assets, not goods and services. Every day a sum larger than an entire year's GDP passes through the New York Clearing House and the Chicago Mercantile Exchange for asset purchases and sales. So more than 99 percent of spending in the United States and other financialized economies is for real estate, mortgages and packaged bank loans, and for stocks

and bonds. By limiting the scope of analysis to commodity prices and wages, mainstream monetarist theory leaves these credit transactions and their debt service out of account.

International payments are dominated by capital flows for direct investment, bonds and stocks, and bank loans and speculation. To the extent trade remains based on the cost of labor and doing business, rising payments to the FIRE sector also dominate. This is a far cry from the early 19th century when prices reflected mainly that of food and other basic consumer goods. Each country's debt overhead, housing prices, tax rates, public subsidies, and fiscal systems determine product prices. And foreign lending and debt service, military spending, and financial speculation are an inherent part of the global system affecting exchange rates. But despite John Stuart Mill's analysis of how "capital transfers" affect exchange rates, popular discussion still calculates purchasing-power parity rates for McDonald's hamburgers and other consumer goods, as if this were a measure of international equilibrium.

Some 70 to 75 percent of typical US wage-earner budgets are paid to the FIRE sector and to government. So economic analysis is trivialized if it only takes into account direct production costs reducible to labor, not taxes or "economic rent" as an element of price with no counterpart in technologically necessary production costs—land rent, monopoly rent (including bank credit-creating privileges), interest charges, and kindred transfer payments to *rentiers*.

This has far-reaching implications for how best to achieve trade competiveness. Neoliberals tell Latvia, Greece, and other countries to impose economic austerity by monetary and income deflation to cut wage levels ("internal devaluation"). But this leaves financial and tax structures in place. Policy discussion is limited to fiscal austerity and currency depreciation—but not a shift of the incidence of taxation to real estate, finance, or monopolies, or less regressive taxation on employment and consumption, not to speak of debt write-downs. What is lacking in this approach is a view of the economy as a system. Wage levels and interest rates are singled out as the only variables to "solve" the debt and balance-of-payments problems. So we are dealing with a purposeful narrow-mindedness.

Latvia has flat taxes on employment that add up to 59 percent of the wage. Cutting this tax by 40 percentage points—down to about 20 percent of the wage—would double labor's take-home pay (from about 40 to 80 percent of the wage). The government would make up the loss by raising the land tax to absorb the ground rent, and also the economic rent now being collected by the buyers of the formerly public infrastructure. But this rental income is the

preferred object of bank lending—turning rent into interest payments, mainly to branches of Scandinavian banks. Yet there has been little discussion of shifting taxes onto land and monopolies, leaving less economic rent to capitalize into interest payments, thereby holding down housing prices.

Latvia's public-sector wages were cut by 30 percent during 2009–10 as the GDP plunged by over 20 percent. But cutting wages also cut employment taxes, so take-home wages fell only by 12 percent—as unemployment spread, turning Latvia into a neoliberal disaster story. Its regressive tax policy has made the nation's industrial labor so uncompetitive that young adults have emigrated to find work, causing Latvia's population to plunge by 10 percent (from 2.2 million to 1.9 million since the last census).

This demographic effect of trade deficits was well-recognized by economic writers already in the 18th century. But free trade theory expurgated the linkages between trade and population growth, for the same reason that it conflated finance capital extracting debt service with industrial capital employing labor to produce goods and services: Greater realism leads to policy conclusions not favored. So economic theory was over-simplified. The rent and tax structure is taken for granted or simply treated as "exogenous," being political or "institutional" and as such, excluded from the sphere of "scientific" economics proper. The resulting legacy of Ricardian trade theory focuses on subsistence consumption, not debt-financed housing costs, education, financialized pensions, Social Security, and other FIRE-sector charges.

A scientific body of analysis would demonstrate how financialization adds to the cost of living and doing business. The financial overhead consists not only of debt, but also compulsory saving in the form of wage withholding to pay for future pensions and medical care. In the United States these wage set-asides gained momentum after 1980. And the post-2001 Bubble Economy that inflated prices on credit for housing, commercial real estate, and corporate ownership celebrated "debt leveraging" as raising returns on equity. But the effect was to absorb more of the national economic surplus in the form of debt service.

All nations face common global prices for fuels and raw materials, and licensing fees for patents such as information technology and pharmaceuticals. Trade competition reflects financial dynamics, economic rent, and tax policy in four main national variables: (1) labor's cost of living, wages, and nonwage benefits (mainly pensions and health care), (2) land rent and debt overhead, (3) the incidence and level of taxation, and (4) the terms on which governments provide infrastructure services such as transportation and communications, Social Security, and

health care, along with economic subsidies. The impact of financialization and an anti-labor tax shift on the deteriorating US industrial trade balance, for example, is clear from the following rough approximation of typical American employee budgets:

Balance-sheet factors (debts taken on to buy assets rather than current output)	
Housing (ownership or rental costs):	32 to 40%
Debt service (non-mortgage)	15%
Private health-care and pension fund contributions	?
Government tax policy structure	
FICA withholding for Social Security and Medicare:	15%
Taxes (income, sales and excise or VAT)	15%

US de-industrialization—and rising motivation to invest in less debt- and rent-ridden economies—reflects the fact that *rentier* payments and taxes absorb as much as 75 percent of family budgets. In Germany, housing absorbs only about 20 percent of family income, half the US rate. So the proportion of German wages available for spending on goods and services (rather than being paid to the financial sector as mortgage interest) is 20 percentage points higher than is the case with US family budgets. This is explained partly by institutional factors and partly by financial practice. Germany has a tradition of rental co-ops, to which many families belong. Membership rents are based on current operating costs. Also, Germany's construction industry is not monopolized or criminalized as it is in New York and other major US cities.

But the major differences between Germany and US real estate are financial and legal. European homebuyers typically must save 20 or 30 percent of the purchase price to obtain a mortgage, in contrast to America's practice of 100 percent mortgages (or even a net cash payment *to* new home buyers) as the 2002–06 real estate bubble gained momentum. European mortgage markets also have been relatively free of no-documentation "liars' loans" to NINJA borrowers ("no income, no job, no assets") backed by crooked real estate appraisals by brokers and appraisers. Wholesale financial fraud has effectively been decriminalized in the United States.

US renters and prospective homebuyers in the 1970s and 1980s were panicked into buying at extortionate prices as residential real estate in the large cities was sold off to

buyers. Co-ops typically were sold with existing mortgages attached to them, with buyers borrowing almost an equivalent volume of new debt. Housing costs soared, prompting speculators to increase their share of the residential housing market to an estimated one-sixth by 2006.

Looser lending terms—lower down payments, slower amortization rates (culminating in no-interest mortgages by 2006), and less regulation to keep income declarations honest—fueled a larger debt pyramid. Real estate or other assets are worth whatever banks will lend against them. And whatever the tax collector relinquishes is "free" to pay the banks to obtain mortgage loans. A lower tax on land rents leaves more to be capitalized into bank loans, and hence inflates the price of housing—while government revenue is balanced by burdening labor and industry with income and sales taxes. The financial sector accordingly aims to shift taxes off its major customers (real estate and monopolies) so as to leave more revenue "free" to be capitalized into bank loans and paid out as debt service. And to subsidize debt leveraging, interest is made tax-deductible.

This has major implications for the how best to adjustment to international payments and debt imbalances. Pro-financial "neoliberal" lobbyists urge an anti-labor policy of "internal devaluation," lowering wages as a means of making economies more competitive to "earn their way out of debt." But the cost of labor could be reduced just as effectively by a tax policy that shifts the fiscal burden off employment onto property rents and other economic rent.

Failure to deal with bank loans, real estate, stocks, and bonds—and the income diverted away from consumption and tangible investment to pay debts—limits monetary and price analysis to relating the money supply and government budget to price and wage levels. Left out of account is the use of credit to fuel asset purchases and speculative gambles. And government deficits may stem from bailouts taking bad bank debts onto the public balance sheet. In 2011, for example, banks used the US Federal Reserve's $700 billion Quantitative Easing (QE2) mainly for foreign currency arbitrage, not making it available for domestic consumer spending. Also left out of account are the prices at which public or private infrastructure services are supplied.

Failure to take account of debt service and government spending on anything except current employment affecting consumer prices makes trade theory unrealistic. But financial interests endorse this narrow-mindedness to promote anti-labor austerity and high interest

rates, and to exclude an understanding of how financialization burdens economies with banking and financial charges while lobbying for fiscal austerity.

To secure its privileges and tax favoritism, the financial sector opposes government power to tax or regulate. Fighting under the banner of "free markets," it is now fighting to centralize economic planning power in Wall Street, the City of London, and other financial centers. What is remarkable is that under ostensibly democratic politics, an "independent" central bank has been carved out—independent from elected officials, not from the commercial banks whose interests it represents. Many voters believe that a financial bubble enriches the economy rather than turning the surplus into a flow of interest and banking fees.

THE 2011 CRISIS OVER WHETHER THE EUROPEAN CENTRAL BANKS CAN CREATE MONEY TO BAIL OUT FRENCH AND GERMAN BANKS HOLDING GREEK GOVERNMENT DEBT, BUT NOT TO SPUR "REAL" ECONOMIC RECOVERY

The eurozone's stricture against central banks lending to governments has been attributed largely to Germany's hyperinflation trauma in the early 1920s. The myth is the old MV=PT tunnel vision claiming that the problem was caused by the Reichsbank using the printing press to finance Germany's budget deficit. Today's constitution accordingly prevents the central bank from creating credit to loan to government. This is what psychologists call an implanted memory, a false image suggested in this case by anti-government ideologues.

Every hyperinflation in history has been caused by international payments deficits. For the industrial nations these deficits almost always involve foreign military spending. War spending also is responsible for most growth in public debt (as government budgets tended until quite recently to be approximately in balance during peacetime). Paying these debts abroad involves the capital transfers that Ricardo argued could not cause serious structural problems, on the myth that such transfers are self-financing!

But in the 1920s the Allies imposed an unpayably high reparations burden on Germany—largely to obtain the foreign exchange to pay the Inter-Ally arms debts that the US Government insisted on collecting, rather than forgiving these debts as allies traditionally had

done among themselves upon achieving victory.[1] The Reichsbank created German marks to throw onto the international currency markets to obtain the foreign exchange to pay reparations. France also monetized francs to obtain the dollars to pay the American Government. A monetary theory that looks only for links between the money supply and current production and consumption will fail to understand this situation. The tragic results are clear from reviewing the narrow-minded arguments of Jacques Rueff and Bertil Ohlin with Keynes and Harold Moulton in the 1920s over the roots of international instability in the way that World War I was settled financially.

The moral is that in addition to the international and financial-*rentier* dimensions, the government sector plays a key role in the economic system. This dimension is missing from models that limit their scope to private sector transactions and, indeed, to "current" production and consumption spending without reference to the purchase of assets on credit. The ECB's operating philosophy fails to distinguish between creating money to spend on employment, production, and consumption in the "real" economy (affecting consumer prices, commodity prices, and wages) as compared to creating credit (or simply Treasury debt) to give to banks to buy or lend against assets in the hope that this will bolster prices for real estate, stocks, and bonds. The latter policy inflates asset prices but deflates current spending.

The $13 trillion increase in US Treasury debt in the post-2008 financial meltdown was not spent in product markets or employment in the "real" economy. It was balance-sheet help. Likewise for the ECB in 2011, pressure arose by October to violate the German constitution and the Lisbon agreements to buy Greek debt—the bonds that French, German, and Belgian banks held, along with other debts of the PIIGS (Portugal, Ireland, Italy, Greece, and Spain). European financial stability came to rest on the ability of Greece and other debtor states to pay their debts, or to rescue banks holding these debts. This new money and debt creation has little interface with the "real" production-and-consumption economy, except to burden taxpayers.

This eurozone financial crisis of summer and autumn 2011 shows the importance of distinguishing between two applications of central bank money and debt creation. The first is to spur spending deficits "Keynesian-style" by spending on employment, goods, and services. The second is simply to increase balance-sheet debt without necessarily spending on current output.

[1] I describe the reparations and arms-debt tangle in *Super Imperialism* (2nd ed. 1992), and the distinction between the domestic "budget problem" and the international "transfer problem" in my historical review of theories of *Trade, Development and Foreign Debt* (2nd ed. 2010).

This policy was to give banks government bonds to add to their reserves—to buy bonds and make loans or, as was promised in the United States, to write down mortgage loans so as to pull property owners out of negative equity in order to start re-inflating real estate prices.

The eurozone has fallen into an intellectual trap in which banks have come to believe their own anti-government propaganda. Associating budget deficits only with wage and price inflation excludes consideration of government spending to bail out banks or provide credit to re-inflate asset prices (as well as creating infrastructure to hold down the cost of living and doing business). Opposing public social spending, German and other European banks threw out the baby with the bathwater by blocking central banks from doing what the Bank of England, the US Federal Reserve, and other central banks were created to do: finance public deficits. This obliges governments to borrow from banks, insurance companies, and other financial institutions. The resulting debt overhead leads to debt deflation that slows the economy and its tax yield, producing a fiscal crisis that in due course becomes a financial crisis.

To resolve matters, banks are backtracking and urging the ECB to make loans to government—for the purpose of bailing out banks and bondholders, not to spend on employment in the "real" economy. Voters understandably resent further bank bailouts, under conditions where many debtors are themselves facing foreclosure and have lost much of their net worth. Why should governments bail out the financial sector at the top of the economic pyramid but not reflate production and consumption in the "real" economy. The problem today, after all, is underemployment and debt deflation, not inflation.

Economic theorizing has not caught up with this reality. National income statistics do not distinguish the economy's *rentier* layer from the "real" economy below it, much less how the wealthiest 1 percent (and especially the richest 0.1 percent) are making money at the expense of the bottom 90 percent or even 99 percent. Credit is depicted only as financing economic expansion, not leading to shrinkage and austerity. But in America the easiest way to make money is not by "creating jobs" but by loading the economy down with debt, inflating asset prices on credit, privatizing natural monopolies, and extracting economic rent in the form of higher access charges. None of this increases real output. But it does increase the cost of living and doing business.

PUBLIC OVER-INDEBTEDNESS LEADS TO PRIVATIZATION SELL-OFFS

New investment and hiring taper off as rising debt charges divert income from being spent on current output. Economic growth slows in an S-curve, yet debts continue to accrue interest, which is lent out to obtain yet more interest, diverting yet more income from production and consumption. Slower income growth net of this debt service leads to lower tax payments (especially as interest is deemed tax-deductible), and hence to deepening budget deficits.

The financial sector's political strategy is to use these deficits as an opportunity to insist that governments balance their budgets by selling off public enterprises and other assets. The result is a modern version of Britain's Enclosure Movements of the 16th to 18th centuries, except that today's version is international and driven by the financial sector. Starting with the IMF and World Bank, and most recently the ECB, intergovernmental financial institutions have gained authority over national governments. The ECB has taken the lead in telling Greece to sell off some 50 billion euros worth of prime tourist land, some of its islands, offshore oil-drilling rights, or even the Parthenon, as well as the water and sewer systems of Athens and other cities, the Piraeus port, and other parts of the Commons.[2]

When the new buyers charge monopoly prices for the infrastructure being sold off, this increases the cost of living and doing business, turning the economy into a set of tollbooth opportunities. The resulting economic rent is financialized as buyers borrow from banks whose loan officers calculate the prospects for rent extraction available to pay interest. What the public sector relinquishes in user fees and taxes is made available to pay (tax-deductible) interest to the FIRE sector—without the public-interest dimension of public investment. So instead of being "neutral" in its price and income effects, credit transforms the economy's structure itself.

A century ago US economists described public infrastructure investment as a "fourth factor of production"—roads and canals, urban water and sewer systems, education, the post

[2] See for instance Andy Kessler, "The 'Brady Bond' Solution for Greek Debt," *Wall Street Journal*, June 29, 2011: "Private buyers are increasingly skeptical of government guarantees and will demand real collateral. Credit default swap derivatives, which merely spread the risk, will no longer do. Some other sweetener will be needed. The solution? Bonds backed by real Greek assets. ... utilities, railroads, toll ways, airports, cell phone services, tourism, Ouzo factories, and maybe even the islands of Santorini and Mykonos. If (some say when) the Greeks default, the Germans or new bondholders end up with the assets, much like in a home foreclosure." This is why the *Financial Times*' Lex column reported ("Greece: reckoning postponed," June 29, 2011): "the vote in parliament was held to the sound of rioting and the smell of tear gas."

office, communications, and other publically-owned utilities that represent the largest category of tangible capital investment (next to buildings) in many economies. Providing their services at cost or on a subsidized basis (transportation) or freely (as in the case of roads), their returns are to be calculated not like private-sector investment in user fees relative to capital investment costs, but in the degree to which this infrastructure lowers the economy's costs and prices.[3]

Privatization adds to these costs by involving expenses that public enterprise rarely charges. These add-ons are headed by interest and dividend payments to private owners, other underwriting and financial fees, and much higher salaries and bonuses to the privatized managers, including stock options. And as part of the structural transformation of society urged by creditors, governments are to deregulate (or simply not put regulatory authorities in place) the sectors being privatized on credit. Finally, labor is outsourced, especially to non-union workers. On the broadest level, the world's major financial centers replace national governments as economic planners allocating resources, particularly in nations that fall into foreign debt.

Financial lobbyists advise governments to sell off public infrastructure to buyers on credit. Equilibrium conditions are resolved when the new owners pledge the current cash flow of rent-extraction opportunities to the banks as interest. They then try to raise access charges to roads, water, power, transportation, and other public services.

Governments are forced into a budget squeeze by depriving them of a central bank of the sort that Britain and the United States have. The proper historical role of central banks or Treasuries is to finance government spending by creating money. This is in practice how the economy is supplied with money and credit which, being fungible, is used as the means of circulation for overall activity—the purchase and sale of goods and services, and the transfer of property, stocks and bonds, or other assets.

If central banks are deprived of this opportunity to create credit, governments must rely on commercial banks to finance their budget deficits—at interest. This provides a free lunch to banks as a result of their privilege of credit creation. To avoid crises and bank runs, bank deposits are insured by government agencies. This provides an opportunity for the

[3] I describe the logic in "Simon Patten on Public Infrastructure and Economic Rent Capture," *American Journal of Economics and Sociology* 70 (October 2011):873–903. Patten was the first Professor of Economics at America's pre-eminent business school, the Wharton School at the University of Pennsylvania.

banking system's losses to be transferred onto the public balance sheet. Unless the bank insurance premiums accurately reflect this risk, such insurance represents a public subsidy to the banks.

Most important from the vantage point of national competitiveness is the fact that the privatization of credit creation raises the cost of living and doing business, by building in financial overhead charges. Privatization of public infrastructure has the same effect, by providing extractive rent-seeking opportunities for natural monopolies financed on credit rather than providing their basic services at subsidized rates or freely, financed out of progressive taxation.

"INTERNAL DEVALUATION" OR TAX AND FINANCIAL REFORM TO MAKE LABOR MORE COMPETITIVE?

Economies are complex systems whose interconnections are broader than current trade theory takes into account. To analyze costs and trade competition requires integrating the "real" production and consumption economy with balance-sheet transactions in assets and the debt overhead, as well as with government fiscal policy.

The key to fiscal policy is much more than the level of taxation. The incidence of taxation affects domestic cost structures and determines whether the burden will fall on labor and its employers (increasing production costs) or on property and rent-yielding assets. Taxing land rent holds down the price of housing; taxing employment and sales raise the cost of living and doing business. Likewise in monetary policy, the terms on which credit is created affect the degree of debt pyramiding, while public capital investment in infrastructure tends to provide its basic services at a lower cost than privatization.

Failure to take account of these property, financial, and government balances leaves today's mainstream trade theory—and above all, the adjustment policies being prescribed for countries in deficit—to focus crudely on labor's overall wage rates rather than on the structure of family and business budgets. What neoliberal policy misses is that its demand for wage cuts overlooks the fact that the cost of labor may be reduced more efficiently by shifting the mode of taxation to focus on collecting economic rent and minimizing the debt overhead. This policy can reduce costs and increase competitiveness much less wastefully than austerity programs aimed at cutting wages and social spending.

The effect of neoliberal austerity programs is to shrink markets and induce emigration of labor, worsening international deficits rather than overcoming them.

A POLICY ANTIDOTE: THE PROGRESSIVE ERA'S ATTEMPT TO WARD OFF FINANCIALIZATION

Financialization has reversed the Progressive Era policies designed to minimize the debt overhead and to minimize the economic rent-extracting opportunities that are today's prime objective of bank marketing departments. The classical anti-*rentier* policy featured:

(1) a central bank to monetize government spending deficits, rather than borrowing at interest from commercial banks and other creditors (e.g., as dictated by the ECB and the Lisbon treaty);
(2) taxing away land rent, and enacting anti-monopoly laws and regulatory agencies to keep prices in line with necessary and justifiable costs of production;
(3) keeping basic infrastructure in the public domain, providing it at cost or at subsidized rates or freely (as in the case of roads), with construction costs financed out of progressive income taxation and taxes on economic rent;
(4) paying for pensions, Social Security, and health insurance on a pay-as-you-go basis rather than by financialization (pre-saving by purchasing bonds and stocks);
(5) not permitting interest payments to be tax deductible; encouraging equity financing rather than subsidizing debt;
(6) providing a national income accounting format that (a) distinguishes economic rent paid to the FIRE sector and monopolies, and (b) recognizes the contribution of public infrastructure investment to lowering the cost of living and doing business.

Countries that recently have been neoliberalized may still rectify matters by taxing rent and windfall gains to recover what has been appropriated or is newly created by infrastructure investment. They also can remove the tax deductibility of interest and "watered" charges, such as high salaries, and tax the fictitious transfer pricing and savings via offshore banking centers at the rate that normal earnings would be taxed. These are the classical economic policies proposed to free markets from the legacy of European feudalism

and conquest of the land. They remain the great tasks confronting economies today as they enter the End Days of the post–World War II credit/debt expansion.

Neoliberal (Ricardian) Theory vs. Classical-Progressive Theory

Scope of economic theory and analysis

Neoliberal Theory	Classical and Progressive Era Reforms
Economic theory is a "science of assumptions." The criterion of excellence is their internal consistency.	Political economy should map empirical reality, not be a hypothetical exercise in science fiction.
Focuses on production and consumption, taxes and saving.	Focuses on wealth distribution and how debt creation diverts revenue from the production-and-consumption economy.
The economy is a single sector; all income and wealth are earned, reflecting their contribution to production and economic growth.	The FIRE sector is wrapped around the "real" production economy, extracting revenue. *Rentier* income and wealth are unearned.
Economies are best analyzed as if they operated on barter beneath their "veil of money." Debt and financial wealth merely reflect this underlying economy.	If economists ignore the financial sector's autonomous behavior, they will not recognize its wins at the point its existence, and hence its deleterious effects: debt deflation and polarization between creditors and debtors.
MV=PT refers only to current output and commodity prices and wages.	Monetary analysis recognizes that most credit is created to buy assets, so focuses on asset prices.
The bankers'-eye view of the world is most realistic, because most wealth is financial.	The financial view looks at how much surplus revenue can be converted into debt service. This is self-terminating, because it is parasitic.
Debt leverage raises the return on equity.	Debt service diverts revenue away from new capital investment and employment.
Assumes that budget deficits are spent on labor.	Recognizes bailout payments to banks and spending on infrastructure.

Political ideology

Neoliberal Theory	Classical and Progressive Era Reforms
Government planning is the road to serfdom.	Every economy is planned by somebody. Removing planning from government shifts it to the financial sector.
Shifting planning to the financial sector and privatizing public enterprise on credit creates wealth by inflating asset prices.	Governments should take the lead in indicative planning and infrastructure investment to shape markets to work efficiently.
Central banks should be independent from democratic government.	Making a central bank independent replaces democracy with financial oligarchy.
A free market is free for *rentiers*, free from public price regulation, taxation of wealth, and even from public infrastructure investment.	A free market is one free of unearned economic rent, including interest and financial fees, monopoly rent, and resource rent.
There is a class war, and the rich have won—mainly the financial class. Attempts to reform the financial or tax system will cause economic collapse. The alternative to oligarchy and debt peonage is a bureaucratic road to serfdom.	The vested interests have fought back against the Progressive Era, but just as economic reform sought to save capitalism from the legacy of feudalism once, the fight can resume.
Minimize taxes so as to leave more revenue "free" to pay interest to banks.	Tax economic rent so as to hold down housing price inflation by leaving less "free" rent to capitalize into bank loans.

Economies live in the short run, but this is efficient, thanks to rational expectations.	Short-run economics is hit-and-run. Long-term investment is needed to raise productivity.
Inflating asset prices on credit is "wealth creation." It increases the balance sheet.	Inflating prices on credit simply raises the debt overhead—which remains in place to cause negative equity when the bubble bursts.
Bubbles create billionaires, whose wealth helps create jobs.	Bubbles transfer revenue and wealth from the "real" economy to creditors and bankers, who recycle their revenue into loans that indebt the rest of the economy to themselves.
Free markets neoliberal style need to be protected by a police state and censorship of alternatives (*viz*. the Chicago Boys in Chile).	If free-market policies require a police state, they are not free but totalitarian.

Fiscal Policy

A free market is free of government regulation or taxation of rentiers.	A free market is one free from unearned (*rentier*) income, and of monopolies and their pricing in excess of reasonable costs of production.
All income and wealth is earned; there is no free lunch.	FIRE-sector revenue is unearned, a reward for privilege, not socially necessary.
Prefers a flat tax on employment and value-added sales taxes. No tax on asset-price gains or business profits. Un-taxing property raises asset prices, creating balance-sheet wealth.	Progressive taxation should fall on the highest property and income brackets, especially on asset-price gains, not fall on employment, because wage taxes raise commodity prices.
FIRE revenue should be taxed at lower rates, if at all.	Taxes should collect FIRE revenue, headed by land and resource rent, monopoly rent, interest, and financial charges.
Because the rich are "job creators."	Economic polarization destroys employment. By impoverishing the market, it encourages capital flight and emigration.
By lowering wage levels, fiscal austerity makes economies more competitive.	Austerity shrinks investment and makes countries more dependent on foreign financing.
Austerity squeezes out more debt service.	Austerity shrinks economies, diverting revenue from the investment needed to pay the debt overhead. So the debt burden increases.
Governments should cover deficits by selling off public enterprises and other assets.	Public infrastructure investment should be supplied on a subsidized basis, paid out of progressive taxation, to lower economy-wide costs of living and doing business.
Social Security and Medicare should be treated as user fees, paid in advance, and lent to government so that it can cut taxes on the wealthy and FIRE.	Social spending should be paid out of the general budget's progressive taxation, financed on a pay-as-you-go basis (as Adam Smith said that wars should be financed).
Every public attempt at regulation is counter-productive and self-defeating, because the market's "rational expectations" will undo it.	Government's proper role is to shape markets by progressive taxes, rules, and regulations.

Neoliberal Trade Policy	**Progressive Trade Policy**
Wage rates are the main variable. Cutting wages is the key to lower prices, as capital goods have a common world price.	The cost of living and doing business consists mainly of payments to FIRE. Cutting debt service, employment taxes, and debt-inflated housing costs reduce employment overhead.
Aims to lower wages by about 30 percent.	Reduce the cost of employment by shifting employment and sales taxes onto FIRE.
Does not recognize wage/productivity feedback.	Higher wages are needed to raise productivity.
Austerity programs go together with privatization sell-offs to pay public debts.	Rejects paying debts where this involves transforming social relations inequitably.
Takes existing wealth distribution and institutions for granted.	Foreign trade transforms economic and political structures, for better or worse. Therefore, protectionist trade policy is needed.
Assumes that price and income adjustments will automatically keep trade and payments in balance.	Imbalances are financed by debt, whose interest charges mount up to polarize the international economy.
It is most efficient to specialize and depend on the US and EU for food imports and credit.	Food and debt dependency lead to debt at interest, polarizing the global economy.
Finance is cosmopolitan, and hence peaceful.	Finance is ultimately national, when money is created by central banks.
Open trade and capital markets are peaceable, replacing war.	Finance aims at what military conquest seeks: the land, natural resources and their rent, and tribute. Finance simply achieves this at a lower cost (= “more efficiently”) than open warfare.