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Full employment abandoned: the triumph of ideology over evidence

Professor William Mitchell

Chair in Economics and Director for the Centre of Full Employment and Equity

at Charles Darwin University

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Charles Darwin University
Darwin, Northern Territory 0909 Australia
T. +61 08 8946 6666
E. mace@cdu.edu.au
W. cdu.edu.au
CRICOS Provider No. 00300K
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Full employment abandoned: the triumph of ideology over evidence

William Mitchell[1]

Introduction

The global economic crisis exposed as a lie the neoliberal promise that markets can self-regulate and deliver sustained prosperity for all. But that fact does not seem to have registered with governments, which have built their responses to the crisis on a series of myths – the same myths that caused the crisis. What actually caused the crisis was three decades of policy choices made by governments infested with this neoliberal lie.

The Great Depression showed that markets fail badly if left unregulated, and that governments have a strong role to play as both an employer and a spender. Unfortunately, in the 1980s, governments abandoned these responsibilities and instead introduced widespread deregulation. This unleashed the destructive dynamics of capitalism, which mixed greed, criminality (e.g. the Enron and Libor scandals) and incompetence into a lethal cocktail that ultimately manifested as the crisis.

Today, millions are unemployed, youth jobless rates exceed 55 per cent in some advanced nations, inequality and poverty rates are rising, and there are major losses in national income on a daily basis. Governments have claimed that there is no alternative but to impose austerity by cutting budget deficits. In most nations, whether neoliberals are in government or opposition, the unquestioned dominance of their ideology has not only homogenised the political debate, but has also obscured the only credible route to recovery. In fact, budget deficits have to increase. The evidence shows that austerity is exactly the opposite of the policy response that is required. But, as Lakatos noted, the dominance of degenerating paradigms is not easily challenged.[2]

The extraordinary events in world financial markets in 2007 and 2008, which undermined the basis of monetary capitalism, initially led to massive injections of public spending. These so-called ‘stimulus packages’ promoted early recovery, negating the claims by mainstream economists that fiscal policy (public spending minus taxes) was ineffective. The glaring defects of mainstream macroeconomic theory were clear.

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

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

In April 2013, some shoddy spreadsheet work by two high-profile American economists was discovered. These economists had promoted the famous 90 per cent threshold on public debt (i.e. public debt greater than 90 per cent of annual income), beyond which they claimed growth would contract. Policy makers used this threshold to justify harsh cutbacks in public spending, which in turn led to economic ruin. These analytical errors (which included omitting key observations), taken together with the weight of empirical evidence, highlighted the fact that there are no credible grounds for the disastrous austerity that the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) have promoted, and that many advanced nations have implemented.

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

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

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

The full-employment era

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

Unemployment was not only seen as wasteful but also as a violation of basic human rights. The 1945 Charter of the United Nations (Articles 55 and 56)[3] enshrined the principle of employment as a basic human right, and declared that governments were responsible for sustaining full employment. This was reinforced in the 1948 Universal Declaration of Human Rights (Article 23).[4]

Western governments realised that, with deficit spending supplementing private demand, they could ensure that all workers who wanted to work could find jobs. All political persuasions accepted this commitment to full employment as the collective responsibility of society.[5] As a result, unemployment in most Western nations persisted at low levels until the mid-1970s. Although private employment growth was relatively strong during this period, governments were important employers in their own right, and also maintained a buffer of jobs for the least skilled workers; for example, in the major utilities, the railways, local public services and major infrastructure functions of government. By absorbing workers who lost jobs when private investment declined, governments acted as an economic safety valve.

Ormerod notes that the economies that avoided high unemployment in the 1970s maintained a '… sector of the economy which effectively functions as an employer of last resort, which absorbs the shocks which occur from time to time, and more generally makes employment available to the less skilled, the less qualified'.[6] Ormerod concluded that societies with a high degree of social cohesion (such as Austria, Japan and Norway) were willing to broaden their concept of costs and benefits of resource usage to ensure that everyone had access to paid employment opportunities.

In addition, welfare systems provided income support and other public services (such as health and education) to citizens in need. Although there were significant differences across nations in the scope of these systems, they all shared the view that the state had a role to play in providing economic security to citizens.[7]

The abandonment of full employment

The stability that came with continuous full employment was always a source of dissatisfaction for the capitalist class, because it led to more equitable sharing of national income.[8] Conservative resistance to the use of budget deficits grew in the late 1960s, particularly in the United States, where inflationary pressures mounted because of spending associated with the Vietnam War. However, the full-employment consensus persisted until the escalating inflation that followed the Organization of the Petroleum Exporting Countries (OPEC) oil-price hikes of the 1970s. This marked the beginning of the neoliberal era, which has dominated the political debate since.

Governments around the world reacted with contractionary policies to quell inflation, and unemployment rose, giving birth to the era of stagflation (i.e. slow economic growth and high unemployment). The economic dislocation that followed provoked a paradigm shift in macroeconomics.[9] With support from business and an uncritical media, the paradigm shift in the academy permeated policy circles, and governments relinquished the defining feature of the post-war framework – the commitment to full employment. The Keynesian notion of full employment, defined by Vickrey as ‘a situation where there are at least as many job openings as there are persons seeking employment’,[10] was abandoned in favour of the so-called ‘natural rate of unemployment’,[11] or, as it later became known, the non-accelerating inflation rate of unemployment (NAIRU). The NAIRU is a conceptual unemployment rate at which inflation is stable. It is conceived as being solely determined by supply-side forces, which makes it invariant to Keynesian demand-side policies. Despite the lack of robust empirical support, this concept remains a dominant policy construct.

The NAIRU concept reintroduced the previously discredited Say’s Law, by alleging that free markets guarantee full employment, and that Keynesian attempts to drive unemployment below the NAIRU will ultimately be self-defeating and inflationary.[12] The Keynesian notion that unemployment represents a macroeconomic failure that can be addressed by expansionary fiscal or monetary policy was rejected. Instead, mass unemployment was now depicted as an individual problem (i.e. poor work attitudes lead to a lack of job-seeking), exacerbated by excessively generous welfare payments, trade unions with too much power, and job protection laws.[13] Textbook versions of the natural-rate hypothesis cast unemployment as a voluntary, optimising choice by individuals seeking to enjoy leisure.

These ideas were promoted vociferously by the emergence of conservative, free-market think tanks, which were liberally funded by business and other anti-government interests. Beder felt that these institutions fine-tuned ‘the art of ‘directed conclusions’, tailoring their studies to suit their clients or donors’.[14] Politicians paraded their so-called ‘independent’ research findings as the authority needed to justify their deregulation agendas. Many organisations, including the

Peterson Foundation and the Cato Institute (US), and the Centre for Independent Studies (Australia), are still distorting the policy debates with their erroneous propaganda.

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

Rising welfare payments were then erroneously constructed as a threat to the fiscal viability of government. Conservative leaders such as Margaret Thatcher lectured us about how governments, like households, have to live within their means. Such leaders use emotional blackmail, claiming that paying back budget deficits would lead to onerous future tax burdens, forcing our children and their children to pay for our profligacy. Also, they claim that government borrowing (to 'fund' the deficits) competes with the private sector for the small amount of funding available, and thus drives up interest rates, which in turn reduces private investment; this is the 'crowding out' hypothesis. Because governments are not subject to market discipline, neoliberals also claim that public use of scarce resources is wasteful. Finally, they assert that deficits require the printing of money, which is inflationary. All of these myths feature in the undergraduate macroeconomics textbooks that are used to indoctrinate students and perpetuate the hegemony of the conservative paradigm. Not one applies to the real world.

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

The hollowed-out state became a servant of capital rather than a mediator in the capital–labour conflict. The Thatcher Government's attacks on the trade union movement in Britain in the 1980s exemplified the broader political ambitions of the neoliberal era.

These same ideas drove the failed policies that both led to and extended the Great Depression. However, history is conveniently forgotten when policy is strengthening the hegemony of the elites.

The 1994 OECD Jobs Study served as the bible for this new microeconomic reform agenda, even though its evidence base was at the time questionable, and was later found to be unacceptable by conventional standards.[15] The OECD articulated the 'activist agenda', whereby the role of government in the labour market was reduced to that of ensuring individuals are employable, and of providing minimal income support.

To establish legitimacy for cutting income support and the like, governments set about redefining the state's obligations towards its citizenry. In this, they were aided by the urgings of the neoliberal intellectuals in the media and in conservative think tanks. The central notion of collective will, which underpinned the post-war commitment to full employment, was usurped by the primacy of the individual. The hallmark of the neoliberal era is that individuals have to accept responsibility, be self-reliant and fulfil their obligations to society.[16] Unemployment is now a problem of welfare dependence rather than a deficiency of jobs. To force individuals to become accountable for their own outcomes, the so-called 'reciprocal obligation' was developed as a leading principle in several countries, as a way to reintegrate the (allegedly) welfare-dependent underclass into the community.[17] Unfortunately, no reciprocal obligation was constructed for government, to ensure that there are enough jobs for all those wanting work. Throughout this period, there were fewer jobs available than people seeking them.

The origins of the crisis and the descent into neoliberal miasma

The origins of the crisis

The tectonic shifts in policy under monetarism caused higher unemployment, rising poverty and a decrease in real wages (i.e. capacity to purchase). These outcomes ran counter to the rhetoric that the new free-market approach would generate better outcomes. But the changes also started the countdown to the global financial crisis.

It is not difficult to pinpoint the triggers for the current crisis. The dynamics began in the USA, with the collapse of the country's real estate boom. But the origins of the crisis can be traced to the earlier decision of most Western governments to introduce policies that unleashed the destructive dynamics of the capitalist system. The key elements of this policy shift were the denial that continuous budget deficits constituted the norm for most nations, the widespread deregulation of labour and financial markets, and the reduction in oversight of the financial regulation that remained. Governments created an economic structure that was ultimately unsustainable, and it was only a matter of time before the system collapsed.[18]

The shift in national income

The deregulation in the labour markets not only increased job instability and created persistently high unemployment, but also led to large shifts in national income from wages to profits. Figure 1 shows the relationship between real wages and productivity growth in Australia from 1978 to 2012. Similar trends have been reported in other advanced OECD nations.[19]

First, in most nations, the wage share in national income has fallen significantly over the past 35 years. Second, in the Anglo nations, 'a sharp polarisation of personal income distribution has occurred',[20] with the top percentile and decile of the personal income distribution substantially increasing their total shares. The excessive executive pay deals that emerged in this period were one manifestation of the munificence gained at the expense of lower income workers.

Until the early 1980s, real wages and labour productivity typically moved together. However, as the attacks on the capacity of workers to secure wage increases intensified, a gap between wages and productivity opened and widened. This widening gap manifested as a rising profit share: in 1975, the Australian wage share was around 62.5 per cent of national income to be distributed to the factors of production; by the end of 2012, it was around 54 per cent. Australian governments aided this redistribution in a number of ways, through privatisation, outsourcing, harsh industrial relations legislation aimed at reducing union power, National Competition Policy and so on.

Figure 1 Real wages and productivity growth, Australia, 1978–2012

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

The rising dominance of the financial sector

Imbued with the now-discredited ‘efficient markets’ hypothesis promoted by the University of Chicago economists, policy makers bowed to pressures from the financial sector. They introduced widespread financial deregulation and reduced their oversight of the banking sector. This led to a massive expansion of the financial sector, and also set the stage for the transformation of banks from safe deposit havens to global speculators carrying increasing (and ultimately unknown) risks. The massive redistribution of the balance between national income and profits provided the banks and hedge funds with the gambling chips to fuel the rapid expansion of the ‘global financial casino’.

Increasingly, the Gordon Gekkos strutted the stage as celebrities, and were cast as important wealth generators. Private returns were high, and the lemming rush unstoppable. But the reality was different. The vast majority of speculative transactions that occur every day in the financial markets are unproductive, in that they are unrelated to the real economy and to advancing our welfare. A substantial portion of the 'wealth' generated was illusory, and the socialised losses were enormous, as we discovered when the huge, unregulated gambling casino collapsed under its own hubris, criminality and incompetence.

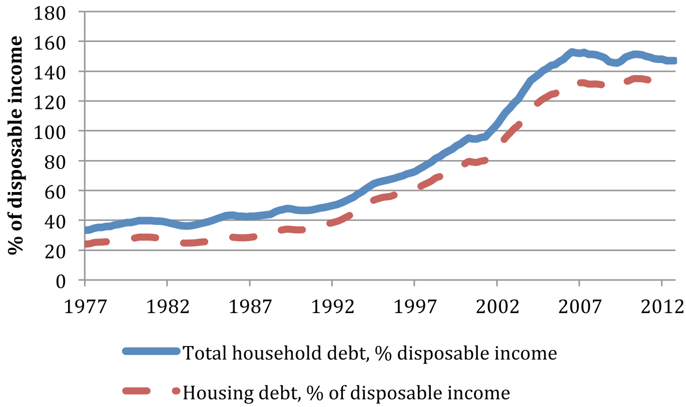
The explosion of private debt

The capitalist dilemma was that real wages typically had to grow in line with productivity, to ensure that the goods produced were sold. So how does economic growth sustain itself when labour productivity growth outstrips the growth in the real wage? This was particularly significant in the context of the increasing fiscal drag coming from public surpluses, which squeezed private purchasing power in many nations during the 1990s and beyond.

The neoliberal period found a new way to solve the dilemma. The 'solution' was so-called 'financial engineering', which pushed ever-increasing debt on to households and firms. The credit expansion sustained the workers' purchasing power, but also delivered an interest bonus to capital, while real wages growth continued to be suppressed. Households, in particular, were enticed by lower interest rates and the vehement marketing strategies of the financial engineers. It seemed too good to be true and it was.

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

Figure 2 Household debt, Australia, 1977–2013 as percentage of disposable income



Source: Reserve Bank of Australia, Household Finances–Selected Ratios–B21.

As debt levels rose, the financial planning industry fell prey to the urgency of capital. To increase their profits further, they moved into the riskier segments of the market – the so-called sub-prime loans. The credit-fuelled economic growth masked the growing precariousness of the world economy. Such was the smugness of the economics profession that Chicago economist Robert Lucas pronounced during his 2003 Presidential Address to the American Economic Association 'the central problem of depression-prevention has been solved, for all practical purposes'.[21] Economists declared the business cycle to be dead, and applauded the gains of deregulation; terms such as the 'great moderation' crept into the literature.[22] International institutions such as the OECD and the IMF praised the progress towards deregulation and urged more.

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

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

The banks themselves took advantage of the lax oversight and deregulation to become gamblers in their own right. Yet, despite the claims made for the efficient markets hypothesis, markets are not rational and efficient, and there were enormous gaps in the information flows between the banks, investors, firm and household borrowers, providers of securitised assets to be used as collateral, providers of insurance for these assets, the credit rating agencies assessing levels of risk in relation to these assets (which include credit-default swaps), and the parties in the 'real sector' who were generating the actual IOUs that eventually become securitised.[23] Add greed and criminality to the mix and the collapse was inevitable.

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

The fiscal squeeze

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

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

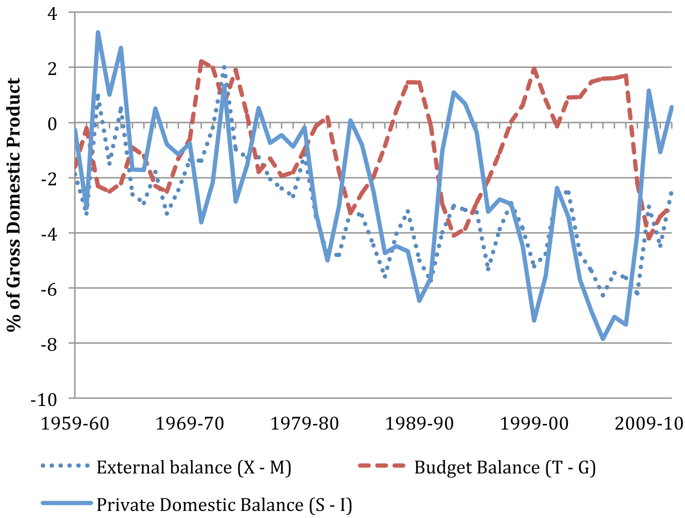
Total private domestic savings (S) is equal to private domestic investment (I) plus the public deficit (spending, G, minus taxes, T) plus net exports (exports, X, minus imports, M), where net exports represent the net savings of non-residents. Thus, when an external deficit ($X-M < 0$) and a public surplus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

The sectoral balances framework allows us to understand the interaction between fiscal policy and private sector indebtedness. In a modern monetary economy where the government issues its own currency, it follows as a matter of national accounting that the sovereign government deficit (surplus) equals the non-government surplus (deficit). The failure to recognise this relationship is the major oversight of neoliberal analysis. In aggregate, there can be no net savings of financial assets of the non-government sector without cumulative government deficit spending. Government (via deficits) is the only entity that can provide the non-government sector with net financial assets (net savings), and thereby simultaneously accommodate any net desire to save in the unit of account, and hence eliminate unemployment. Additionally, and contrary to neoliberal rhetoric, the systematic pursuit of government budget surpluses is necessarily manifested as systematic declines in non-government sector savings.

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

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

Figure 3 Sectoral balances, Australia, 1959–60 to 2011–12; per cent of gross domestic product



Source: RBA Bulletin database and Commonwealth of Australia Budget Paper No.1.

The Australian Government was only able to run surpluses between 1996 and 2007 because the credit binge of the private domestic sector produced the growth that maintained spending growth. But this was an unsustainable growth strategy, because eventually the build-up of private debt became precarious. As the crisis hit, households and firms started to reduce their debt exposure and adopt more typical saving patterns (e.g. household saving went from zero to around 10 per cent of disposable income).

The facts are inescapable. The neoliberal period of public surpluses and private deficits was atypical for Australia. Similar trends occurred in most advanced nations over this period. The sectoral balances show us that, when the private sector is deleveraging and a nation has an external deficit (of any size), then growth can only continue if there are budget deficits. That is the norm for most nations.

Rising income inequality

Not only did economies waste their precious labour resources during the 1980s and 1990s, they also saw rising inequalities in income and wealth (see also Section 4.2). Terms such as 'trickle down' economics were one of many related neoliberal fads during that period. The economics profession convinced governments that growth would be increased if they reduced the tax rates for top income earners (the so-called wealth generators). The evidence did not support these claims, and even the IMF recently admitted that '… longer growth spells are robustly associated with more equality in the income distribution'.[24] But the hallmark of the neoliberal period is that inequalities in income and wealth increased after 1980 in most nations.[25]

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

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

Source: US Congressional Budget Office (2008), Table 3.[26]

In the USA, the contrast between rich and poor is now so stark that the income distribution looks like that from a developed nation. Table 1 compares the distribution of average US household income between

1979 and 2005. There was barely any growth in nominal income for the bottom 20 per cent (which equates to a real decline), and the gap between the top end of the distribution and the bottom exploded. More recently, the crisis has eroded the incomes and wealth of the 'middle class'. The Pew Research Center concluded that 'America's middle class… has endured a lost decade for economic wellbeing. Since 2000, the middle class has shrunk in size, fallen backward in income and wealth'.[27] The claims that the massive debt explosion would generate wealth for all have proven to be illusory.

A modern monetary macroeconomic framework

Budget surpluses do not give governments a greater capacity to meet future needs, and budget deficits do not erode that capacity. Governments always have the capacity to spend in their own currencies. Why? Because they are the issuers of their own currencies; governments such as those of Australia, Britain, Japan and the USA can never run out of money.

Most people are unaware that a major historical event occurred in 1971, when President Richard Nixon abandoned what had been called the gold standard (or US-dollar standard). Under that monetary system, which had endured for about 80 years (with breaks for war), currencies were convertible into gold, exchange rates were fixed and governments could expand their spending only by increasing taxes or borrowing from the private sector. After 1971, governments issued their own currencies by legislative fiat; the currencies were not convertible into anything of value, and were floated and traded freely in foreign currency markets. The flexible exchange rate releases monetary policy from defending some fixed parity; fiscal policy can then target only the domestic spending gap to maintain high levels of employment.

Most nations have operated 'fiat monetary systems' since 1971; as a result, national governments no longer have to 'fund' their spending. The level of liquidity in the system is not limited by gold stocks, or by anything else.

Most of the analysis appearing in macroeconomics textbooks, which permeates into the public debate, is derived from 'gold standard' logic and does not apply to modern monetary systems. Economic policy ideas that dominate the current debate are artefacts from the old system, and do not apply to fiat monetary systems.

MMT describes how such a system actually works.[28]

First, the monetary unit (currency) has no intrinsic worth. The viability of the currency is guaranteed, because it is the only unit acceptable for payment of taxes and other financial demands of the government.

Second, the analogy neoliberals draw between household budgets and government budgets is false. Households use the currency and must finance their spending. However, government issues the currency and must first spend (i.e. credit private bank accounts) before it can tax (i.e. debit bank accounts). The claim that governments must tax or borrow to 'finance' its spending is false under a fiat-currency system. The Euro nations are an exception to this rule. They surrendered currency sovereignty, and thus have to borrow to cover deficits. This makes them dependent on bond markets (in lieu of European Central Bank support) and exposes them to solvency risk. The current Euro problem lies in the flawed design of its monetary system, which was a neoliberal ploy to limit the capacity of these governments to borrow and spend.

The restrictions on government spending are the quantity of real goods and services available for sale in its own currency, including all the unemployed labour. Neoliberal claims that bond markets limit government spending are false.

Despite the collapse of the convertible currency system, most fiat-currency-issuing governments impose voluntary constraints on themselves that resemble the spending constraints under the gold standard. These ideologically motivated fiscal rules are designed to limit the capacity of government to run deficits or borrow from the non-government sector (or both). These rules render fiscal policy subservient to monetary policy, which continues to echo the failed monetarist approach. The fiscal rules represent a denial of the opportunities that a fiat monetary system offers an elected government; in addition, they are undemocratic (e.g. making an unelected 'Budget Commission' responsible for fiscal policy).

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

Something that is often misunderstood is that the budget outcome is determined by the state of overall activity, and is largely beyond the control of government. If private spending is weak, then the budget deficit will typically rise as tax revenue declines, irrespective of what government does.

Thus, by trying to operate within false thresholds and limits (e.g. a 3 per cent deficit-to-GDP rule), governments too easily fail and the pressure for fiscal retrenchment increases. But when private spending collapses and the deficit rises, the correct response is to increase discretionary net public spending, not cut it.

Typical fiscal rules create a bias towards spending restraint; this damages public infrastructure development, reduces the volume and quality of public goods such as education and health, and maintains high rates of underuse of labour. In the current crisis, such rules have resulted in pro-cyclical policy changes, which are anathema to responsible fiscal management. Governments should not cut public spending when the economy is plummeting into recession.

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

The claim that surpluses represent 'public saving', which can be used to fund future public expenditure, is a lie. Government spends by crediting reserve accounts.[29] That balance does not 'come from anywhere', as, for example, gold coins would have had to come from somewhere. Likewise, payments to government reduce reserve balances. Those payments do not 'go anywhere', they are merely accounted for.

Budget surpluses either destroy private wealth by forcing the private sector to liquidate its wealth to obtain cash, or destroy liquidity (debiting reserve accounts), which is deflationary.

Fourth, for aggregate output to be sold, total spending must equal total income. Unemployment occurs when the non-government sector, in aggregate, wishes to spend less of the monetary unit of account than it earns, and public spending fails to fill the gap. Thus, unemployment occurs when net government spending is too low to accommodate the need to pay taxes and the desire to have net savings.[30] The resulting unemployment is involuntary, because the macroeconomic spending constraint renders an individual powerless to improve their employment circumstances. This conception is in contradistinction to the neoliberal approach, which blames market rigidities or individual laziness for unemployment.

Wray says, 'Normally, taxes in aggregate will have to be less than total government spending due to preferences of the public to hold some reserves of fiat money'.[31] Thus, in general, deficit spending is necessary to ensure high levels of employment.

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

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

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

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

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

Austerity is not the only alternative

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

As long as private spending is subdued, the greatest need is to expand budget deficits. That is the only way the advanced economies will drive growth fast enough to absorb the huge pool of unemployed. Inflation is low, and there is considerable slack in the economy, which can be brought back into productive use by further government stimulus.

In advocating further fiscal stimulus, it would be useful to target job creation directly. This could be done in the first instance by introducing an open-ended public employment program – a Job Guarantee – that offers a job at a living (minimum) wage to anyone who wants to work but cannot find employment. These jobs would 'hire off the bottom', in the sense that minimum wages are not in competition with the market-sector wage structure. By not competing with the private market, the Job Guarantee would avoid the inflationary tendencies of old-fashioned Keynesianism, which attempted to maintain full capacity utilisation by 'hiring off the top' (i.e. making purchases at market prices and competing for resources with all other demand elements).

Job Guarantee workers would enjoy stable incomes, and their increased spending would boost confidence throughout the economy and underpin a private-spending recovery. The government could afford this program. The labour is available for work, and the government can easily supply the jobs. Few questions were asked when the government, in the early days of the crisis, instantly provided billions for the banks. To repeat: the government has no financial constraint on its spending and should immediately allocate funds to a massive job-creation program.

Currency-issuing government should refrain from public borrowing. Such borrowing is not necessary to support the net spending (deficits), and it contributes nothing positive in terms of advancing the primary goals of the national government. Also, the issuance of Treasury bonds is akin to corporate welfare for purchasers, who are typically financial institutions and foreign governments. Why should they enjoy a risk-free government annuity?

A range of financial and labour market reforms are needed to force banks to be banks again, increase prudential oversight and reduce inequality (such reforms are beyond the scope of this paper).

Conclusion

In 2009, it was claimed that private sector spending would increase if deficits were cut. All the evidence showed that firms were pessimistic, and were therefore unwilling to expand employment and production until they saw stronger growth in demand for their products. Consumers were also pessimistic, because they feared unemployment. In addition, the massive private debt was motivating increased saving. At that time, cutting public spending only deepened this pessimism. The same is true today. When private demand is subdued, the only way to increase growth is for government to spend, via deficits. Austerity just withdraws the lifeline that is required to keep our economies growing while the private sector reduces its debt levels to more comfortable limits.

Harvard academic Richard Freeman called the neoliberal period 'a giant experiment in laissez-faire capitalism'.[32] The experiment failed, and inflicted dramatic costs as it did so. Clearly, the economic theory that supported the experiment is deeply flawed, and cannot be applied to a modern monetary economy.

The size of the deficit should never be the concern of policy. The austerity myth defines fiscal sustainability in terms of some arbitrary financial ratio. However, deficits should be whatever is required to maintain overall spending at the level consistent with full employment; no more, no less. Fiscal sustainability is about fulfilling the government's responsibility to maintain an inclusive society in which everyone who wants to work can do so.

Governments around the world that have deliberately introduced policies that force people into joblessness and poverty have lost their economic and moral compass.

Endnotes

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Professor William Mitchell

Chair in Economics
Director, Centre of Full Employment and Equity (CofFEE)
Charles Darwin University

Professor William Mitchell holds the Chair in Economics at Charles Darwin University and is the Director for the Centre of Full Employment and Equity (CofFEE) at CDU. He holds conjoint professorial positions at the University of Newcastle and Monash University (attached to the European Centre). He also is a Visiting Professor at Maastricht University, The Netherlands, and is on the management board of CofFEE-Europe, a sister centre located at that university.

He has published widely in refereed academic journals and books, and he regularly is invited to give Keynote presentations at conferences in Australia and abroad. He has an established record in macroeconomics, labour market studies, econometric modelling, regional economics and economic development.

Professor Mitchell has extensive experience as a consultant to the Australian Government, trade unions and community organisations, and several international organisations (including the European Commission, the International Labour Organization and the Asian Development Bank).