DRAFT

The 7 Deadly Innocent Frauds of Economic Policy

Introduction

The term 'innocent fraud' was introduced by Professor John Kenneth Galbraith in 'The Economics of Innocent Fraud', which was the last book he wrote before he died. He used the term to describe fraudulent concepts that were being sustained by the 'conventional wisdom' (a term he created in a previous book). The presumption of innocence by those perpetrating the frauds is characteristic of Professor Galbraith's cynically gracious approach.

But this story began in earnest back in the early 90's when Italian government bonds denominated in lira yielded about 2% more than the cost of borrowing the lira from the banks. This was largely due to perceived risk of default by the Italian goverment.

This book reviews 7 'innocent frauds' that I suggest are THE most imbedded obstacles to national prosperity. The first 4 concern the federal government budget deficit, the 5th addresses social security, the 6th international trade, and the 7th savings and investment.

I begin with the innocent frauds of the budget deficit, because they are the most pervasive and most damaging to both the US and the rest of the world's standard of living.

Deadly Innocent Fraud #1:

The government must raise funds through taxing or borrowing in order to spend.

In other words, government spending is limited by the government's ability to tax or borrow.

Fact:

Government spending is NOT operationally limited or in any way constrained by taxing or borrowing.

Ask any congressman (as I have many times), or private citizen, how it all works, and he will tell you emphatically that:

“…the government has to either tax or borrow to get funds to spend, just like any household has to somehow get the money it needs to spend.”

Furthermore, borrowing in order to spend only delays the eventual taxation, or other income, that is needed to repay all the debt.

They get this from the popular notion that the government, just like any household, must somehow first get money to be able to spend it.

Yes, they have heard that it’s different for a government, but they don’t believe it, and there’s never a convincing explanation that makes sense to them.

What they all miss is the difference between spending your own currency that only you create, and spending a currency someone else creates.

The $ US is the creation of the government. So to utilize this popular government/household analogy in a meaningful way, we need to look at a currency created by a household.

One example of the right analogy would be parents creating coupons they can then use to pay their children for doing various household chores.

And to make it all work, the children would be required to give their parents 10 coupons a week to avoid punishment.

These coupons are now the new household currency. Think of the parents as 'spending' these coupons to purchase 'services' (chores) from their children.

The parents, like the government, are now the issuer of their own currency.

Do they have to somehow get coupons from their children before they can pay them to their children to do chores? Of course not!

In fact, the parents must first spend their coupons by paying their children to do household chores, to be able to collect the payment of 10 coupons a month from their children.

How else can the children get the coupons they owe the parents?

Likewise, in the real economy, the funds we need to pay taxes must come from government spending (or government lending, which I'm saving for later).

Yes, that means the government has to spend first, to provide us with the funds we need to pay our taxes.

And, neither the government, nor the parents, from inception, can collect more of their own currency than they spend.

Where else could it possibly come from?

So while our politicians truly believe government needs to take our funds either by taxing or borrowing for them to be able to spend,
instead,
the truth is:
WE NEED THE GOVERNMENT'S SPENDING TO GET THE FUNDS WE NEED TO PAY OUR TAXES.

Beware the Shredder!

Here’s an anecdote that makes it clear the government doesn’t need our funds in order to spend.

Consider what happens should you go to the Federal Reserve to pay taxes with actual cash.

First, you hand over a pile of currency to the Fed as payment.

Next, the Federal Reserve counts it, and then gives you a receipt and a thank you for helping to pay for social security, the interest on the national debt, and the Iraq war.

And as you, the tax payer, leave the room and close the door behind you, they take that hard earned cash you just forked over and throw it in a shredder.

Yes, they throw it away.
Destroy it!
Why?
They have no further use for it.
Just like a ticket to the Super Bowl.

As you go into the stadium, you hand the man a ticket that was worth maybe $1000, and then he tears it up and throws it away.

And just like when the children pay their 10 coupons to their parents every month that were earned by doing their household chores, the parents don't actually need those coupons for anything.

So if government throws away your cash after collecting it, how does that cash pay for social security, and the rest of their spending?
It doesn't.
Something else is going on.
Just like with the household coupons- the parents are not collecting the coupons because they need them to spend.

The answer?

Taxes function to reduce what's called aggregate demand- a fancy phrase for 'spending power.'

The government takes away your funds to keep you from spending them. That leaves room for the government to spend without causing 'inflation.'

Now let's look at what happens if you pay your taxes by writing a check. It's almost the exact same thing. When your check 'clears,' all the government does is change the number in your checking account (downward) when they subtract the payment from your bank balance.
Do the government actually get anything real?
No, it's not like they get a gold coin to spend.
All they did was change a number in your bank account.

Just like the household.
When the children give their coupons to the parents, do the parents get richer?
Of course not!

Next question: "So how does government spend when they never actually have anything to spend?" Good question! Let's now take a look at exactly how government spends.

Imagine you are expecting your $1,000 social security payment to hit your bank account which already has $500 in it, and you are watching your account on your computer screen. You are about to see how government spends without having anything to spend.

Presto! Suddenly your account statement that read $500 now reads $1,500.

What did the government do to give you that money?

It simply changed the number in your bank account from 500 to 1,500.

It added a '1' and a comma.

That's all.

It didn't take a gold coin and hammer it into its computer. All it did was change a number in your bank account. It does this by making entries into its own spread sheet which is linked to other spread sheets in the banking system.

Government spending is all done by data entry on its own spread sheet we can call 'The US dollar monetary system.' And even if the government paid you with actual cash, that cash is nothing more than the same data, but written on a piece of paper rather than entered into a spread sheet.

And how about this quote from the good Fed Chairman on 60 minutes for support:

(PELLEY) Is that tax money that the Fed is spending?

(BERNANKE) It's not tax money. the banks have– accounts with the Fed, much the same way that you have an account in a commercial bank. So, to lend to a bank, we simply use the computer to mark up the size of the account that they have with the Fed.

There is no such thing as having to 'get' taxes or borrow to make a spread sheet entry that we call 'spending.'

Computer data doesn't come from anywhere. Everyone knows that!

Where else do we see this happen?

Your team kicks a field goal and on the scoreboard the score changes from, say, 7 point to 10 points. Does anyone wonder where the stadium got those three points? Of course not!

Or you knock down 5 pins at the bowling alley and your score goes from 10 to 15. Do you worry about where the bowling alley got those points? Do you think all bowling alleys and football stadiums should have a ‘reserve of points’ in a ‘lock box’ to make sure you can get the points you have scored?

Of course not!

And if the bowling alley discovers you ‘foot faulted’ and lowers your score back down by 5 points, does the bowling alley now have more score to give out?

Of course not!

We all know how ‘data entry’ works, but somehow this has gotten all turned around upside down and backwards by our politicians, media, and most all of the prominent main stream economists.

When the federal government spends, the funds don’t ‘come from’ anywhere any more than the points ‘come from’ somewhere at the football stadium or the bowling alley.

Nor does collecting taxes (or borrowing) somehow increase the government’s ‘hoard of funds’ available for spending.

In fact, the people at the US Treasury who actually spend the money (by changing numbers on bank accounts up) don’t even have the phone numbers of the people at the IRS who collect taxes (they change the numbers on bank accounts down), or the other people at the US Treasury who do the 'borrowing' (issue the Treasury securities).

If it mattered at all how much was taxed or borrowed to be able to spend, you'd think they at least would know each other's phone numbers! Clearly, it doesn't matter for their purposes.

From our point of view (not the government's) we need to first have $US to be able to make payments. Just like the children need to earn the coupons from their parents before they can make their monthly coupon payments.

We don't get to just change numbers like the government does (or the bowling alley and the football stadium), and neither do our children. Our children have to earn or somehow get their coupons to make their payments, just like we have to earn or somehow get $US to make our payments.

So, collectively, at what's called the 'macro level,' where do we all get the funds to pay taxes or buy government securities?

The answer, as previously stated, is that from inception,

the funds to pay taxes can only come from government spending or government lending.

And, as you now understand, this is just like it happens in any household that issues its own 'coupons.' The coupons the kids need to make their payments to their parents have to come from their parents.

Imagine a new country with a newly announced currency.

No one has any.

Then the government proclaims a property tax. How can it be paid?

It can't, until the government starts spending. Only after the government spends its new currency does the population have the funds to pay the tax.

To repeat, **the funds to pay taxes come from government spending or lending.** Where else can they come from???

***For those of you who understand reserve accounting, note that the Fed can't do what's called a reserve drain without doing a reserve add. So what does the Fed do on settlement day when Treasury balances increase? It does repos, to add the funds to the banking system that banks then have to buy the Treasury Securities. Otherwise, the funds aren't there to buy the Treasury securities, and the banks will have overdrafts in their reserve accounts. And what are overdrafts at the Fed? Functionally an overdraft is a loan from the government. So, again, one way or another, the funds that are used to buy the Treasury securities come from the government itself.

And because the funds to pay taxes, or buy government securities, come from government spending, the government is best thought of as spending first, and then collecting taxes or borrowing.

And government spending is in no case operationally constrained by revenues.

Yes, there can be and there are 'self imposed' constraints on spending by Congress, but that's an entirely different matter. These include debt ceiling rules, Treasury overdraft rules, and restrictions of the Fed buying securities from the Treasury. They are all imposed by a Congress that does not have a working knowledge of the monetary system. And, with our current monetary arrangements, they are all counterproductive with regard to furthering public purpose.

The fact that government revenue is in no case operationally constrained by revenues means **there is no 'solvency risk-'** the government can always make any and all payments in its own currency, no matter how large the deficit is, or how few taxes it collects.

So next time you hear 'where will the money for social security come from' go ahead and tell them- it's just data entry!

Putting it all another way, government checks don't bounce, unless the government decides to bounce its own checks.

Government checks don't bounce

A few years ago I gave a talk in Australia at an economics conference. The title was 'Government Checks Don't Bounce.' In the audience was the head of research for the Reserve Bank of Australia, a Mr. David Gruen. This was high drama. I had been giving talks for several years to this group of academics and I had not convinced most of them that government solvency wasn't an issue. They always started with the familiar 'What Americans don't understand is that it's different for a small, open economy like Australia than it is for the United States.' There seemed to be no way to get it through their perhaps overeducated skulls that at least for this purpose none of that matters. A spread sheet is a spread sheet. All but Professor Bill Mitchell and a few of his colleagues seemed to have this mental block, and so they deeply feared what would happen if 'the markets' turned against Australia to somehow keep them from being able to 'finance the deficit.'

So I began my talk about how government checks don't bounce, and after a few minutes David's hand shot up with the statement familiar to all modestly advanced economic students: 'If the interest rate on the debt is higher than the rate of growth of GDP, than the government's debt is unsustainable.’ It wasn’t even a question. It was presented as a fact.

I then replied ‘I’m an operations type of guy, so tell me, what do you mean by the word ‘unsustainable?’ Do you mean that if the interest rate is very high, and 20 years from now the government debt has grown to a large enough number the government won’t be able to make its interest payments? And if it writes a check to a pensioner that check will bounce?’

David got very quiet, deep in thought, and said while he was thinking it through ‘you know, when I came here, I didn’t think I’d have to think through how the Reserve Bank’s check clearing works’ in an attempt at humor. But no one in the room laughed or made a sound. They were totally focused on what his answer might be. Again, this was high drama- it was the ‘showdown’ on this issue.

David finally said ‘no, we’ll clear the check, but it will cause inflation and the currency will go down. That’s what people mean by unsustainable.’ There was dead silence in the room. The long debate was over. Solvency is not an issue, even for a small, open economy. Bill and I instantly commanded an elevated respect, which took the usual outward form of ‘well of course, we always said that’ from the former doubters and skeptics.

I continued with David, ‘Well, I think most pensioners are concerned about whether the funds will be there when they retire, and whether the government will be able to pay them.’ To which David replied, ‘No, I think they are worried about inflation and the level of the Australian dollar.’ To which Martin Watts, head of the economics department at the University of New Castle replied, ‘The Hell they are, David!’ To which David very thoughtfully replied, ‘Yes, I suppose you’re right.’

So what actually was confirmed to the Sydney academics in attendance that day? Government can spend what they want when they want, just like the football stadium can put points on the board at will. The consequences of overspending might be inflation or a falling currency, but never bounced checks. The fact is:

Government deficits can never cause a government to miss any size payments.

But as long as government continues to believe this first of 7 deadly innocent frauds- that they need to get money from taxing or borrowing in order to spend, they will continue to support policy that constrains output and employment, and prevents us from achieving what are otherwise readily available economic outcomes.

Deadly Innocent Fraud #2

With government deficits we are leaving our debt burden to our children.

Fact:

Collectively, in real terms, there is no such burden possible.

Debt or no debt, our children get to consume whatever they can produce.

This deadly innocent fraud is often the first answer most give to what they perceive to be the main problem associated with government deficit spending.

Borrowing now means paying later.

And paying later means somehow our children's real standard of living will be lower because of our deficits.

Fortunately, like all of the 7 deadly innocent frauds, it is readily dismissed in a way that all can understand.

Professional economists call this the 'intergenerational' debt issue. It is thought that if the federal government deficit spends it is somehow leaving the real burden of today's expenditures to somehow be 'paid for' by future generations.

And the numbers are staggering.

But, fortunately, they are completely irrelevant.

In fact, the idea of our children being somehow necessarily deprived of real goods and services in the future because of what's called the national debt is nothing less than ridiculous.

A year or so ago I ran into former Senator and Governor Lowell Weicker of Connecticut and his wife Claudia on a boat dock in St. Croix. I asked Senator Weicker what was wrong with the fiscal policy. He replied we have to stop running up these deficits and leaving the burden of paying for today's spending to our children.

I then asked him the following questions to hopefully illustrate the absurdity of his statement:

"When our children build 20 million cars per year 20 years from now, will they have to send them back in time to 2008 to pay off their debt?"

"Are we still sending real goods and services back in time to 1945 to pay off the lingering debt from World War II?"

Interestingly, it was Claudia who instantly grasped it, agreed with me, and asked her husband what he had to say to that. All he could say was he had to think about it some more.

Of course we don't send real goods and services back in time to pay off federal government deficits, and our children won't have to do that either!

Nor is there any reason government debt should prevent our children from going to work and producing all the goods and services they are capable of producing.

In 2029, just like today, the living will produce and consume their real output of goods and services, no matter how many US Treasury securities are outstanding.
There is no such thing as giving up current year output to be sent back in time to previous generations.
Our children won't and can't pay us back for anything we leave them- even if they wanted to.

What the government deficits can influence, especially if not understood by the politicians, is the current year DISTRIBUTION of real output. Distribution is about who gets all the goods and services that are produced. But any distribution deemed unreasonable by the political forces at any time can be readily altered.

Each year, for example, Congress discusses tax policy, always with an eye to the distribution of income and spending. Many seek to tax those 'who can most afford it' and direct federal spending to 'those in need.' And they also decide how to tax interest, capital gains, estates, etc. as well as how to tax income. All of these are distributional issues.

In addition, Congress decides who they hire and fire, who they buy things from, and who gets direct payments. Congress also makes laws that directly affect many other aspects of prices and incomes.
This is all perfectly legal and business as usual, as each year's output is 'divided up' among the living. None of the real output gets 'thrown away' because of outstanding debt, no matter how large. Nor does outstanding debt necessarily reduce output and employment, except when policy makers decide to take measures that do reduce output and employment.

Unfortunately, that is currently the case, and that is why this is a deadly innocent fraud.

So yes, those alive get to consume this year's output, including the decision to use some of the output as 'investment goods and services' which serve to hopefully increase future output. And yes, Congress has a BIG say in who consumes this year’s output. And previous federal deficits that might alter distribution if left alone can be readily addressed by Congress and altered to their satisfaction.

Paying off the China

And those worried about paying off the national debt can’t possibly understand how it all works at the operational, nuts and bolts, debits and credits level.

Both ‘money’ and ‘Treasury debt (securities)’ are nothing more than accounts- again, data entry- on the governments own books. When a Treasury bill, note, or bond is purchased by a bank, for example, the government makes two entries on its spreadsheet we call the ‘monetary system.’

First, it debits (subtracts from) the buyer’s ‘checking account’ at the Fed.
Then it increases (credits) the buyer’s securities account at the Fed.

As before, the government simply changes numbers on its own spread sheet- one number gets changed down and another gets changed up.

And so what does happen when the dreaded day arrives and the Treasury securities Chinas holds come due and need to be repaid?

Same thing.
The Fed simply changes two numbers on their own spread sheet.
They debit (subtract from) China's securities account at the Fed.

And they credit (add to) China's bank account at the Fed.

That's all- debt paid!

To repeat, **paying off the national debt is but a matter of subtracting the value of the maturing securities from one account at the Fed, and entering adding that valued to a bank account at the Fed.**

Even briefer- to pay off the national debt the government changes two entries in its own spreadsheet- a number that says how many securities are owned by the private sector is changed down, and another number that says how many $US are being kept at the Fed is changed up.

Nothing more.

Debt paid, all creditors have their 'money back.'

What's the big deal?

And our children will be able to change numbers on what will be their spread sheet just as easily as we did. Though hopefully with a better understanding!

But for now, the deadly innocent fraud of leaving our debt to our children continues to drive policy, and keeps us from optimizing output and employment. This is a price we and our children pay. We make do with less than what we can produce and high levels of unemployment, while our children are deprived of the real investments that would have been made on their behalf if we knew how to keep our human resources fully employed and productive.

Deadly Innocent Fraud #3

Government budget deficits take away savings.

Fact:

Government budget deficits ADD to savings.

Several years ago I had a meeting with Senator Tom Daschle and then Asst. Treasury Secretary Lawrence Summers. I had been discussing these innocent frauds with the Senator, and explaining how they were working against the well being of those who voted for him. So he set up this meeting with the Asst. Treasury Secretary, who was also a former Harvard economics professor and had two uncles who had won Nobel prizes in economics, to get his response and hopefully confirm what I was saying.

I opened with a question:

"Larry, what's wrong with the budget deficit?"

To which he replied:

“It takes away savings that could be used for investment.’

To which I replied:

“No it doesn’t, all Treasury securities do is offset operating factors at the Fed. It has nothing to do with savings and investment”

To which he replied:

“Well, I really don’t understand reserve accounting so I can’t discuss it at that level.”

Senator Daschle was looking at all this in disbelief. The Harvard professor of economics Asst. Treasury Secretary Lawrence Summers didn’t understand reserve accounting? Sad but true.

So I spend the next twenty minutes explaining the ‘paradox of thrift’ step by step, which he sort of got it right when he finally responded “…so we need more investment which will show up as savings?” I responded with a friendly ‘yes’ after giving this first year economics lesson to the good Harvard professor and ended the meeting. And the very next day I saw him on a podium with the Concord Coalition- a band of deficit terrorists- talking about the grave dangers of the budget deficit.

This third deadly innocent fraud was and is alive and well at the very highest levels.

So here's how it really works, and it could not be simpler:
Any $US government deficit exactly EQUALS the total net increase in the holdings $US financial assets of the rest of us- businesses and households, residents and non residents- what's called the 'non government' sector.

So, for example, if the government deficit was $500 billion last year, it means the net increase in savings for everyone else combined was exactly $500 billion. To the penny.

***For those who understand reserve accounting, that net savings of financial assets is held as some combination of actual cash, Treasury securities, and member bank deposits at the Federal Reserve.

This is economics 101. It is beyond dispute. It's an accounting identity. Yet it's misrepresented continuously, and at the highest levels of political authority. They are just plain wrong.
Just ask anyone at the CBO (Congressional Budget Office), as I have, and they will tell you they have

to ‘balance the check book’ and make sure the government deficit equals our new savings, or they have to stay late and find their accounting mistake.

As before, it’s just a bunch of spread sheet entries on the government’s own spreadsheet.

When the accountants debit (subtract from) the account called ‘government’ when government spends, they also credit (add to) the accounts of whoever gets those funds. When the government account goes down, some other account goes up by exactly the same amount.

Here’s an example of how government deficits add to savings.

This also puts to rest a ridiculous new take on this innocent fraud that’s popped up recently:

“Deficit spending means the government borrows from one person and gives it to another, so nothing new is added- it’s just a shift of money from one person to another.”

In other words, they are saying deficits don’t add to our savings, but just shift savings around.

This could not be more wrong!

So let's demonstrate how deficits do ADD to savings, and not just shift savings:

1. Start with the government selling $100 billion of Treasury securities.
2. When we pay for these securities our bank accounts at the Fed are reduced by $100 billion to make the payment.

   In other words, money in the banks is exchanged for the new Treasury securities.

   At this point savings is unchanged.

   We now have new Treasury securities for savings rather than the money that was in our bank accounts.
3. Now the government spends the $100 billion it got from selling its Treasury securities.
4. This spending puts the $100 billion back into our bank accounts.
5. We now have our bank accounts back AND our new Treasury securities.

Bottom line-

Deficit spending directly adds to our savings.

And, likewise,

A federal budget surplus directly subtracts exactly that much from our savings.

And the media and politicians and even top economists all have it BACKWARDS!

In July 1999 the front page of the Wall St. Journal had two headlines. Towards the left was a headline praising President Clinton and the record government budget surplus, and explaining how well fiscal policy was working. On the right margin was a headline that said Americans weren't saving enough and we had to work harder to save more. Then a few pages later there was a graph with one line showing the surplus going up, and another line showing savings going down. They were nearly identical, but going in opposite directions, and clearly showing the gains in the government surplus roughly equaled the losses in private savings.

There can't be a budget surplus with private savings increasing (including nonresident savings of $US financial assets). There is no such thing, yet not a single mainstream economist or government official had it right.

Early in 2000, in a private home in Boca Raton Florida, I was seated next to then Presidential Candidate Al Gore at a fundraiser/dinner to discuss the economy.
The first thing he asked was how I thought the next president should spend the coming $5.6 trillion surplus forecast for the next 10 years. I explained that there wasn't going to be a $5.6 trillion surplus, because that would me a $5.6 trillion drop in non government savings of financial assets, which was a ridiculous proposition. At that time the private sector didn't even have that much in savings to be taxed away by the government, and the latest surpluses of maybe $ several hundred billion had already removed more than enough private savings to turn the Clinton boom to the soon to come bust. I pointed out how the last 6 periods of surplus in our 200+ year history had been followed by the only 6 depressions in our history, and how the coming bust due to allowing the past surplus would result in a recession that would not end until the deficit got high enough to add back

our lost income and savings and deliver the aggregate demand needed to restore output and employment. I suggested the $5.6 trillion deficit forecast for the next decade would more likely be a $5.6 deficit, as normal savings desires are likely to average 5% of GDP over that period of time.
And that's pretty much what happened. The economy fell apart, and President Bush temporarily reversed it with his then massive deficit spending of 2003, but after that, and before we had enough deficit spending to replace the financial assets lost to the Clinton surplus years, we let the deficit get too small again, and after the sub-prime debt driven bubble burst we again fell apart due to a deficit that was far too small for the circumstances.

Anyway, Al was a good student, and went over all the details, and agreed it made sense and was indeed what might happen, but said he couldn't go there, and I said I understood the political realities, as he got up and gave his talk about how he was going to spend the coming surpluses.

So back to the present.

When the January 09 savings report was released, and the press noted that the rise in savings to 5% of

GDP was the highest since 1995, they failed to note the current budget deficit passed 5% of GDP, also about the highest it's been since 1995.

Clearly they don't yet realize deficits add to savings. And if Al Gore does, he isn't saying anything.

So watch this year as the federal deficit goes up and savings goes up. Again, the only source of 'net $US monetary savings' (financial assets) for the non government sectors combined (both residents and non residents) is US government deficit spending.

And watch how the same people who want us to save more at the same time want to 'balance the budget' by taking away our savings, either through spending cuts or tax increases.

They are all talking out of both sides of their mouths. They are part of the problem, not part of the answer.

And they are at the very highest levels.

Review

So now we know deficits aren't the 'bad things' the world thinks they are.
The government won't go broke;
Federal deficits don't burden our children;
Federal deficits don't just shift funds from one person to another; and
Federal deficits add to our savings.

What we haven't directly discussed is why the economy needs or doesn't need deficits at any point in time. But at least at this point we know that if there is a good reason for what might be considered a very large deficit there's nothing to be afraid of regarding solvency, sustainability, or doing bad by our children.

So what is the role for deficits in regard to policy?
It's very simple.
Whenever spending falls short of sustaining our output and employment, for ANY reason, government can act to see to it our own output is sold by either increasing spending and/or by cutting taxes.

So if everyone wants to work and earn money but doesn't want to spend it, fine! Government can either buy the output (hand out contracts for infrastructure repairs, national security, medical research, and the like) and/or keep cutting taxes until we decide to spend and buy our own output.

The right sized deficit is the one that gets us to where we want to be regarding output and employment, no matter how large or how small a deficit that might be.

What matters is real life- output and employment- not the size of the deficit. In the 1940's an economist named Abba Lerner called this 'Functional Finance' and wrote a book by that name that is still very relevant today.

More later, as we now move on to the next innocent fraud.

Deadly Innocent Fraud #4

Social Security is broken

Fact:

Government Checks Don't Bounce

If there is one thing all members of Congress believe is that social security is broken. President elect Obama says ‘the money won’t be there,’ President Bush used the word bankruptcy four times in one day, and Senator McCain says social security is broken.

They are all wrong.

And one of the major discussions in Washington is whether or not to privatize social security.

That entire discussion, too, makes no sense whatsoever, so let me begin with that and then move on.

The idea of privatization is that

1. Social security taxes and benefits are reduced, and instead
2. The amount of the tax reduction is used to buy specified shares of stock. And
3. Because the government is going to collect that much less in taxes the budget deficit will be that much higher, and so the government will have to sell that many more Treasury securities to ‘pay for it all’ (as they say).

Got it?

1. They take less each week from your pay check for social security and
2. You get to use the funds they no longer take from you to buy stocks.
3. You later will collect a bit less in social security payments when you retire, but
4. You will own stocks that will hopefully become worth more than the social security payments you gave up.

From the point of view of the individual it looks like an interesting trade off. The stocks you buy only have to go up modestly over time for you to be quite a bit ahead.
Those who favor this plan say yes, it's a relatively large 'one time' addition to the deficit, but the savings in social security payments down the road for the government pretty much makes up for that, and the payments going into the stock market will help the economy grow and prosper.

Those against the proposal say the stock market is too risky for this type of thing, and point to the large drop in 2008 as an example. And if people lose in the stock market the government will be compelled to increase social security retirement payments to keep them out of poverty. Therefore, unless we want to risk a high percentage of our seniors falling below the poverty line, government is taking all the risk.

They are both terribly wrong.

The major flaw in this main stream dialogue is what is called a 'fallacy of composition.'
The typical textbook example of a fallacy of composition is the football game where you can see better if you stand up, and then conclude that everyone would see better if all of them stood up.

Wrong!

They all are looking at what is called the micro level for the individual social security participants rather than looking at the macro level which includes the entire population.

To understand what's fundamentally wrong at the macro (big picture, top down) level, you first have to understand that participating in social security is functionally the same as buying a government bond.

With the current social security program you give the government your dollars now and it gives you back dollars later. That is exactly what happens when you buy a government bond. You give the government your dollars now and you get dollars back later.

Yes, one might turn out to be a better investment and give you a higher return, but apart from the rate of return, each is the same.

Now that you know this, you are way ahead of Congress, by the way.

And now you are ready to read about the conversation of several years back I had with Steve Moore, then head of CATO, now a CNBC regular, and one of the first to advocate privatizing Social Security.

Steve came down to speak about social security at one of my conferences in Florida. He gave his talk that went much like I just stated- by letting people put their money in the stock market rather than making social security payments they will better off over time when they retire, and the one time increase in the government budget deficit will be both well worth it and probably paid down over time in the expansion to follow, as all that money going into stocks will help the economy grow and prosper.

At that point I led off the question and answer session.

Me:

“Steve, giving the government money now in the form of social security taxes, and getting it back later is functionally the same as buying a government bond, where you give the government money now and it gives it back to you later. The only difference is the return.”

Steve:

“OK, but with government bonds you get a higher return than with Social Security which only pays your money back at 2% interest. Social Security is a bad investment for individuals.”

Me:

“OK, I’ll get to the investment aspect later, but let me continue. Under your privatization proposal, the government would reduce Social Security payments and the employees would put that money into the stock market."

Steve:

"Yes, about $100 per month, and only into approved, high quality stocks."

Me:

"OK, and the US Treasury would have to issue and sell additional securities to cover the reduced revenues."

Steve:

"Yes, and it would also be reducing social security payments down the road."

Me:

"Right. So to continue with my point, the employees buying the stock buy them from someone else, so all the stocks do is change hands. No new money goes into the economy."

Steve:

"Right"

Me:

"And the people who sold the stock then have the money from the sale which is the money that buys the government bonds."

Steve:

"Yes, you can think of it that way."

Me:

“So what’s happened is the employees stopped buying into social security, which we agree was functionally the same as buying a government bond, and instead bought stocks. And other people sold their stocks and bought the newly issued government bonds. So looking at it from the macro level, all that happened is some stocks changed hands, and some bonds changed hands. Total stocks outstanding and total bonds outstanding, if you count social security as a bond, remained about the same. And so this should have no influence on the economy, or total savings, or anything else apart from generating transactions costs?”

Steve:

“Yes, I suppose you can look at it that way, but I look at it as privatizing, and I believe people can invest their money better than government can.”

Me:

“Ok, but you agree the amount of stocks held by the public hasn’t changed, so with this proposal nothing changes for the economy as a whole.”

Steve:

“But it does change things for Social Security participants.”

Me:

"Yes, with exactly the opposite change for others. And none of this has even been discussed by Congress or any mainstream economist? It seems you have an ideological bias towards privatization rhetoric, rather than the substance of the proposal."

Steve:

"I like it because I believe in privatization- I believe that you can invest your money better than government can."

I'll let Steve have the last word here.

The proposal in no way changes the number of shares of stock, or which stocks the American public would hold for investment.

So at the macro level it is not the case of allowing the nation to 'invest better than the government can.' And Steve knows that, but it doesn't matter, and he continues to peddle the same illogical story that he knows is illogical. And he gets no criticism from the media apart from the discussion as to whether stocks are a better investment than social security, and whether the bonds the government has to sell will take away savings that could be used for investment, and whether the government risks its solvency by going even deeper into debt, and other such innocent fraud nonsense.

Unfortunately, the deadly innocent frauds continuously compound and obscure any chance for legitimate analysis.

And it gets worse yet.

The ‘intergenerational’ story continues with something like this:
“The problem is that 30 years from the there will be a lot more retired people and proportionately fewer workers. [that part’s right] and the Social Security trust fund will run out of money [silly, but they believe it], so to solve the problem we need to figure out a way to be able to provide seniors with enough money to pay for the goods and services they need.”

With that last statement they assume that real problem of fewer workers and more retirees, which is also known as the dependency ratio, can be ‘solved’ by making sure the retirees have sufficient funds to buy what they need.

Let's look at it this way. 50 years from now when there is one person left working and 300 million retired people, that guy is going to pretty busy since he'll have to grow all the food, build and maintain all the buildings, do the laundry, take care of all medical needs, produce the TV shows, etc. etc. etc.

So what we need to do is make sure those 300 million retired people have the funds to pay him??? I don't think so!

This problem obviously isn't about money.

What we need to do is make sure that one guy working is smart enough and productive enough and has enough capital goods and software to be able to get all that done, or those retirees are in serious trouble!

So the real problem is, if the remaining workers aren't sufficiently productive there will be a general shortage of goods and services and more 'money to spend' will only drive up prices, and not somehow create more goods and services.

The story deteriorates further as it continues:

“Therefore, government needs to cut spending or increase taxes today, to accumulate the funds for tomorrow’s expenditures.”

And it gets even worse. Any mainstream economist will agree that there pretty much isn’t anything in the way of real goods we can produce today that will be useful 50 years from now. They go on to say that the only thing we can do for our descendents that far into the future is to do our best to make sure that they have the knowledge and technology to help them meet their future demands.

So the final irony is that in order to somehow ‘save’ public funds for the future, what we do is cut back on expenditures today, which does nothing but set our economy back and cause the growth of output and employment to decline. And, for the final ‘worse yet,’ the great irony is that the first thing we cut back on is education- the one thing the mainstream agrees we can actually do that actually helps our children down the road.

Should our policy makers ever actually get a handle on how the monetary system functions, they would understand that we can pay seniors whatever we want regardless of what the balance in the Social Security trust fund happens to be.

They would realize the issue is equity, and possibly inflation, but never government solvency.

They would realize that if they want seniors to have more income, it's a simple matter of raising benefits.

And if they are concerned about the future, they would support the education they thought would be most valuable for that purpose.

But they don't understand so they won't see it that way until they do understand. Meanwhile, the deadly innocent fraud of Social Security takes its toll.

Deadly Innocent Fraud #5

The trade deficit is an unsustainable imbalance that takes away jobs and output.

Facts:

Imports are real benefits and exports real costs. Trade deficits directly improve our standard of living.

By now you might suspect that, once again, the mainstream has it all backwards, including the trade issue.

To get on track with the trade issue, always remember this:

In economics, unlike religion, it's better to receive than to give.

Likewise:

Imports are real benefits.

Exports are real costs.

In other words, going to work to produce real goods and services to export to someone else to consume, does you no economic good at all.

Unless you get to import and consume the real goods and services they produce in return.

And also remember:

The real wealth of a nation is all it produces, plus all it imports, minus what it must export.

And, therefore, a trade deficit increases our real standard of living. How can it be any other way? And the higher the trade deficit the better!

Yes, the mainstream economists, politicians, and media all have the trade issue completely backwards. Sad but true.

To further make the point, if general McArthur had proclaimed after WWII that since Japan had lost the war, they would be required to send the US 2 million cars a year and get nothing in return, the result would have been a major international uproar about US exploitation of conquered enemies. We would have been accused of fostering a repeat of the aftermath of WWI, where the allies demanded reparations from Germany that were presumably so high and exploitive they caused WWII.

Yet for over 50 years, Japan has in fact been sending us about 2 million cars per year, and we have been sending them little or nothing. And, surprisingly (?) they think this means they are winning, and we think we are losing.

Same with China- they think they are winning because they keep our stores full of products and get nothing in return. And our leaders agree and think we are losing.

This is madness on a grand scheme!

Now take a fresh look at the headlines and commentary we see and hear daily:

*The US is suffering from a trade deficit.
*The trade deficit is an UNSUSTAINABLE IMBALANCE.
*The US is LOSING JOBS to China.
*Like a drunken sailor, we are borrowing from abroad to fund our spending habits, leaving the bill to our children, as we deplete our national savings.

I've heard it all. It's all total nonsense. We are benefiting IMMENSELY from the trade deficit. The rest of the world has been sending us hundreds of $billions worth of real goods and services in excess of what we send them. They get to produce and export, and we get to import and consume.

Is this an unsustainable imbalance?

Certainly not for us!

Why would we want to end it?

As long as they want to send us goods and services without demanding any goods and services in return, why should we not be able to take them? There is no reason, except a complete misunderstanding of our monetary system by our leaders.

Recall from the previous innocent frauds, the US can ALWAYS support domestic output and employment with fiscal policy- even when China, or any other nation, decides to send us real goods and services that displace our industries previously doing that work. All we have to do is keep American spending power high enough to be able to buy BOTH what foreigners want to sell us AND all the goods and services we can produce as ourselves. Yes, jobs may be lost in one or more industries. But with the right fiscal policy there will be sufficient domestic spending power to be able to employ those willing and able to work producing other goods and services for our private and public consumption. In fact, up until recently, unemployment remained relatively low even as our trade deficit went ever higher.

So what about all the noise about the US borrowing from abroad like drunken sailor to fund our spending habits?

Also not true!

We are not dependent on China to buy our securities or in any way fund our spending.

Here's what's really going on:

Domestic credit is funding foreign savings

What does this mean? Let's look at an example of a typical transaction.

Assume you live in the US and decide to buy a car made in China.

You got to a US bank, get accepted for a loan, and spend the funds on the car.

So where do things then stand?

You exchanged the borrowed funds for the car, the Chinese car company has a deposit in the bank, and the bank has a loan to you and a deposit belonging to the German car company on their books.

1. You would rather have the car than the funds, or you would not have bought it.

2. The Chinese car company would rather have the funds than the car, or they would not have sold it.

3. The banks wants loans and deposits, or they wouldn't have made the loan.

Where is the imbalance? Everyone is sitting fat and and happy. They all got exactly what they wanted.

The bank has a loan and a deposit, so they are happy and in balance.

The Chinese car company has the $US deposit they want as savings, so they are happy and in balance.

And you have the car you want and a car payment you agreed to, so you are happy and in balance as well.

So there is no imbalance. Everyone is happy with what they have at that point in time.

And domestic credit creation-the bank loan- has funded the Chinese desire to hold a $US deposit at the bank.

Where's the 'foreign capital?' There isn't any! The entire notion is inapplicable.

Instead, they are dependent on our domestic credit creation process to fund their desire to save $US financial assets.

Domestic credit funds foreign savings.
We are not dependent on foreign savings for funding anything.
Nor can we be. Again, it's our spread sheet and if they want to save our $ they have to play in our sandbox.

Deadly Innocent Fraud #6

We need savings to provide the funds for investment.

Fact:

Investment adds to savings

Last but not least, this innocent fraud undermines our entire economy, as it diverts real resources away from the real sectors to the financial sector, and results in real investment being directed in a manner totally divorced from public purpose.

In fact, this deadly innocent fraud drains over 20% annually from useful output and employment- a staggering statistic unmatched in human history.

And it leads directly the type of financial crisis we've been going through.

It begins with the paradox of thrift which goes something like this:

In our economy, spending must equal all income, including profits, for the output of the economy to get sold.

(Think about that some to make sure you've got it before moving on.)

If anyone attempts to save by spending less than his income, at least one other person must make up for that by spending more than his own income or the output of the economy won't get sold.

And if that doesn't happen, unsold output means excess inventories, production and employment cuts, and less total income equal to the amount not spent by the person trying to save.

Think of it as the person trying to save by not spending his income losing his job and not getting any income, because his employer can't sell all the output.

So the paradox is decisions to save by not spending income result in less income and no new net savings.

Likewise, decisions to spend more than one's income by going into debt cause incomes to rise and can drive real investment. Consider this extreme example to make the point:

Supposed everyone ordered a new pluggable hybrid car from our domestic auto industry. Because the industry can't currently produce that many cars, they would hire us and borrow to pay us to first build the new factories to meet the new demand.

That means we'd all be working on new plant and equipment- capital goods- and getting paid. But there would not yet be anything to buy, so we would necessarily be 'saving' our money to buy the new cars when they rolled off the new assembly lines.

The decision to spend in this case resulted in less spending and more savings.

And the production of capital goods, which constitute real investment, led to an equal amount of savings.

I like to say it this way-

'Savings is the accounting record of investment'

I had this discussion with a Professor Basil Moore in 1996 at a conference in New Hampshire, and he asked if he could use that expression in a book he wanted to write. I'm pleased to report the book with that name has been published and I've heard it's a good read. (I'm waiting for my autographed copy.)

Unfortunately, Congress, the media, and mainstream economists get this all wrong, and somehow conclude we need more savings so there will be funding for investment. What seems to make perfect sense at the micro level is again totally wrong at the macro level.

Just as loans create deposits, investment creates savings.

So what do our leaders do in their infinite wisdom when investment falls usually because of low spending?

They decide we need more savings so there will be more 'money' for investment. And to accomplish this they use the tax structure to create tax advantaged savings incentives, such as pension funds, IRA's, and all sorts of tax advantaged institutions that accumulate reserves on a tax deferred basis.

Predictably, all that these incentives do is remove aggregate demand. They function to keep us from spending our money to buy our output.

This slows the economy and introduces the need for private sector credit expansion and public sector deficit spending just to get us back to even. That's why what seem to be enormous deficits turn out not to be as inflationary as they otherwise might be.

In fact the deficits are necessary to offset these Congressionally engineered demand leakages of the tax advantaged savings vehicles.

And, ironically, the same Congressmen pushing the tax advantaged savings programs (because they think we need more savings to have money for investment) are the ones most against the federal deficit spending periodically needed in large size to offset them.

But the worst has yet to come. These massive pools of funds (created by the deadly innocent fraud that savings are needed for investment) also need to be managed, and for the further purpose of compounding the monetary savings for the beneficiaries.

This is the base of the dreaded financial sector-thousands of pension fund managers whipping around vast sums of dollars, which are largely subject to government regulation. For the most part that means investing in publicly traded stocks, rated bonds, and with some diversification to other strategies such as hedge funds and passive commodity strategies.

And feeding on these whales are the thousands of financial professionals in the brokerage, banking, and financial management industries.

Deadly Innocent Fraud #7

Conclusion