The Seven Deadly Frauds of Economic Policy

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For xxxxxxx

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Introduction

The term *"innocent fraud"* was introduced by Professor John Kenneth Galbraith in his last book, ***The Economics of Innocent Fraud***, which he wrote at the age of ninety-four in 2004, just two years before he died. [1] Professor Galbraith coined the term to describe a variety of incorrect assumptions embraced by mainstream economists, the media, and most of all, politicians.

The presumption of innocence, yet another example of Galbraith's elegant and biting wit, implies those perpetuating the fraud are not only wrong, but also not clever enough to understand what they have been doing. And any claim of prior understanding becomes an admission of deliberate fraud—an unthinkable self incrimination.

Galbraith's economic views gained a wide audience during the 1950's and 1960's, with his best selling books ***The Affluent Society***, and ***The New Industrial State***. He was well connected to both the Kennedy and Johnson Administrations, serving as the United States Ambassador to India from 1961 to 1963, when he returned to his post as Harvard's most renowned Professor of Economics.

Galbraith was largely a Keynesian who believed that only fiscal policy can restore "spending power." Fiscal policy is what economists call tax cuts and spending increases, and spending in general is what they call aggregate demand.

Galbraith's academic antagonist, Milton Friedman, led another school of thought known as the "monetarists." The monetarists believe the Federal government should always keep the budget in balance and use what they called "monetary policy" to regulate the economy. Initially that meant keeping the "money supply" growing slowly and steadily to control inflation, and letting the economy do what it may. However they never could come up with a measure of money supply that did the trick, nor could the Federal Reserve ever find a way to actually control the measures of money they experimented with.

Paul Volcker was the last Fed Chairman to attempt to directly control the money supply. After a prolonged period of actions that merely demonstrated what most central bankers had known for a very long time—that there was no such thing as controlling the money supply—Volcker abandoned the effort.

Monetary policy was quickly redefined as a policy of using interest rates as the instrument of monetary policy rather than any measures of the quantity of money. And "inflation expectations" moved to the top of the list as the cause of inflation, as the money supply no longer played an active role. Interestingly, "money" doesn't appear anywhere in the latest monetarist mathematical models that advocate the use of interest rates to regulate the economy.

Whenever there are severe economic slumps, politicians need results—in the form of more jobs—to stay in office. At first they watch as the Federal Reserve cuts interest rates, waiting patiently for the low rates to somehow "kick in." Unfortunately, interest rates never to seem to "kick in." Then, as rising unemployment threatens the re-election of members of Congress and the President, the politicians turn to Keynesian policies of tax cuts and spending increases. These policies are implemented over the intense objections and dire predictions of the majority of central bankers and mainstream economists.

It was Richard Nixon who famously declared during the double dip economic slump of 1973 that "We are all Keynesians now."

Despite Nixon's statement, Galbraith's Keynesian views lost out to the monetarists when the "Great Inflation" of the

the 1970s sent shock waves through the American psyche. Public policy turned to the Federal Reserve and its manipulation of interest rates as the most effective way to deal with what was coined "stagflation"—the combination of a stagnant economy and high inflation.

This book is divided into three sections. Part one immediately reveals the seven 'innocent frauds' that I submit are the most imbedded obstacles to national prosperity. They are presented in a manner that does not require any prior knowledge or understanding of the monetary system, economics, or accounting. The first three concern the federal government's budget deficit, the fourth addresses social security, the fifth international trade, the sixth savings and investment, and the seventh returns to the budget deficit. This chapter is the core message. It's purpose is to promote a universal understanding of these critical issues facing our nation.

Part two is a history of how I discovered these seven innocent frauds during my more than three decades of experience in the world of finance.

In part three, I set forward a specific action plan for our country to realize our economic potential and restore the American Dream.

April 15, 2010

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PART ONE—THE SEVEN DEADLY INNOCENT FRAUDS

CHAPTER ONE—THE FIRST DEADLY INNOCENT FRAUD

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:

The actual act of 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."

And from this comes the inevitable question about healthcare, defense, social security, and everything else:

'How are you going to pay for it?!'

This is the killer question, the one no one gets right, and getting the answer to this question right is the core of the public purpose behind writing this book.

In the next few moments of reading it will all be revealed to you with no theory and no philosophy- just a few hard, cold facts.

I answer this question by first looking at exactly how government taxes, followed by how government spends.

HOW GOVERNMENT TAXES

Let's start by looking at what happens should you go to the Federal Reserve ("the Fed") to pay your taxes with actual cash.

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

Next, the Fed 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.

Then, 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

They 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.

So if government throws away your cash after collecting it, how does that cash pay for anything, like Social Security and the rest of the government's spending?

It doesn't. Something else is going on.

Now let's look at what happens if you pay your taxes by writing a check.

When the government gets your check, and your check is deposited and 'clears,' all the government does is change the number in your checking account 'downward' when they subtract the amount of your check from your bank balance.

Does the government actually get anything real to give to someone else? No, it's not like they get a gold coin to spend.

You can actually watch this happen with online banking. You can see the balance in your bank account on your computer screen.

Suppose the balance in your account is $5,000 and you write a check to the govt. for $2,000.

When that checks clears, what happens? The 5 turns into a 3, and your new balance is now down to $3,000. All before your very eyes!

And all they did was change a number in your bank account.

The government didn't actually 'get' anything to give to someone else.

No gold coin dropped into a bucket at the Fed.

All they did was change numbers in bank accounts. Nothing 'went' anywhere.

(Can you now see why it makes no sense at all to say the government has to get money by taxing in order to spend?)

So if govt. doesn't actually get anything when it taxes, how and what does it spend?

HOW GOVERNMENT SPENDS

Imagine you are expecting your $2,000 social security payment to hit your bank account which already has $3,000 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 $3,000 now reads $5,000. What did the government do to give you that money?

It simply changed the number in your bank account from 3,000 to 5,000. It changed the 3 into a 5. That's all. It didn't take a gold coin and hammer it into a computer. All it did was change a number in your bank account by making data 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.[1]

The Chairman of the Federal Reserve is telling us in plain English that they give out money (spend and lend) by changing numbers in bank accounts. There is no such thing as having to 'get' taxes (or borrow) to make a spread sheet entry that we call 'Government 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.

Just keep this in mind as a starting point:

The Federal Government doesn't ever 'have' or 'not have' any dollars.

Just like the stadium doesn't 'have' or 'not have' points to give out.

When it comes to the dollar our Government is the score keeper. (And it also makes the rules!)
You now have the operational answer to the question:

'How are we going to pay for it?'

Answer- the same way government pays for anything- it changes the numbers in our bank accounts.

Government isn't going to 'run out of money' as our President has repeated. It is not dependent on China or anyone else, as discussed later in this book. There is no operational limit to how much Government can spend, when it wants to spend. This includes making interest payments and Social Security and Medicare and Medicaid payments. It includes all Government payments made in dollars to anyone.

This is not to say exess government spending won't possibly cause inflation.

It is to say the government can't go broke and can't be insolvent or bankrupt. There is simply no such thing.

****I know you've got this question on your mind, right now. I answer it a bit later in this book, but let me state the question and give you a quick answer to tide you over:*

If the govt. doesn't tax because it needs the money to spend, why tax at all?

*Answer: The govt taxes to regulate what economists call 'aggregate demand' which is a fancy word for 'spending power' In short, that means that if the economy is 'too hot' raising taxes will cool it down, and if it's 'too cold' cutting taxes will warm it up. Taxes aren't about getting money to spend, they are about regulating our spending power to make sure we don't have too much and cause inflation, or too little which causes unemployment and recessions.*****

So why does no one in government seem to get it? Why does the Ways and Means Committee in Congress worry about 'how are we going to pay for it'?

One reason might be because they are stuck in 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.

So to properly utilize this popular government/household analogy in a meaningful way, we next look at an example of a 'currency' created by a household.

The story begins with the parents creating coupons they then use to pay their children for doing various household chores.

Additionally, to ‘drive the model,’ the parents require the children to pay them a tax of 10 coupons a week to avoid punishment.

This closely replicates taxation in the real economy, where we have to pay our taxes or face penalties.

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

With this new household currency, the parents, like the government, are now the issuer of their own currency.

And now you can see how a household with its own currency is indeed very much like a government with its own currency.

Let’s begin by asking some questions about how this new household currency works.

Do the parents have to somehow get coupons from their children before they can pay their coupons 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 week from their children. How else can the children get the coupons they owe the parents?

Likewise, in the real economy, the Federal Government, just like this household with its own coupons, doesn’t have to get the dollars it spends from taxing or borrowing, or anywhere else, to be able to spend them. With modern technology, the Federal Government doesn't even have to print the dollars it spends the way the parents print their own coupons.

Remember, the Federal Government itself neither has nor doesn't have dollars, any more than the bowling alley ever has a box of points.

And how many coupons do the parents have in the parent/child coupon story? It doesn't matter. They could even just write down on a piece of paper how many coupons the children owe them, how many they've earned, and how many they've paid each month.

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 dollars to be able to make payments. Just like the children need to earn the coupons from their parents before they can make their weekly coupon payments.

In fact, as a point of logic, the dollars we need to pay taxes must, directly or indirectly, from the inception of the currency, come from government spending (or government lending, which I'll discuss later).

Now let's build a national currency from scratch.

Imagine a new country with a newly announced currency.

No one has any.

Then the government proclaims, for example, a property tax.

How can it be paid?

It can't, until after 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, from inception, come from government spending (or lending). Where else can they come from??? [2]

FootNote 2, displayed here in the draft: 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.

Yes, that means the government had to spend first, to ultimately provide us with the funds we need to pay our taxes. The government, then, is just like the parents have to spend their coupons first, before they can start actually collecting them from their children.

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?

****Note on how this works inside the banking system:*

*When you pay taxes by writing a check to the Federal Government, they debit your bank's reserve account at the the Federal Reserve. Bank reserves can only come from the Fed. The private sector can't generate them. If your bank doesn't have any, the check you wrote results in an overdraft in that bank's reserve account. An overdraft is a loan from the Fed. So in any case the funds to make payments to the Federal Government can only come from the Federal Government.****

So while our politicians truly believe government needs to take our dollars, either by taxing or borrowing, for them to be able to spend, the truth is:

We need the Federal Government's spending to get the funds we need to pay our taxes.

[FootNote3 :Just a quick reminder that our State governments are users of the US dollar, and not the issuers like the Federal government is. In fact, the US States are in a similar position as the rest of us- we and the States both need to get funds into our bank accounts before we write our checks, or those checks will indeed bounce. In the parent/children analogy, we and the States are in much the same position the children are in.]

We don't get to change numbers like the government does (or the bowling alley and the football stadium).

Our children have to earn or somehow get their coupons to make their coupon payments, just like we have to earn or somehow get US dollars to make our payments.

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.

And, as previously stated, government spending is in no case operationally constrained by revenues (tax payments and borrowings). 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. All they do is put blockages in the monetary plumbing that wouldn't otherwise be there, and from time to time create problems that wouldn't otherwise arise. In fact, it was some of these self imposed blockages that caused the latest financial crisis to spill over to the real economy and contribute to the recession.

The fact that government spending 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.

This, however, does NOT mean the government can spend all it wants without consequence.

If it spends too much more than it 'makes room for' by taxing us, it can create a lot of inflation.
What it does mean is there is no solvency risk.

There is no such thing as our government 'running out of money to spend' as President Obama has incorrectly stated repeatedly. Nor, as President Obama also stated, is US spending limited by what it can borrow.

So next time you hear 'where will the money for social security come from' go ahead and tell them- it's just data entry. It comes from the same place as your score at the bowling alley comes from.

Putting it all yet 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, David, 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 Australian 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 Professor Martin Watts, head of the economics department at the University of Newcastle 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? Governments using their own currency 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 payment. There is no solvency issue. There is no such thing as running out of money when spending is just changing numbers upwards in bank accounts at your own central bank.

Yes, households, businesses, and even the states need to have dollars in their bank accounts when they write checks, or those checks can bounce. That's because the dollars they spend are created by someone else—the Federal Government.

So why does government tax us, if it doesn't actually get anything to spend?

Hint: It's the same reason the parents demand 10 coupons a week from their children, when the parents don't actually need the coupons for anything.

There is a very good reason they tax us.

Taxes create an ongoing need to get dollars and therefore an ongoing need for people to work to get dollars.

And guess who does all this in the first place to get people to work for it and sell it the goods and services it needs?

Right, the federal government!

Just like the coupon tax on the children creates an ongoing need for them to need coupons and do chores for the parents to get them.

Think of a property tax. (You're not ready to think about income taxes—it comes down to the same thing, but it's a lot more indirect and complicated). You have to pay the property tax in dollars or lose your house. It's just like the kids situation, where the need to get 10 coupons or face the consequences.

So now you are motivated to sell things—goods, services, your own labor—to get the dollars you need. It's just like the kids, who are motivated to do chores to get the coupons they need.

Finally, I have to connect the dots from some people needing dollars to pay their taxes to everyone wanting and using dollars for almost all of their buying and selling. To do that, let's go back to the example of a new country, with a new currency I'll call "the crown", where the government levies a property tax.

Let's assume the government levies this tax for the further purpose of raising an army, and offers jobs to soldiers who are paid in "crowns".

Suddenly, a lot of people who own property now need to get crowns, and many of them won't want to get crowns directly from the government by serving as soldiers. So they start offering their goods and services for sale in exchange for the new crowns they need and want, hoping to get these crowns without having to join the army.

Other people now see many things for sale they would like to have—chickens, corn, clothing, and all kinds of services like haircuts, medical services, and many other services. The sellers of these goods and services want to receive crowns to avoid having to join the army to get the money they need to pay their taxes.

The fact that all this other stuff is being offered for sale in exchange for crowns makes some other people join the army to get the money needed to buy some of those goods and services.

In fact, prices will adjust until as many soldiers as the government wants are enticed to join the army. Because until that happens, there won't be enough crowns spent by the government to allow the taxpayers to pay all of their taxes, and those needing the crowns who don't want to go into the army will cut the prices of their goods and services as much as they have to in order to get them sold, or else thow in the towel and join the army themselves.

This is not merely a theoretical example. It's exactly what happened in Africa in the 1800's when the British established colonies there to grow crops. The British offered jobs to the local population, but none of them were interested in earning British coins. So the British placed a "hut tax" on all their dwellings, payable only in British coins. Suddenly, the area was "monetized," as everyone now needed British coins, and the local population started offering things for sale to get the needed coins, including offering their labor for sale. The British could then hire them and pay them in British coins to work the fields and grow their crops.
WARREN: THIS IS A GREAT HISTORICAL EXAMPLE, BUT IT NEEDS MORE SPECIFICITY. FOR INSTANCE, WHICH COUNTRY IN AFRICA AND WHEN ? WAS IT KENYA FOR INSTANCE? THERE MAY BE AN INTERESTING WAY TO DESCRIBE THIS IF IT WAS KENYA—WE KNOW, FOR INSTANCE, THAT BARACK OBAMA'S PATERNAL GRANDFATHER WORKED FOR THE BRITISH IN KENYA IN THE 1920's.
GHANA FOR SURE, PROBABLY KENYA TOO. THE ECONOMIST REPORTING WAS NAMED RODNEY. PROFESSOR MAT FORSTATER HAS ALL THE REFERENCE MATERIAL. AND I MET A PROFESSOR FROM AFRICA WHO'S FATHER HAD BEEN THERE

BEFORE AND AFTER THE TAX WAS IMPLEMENTED. HE TELLS A WONDERFUL STORY ABOUT IT.

And this is exactly what the parents did to get labor hours from their children to get the chores done.

And that's exactly how all of what are called non convertible currencies work, like the US dollar, the Japanese yen, and the British pound.

Now we're ready to look at the same thing from a different angle, that of today's economy, using some of the language of economics.

A learned economist today would say that "taxes function to reduce ***aggregate demand***." Their term ***aggregate demand*** is just a fancy term for "spending power."

The government taxes us and takes away our money for one reason—so we have that much less to spend which makes the currency that much more scarce and valuable.

Taking away our money can also be thought of as leaving room for the government to spend without causing 'inflation.'

Think of the economy as one big department store full of all the goods and services we all produce and offer for sale every year. We all get paid enough in wages and profits to buy everything in that store, assuming we spent all the money we earned and all the profits we made. (And if we borrow to spend we can buy even more than there is in that store.)

But some of our money is going to pay taxes, leaving us short of the spending power we would need to buy all of what's for sale in the store. So if government taxes us and doesn't spend anything (and we decide not to go into debt to buy things), there would be a lot of goods and services in that store going unsold. People would lose their jobs, and we would go into a recession.

This is what happens when the government taxes too much relative to its spending, and total spending isn't enough to make sure everything in the store gets sold.

Keep in mind the public purose behind government doing all this is to raise an army, operate a legal system, support a legislature and executive branch of government, promote public infrastructure, promote basic research, etc. So there is quite a bit that even the most conservative voters would have the government do.

So I look at it this way-

for the 'right' amount of government spending which we presume is necessary to run the nation the way we would like to see it run, how high should taxes be?

The reason I look at it this way is because the 'right amount of government spending' is an economic and political decision that, properly understoon, has nothing to do with government finances. The real 'costs' of running the government are the real goods and services it consumes- all the labor hours, fuel, electricity, steel, carbon fiber, hard drives, etc. etc. etc. The real cost of the government using all these real goods and services is that those resources would other wise be available for the private sector. So when they government takes those real resources for its own purposes, there are that many fewer real resources left for private sector activity.

So, for example, the real cost of the 'right size' army with enough soldiers to defend ourselves is that there are fewer workers left in the private sector to grow the food, build the cars, do the doctoring and nursing and administrative tasks, sell us stocks and real estate, paint our houses, mow our lawns, etc. etc. etc.

Therefore, the way I see it, we first set the size of government at the 'right' level, based on real benefits and real costs, and not the 'financial' considerations. The monetary system is the tool we use to achieve our real economic and political objectives, not the source of information as to what those objectives are. And after deciding what we need to spend to the 'right sized' government, we adjust taxes so that we all have enough spending power to buy what's still for sale in the 'store' after the government is done with its shopping. In general, I'd expect taxes to be quite a bit lower than government spending, for reasons already explained and also for reasons explained later in this book. In fact, a budget deficit of perhaps 5% of our gross domestic product might turn out to be the norm, which in today's economy is about $750 billion annually. However, that number per se is of no particulary economic consequence. What matters is that taxes are set to balance the economy and make sure it's not too hot or not too cold. And government spending is set at the 'right amount' given the size and scope of government we want.

That means just because we are in a slow down, we should not add to the size of government to help the economy. We should already be at the 'right' size for government, and therefore not add to it every time the economy slows down and grow it to the 'wrong' size. So while during a slowdown increasing government spending will indeed make the numbers work, and will indeed end the recession, for me that is far less desireable than accomplishing the same thing with the 'right' tax cuts in sufficient size to restore spending to the desired amounts.

Even worse is increasing the size of government just because the government might find itself in surplus. Again, government finances tell us nothing about how large government should be. That decision is rightly and totally independent of government finances. The right amount of government spending has nothing to do with tax revenues or the ability to borrow, as both of those are but tools for implementing policy, and not reasons for spending or not spending, and not sources of revenue needed for actual government spending.

I'll get specific on what role I see for government later in this book, but rest assured my vision is for a far more streamlined and efficient government, that's intensely focused on the basis of fundamental public purpose. Fortunately, there are readily available, and infinitely sensible ways to do this. We can put the right incentives in place that channel market forces with far less regulation and guidance to better promote the public purpose. This will result in a government and culture that will continue to be the envy of the world. It will be a government that expresses our American values of rewarding hard work and innovation, and promoting equal opportunity, equitable outcomes, and enforceable laws and regulations we can respect with true pride.

But I digress. Returning to the issue of how high taxes need to be, recall that if the government simply tried to buy what it wanted to buy and didn't take away any of our spending power-no taxes- there would be 'too much money chasing too few goods' and the result would be a lot of inflation. In fact, with no taxes nothing would even be offered for sale in exchange for the government money in the first place, as previously discussed.

To prevent the government's spending from causing that kind of inflation, the government must take away some of our spending power by taxing us, so their spending won't cause inflation.

In other words, the government taxes us, and takes away our money, to prevent inflation, and not to actually get our money in order to spend it.

Restated one more time-

Taxes function to regulate the economy, and not to get money for Congress to spend.

And, again, the government neither has nor doesn't have dollars, it simply changes numbers in our bank accounts upward when it spends, and downwards when it taxes.
All, presumably, for the further public purpose of regulating the economy.

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.

CHAPTER TWO—THE SECOND DEADLY INNOCENT FRAUD

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 for today's spending later.

Or, as commonly seen and heard in the media:

"Higher deficits today mean higher taxes tomorrow."

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

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

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 two 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 country's 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 15 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 all know we don't send real goods and services back in time to pay off federal government deficits, and that our children won't have to do that either.

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

And in our children's future, just like today, whoever is alive will be able to go to work and 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 the past, and sending it 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 is the current year distribution of real output.

Distribution is about who gets all the goods and services that are produced. In fact, this is what politicians do every time they pass legislation. They redirect real goods in services by decree, for better or for worse. And the odds of doing it for better are substantially decreased when they don't understand the 7 deadly innocent frauds. 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.

Foreigners who hold US dollars are particularly at risk. They earn those dollars from selling us real goods and services, yet have no assurance they will be able to buy real goods and services from us in the future. Prices could go up (inflation) and the US Government could legally impose all kinds of taxes on anything foreigners wish to buy from us, which reduces their spending power. Think of all those cars Japan sold to us for under $2,000 years ago. They've been holding those dollars, and would now probably have to pay in excess of $20,000 per car to buy cars from us, if they even wanted to. What can they do? Call the manager and complain? They've traded millions of perfectly good cars to us in exchange for credit balances on the Fed's books that can buy only what we allow them to buy. And look at what happened recently- the Federal Reserve cut rates which reduced the interest Japan earns on its US Treasury securities. (This discussion continues in a subsequent innocent fraud.)

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 of course when ill informed policy makers decide to take anti deficit measures measures that do reduce output and employment. Unfortunately, that is currently the case, and that is why this is a deadly innocent fraud.

Today (December, 2009), it's clear Congress is taking more spending power away from us in taxes than is needed to make room for their own spending. Even after we spend what we want and our government does all of its massive spending, there's still a lot left unsold in that big department store called the economy.

How do we know that? Easy, count the bodies in the unemployment lines. Looks at the massive amount of excess capacity in the economy. Look at what the Fed calls the 'output gap' which is the difference between what we could produce at full employment and what we are now producing. It's enourmous.

Sure, there's a 'record deficit and national debt,' though still far below Japan's, most all of Europe, and WWII US deficits that got us out of that depression with no 'debt burden consequences' of course.

And if you've gotten this far into this book hopefully you know why the size of the deficit isn't a financial issue. And hopefully you know that taxes function to regulate the economy, and not to raise revenue the way Congress thinks.

When I look at today's economy it's screaming at me that that problem is people don't have enough money to spend. It's not telling me they have too much spending power and are over spending.

Who would not agree?

Unemployment has doubled and GDP is more than 10% below where it would be if Congress wasn't taking so much spending power away from us.
THAT IS THE EVIDENCE WE ARE OVER TAXED.

And when we operate at less than our potential- less than full employment- then we are depriving our children of the real goods and services we could be producing on their behalf. When we cut back on our support of higher education we are depriving our children of the knowledge they'll need to be the very best they can be in their future days. When we cut back on basic research and space exploration we are depriving our children of all the fruits of that labor we are instead transferring to the unemployment lines.

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 potential distributional issues due to previous federal deficits can be readily addressed by Congress and distribution can be legally altered to their satisfaction.

So How Do We Pay Off China?

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. Otherwise they would realize that question is entirely inapplicable.

What they don't understand is that both dollars and US Treasury debt (securities) are nothing more than 'accounts' which are nothing more than numbers that the government makes on its own books.

So let's start by looking a how we got where we are today with China.

It all started when China wanted to sell things to us and we wanted to buy them.

For example, let's suppose the US Army wanted to buy $1 billion worth of uniforms from China, and China wanted to sell $ billion worth of uniforms to the US Army at that price.

So the Army buys $1 billion worth of uniforms from China.

First, understand both parties are 'happy.' There is no 'imbalance.' China would rather have the $1 billion than the uniforms or they wouldn't have sold them, and the US army would rather have the uniforms than the money or it wouldn't have bought them. The transactions are all voluntary.

But back to our point- how does China get paid?

China has a 'reserve account' at the Federal Reserve Bank. A reserve account is nothing more than a fancy name for a checking account. It's the Federal RESERVE Bank so they call it a RESERVE account instead of a checking account.

So to pay China, the Fed adds $1 billion to China's checking account at the Fed. It does this by changing the numbers in China's checking account up by $1 billion.

China then has some choices. It can do nothing and keep the $1 billion in its checking account at the Fed, or it can buy US Treasury securities.

A US Treasury security is, functionally, nothing more than a fancy name for a savings account at the Fed. The buyer gives the Fed money, and gets it back later with interest. That's what a savings account is- you give a bank money and you get it back later with interest.

So let's say China buys a one year Treasury security.

All that happens is that the Fed subtracts $1 billion from China's checking account at the Fed, and adds $1 billion to China's savings account at the Fed.

And all that happens a year later when China's one year Treasury bill comes due is the Fed takes that money out of

China's savings account at the Fed and puts it in China's checking account at the Fed.

Right now China is holding some $2 trillion US Treasury securities. So what do we do when they mature and it's time to pay China back? We move the money from their savings account at the Fed to their checking account at the Fed and wait for them to say what, if anything they might want to do next.

This is what happens when all US government debt comes due, which happens continuously. The Fed moves money from savings accounts to checking accounts on its books. And when people buy Treasury securities, the Fed moves money from their checking accounts to their savings accounts. So what's all the fuss?

It's all a tragic misunderstanding.

China knows we don't need them for anything and is playing us for total fools. Today that includes Geithner, Clinton, Obama, Summers, and the rest of the administration. It also includes Congress and the media.

They know all we owe them to 'pay them back' is a bank statement from the Fed that says how much is in their checking account at the Fed.

Now let me describe this all a bit more technically for those of you who care.

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 reserve account (checking account) at the Fed.

Then it increases (credits) the buyer's securities account (savings 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 when the dreaded day arrives, and the Treasury securities Chinas holds come due and need to be repaid, the Fed again simply changes two numbers on its own spread sheet.

The Fed debits (subtracts from) China's securities account at the Fed.

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

That's all- debt paid!

China now 'has its money back.' It has a (very large) dollar balance in its checking account at the Fed. If it wants anything else- cars, boats, real estate, other currencies- it has to buy them at market prices from a willing seller who wants dollar deposits in return. And if China does buy something the Fed will subtract that amount from China's checking account and add that amount to the checking account of whoever China bought it all from.

Notice too, that 'paying off China' doesn't change China's stated $ wealth. They simply have dollars in a checking account rather than US Treasury securities of equal dollars. And if they want more Treasury securities instead, no problem, the Fed just moves their dollars from their checking accout to their savings account again, by appropriately changing the numbers.

Paying off the entire US 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 another account at the Fed. These transfers are non-events for the real economy, and not the source of dire stress presumed by the mainstream economists, the politicians, business people, and the media.

One more time:

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 in reserve accunts is changed up.

Nothing more.

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

What's the big deal?

So WHAT HAPPENS IF:

CHINA REFUSES TO BUY OUR DEBT AT CURRENT LOW INTEREST RATES PAID TO THEM. INTEREST RATES HAVE TO GO UP TO ATTRACT THEIR PURCHASE OF THE TREASURY SECURITIES, RIGHT?

Wrong! They can leave it in their checking account. It's of no consequence to a US government that understands it's own monetary system. The fundes are not 'used' for spending, as we previously described. There are no NEGATIVE CONSEQUENCES OF THAT.

WHAT HAPPENS IF CHINA SAYS—I DON'T WANT TO KEEP A CHECKING ACCOUNT AT THE FED ANY MORE? PAY ME IN GOLD OR SOME OTHER MEANS OF EXCHANGE?

NOT POSSIBLE UNDER OUR CURRENT "FIAT CURRENCY" SYSTEM1

And some day it will be our children changing numbers on what will be their spread sheet, just as seamlessly 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.

The lost output and depreciated human capital is a real price we and our children paying for now that diminishes both the present and the future. We make do with less than what we can produce, and sustain 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.

Chapter Three—The Third Deadly Innocent Fraud

Deadly Innocent Fraud #3:

Government budget deficits take away savings.

Fact:

Government budget deficits ADD to savings.

Meeting with Lawrence Summers

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 spent the next twenty minutes explaining the 'paradox of thrift' (more detail on this innocent fraud #6 later) step by step, which he sort of got 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 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.

In other words,

Government deficits = increased 'monetary savings' for the rest of us. To the penny.

Most simply- Governmtent deficits ADD to 'our' savings, to the penny.

This is accounting fact, not theory or philosophy. There is no dispute. It is basic national income accouting.

So, for example, if the government deficit was $1 trillion last year, it means the net increase in savings of financial assets for everyone else combined was exactly $1 trillion.

To the penny.

(For those who took some economics courses, you might remember 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, and first year money banking. 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.

Next is an example of how operationally 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.

> (Note this sale is voluntary, which means the buyer buys the securities because he wants to. Presumably because he believes he is better off buying them than not buying them. No one is ever forced to buy government securities. They get sold at auction to the highest bidder who is willing to accept the lowest yield.)

2. When the buyers of these securities pay for them, bank accounts at the Fed are reduced by $100 billion to make the payment.

In other words, money in bank accounts at the Fed is exchanged for the new Treasury securities (which are also accounts at the Fed). At this point (non government) savings is unchanged. The buyers now have new Treasury securities as savings, rather than the money that was in their bank accounts before they bought the Treasury securities.

3. Now the Treasury spends $100 billion after the sale of the $100 billion of new Treasury securities.

4.   This Treasury spending adds back $100 billion to someone's bank accounts.

5. The non government sector now has its $100 billion of bank accounts back

AND $100 billion of new Treasury securities.

Bottom line-

The deficit spending of $100 billion directly added $100 billion of savings in the form of new Treasury securities to non government savings (which includes everyone but the government).

The savings of the buyer of the $100 billion of new treasury securities shifted from money in his bank account to his holdings of the Treasury securities.

Then the Treasury spent $100 billion after selling the Treasury securities, and the savings of receipents of those funds saw their bank accounts and savings increase by that amount.

So, to the original point, deficit spending doesn't just shift financial assets (money and Treasury securities) outside of the government.

Instead, deficit spending directly adds that amount of savings of financial assets to the non govt sector.

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.

Meeting with Al Gore

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 mean 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 several hundred billion dollars had already removed more than enough private savings to turn the Clinton boom to the soon to come bust.

I pointed out to Candidate Gore 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 budget to go into surplus and drain our savings 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 surplus forecast for the next decade would more likely be a $5.6 trillion 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 (a budget surplus takes away exactly that much savings from the rest of us), 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 and remains far too small for the circumstances.

For the current level of government spending, govt is over taxing us and we don't have enough after tax income to buy what's for sale in that big department store called the economy.

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.

Meeting with Robert Rubin

Maybe 10 years ago, around the turn of the century, just before it all fell apart, I found myself in a private client meeting at Citibank with Robert Rubin and about 20 Citibank clients. Rubin gave his take on the economy, and indicated the low savings rate might turn out to be a problem. With just a few minutes left, I told him I agreed about the low savings rate being an issue, and added:

"Bob, does anyone in Washington realize that the budget surplus takes away savings from the non government sectors?

To which he replied:

"No, the surplus adds to savings. When the govt runs a surplus, it buys Treasury securities in the market, and that adds to savings and and investment.

To which I replied:

"No, when you run a surplus we have to sell our securitites to get the money to pay our taxes, and our net financial assets and savings go down by the amount of the surplus."

Rubin: "No, I think you're wrong."

I let it go and the meeting was over. My question was answered. If he didn't understand surpluses removed savings no one in the administration did. And the economy crashed soon afterwards.

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, which also happens to be the highest it's been since 1995.

Clearly the mainstream doesn'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.

Professor Wynne Godley

Except for one. Professor Wynne Godley, retired head of Economics at Cambridge University and now over 80 years old, was widely renouned as the most successful forecaster of the British economy for multiple decades. And he did it all with his 'sector analysis' which had at its core the fact that the government deficit equals the savings of financial assets of the other sectors combined. And even the success of his forecasting, the iron clad support from the pure accounting facts, and the weight of his office, all of which continues to this day, he has yet to convince the mainstream of the validity of his understandings.

So now we know deficits aren't the 'bad things' the way the mainstream 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.

Taxes function to regulate our spending power and the economy in general.

If the 'right' level of taxation needed to support output and employment happens to be a lot less than government spending, that resulting budget deficit is nothing to be afraid of regarding solvency, sustainability, or doing bad by our children.

The only risk is inflation (to be discussed in detail later in this book).

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; when we don't have enough spending power to buy what's for sale in that big department store we call the economy for ANY reason; government can act to see to it our own output is sold by either cutting taxes or increasing govt. spending.

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 or spend directly)

and/or keep cutting taxes until we decide to spend and buy our own output. The choices are political. 'Finance' and the size of the deficit offers no useful informantion in making that decision.

The right sized deficit is the one that gets us to where we want to be with regards to output and employment, as well as the size of government we want, 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, which is an accounting statistic. 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 on this later, as we now move on to the next innocent fraud.

Chapter Four—The Fourth Deadly 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 said the money won't be there. President Bush used the word bankruptcy four times in one day, and Senator McCain said social security is broken. They are all wrong.

As we've already discussed, the government never has or doesn't have any of its own money. It spends by changing numbers in our bank accounts. This includes social security.

There is no operational constraint on the Government's ability to meet all Social Security payments in a timely manner.

It does't matter what the numbers are in the Social Security Trust Fund account.

The trust fund is nothing more than record keeping, as are all accounts at the Fed.

When it comes time to make Social Security payments, all the govt has to do is change numbers up in the beneficiary's accounts, and then change numbers down in the trust fund accounts to keep track of what it did. If the trust fund number goes negative, so be it. That just reflects the numbers that are changed up as payments to beneficiaries are made.

And one of the major discussions in Washington is whether or not to privatize social security. As you might be guessing by now, that entire discussion 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 mistaken. (Who would have thought!)

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 everyone stood up.

Wrong! If everyone stands up no one can see better, and everyone is standing up rather than sitting down. So all are worse off.

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. Let me explain.

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 (yes, or put your money in a savings account). You give the government your dollars now and you get dollars back later plus any interest.

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 very much the same.

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

Steve Moore story

And now you are ready to read about the conversation of several years back I had with Steve Moore, then head of economics at the CATO institute, now a CNBC regular, and a long time supporter of 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.

Warren: "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."

Warren: "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."

Warren: "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."

Warren: "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"

Warren: "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."

Warren: "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."

Warren: "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."

Warren: "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."

With that 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 all the 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 now 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 (as if number in a trust fund is an actual constraint on govt's ability to spend…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 will need."

With that last statement it all goes bad. They assume that the 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 (I exaggerate to make the point), 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, no matter how much money they might have.

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 mainstream story deteriorates further as it continues:

"Therefore, government needs to cut spending or increase taxes today, to accumulate the funds for tomorrow's expenditures."

By now I trust you know this is ridiculous, and evidence of the deadly innocent frauds hard at work to undermine our well being and the next generation's standard of living as well.

Our government neither has or doesn't have dollars. It spends by changing numbers up in our bank accounts, and taxes by changing numbers down in our bank accounts.

And raising taxes serves to lower our spending power. That's ok if spending is too high causing the economy to 'overheat' as we have too much spending power for what's for sale in that big department store called the economy.

But if that's not the case, and, in fact, spending is falling far short of what's needed to buy what's offered for sale at full employment levels of output, raising taxes and taking away our spending power only makes things that much worse.

And the story 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 they cut back on is education- the one thing the mainstream agrees should be done that actually helps our children 50 years down the road.

Should our policy makers ever actually get a handle on how the monetary system functions, they would realize the issue is social equity, and possibly inflation, but never government solvency.

They would realize that if they want seniors to have more income at any time, it's a simple matter of raising benefits, and that the real question is, what level of real resource consumption do we want to provide for our seniors? How much food do we want to allocate to them? How much housing? Clothing? Electricity? Gasoline? Medical services? Those are the real issues, and yes, giving seniors more of those goods and services means less for us. The amount of goods and services we allocate to seniors is the real cost to us, not the actual payments, which are nothing more than numbers in bank accounts.

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

But they don't understand the monetary system and they won't see it the 'right way around' until they do understand it.

Meanwhile, the deadly innocent fraud of Social Security takes its toll on both our present and our future well being.

CHAPTER FIVE—THE FIFTH DEADLY INNOCENT FRAUD

Deadly Innocent Fraud #5:

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

Facts:

Imports are real benefits and exports are real costs. Trade deficits directly improve our standard of living. Jobs are lost because taxes are too high for a given level of government spending, not because of imports.

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, it's better to receive than to give.

Therefore:
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 others produce in return.

And also remember:

The real wealth of a nation is

all it produces and keeps for itself,

plus all it imports,

minus what it must export.

A trade deficit in fact 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, for example, 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.

Well, McArthur did not order that, yet for over 60 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 the 'trade war' and we think it means we are losing it.

Same with China- they think they are winning because they keep our stores full of their 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, the US is borrowing from abroad to fund its 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 of dollars 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, apart from a complete misunderstanding of our monetary system by our leaders that's turned a massive real benefit into a nightmare of domestic unemployment.

Recall from the previous innocent frauds, the US can ALWAYS support domestic output and sustain domestic full employment with fiscal policy (tax cuts and/or govt. spending), 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 ourselves at full employment levels. Yes, jobs may be lost in one or more industries. But with the right fiscal policy there will always 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 creation 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 go 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 Chinese car company on their books. First, all parties are 'happy.'

You would rather have the car than the funds, or you would not have bought it, so you are happy.

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

The bank wants loans and deposits, or it wouldn't have made the loan, so it's happy.

There is no 'imbalance.' Everyone is sitting fat 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. 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 which we also call savings.

Where's the 'foreign capital?' There isn't any! The entire notion of the US somehow depending on foreign capital is inapplicable. Instead, it's the foreigners who are dependent on our domestic credit creation process to fund their desire to save $ US financial assets.

It's all a case of domestic credit funding 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. And what options do foreign savers have for their dollar deposits? They can do nothing, or they buy other financial assets from willing sellers, or they buy real goods and services from willing sellers. And when they do that, at market prices, again, both parties are happy. The buyers get what they want- real goods and services, other financial assets, etc. The sellers get what they want- the dollar deposit. No imbalances are possible. And there is not even the remotest possibility of US dependency on foreign capital, as there's no foreign capital involved anywhere in this process.

Chapter Six—The Sixth Deadly Innocent Fraud

Deadly Innocent Fraud #6:

We need savings to provide the funds for investment.

Fact:

Investment adds to savings

Second to 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, it's my guess that this deadly innocent fraud might be draining 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 what's called the paradox of thrift in the economics text books, 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.

Unsold output means excess inventories, and the low sales means production and employment cuts, and less total income. And that shortfall of income is 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 and savings.

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 for the day the new cars roll off the new assembly lines.

The decision to spend in this case resulted in less spending and more savings. And funds spent on 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'

Professor Basil Moore

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 invariably decide 'we need more savings so there will be more money for investment.' (And I've never heard a single objection from any mainstream economist.) And to accomplish this Congress uses 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 (spending power). 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' caused by the tax advantaged savings vehicles.

Ironically, the same Congressmen pushing the tax advantaged savings programs, we need more savings to have money for investment, are the ones categorically opposed to federal deficit spending.

But it gets even worse. The 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 support 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 'bloated whales' are the inevitable sharks- the thousands of financial professionals in the brokerage, banking, and financial management industries. But that's another story...

Chapter Seven—The Seventh Deadly Innocent Fraud

Deadly Innocent Fraud #7:

Your reward for getting this far is a look at what has become the most common criticism of government deficits:

Higher deficits today mean higher taxes tomorrow.

Fact:

I agree,
the innocent fraud is that it's a bad thing,
when in fact it's a good thing!!!

Your reward for getting this far is you already know the truth about this most common criticism of government deficits. I saved this for last so you would have all the tools to give it a decisive and informed response.

First, why does government tax?

Not to get money, but to take away our spending power if it thinks we have too much spending power and it's causing an inflation problem.

Why are we running higher deficits today?

Because the 'department store' has a lot of unsold goods and services in it- unemployment is high and output is lower than capacity. The government is buying what it wants and we don't have enough after tax spending power to buy what's left over. So we cut taxes and maybe increase government spending to increase spending power and help clear the shelves of unsold goods and services.

And why would we ever increase taxes?

Not for the government to get money to spend- we know it doesn't work that way.

We would increase taxes only when our spending power is too high, and unemployment has gotten so low, and the shelves have gone empty do to our excess spending power, and our available spending power is causing unwanted inflation.

So the statement "Higher deficits today mean higher taxes tomorrow" in fact is saying:

"Higher deficits today when unemployment is high will cause unemployment to go down to the point we need to raise taxes to cool down a booming economy."

Agreed!!!

PART TWO-HOW I DISCOVERED THESE FRAUDS