Reply to Prof. Hansen from Michael Hudson

A few years ago when I was Prof. of Economics and Director of Economic Research for the Riga Graduate School of Law, I had occasion to meet and debate Prof. Hansen at the Stockholm School for Economics. We had diametrically opposing positions on whether a country should grow by raising its living standards (as I believed), or by lowering wages (as Prof. Hansen contended.) I wanted to stem the emigration of labor from Latvia. He urged immigration from low-wage Central European countries. He believed that reducing Latvian wages would make the economy more competitive and hence was necessary to cure the trade deficit. I thought that the government had to remove the burdensome flat tax from labor and shift it onto property, not only because progressive taxation is essential for economic growth, but because taxing location-rent would hold down the price of housing and commercial office space. Whatever the government refrains from taxing (land rent, monopoly rent, etc.) is available to be pledged to bankers as debt service. The result, I argued, was that Latvia is taking on a heavy foreign-currency debt that adds interest charges to the cost of living and doing business. The result would be economic shrinkage, I warned. My position is that rather than Latvian labor being too HIGHLY paid, it is taxed too much and must spend too much of its income on housing – whose prices are determined by how much banks will lend.

Prof. Hansen’s critique of my criticism of the IMF-EU loan shows that this debate is still going on. His position defends the current policy of taxing labor, not property. This is the major difference between us. It is a debate that has been going on now for more than 200 years,
throughout the history of British, French and American political economy. (The history of this debate is the subject matter of my textbook on Trade, Development and Foreign Debt.)

What American economists have called the “Economy of High Wages” doctrine is the policy by which the United States rose to world industrial supremacy. It is the principle that is empirically confirmed in nation after nation: Highly paid labor is highly educated, well-housed, healthy and high-productivity labor. As such, it can undersell low-wage “pauper” labor. The most successful industrial and agricultural exporters for the past two centuries have been those with the highest wages, not the lowest.

The idea that an economy can get rich by lowering wages (and raising property prices) turns international competition into a “race to the bottom” of lower wages and living standards. Trying to play this game would doom Latvia to become a third world banana republic. Rather than creating a thriving domestic market with rising productivity, it would spur emigration.

This what has been happening for many years now. Rather than becoming sufficiently competitive to turn its trade deficit into a surplus, Latvia has become more dependent on imports. It is now using its government tax revenue to pay foreign debts, not to build up the infrastructure needed to make Latvians healthier, better educated and hence more competitive in the world economy.

It is ironic that Prof. Hansen and I were in agreement from the outset on one point: We both saw that Latvia’s balance of payments position was unsustainable. The nation has financed its trade deficit and
dependency by borrowing in foreign currency – not to undertake direct
capital formation but to inflate real estate prices. The real estate
bubble is what has financed its trade deficit. This is a situation that
cannot go on for long for any economy (including nearly all the other
post-Soviet economies). Prof. Hansen’s article in Diena forecast
currency depreciation a few years ago. It led to a run on the lat. That
made discussion of Latvia’s problem off-limits. In fact, there was even
a law against saying or writing things that might hurt the currency.
This led to people shutting their eyes so as not to see the inconvenient
truth that the economy was like a Magic Flying Carpet: there was no
visible means of support over time.

A short while later, my colleague Jeffrey Sommers and I wrote a piece
for Diena explaining that what was financing Latvia’s chronic trade
deficit was the foreign-exchange lending to inflate its real estate
bubble. We explained that this could not go on: At the point where real
estate was “fully loaned up,” foreign-currency lending against real
estate would cease and the nation would have no means of financing
its trade deficit. What I found most worrying about this prospect was
what its consequences would be. My aim was to prevent depreciation
from bankrupting Latvian homeowners and businessmen whose
income is in “soft” lats, but whose debt service is in “hard” euros.
Depreciation would make the carrying charges on Latvian debts much,
much higher. And Latvia has no U.S.-style bankruptcy laws. In
America, homeowners can simply walk away from their building, and
lenders can foreclose on the property, but the mortgage debtor usually
is not personally liable. But in Latvia, debtors who are falling into
negative equity today (where the mortgage debt is higher than the
falling market price of their home) cannot just walk away. They are
saddled for years to come with the debt-burden hanging around their neck.

So my first warning is that IF Latvia (or any other economy) faces a problem of a chronic trade deficit and hence a weak currency, it FIRST needs to pass a law re-denominating domestic debts – that is, all debts owed to domestic creditors – in lats. Obviously, the government has no authority over foreigners, so it cannot unilaterally adjust its official euro debt to the IMF and EU.

Fortunately, Latvia’s government debt is low. It is the private debt that is most problematic – above all its real estate mortgage debt.

This is the background for reviewing Prof. Hansen’s five criticisms of the letter I wrote reviewing the IMF-EU loan agreement with Latvia’s government. I address them in turn below.

1) Let’s put matters in perspective by asking what might have been, and whether neoliberalism was the best road that could have been taken. It was a road that was unique, and quite opposite from the development strategy that made the United States, Western Europe and Japan international powerhouses. Latvia emerged in 1991 with no debt and no property claims. About ten years ago it began borrowing foreign-currency debt – not to put in place the means of paying off this debt, not to produce and export more, but to inflate real estate prices. This was called the “Baltic Miracle.” But miracles usually are illusory – and this has turned out to be the case with Latvia’s Bubble Economy as well.

It didn’t have to be this way. And it still doesn’t have to be. The neoliberal economic ideology that guided Latvian policy rejects three
centuries of the classical economists’ distinction between earned income (wages and profits on capital formation) and unearned income ("tollbooth" claims by finance and property that have no counterpart in any technologically necessary cost of production, but are purely the result of political and legal privilege).

This neglect of the essence of classical economics is why I called neoliberal economics junk economics. It is the counterpart to junk science in the sphere of public policy with regard to fiscal policy (the flat tax instead of progressive taxation of wealth), the denial of global warming, the rejection of Darwinian ideas of evolution, and so forth. The Neoliberal Experiment has failed. It was a cruel experiment, and I think many Latvians now regret having been experimented on. Latvia deserves a better policy. Debt was run up not for what the classical economists called productive purposes – investment that generates the income to pay back the debt with its stipulated interest payment (in foreign currency, no less!). Latvia ran up debt simply to bid up asset prices. In fact, foreign credit for asset-price inflation became a means of subsidizing Latvia’s chronic trade deficit. This was unsustainable. But the banks lending to load down real estate with debt were making fortunes, so they didn’t care. They looked only at the short run, not the long run. This is the tragic time frame of the financial mentality in most countries. Already in the late 19th century, British financial critics were decrying this short-termism – as American critics are doing today.

I fear that Latvia is courting disaster by borrowing from the IMF to obtain the foreign currency to pay Swedish banks. Latvian labor is to be taxed and public services wound down, living standards will be
squeezed further in order to pay Swedish bankers for loans that, in the end, must go bad. My solution – and that of Prof. Sommers – is that in order to prevent Latvian labor from suffering an intolerable decline in living standards (and personal debt peonage to carry its debt burden that would rise when the currency falls), the government needs to denominate domestic debts in its own currency. Prof. Hansen believes that this is “populist” and irresponsible.

2) A basic axiom of international law, taught to every political science student, is that nations have three inherent rights: to levy taxes, to make war, and to coin (or create) their own money. The latter right includes legislating the terms on which debts can be repaid – in their own currency instead of gold (as FDR decreed in the United States in 1932). This is the foundation of political science as taught in universities throughout the world.

Obviously, a nation only has authority over credit extended within its own borders. It does not have control over the IMF. This seems so obvious I thought it did not require a special separate explanation. It is not necessary to repudiate debt, but to “let markets work their magic,” as neoliberals so often say. “The magic of compound interest” means that mathematically, debts cannot be paid in the end. This is basic classical economics known from antiquity through the 18th, 19th and 20th centuries.

The term “efficient exporter” means a nation whose price of production is lower than other countries. It means a competitive economy. Cutting back basic social services, wage levels and living standards, scrapping factories and failing to sponsor capital investment in
agriculture is not efficient and hence makes Latvia trade-dependent. To imagine that economic efficiency would make Latvia like North Korea is just plain silly. I was thinking of how the United States grew rich and competitive, how Britain did before that, and how Germany, Japan and China have grown rich – by developing an internal market, with the public sector providing basic infrastructure services at prices that minimize the cost of living and doing business.

3) Latvia has great room to export crops to help cover its imports. This does not make it an “agricultural paradise.” It means relying on Latvia’s own economic advantages. To do this, it needs the kind of agricultural extension services that the U.S. Government provided from 1860 through the 20th century: inexpensive transport free of railroad rent-extraction; road development; rural credit; guidance in seed varieties and marketing co-operatives. Europe’s Common Agricultural Policy (CAP) does these things. The strategy of agricultural development is well-known.

Prof. Hansen makes the incredible generalization that “Agricultural economies today are poor economies.” The United States is not a poor economy. Nor are Canada, and Australia, all which have significant agricultural exports of grain. The mainstay of its foreign trade for the past half-century has been agriculture! Every wealthy, prosperous self-sustaining economy needs to be agriculturally self-supporting. This requires modernization of its farm sector, invariably with government support. I simply want Latvia to do what Western Europe and North America have done. Latvia has a long history of grain production, and the current global demand for biofuels is driving prices for grains (with the normal fluctuations) up.
4) Like any other economy, Latvia needs to develop a thriving domestic market. Prof. Hansen pooh-poohs this. He says that he’s searching my report for just how to do this.

The answer is simple: Do what the United States, Western Europe and every successfully industrialized and modernized economy in the world does: tax land and rentier wealth, not labor.

Latvia’s high flat tax strips labor and its employers of revenue, so as to leave the “free lunch” of site-value rent “free” to be pledged to banks as interest – indeed, foreign-currency debt. This enriches wealth at the top 10% of the economic pyramid, and foreign investors. It impoverishes Latvian labor and the domestic market. It is not sustainable.

By supporting the idea that wealth should not be taxed, but labor should be taxed – and indeed, taxed at the highest flat-tax rate in Europe – Prof. Hansen and other neoliberals argue on behalf of property against labor. This rarely is a popular position. But most economists throughout history also have rejected it, on scientific grounds.

Why would advocating rising living standards and economic growth be accused of vulgar “populist” character, or even “Marxist” character as Mr. Hansen’s student wrote? It is because the accuser wants to ring a siren as loud as he can to drown out the actual argument being made.

Regressive taxation – taxing labor more highly than wealth – and the failure to tax rentier income, has the effect of destroying economies (viz. most notoriously the decline and fall of the Roman Empire as its population was reduced to debt serfdom).
Debt deflation is the great danger threatening the global economy today. IMF-style austerity plans weaken economies and make them even less able to carry their foreign debt burden or pay for their deepening trade dependency. (This is what my books and articles are about.)

The facts and mathematics are clear: A debt that can’t be paid, won’t be. Latvian real estate is falling into negative equity. It is denominated in hard currency such as euros. Prof. Hansen already has forecast that something must give.

He recommends devaluation. But this will sharply increase the domestic lat-price of carrying mortgage payments and avoiding default. Latvian citizens must consume less and less, and the domestic market will shrink. Stores will close down, become vacant, rents will fall, and even more property owners will default.

This is not the way to grow. It will leave Latvia even more dependent on foreign suppliers – and foreign creditors. No “real” nation would submit voluntarily to so awful a fate – unless it was intellectually tricked into doing so. This is why I called its rationale “junk economics.” The term has become quite popular in the United States, Iceland and Asia to describe neoliberal anti-labor doctrine.

5 Like most economists these days, Prof. Hansen is unclear about national income accounting with regard to government budget deficits. Any balance sheet balances. But within this balance there is (a) the deficit, and (b) how it is financed. When a government runs a budget
deficit by spending more than it collects in user fees and taxes, it
STILL is in deficit when it FINANCES this deficit by borrowing from the
IMF-EU. The fact that a deficit is financed does not mean that there is
no deficit. It means that there is a buildup of debt. Running up more
debt to the IMF-EU is HOW Latvia finances its deficit.

The fact that a government runs up debt – or a private sector runs up
debt – shows that there IS a deficit to be financed. That is how
accounting works. So the fact that consumer debt, business debt and
government debt are all rising show that the economy is operating in
deficit. This is a situation that cannot go on – except by further
borrowing, or else by increasing the economic surplus. And my critique
of the IMF-EU loans is that the terms of these loans will shrink the
economy and make it even less able to produce a surplus.
Latvia’s case is especially problematic, because its private and public
debts are denominated in foreign currency. This breaks the cardinal
rule of sound credit: Never borrow in a “hard” currency against income
that is in a “soft” domestic currency. To do so invariably is financial
suicide.

The terms on which the IMF-EU are lending to Latvia make it more
impoverished and more import-dependent. Hence, the terms of IMF-
EU loans are such that they PREVENT the loan from being repaid. This
is the quandary into which Latvia is painting itself under the current
regime.

What is at issue here? The wealthiest class – and foreign investors –
don’t like to be taxed. They want the government to tax labor rather
than adopting the progressive taxation that characterizes the United
States, Western Europe and every successful industrial economy in the world. Latvia thus has followed a tax policy diametrically opposite than industrial North America and Europe.

The neoliberal model has failed throughout the post-Soviet economies. It has brought a real estate bubble increasing the price of real estate and property relative to labor. The result is structural trade deficits, and a rising foreign-debt burden that can only be financed by running deeper and deeper into debt to foreigners. Latvia can borrow more only by following policies that benefit property owners and hurt labor.

This is why Prof. Hansen urges lower wage levels for Latvia. This is supposed to lower the cost of doing business. But instead of doing that, Latvia’s high flat-tax raises the cost of labor, and also raises the price of housing, commercial office space and basic infrastructure services. I don’t see how Latvia can compete internationally in a world where its real estate bubble has burdened its labor with high housing costs and also with high personal debt charges – and with extremely high tax overhead. All these are elements of price competition in world markets. But rather than lowering the price of labor and doing business by taxing property, Prof. Hansen wants to lower Latvian wages yet further.

What is the neoliberal response when their model fails and leads to the present foreign-exchange crisis in Latvia, its Baltic neighbors, most other post-Soviet economies and Iceland—the “neoliberal laboratory,” so to speak. The response is for bankers to insist that the government cut back its spending on education, close hospitals, tell the doctors to emigrate, and go into public debt to the IMF-EU to subsidize foreign-
currency mortgages to keep the real estate bubble afloat. Latvia’s economic problem today is over-indebtedness. The neoliberal IMF-EU response is to “borrow its way out of debt.” This must fail in the end – and fail soon. It is a radioactive decay process with a very short half-life.

I have obviously upset Prof. Hansen and his colleagues by looking ahead and urging Latvia not to throw “good money” (hard currency borrowed from the IMF and EU) on a hopeless attempt to maintain the power of property over labor – the Bubble Economy instead of a classical Growth Economy with rising living standards. Latvia’s government and its finance ministry are acting in a self-destructive way that threatens to shrink the economy. And I’m sorry to say that Prof. Hansen seeks to rationalize this erroneous view of how economies operate. My view is based on economic history. His view is based only on its great appeal to property owners and foreign creditors.

I would like to see Latvia adopt the tax system that has been a hallmark of the Enlightenment, classical political economy and the Reform Era of Social Democracy: a tax on property and wealth, above all rentier “free lunch” wealth in the form of land and monopoly rights. The vested interests don’t want to be taxed. They want labor to be taxed.

Prof. Hansen criticizes the classical economic position of raising labor productivity by increasing health standards, educational standards and public infrastructure, and on taxing what John Stuart Mill called the “unearned increment” of rising locational rent, which is in fact common
sense. Prof. Hansen calls this classical economics being “populist.” But it is the economic doctrine of Adam Smith, John Stuart Mill and the Progressive Era that led the Industrial Revolution to succeed so well in the United States, Western Europe and East Asia. If this body of classical thought is populist, then neoliberal economics as oligarchic. As such, it is antithetical to democracy.

I hope that Latvia chooses the democratic policy of growing by raising living standards, not creating a creditors’ paradise with a debt-financed real estate bubble that makes banks rich while leaving borrowers with negative equity when the bubble bursts, as it is now doing. What we need is an analysis of what has actually worked, economic history, versus a slavish beholding to a neoliberal model which has now revealed its total failure.

Michael Hudson