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## **Cause and cure of the crisis**

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# Cause and cure of the crisis

Thomas Colignatus  
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## Abstract

The welfare state was created after 1950 with counterproductive mechanisms and this caused high inflation and high unemployment and stagnating growth by 1970, called stagflation. Since 1970 governments redressed the welfare state but did not succeed in finding workable mechanisms. They rather fought stagflation with the ideology of the day, shifting from vulgar Keynesianism first to monetarism and then to neoliberalism, and now 'muddling through'. The deregulation of financial markets seemed to solve stagflation but only repressed it and resulted into the crisis since 2007. The return of regulation also causes the return of stagflation: what was repressed before now is into the open again. Re-regulation is required indeed but the fundamental cure lies in focussing on workable mechanisms for the welfare state. Return to the 19th century laissez-faire will generally be rejected. If economic management had made better use of the available information then these policy errors could have prevented. A mixed economy requires a constitutional Economic Supreme Court to monitor the quality of information for policy making.

## Keywords

Great Depression, Great Stagflation, Great Moderation, stagflation, inflation, unemployment, Phillipscurve, poverty, subsistence, minimum wage, labour market, welfare state, mixed economy, social security, productivity, tax, insurance, tax void, regime switch, Keynes, vulgar keynesianism, fiscal policy, monetarism, monetary policy, neoliberalism, regulation, deregulation, financial crisis, economic crisis, muddling through, repressed stagflation, Economic Supreme Court, Trias Politica, Tessera Politica, National Investment Bank, economic cycle, counter-cyclical, economic structure, Eurozone, euro, gold standard, fiat money, European Central Bank, ECB, no bail-out, national debt, bank balance sheet, global warming

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## **Introduction**

### The need for a long view in history

The events since 2007 have caused economists and governments to focus on the financial sector, monetary policy and national debt. This is reasonable to a large extent since market confidence is fragile and attention for appropriate regulation is surely appropriate. There are limits to what can be achieved however. It is also necessary to look at fiscal policy, investment and labour.

In these areas the tendency exists to take a historical outlook of only a couple of decades, say to the period of president Ronald Reagan 1981-1989 who is thought to have created the foundations and president Clinton 1993-2001 when the world economy seemed to do well. Instead, we must look further back to the rise of the welfare state since 1950 and the endemic stagflation that this caused since 1970.

The crisis teaches us, again after the 1930s, that regulation is needed. In retrospect regulation was an important factor for the rise in welfare since 1950. The deregulation in 1980 thus was a wrong experiment, much guided by political rhetoric. What alternative was overlooked? In the following we will start in 1950 and then discuss the various phases, and conclude with the current situation.

### The impact of a regime switch

The economic system can be subjected to regime switches. The same mechanisms can work out a bit differently depending upon the regime. For the whole OECD, the period 1950-1970 can be seen as the incubation and the period 1970-2014+ can be seen as the *Great Stagflation*. The crisis since 2007 can be seen as just another phase in that overall history of stagflation. The specific issues in money and banking that are relevant for 2007+ cannot solve the underlying issue of the Great Stagflation since 1970. The question is not only what to do just now, but rather also what would have been the right analysis in 1970. When we understand the causal relations in the regime switch then we can identify the general cure since 1970 that is also relevant today. The solution approaches since 1970 that got us here in fact contained errors, as shall be discussed below.

### Stagflation is the shift of the Phillipscurve

The term *stagflation* was coined by UK MP Iain Macleod in a speech in the UK Parliament in 1965. The conventional idea at that time was that inflation and unemployment could be traded off, notably along a stable schedule called the Phillipscurve. This stability broke down after 1965 with both high inflation and high unemployment, and subsequent stagnating growth. Stagflation thus is a shift of the Phillipscurve from favourable to unfavourable combinations of inflation and unemployment.

Some if not most economists nowadays hold that there cannot be any relationship between inflation and unemployment, since the data are all over the plots. However, conceptually, prices respond to market slacks and shortages, wages responds to unemployment and vacancies, and wages form a part of the consumer prices. There is more stability once we understand the true mechanisms (including expectations and NAIRU of course).

Economists and governments could have solved the problem *right then and there* and the world would have been quite different. However, economists and governments were blind to the proper analysis and they embarked on policies that have sent the world economy on a roller coaster since 1970. Also the chance provided by the analysis in Colignatus (1990) was missed.

## The rise of stagflation 1950-1970

### The welfare state is necessary against unemployment and poverty

After WW II the fear was that the economy would return to and continue the Great Depression but the Keynesian approach performed miracles. Around 1950 OECD countries started with the welfare state. Indeed, a mixed economy with a welfare state is the necessary and sufficient solution for unemployment and poverty, see Colignatus (2011). There is no alternative to combining freedom, full employment and social security. Indeed, the world as a whole can only solve those problems when each country adopts that solution within its borders. However, the specifics matter. The OECD adopted arrangements that cause stagflation. Those were also introduced gradually without sufficient awareness of the longer run total impact.

### Taxes & premiums and the tax void due to the minimum wage

Income taxes have low exemption, while on the contrary there is no exemption for VAT and welfare state insurance premiums. Levies without exemption increase the cost of labour at the lowest levels of productivity. Also the current unemployment insurance scheme causes unemployment. Workers with productivity at the net minimum (subsistence) ( $N$ ) are supposed to pay those levies, but this raises their labour costs ( $C$ ), and this causes their unemployment and dependence on benefit. This system was established in 1950-1970 and still forms the core of our economies. Welfare state bureaucracies tend to have great confidence in their predecessors and to regard conditions of five to ten years ago as yardsticks that should not be infringed upon, and they do not conceive that the system was already derailed in 1970.

The table gives the legal minimum wage in the US (dollars), in the UK (pounds) and in Holland (euros) as key examples for the OECD in recent years. The table is best understood from the principle “Don’t tax sweat”, see Colignatus (2010, 2013a). That is, workers at the minimum ( $N$ ) should be exempt from levies. The Dutch economist A.J. Cohen Stuart in 1889 (125 years ago) gave the perfect analogy: “A bridge must bear its own weight before it can carry a load.” In the same way a worker at the minimum must first earn subsistence before he or she can contribute to the community. As we can see in the table, the tax wedge at the minimum is 18.1% in the US, 23.7% in the UK and a huge 48.5% in Holland. This table disregards sales tax (VAT) so that the problem is actually bigger: for example in the US another 8% (cumulation from cascading).

Legal minimum wage and the tax wedge at that level (taxes and premiums), US 2009, UK & Holland 2010	US (dollar)	UK (pound)	Holland (euro)
Gross minimum wage	11790	11341	18309
Net income, after deduction of income tax and premiums ( $N$ )	10751	9751	14889
Gross labour costs: gross wage plus employer premiums ( $C$ )	12692	12059	22106
Taxes and premiums (excl. VAT) ( $C - N$ )	1941	2307	7217
Tax incidence as a percentage of gross labour costs ( $C - N$ ) / $C$	15.3%	19.1%	32.6 %
Tax incidence as a percentage of net income ( $C - N$ ) / $N$	18.1%	23.7%	48.5 %

The US estimate is from own calculation. The UK estimate is by courtesy of Mr Donald Hirsch and Mr Chris Goulden from the Joseph Rowntree Foundation. The Dutch data are from its Central Planning Bureau.

There arises a curious point: the tax wedge at the level of the minimum wage ( $C - N$ ) becomes a **tax void**. Workers with a productivity higher than the net minimum wage ( $N$ ) but lower than the gross labour minimum wage costs ( $C$ ), thus in the range  $N$  to  $C$ , will be unemployed due to the minimum wage law. The statutory levies in that productivity range are actually not collected. That those levies are not collected also gives a direct costless policy: create employment opportunities by abolishing the tax void. Workers who will find employment will still earn the net minimum, as this is their minimum level of productivity.

In graphical plots with productivity or earnings on the horizontal axis and levies on the vertical axis, the tax wedges show up as vertical values. The tax void however is the horizontal value in

the productivity range from net ( $N$ ) to gross minimum wage cost ( $C$ ). The horizontal value comes about as a shadow (along the  $45^\circ$  line) from the vertical tax wedge at the minimum wage, see Colignatus (2011) (inside and colour cover).

## Increase of the tax void due to differential indexation

As the welfare state grew, this problem started small but grew behind the scenes, also because of the OECD indexation policy. Taxes and exemption are adjusted for inflation but subsistence or the net minimum wage is generally indexed on the rise in the general welfare, i.e. both inflation and real growth. This differential indexation caused a rapid increase of the size of the tax void and the associated unemployment at the low income section of the labour market. Minimum wages were introduced to safeguard net income, but policy makers should also have raised exemption to keep net income equal to wage cost ( $N = C$ ).

The unemployment at the minimum causes that labour demand shifts to higher productive workers. These workers meet with less competition and can demand a higher wage, which contributes to inflation. The higher unemployment and inflation generate that unfavourable shift of the Phillipscurve.

## Tax disincentives and partial or total derivatives

Economists who study taxation and the labour market concentrate on partial derivatives and neglect the total differential. This is the difference between the statutory marginal tax rate and the dynamic marginal tax rate that arises over time when rates are adjusted, notably with the indexation of tax brackets. Official policy has been to reduce both exemption and static rates, and to switch from income tax to VAT that has no exemption at all. This is exactly the opposite of the optimal policy, that would be to maintain high exemption while VAT could be 1%. The traditional theory of optimal taxation concentrates on incentives but loses from the encompassing theoretical and empirical analysis that includes the Phillipscurve.

The notions of the tax void and the dynamic marginal tax rate are for example lacking in the UK Mirrlees Review (2011), that proposes a redesign of UK taxation.

## Reduced form model, prediction and confirmation

Colignatus (1992) (2011) provides a stylized and reduced form model with high, low and subsistence productivity workers, with a minimum (subsistence) wage and unemployment insurance, and an indicator for the state of information. The OECD policy mechanism generates a tax void in the model and thus a regime switch from full employment to structural unemployment. The result was confirmed by Dutch data 1950-1990, then predicted for the future and has been confirmed till now. Colignatus (2012) finds confirmation for the US, UK and Ireland. It is rather a logical issue that follows from the very definitions of economic modelling.

## Other causes have their influences but should not distract

The current crisis is much aggravated by the imbalances in Europe because of the euro that works out as a gold standard, and the imbalance between the US and China on trade and debt. However, a managed float in Europe instead of the common euro might have caused havoc in this situation as well. The relationship between the US and China is quite special anyway. These issues deserve attention but are not the main ones either. The key aspects of the Great Stagflation are internal to each separate nation and cannot be resolved by exchange rates.

## Policy advice

Part of the cure of the crisis thus is to keep minimum wage workers into jobs at net = cost, thus to raise exemption, also for premiums, and to shift from VAT to income tax. Abolition of the tax void does not cost anything while a shift from structural unemployment to full employment would be advantageous anyway.

## ***Vulgar Keynesianism, monetarism, neoliberalism, muddling through 1970-2014***

### Ideologies and failed solution approaches

In the period 1970-2007 policy makers tried to solve above problem in taxation and the labour market by means of first vulgar Keynesianism, then monetarism and then neoliberalism. In sum, stagflation was out in the open in 1970-1980, was repressed in 1980-2007 by exuberant neoliberalism, and comes out into the open again nowadays because of the return of regulation.

The vulgar Keynesian stimulus of the demand side was the established method after 1950 to fight unemployment. By 1965 it was already possible to see that this was erroneous. Had Keynes himself not warned about inflation ? Still, policy makers applied a stronger dose. The result was accelerating inflation. The situation was aggravated by the oil crises, see Bruno & Sachs (1985), and the problem of reduced demand since oil dollars were stored and not recycled. In the US and the UK vulgar Keynesianism was abandoned around 1976 and other countries followed suit by 1980. First there was monetarism and subsequently there came what is called neoliberalism, because it consists of liberalisation, deregulation, privatisation, and the encouragement of the free market and the supply side. This started already under president Carter but president Reagan turned it into a philosophy by 1981.

### How 'supply side'-deregulation actually stimulated demand

Ironically neoliberalism also implied a massive demand stimulus. The deregulation of financial markets released vast sums that started to search for investment opportunities. The distinction between demand and supply becomes blurred here, and the years 1981-2007 can also be called Keynesian years. The stimulus also boosted labour productivity in monetary terms and thus repressed stagflation. Another irony is that the UK Medium Term Financial Strategy (MTFS) of Margaret Thatcher promised strict control of money and credit, but at the same time the MTFS deregulated banks and building societies so that control became impossible. A useful consequence though is that monetarism as an ideology was abandoned too.

The Great Moderation and the so-called UK Goldilocks Economy of 1992-2007, in which the UK performed close to historical standards, were bought at the price of hidden imbalances. It seemed to work but the price is being paid now.

### Minsky Moment and Muddling Through

Deregulation eventually caused massive financial leveraging with its final Minsky Moment. The collapse of Bear Stearns in August 2007 is taken by many as the official beginning of the current crisis. Now that we are re-regulating again, stagflation rears its ugly head again in high unemployment and stagnating investments, with also the threat that inflation will be used again to reduce government debt. There is no common label yet for the current disarray in approaches to the crisis, but '*Muddling Through*' is an often heard word or perhaps exasperation.

### ***The cure 2014+***

#### The current structure of policy making causes highly unreliable policies

For the cure of the crisis, we obviously must resolve the two points in taxation and the labour market mentioned above. Can we rely on that policy makers will actually do so ? Will they really try, and, if so, might they not cause havoc again by some misconception along the way ? Perhaps there is a climate crisis too, that is currently 'managed' as well as stagflation since 1970 ? Thus it is important to learn lessons about crises in general. At least two lessons are important.

## Counter-cyclical national development and investment banks

Though the problem in Europe is rather structural these years, there is an overall need for counter-cyclical national development and investment banks. This point is mentioned briefly in Colignatus (2011) but has gotten more attention in Colignatus (2012 & 2013ab) because of the current crisis. Overall, technology and trade increase welfare. They were no cause for the unemployment in the last 1970-2007 period, as we have shown that the main cause was the lack of co-ordination of levies and the minimum wage. However, in the current conditions of technology and globalisation, developments are so fast that credit from commercial banks likely is insufficient to get full unemployment at price stability. Government involvement is required. The design of the market is crucial here, of course, as always for an optimum in the mixed economy.

## Economic co-ordination, nationally and internationally

There is the failure of economic co-ordination itself. Not just internationally, but crucially also in each country itself. The crises in the 1930s, 1970s, and 2010s have properties that are the same over time and space. One cannot look back at the period since 1950 with the various crises and the Great Stagflation itself without concluding that there is something seriously amiss in the co-ordination of economic policy *within countries themselves*.

Economic science has increased our knowledge enormously since 1850 but the system of management is stuck in 1850. The economic performance of nations and the lives of seven billion people depend upon the economic theory that nations select. The method of selection however is haphazard and determined in *penny wise, pound foolish* manner. The common denominator in Western countries is the Trias Politica model of democracy, in which scientific economic advice has a subordinate role and in which there is too much room for political ideology and manipulation. Our economies have become so complex that they require better compasses. The information exists but is not used yet and the compasses can be created.

## From Trias Politica to Tessera Politica with an Economic Supreme Court

The advice is to extend the checks and balances of the Trias Politica into a Tessera Politica with the addition of an Economic Supreme Court (ESC). That ESC would have a scientific basis and be open to science and the general public, as is currently intended for example for the UK Office for Budget Responsibility (OBR), but the ESC would enhance its scientific base and also have the power to veto the budget if that contains wrong information (according to the ESC). The ESC thus has an independent role in the democratic process. The Court could for example consist of seven economic scientists with terms of seven years on a rotating basis, with the possibility of one reappointment. The Court would annually propose a candidate to Parliament that does the appointment. A draft constitutional amendment is in Colignatus (2011).

## Can the world trust economic science ?

Can Parliament trust economic scientists to function in that role at an ESC ? The economy has had crises but there have been similar crises in economic theory itself. In that respect it might be silly to have an ESC, with its members in similar disarray as politicians or the stock markets. However, consider the analysis. A problem caused by failure in taxation has been approached subsequently by vulgar Keynesians then monetarists then neoliberals and now muddling through with reregulators, each trying to solve the errors of the predecessor. The current system allows each solver to take a rather narrow (and soon ideological) view. A national ESC will be grounded both in science and society so that a narrow view is much less likely.

For comparison, we have an independent Judiciary that will surely not be perfect, but it is better to discuss its faults under the regime of such an independent Judiciary rather than under a regime like we now have in economics.



The prime reasons for diverging economic analyses are (a) the incentive structure in economic science to generate "controversy" and (b) the room for ideologically motivated policy makers to pick their winners. In the proposed alternative situation, the ESC's objective is to check the quality of the information and this will cause more focus.

## Economic science warned about stagflation and about the euro

An example is the euro. The euro is a political project. In a democracy we would like to see that policy makers have their way. But the information on the euro from the body politic to the general public was tainted, and then democracy disappears. See Bernard Connolly (1996, 2012) *The rotten heart of Europe*, the interview with him by Brian Carney (2013), and consider his dismissal from the European Commission. Is this the kind of Europe that economic scientists must advise to the general public ?

Another example is that this present analysis on stagflation was developed in 1990 at the Dutch Central Planning Bureau (CPB), see Colignatus (1990). Clearly the CPB is not an ESC. The high quality of the CPB is a reason for the suggestion to promote it into an ESC, so that there will be scientific freedom to start studying this analysis.

## Protecting the quality of information for policy making

When EU nations have their ESCs then scientific information falls under scientific protection, warranted by the constitution, against political manipulation from the other pillars of democracy. The quality of information for Parliament and the public would increase dramatically.

Of course, the ESCs of the democratic nations of the world would exchange information, and thus automatically provide for some form of international co-ordination.

## **Money & banking and the euro**

### Monetary policy in the current crisis

The advantage of the current crisis is that most economists who forgot about money and banking now have had a crash update on theory and practice. We had been aware about Milton Friedman and monetarism around 1980, but this faded into the background during the Great Moderation, while monetarism is rather vague on banking anyway (tending to the view that 'money is money' and treating institutional details as less interesting).

This attitude might already have been upset by the Japanese stagnation, but few seemed to care except the Japanese themselves. Paul Krugman took the opportunity to revive some of Keynes's insights but with little interest from the rest of the world. Post-keynesians (Davidson / Chick / Wray / Arestis / Sawyer and others) studied the monetary and financial system but will have thought they were talking to each other. If nothing else, the economic crisis finally corrects this lack of interest in money and banking. Above discussion of the real economy also helps us to understand how we got in the current monetary and financial trap.

### Incentives from who owns the Central Bank

Fundamental issues are how money is created, who owns the central bank (the government or the banks), and how to evaluate government debt (as an instrument or to feel very guilty about). The gap between economic theory and popular understanding is even larger and nastier here than in other areas. An important note is by Werner (2013). Money theory has the old distinction in flows towards the real economy and flows to the financial sector itself. Werner has pointed since the 1990s, as had Fisher and Keynes in the 1930s, to the differences in how agents in these flows react to government policies. Traditional instruments can be redirected to optimize the effects on the real economy.

## The euro, the mechanisms of the gold standard, the optimal currency area

For the euro the relevant analytical points are (a) the theory of the optimal currency area and (b) the phenomenon that the euro works as a gold standard. Consider the last first.

(ad b) Since the Great Depression we know that the gold standard wreaks havoc. Eurozone governments now hold debt in a denomination that they cannot control, thus their countries have to export to pay off debt, but they cannot easily stimulate exports. Thus the architecture of the euro causes it to function as a gold standard even though the euro itself is fiat money, see Colignatus (2013a).

(ad a) The conventional theory of the optimal currency area allows for a single currency only when there is also fiscal integration. The Eurozone has a single currency but without popular support for fiscal integration in which Northern Europe shall pay for the unemployed and pensioners in Southern Europe. Colignatus (2013a) extends the theory of the optimal currency area with a third option, namely the suggestion that economic co-ordination might also be achieved if each member state adopts its own national ESC. The Eurozone could adopt the ESCs, have the known benefits from these, and might also check whether there would also be that secondary co-ordination effect on the currency area.

### Using fiat money as a policy instrument

The euro architecture still needs mending to allow for the optimal use of fiat money. Let us consider three examples how the Eurozone no-bailout conditions block proper use of the monetary instrument, see Colignatus (2012)(2013a).

(1) When the ECB would become a public utility such that individual agents can have their checking accounts at the ECB, then there would be a stable payment system without the need for deposit insurance on this. Germany would not need to fear that it will have to pay insurance premiums to bail out failing Spanish banks. Everyone could understand that if you put money into your checking account then it ought to be safe. There is no difference here between Germany or Spain. With this solved, we can focus on evaluating the risks in lending.

(2) The ECB can create EUR 400 billion to replenish insufficient bank capital, and neutralise this at the same time by higher capital requirements, thus neutralising an effect on inflation. The capital is divided into shares for Eurozone governments proportional to GDP. Then the no-bailout condition is met in the sense that there is no specific benefit per country since they all benefit proportionally. Admittedly bad Spanish banks are somewhat bailed out since they avoid bankruptcy but they are punished by dilution of capital. Perhaps German banks would like Spanish banks to fail so that they can take over the market, but the Eurozone goals would be different.

(3) The ECB can create EUR 400 billion to repair the debts of Italy and Greece. Their participation in the euro was a political decision and thus the Eurozone has to bear the consequences. In terms of finance they are bailed out but as a countermeasure, however, Italy and Greece could create investment zones under international law, say for 40 years, like the Hong Kong lease. With this crisis and its economic insecurity, it is hard to see how anything less would work. That Italy and Greece would be muddling through with low international investment confidence is an uninviting prospect for the EU as a whole.

### ***Some key points for a summary***

It seems impossible to summarize the above but the following points seem of key importance:

(1) Abolish the tax void. Increase exemption in income tax, VAT and social and medical insurance, so that net income becomes equal to the wage cost of the lowest productivity workers.

(2) Economic research in taxation and the labour market and incentives in general should also include the total differential and the dynamic marginal tax rate.

(3) The economy needs counter-cyclical national development and investment banks.

(4) Democracy needs an Economic Supreme Court.

(5) The euro needs monetary reform with restoration of fiat money as a policy instrument, and thus a more enlightened 'no bail-out' construction, see the suggestions above.

## **Conclusion**

There exists an explanation of the stagflation and the subsequent policy errors since 1970. This analysis provides a cure for the present crisis. This contrasts with the present temptation for economists to try to discover the hidden secret of the Great Moderation, i.e. to find some ideal mixture of deregulation and market stimulus, and to think that the current crisis can be solved with an additional dose of neoliberalism. Instead, the Great Moderation can be diagnosed as Repressed Stagflation. The underlying problem in taxation and the labour market was not tackled but only repressed by deregulation. What was hidden comes out into the open again. The correct conclusion is that the mixed economy with the welfare state requires a better balance between economic management and the market. The prime point is that the Trias Politica model of democracy requires an extension into a Tessera Politica with a constitutional Economic Supreme Court.

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