# Financial Credit as a Merit Good

## Introduction: Wagner's Law

> 'Modern Progress is really towards the free aggregation of free individuals so as to supplant government in all those functions which formerly were entrusted to it, and which it mostly performed so badly.' - Peter Kropotkin[1].

Perhaps there is no starker contrast between our time and the pre-World War One era, than in the attitude of the intelligentsia towards the State. An age in which Oscar Wilde declared 'All forms of government are failures', where Friedrich Engels wrote of the withering away of the State, and Edward Carpenter published 'Non-Governmental Society' - seems very remote indeed. This is all the more ironic given the current widespread dissatisfaction with governments in many parts of the world, as well as the fact that technological developments have made 'the free aggregation of free individuals' possible on a truly global scale.

Yet, the same nineteenth century whose intellectuals discussed the end of the State, also produced an economist who postulated the opposite on the basis of his investigations, in the form of a law that bears his name. A leading member of the German Historical School, Adolph Wagner discovered that the size of government was rising relative to society, and extrapolated accordingly. Thus, Wagner's Law is:

> 'An observation made in the 19th century by Adolph Wagner (1835–1917) that the share of the public sector in gross domestic product had increased over time. Wagner's law was the prediction that this trend would continue.'[2]

Neither mainstream economics, nor political science, have paid much attention to Wagner's Law, even though, unlike Say's Law, it has been confirmed time and time again: this is usually a sure sign that it points to a matter of great significance. By connecting it with another matter that has been greatly neglected in both fields - namely the debt-finance system, we can suddenly see why the intelligentsia were so wide off the mark.

The debt-finance system, by generating a chronic insufficiency of purchasing power, thereby requiring increased borrowing (in lieu of large trade surpluses) if economic activity is not to grind to a halt, causes the State - with its great, almost unlimited capacity to borrow, thanks to its power to tax (i.e. creditors are eager to lend to it in the knowledge that it will always have a means to pay them back), <u>to expand its role in the economy</u>.

Thus, as society finds its purchasing power increasingly insufficient to satisfy its requirements, the State steps in, with its role becoming larger and larger as it fills the growing gap. Caught unawares by these developments, which they were utterly incapable of anticipating, economists scrambled to come up with theories explaining - and indeed, justifying - such extensive government intervention.

Accounting for government provision of national defence, policing, lighthouses, etc.. was easy enough: these were public goods which, being non-rivalrous and non-diminishable, had to be provided by the State since the private sector could not profit from their provision.[3] But when governments began providing healthcare and education, a much more serious theoretical difficulty arose, since these are not public goods *per se*. The concept of a merit good was developed in order to address this, but as we shall see, this opens a breach which will enable Social Credit to storm the citadel of neoliberal economics.

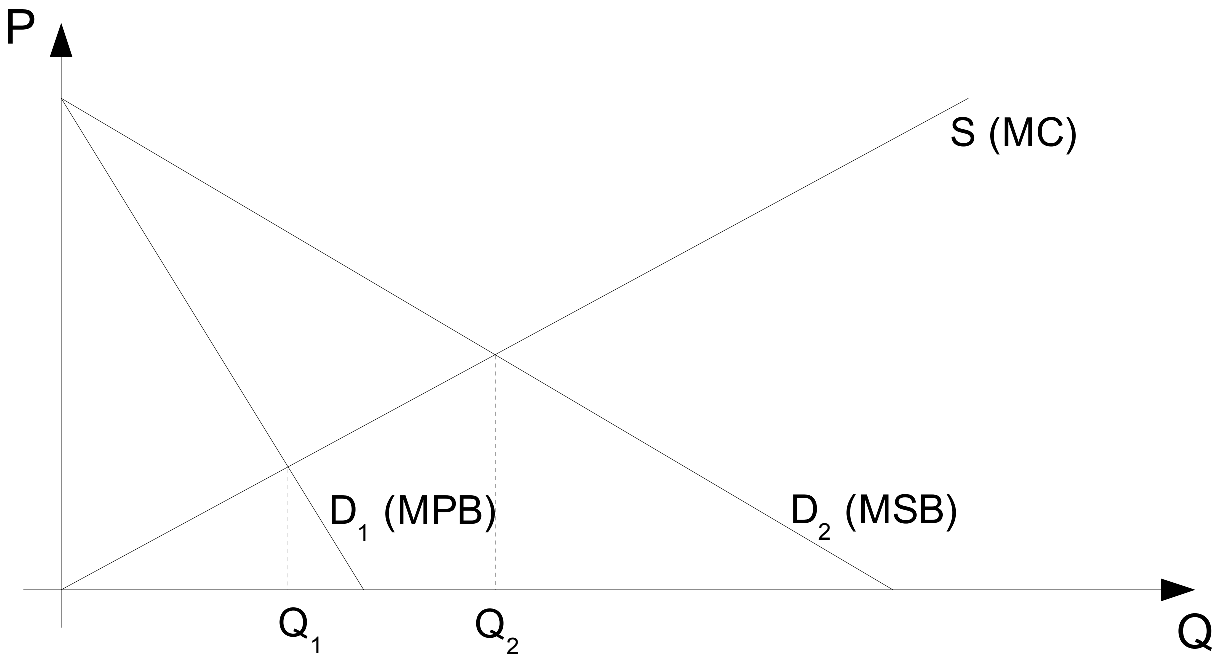
## I.) Externalities and the Definition of a Merit Good.

Mainstream economics aspires to understand the economy through an approach denoted as methodological individualism. This viewpoint regards an economy as simply a multitude of separate agents each interacting with the others through the market mechanism, in the pursuit of his own interest. It bears more than a passing resemblance to physics, with the latter's multitude of separate atoms, and it is no coincidence that economists are wont to speak of 'market forces': this connection has been studied at length by Philip Mirowski in his path-breaking tome 'More Heat Than Light'. What is worth noting is that in attempting to account for government provision of health care, education, etc... economists had to step outside the physics metaphor that had traditionally been their haven.

To cope with the afore-mentioned challenge, the concept of the 'externality' was introduced into economics. An externality is an effect, (positive or negative) that the activities of market participants have on third-parties - i.e. on those who are not involved in their transactions. Two types immediately follow from this definition: positive externalities - those which have a beneficial effect on third-parties, and negative externalities - those which have a harmful effect on third-parties. In simple terms: external benefits and external costs.[4]

A merit good is one whose consumption bestows a substantial external benefit to third-parties - indeed, to society at large. According to conventional economic analysis, the private sector will tend to produce less than the socially optimal level of these goods because market participants only consider the private benefit accruing from these goods and not the external benefit, and thus, not the social benefit, (which is the sum of private and external benefits). We may depict the situation as follows:

**Figure 1: The Typical Merit Good.**




In Figure 1, $\mathbf{D_1}$ represents private demand for the good in question (and is determined by **M**arginal **P**rivate **B**enefit - MPB) while $\mathbf{D_2}$ represents social demand for the good in question - i.e. the demand that would exist if external benefits were taken into consideration along with private benefits: **M**arginal **S**ocial **B**enefit - MSB, is the sum of external and private benefits.

Thus, whilst $\mathbf{Q_2}$ is the socially optimal level of output (given the existing supply constraints), $\mathbf{Q_1}$ is the amount actually produced by the private sector. Therefore, there exists a sound economic justification for the provision of the quantity $Q_2 - Q_1$ by the public sector or any other non-market participant.

## II.) Financial Credit as a Merit Good.

Social Crediters might be tempted to look at the diagram above, identify $Q_1$ as the level of financial credit created by the banks, $Q_2$ as the level of financial credit needed to fully utilize real credit and the difference ($Q_2$-$Q_1$) as the financial credit that the National Credit Office will be required to supply. However, the actual gap is far larger, as we will proceed to demonstrate.

We commence with two definitions.

Real Credit: A society's capacity to produce and distribute the goods and services desired by its members.

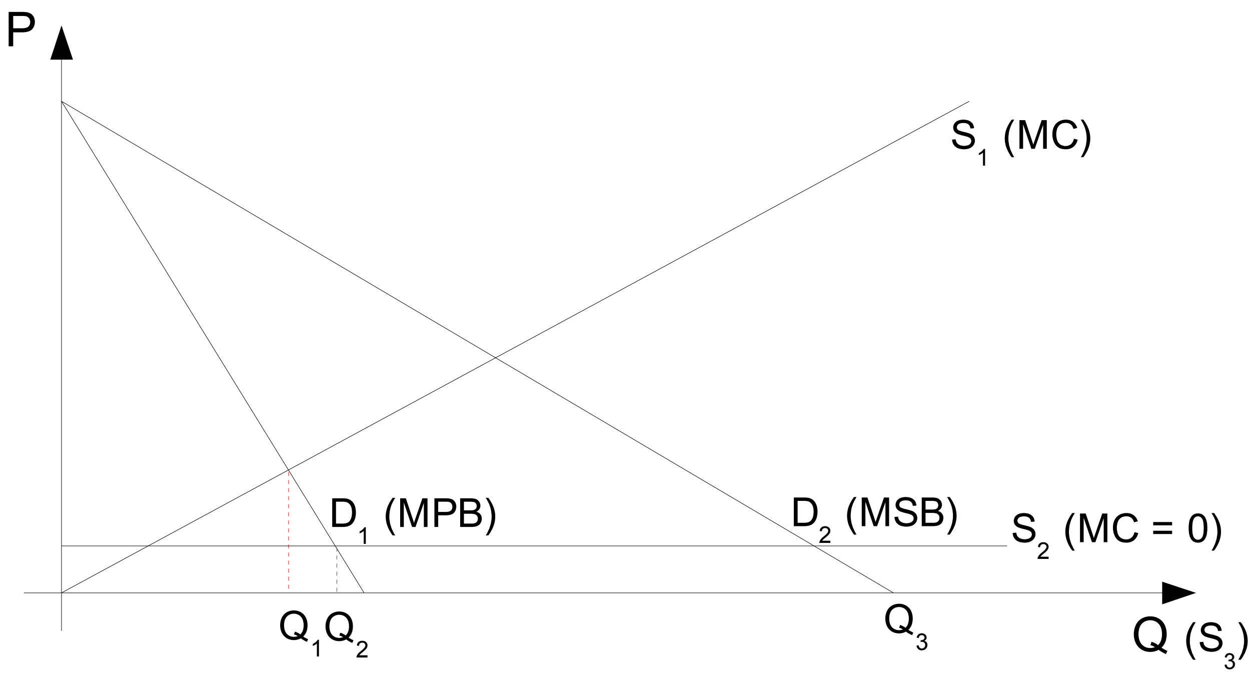
Financial Credit: A society's capacity to produce and distribute the money desired by its members - for the actualisation of real credit.

Regarding financial credit, the key phrase is 'for the actualisation of real credit': money that is supplied to increase production, facilitate consumption or improve distribution, comes under this category. In contrast, money that is supplied for the purpose of financial speculation (for example, loans for purchasing bonds, shares, derivatives, etc...) does not - until and unless it enters into the real economy[5].

Society's interests are best served when its real credit is fully actualised - i.e. when it produces and distributes all the goods and services desired by its members, barring demerit goods[6]. However, the interests of the suppliers of financial credit, (namely, the banking system) differs from society's: their concern is not with the social benefits of supplying it, but their own private benefit - and as such, this would dictate supplying much less than the socially optimal level, in order to maximise profit, maximise liquidity or any mixture of the two. Likewise, individuals and firms seeking to borrow financial credit usually do so on the basis of their own private benefits, rather than with regard to wider social considerations - and thus, will end up injecting much less than the optimal amount into the economy.

Whilst credit is, strictly speaking, not a 'good', it can be analysed in much the same manner, since there is a supply and demand for it, and those providing it are distinct from those seeking it. *It is worth noting that the marginal cost of supplying credit is very low*: a few clicks on a computer screen or a few more zeroes on a bank draft. Therefore, a horizontal supply curve is the best depiction of its supply in terms of pure cost considerations. However, profit-seeking private providers will tend to withhold supply at lower interest rates, and therefore, we get greater supply at higher interest rates.

**Figure 2: Financial Credit as a Merit Good.**



In Figure 2, as before, we have $\mathbf{D_1}$ and $\mathbf{D_2}$ reflecting marginal private and marginal social benefits respectively. $\mathbf{S_1}$ represents the private supply of financial credit, $\mathbf{S_2}$ represents a public supply of financial credit (via nationalized banks for example) at a low interest rate: the line is horizontal because the marginal cost of creating additional credit is, for all practical purposes, sufficiently negligible to be considered zero. $\mathbf{S_3}$ - a line that runs on the X axis - is the public supply of interest-free (and debt-free) financial credit generated by a National Credit Office or a National Credit Commission.

$\mathbf{Q_1}$ represents the quantity of credit supplied by the private banking system. $\mathbf{Q_2}$ represents the quantity supplied if financial credit creation is carried out by public banks lending at a low, fixed rate of interest, (with the government being fiscally neutral - 'running a balanced budget'). $\mathbf{Q_3}$ is the quantity of financial credit that actualizes all real credit - the optimum.[7]

Thus, from society's perspective, there is a grave deficiency of financial credit: borrowing by governments is the means by which this gap has (partially) been covered, with the consequence of increasing State involvement in the economy. Having identified this deficiency, it is time to consider how it may be overcome.

## III.) The Provision of Merit Goods.

Given that the total quantity of a merit good produced and consumed is seriously suboptimal from society's point of view, there are two approaches to rectifying this problem: raising production and increasing consumption. In other words, a government can opt to increase capacity or increase utilisation of existing capacity - with the relation of capacity to optimal quantity determining which approach prevails.

Thus, in the fields of health care and education, if capacity is lacking, merit good provision entails the construction of health care centres, hospitals, public schools, universities, etc... On the other hand, where capacity is deemed adequate and utilisation insufficient, then publicly financed medical insurance, government-subsidized education, etc.. may be preferred instead of the construction of new facilities.

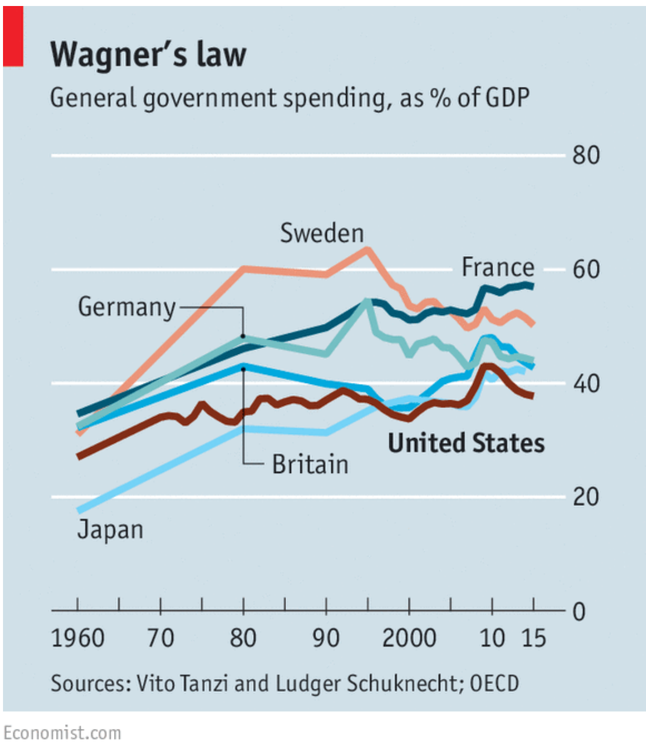
Having established financial credit as a merit good, we may address the inadequacy in the same manner. Where a shortage of credit has resulted in production capacity being less than ideal, the establishment of public banks dedicated to the provision of loans to producers on easy terms would be appropriate - a policy that has been applied to great effect in East Asia, as well as in Germany (via the Sparkassen for example).

However, it has long been argued, (and can be demonstrated) that the existing productive capacity of developed countries, (and one suspects, of many developing countries as well) is more than equal to the task of meeting all the primary needs and many of the other desires of the general public - with *all that is lacking being the means for its full utilisation*. To this end, the approach to be taken is that which Major Douglas postulated nearly a century ago - namely, the establishment of a National Credit Authority and the provision of consumer credits in the form of a National Dividend and a National Discount.

To sum up: finance may be regarded in the same manner as health care. Inadequate provision by the private sector may be addressed through direct state intervention - the creation of a public health system; the establishment of a public banking system. Insufficient consumption may likewise be corrected by subsidization: public medical insurance; public financial insurance in the form of a steady supply of consumer credit. Of course, the consequences of public financial insurance are far greater than those of public medical insurance as we shall see.

## Conclusion: Reversing the Law

Conservatives, libertarians and others have long sought to combat the growth of the State - looking forward to the day when they could 'reduce it to the size where I can drag it into the bathroom and drown it in the bathtub'[8], in the famous words of the American taxpayer advocate, Grover Norquist. Yet Wagner's Law has proven mightier than their efforts:




Source: https://www.economist.com/united-states/2017/03/16/warfare-helps-explain-why-american-welfare-is-different

'In this study, the validity of Wagner’s Law, which explains the relationship between public expenditures and economic growth, was analyzed over its alternative models by using the data from 27 OECD economies between the years 1995-2012. ....

The results obtained from this study point out that, the growth performance in the analyzed countries causes stimulating effects on governmental expenditures hence indicating the validity of Wagner’s Law. '[9]

The failure to shrink the State bears more than a passing resemblance to the failure of fiscal conservatives to reduce the national debt: this is because both are inevitable consequences of the State's abdication of what may well be its central responsibility - the issuance of a country's money. In other words, the political authorities are interfering and intervening more in every domain except the one which they are responsible for - and are running up enormous debts as a result of this.

It is well worth reviewing how this situation arose.

Originally, all of a community's money came from the ruler - hence it often had the monarch's profile on the coinage (we still see this on some British coins). With the rise of credit instruments in Ancient Mesopotamia, this government monopoly was secretly and silently overthrown - and the same process was repeated more recently with the growth of bank finance over the last few centuries.[10] The establishment of a cashless economy would mark the culmination of this trend - for cash, (notes and coins) remains the only form of government-issued money at present, and with its elimination, the State's abdication of its primary responsibility would be complete.

Where money is supplied entirely by the private sector, its supply is likely to be seriously sub-optimal for society, as we have endeavoured to show. Lacking the financial means for meeting its needs, the general public turns to the government and expects it to provide them with what they are no longer able to financially afford. Thus was born the welfare state - which, like its military counterpart, the warfare state - is an offspring of debt-finance.

Increasingly denying itself the means of financing these new responsibilities through the exercise of its coinage sovereignty, partly because of poor advice from ignorant economists, the State resorts to increased taxation and incessant borrowing. As the pressures of rising taxes, growing debt and insufficient funds take their toll on society, government regulation increases in order to prevent or at least mitigate a range of resulting negative effects - from the growth of gambling to rising drug abuse. The political system soon reflects this grim situation, with right-wingers condemning the victims of financial scarcity for their plight while the left presses for ever-increasing government spending, taxation, borrowing and intervention - in the belief that this is somehow 'progressive'. Verily, both halves of the political spectrum are stuck in Plato's Cave.

Having identified its root cause, we can see, not only that Wagner's Law is a social, as opposed to a natural, phenomenon, but also that we can reverse it, and thereby strengthen society whilst weakening the State. Doing so entails increasing government intervention in the one field where it is not only sorely needed, but where it is entirely justified - the realm of money creation. The public provision of financial credit sets off a train of consequences that will ultimately result in the State withdrawing from one field after another, reducing its taxation, borrowing and expenditure accordingly - not because it has become unable to sustain them - but because its intervention will no longer be necessary, as society reclaims its domains. Perhaps we might even find ourselves heading towards the 'Non-Governmental Society' that Edward Carpenter envisioned a century ago.

1 P. Kropotkin, *Anarchism: A Collection of Revolutionary Writings*, page 67.
2 Source: http://www.oxfordreference.com/view/10.1093/oi/authority.20110803120324615
3 As a matter of fact, lighthouses in Britain were usually provided by coalitions of shipowners. One could also argue that militias can provide national defence just as easily, (and probably less expensively) than militaries.
4 It should be noted that once one breaks from methodological individualism and acknowledges that individuals exist in society, it becomes obvious that all private goods bring an external benefit: insofar as they gratify an individual and make him happier (or less unhappy), they serve to make him more helpful/less harmful to society, if only by improving his mood and making him slightly more pleasant, (or less unpleasant) to his fellow-men. Of course, this must be balanced against any external costs in order to determine the net effect.
5 Financial speculation can easily undermine the functioning of the real economy, but this is a subject beyond the scope of this work.
6 Demerit goods are those with negative externalities - i.e. their external costs exceed their external benefits.
7 Thus, the total amount of financial credit that a National Credit Commission should issue is not $Q_2$-$Q_1$ as an analysis of a typical merit good in Figure 1 would indicate, but rather $Q_3$ - $Q_1$.
8 Source: https://en.wikiquote.org/wiki/Grover_Norquist
9 M. Bayrak & O. Esen, 'Examining the Validity of Wagner's Law in the OECD Economies', *Research in Applied Economics*, Macrothink Institute, http://www.macrothink.org/journal/index.php/rae/article/view/5354.
10 Source: David Astle's exceptional book, *The Babylonian Woe*, which can be found at http://yamaguchy.com/library/astle/astle_index.html