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Alternative Ways of Financing Production

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INTRODUCTION

Based upon the work of C.H.Douglas, this paper explores the role of debt in the economy. In the 1920s Douglas observed the workings of financial mechanisms within the real economy, noting that they could be modified to achieve a socially and ecologically sustainable economics of sufficiency (see Hutchinson and Burkitt 1997; Hutchinson 1998). Douglas' exploration of the role of debt (loan credit) in the economy accords well with Veblen's institutional analysis (Veblen 1990), while his writing reverberates with Veblenian terminology. As an economist, Douglas is both intuitive and eclectic, and, as Mehta (1983) observes, "no writer in economics has made his thought so opaque to the reader." Nevertheless, Douglas' rejection by orthodoxy was due in no small measure to the impracticality of tailoring his theoretical observations within the constraints of neo-classical general free market equilibrium theory. Although they gave rise to a widespread popular movement, Douglas' proposals for debt-free finance of production could not be accommodated within economic orthodoxy.

PRODUCTION, DISTRIBUTION AND EXCHANGE IN ORTHODOX THEORY

Neo-classical economic theory evolved to provide convincing explanations for economic phenomena in order to generate policy prescriptions capable of providing solutions to observed economic problems. Neo-classical theory has held sway in the vast majority of economics departments throughout the twentieth century.

However, mainstream economic theory has become detached from everyday reality, sanctifying fictions while diverting the attention of political leaders from creating a meaningful analysis of real world phenomena. According to theory, all economic problems are best left to the free play of market forces. However, this analysis ignores the fact that the market itself is a social institution, underpinned by a network of legal sanctions which define and determine contracts, property rights, the legality of currencies and many other matters essential to the ability of individual traders to conduct their business within the real life economy. In short, the free market is not an ideal or natural order; it is bounded by institutional rules.

Although the demise of neo-classical theory has been long predicted (Hodgson 1993), its immediate disappearance would create a theoretical void. However, an institutionalist/evolutionary alternative has existed throughout the twentieth century. In this paper we develop and refine institutionalist theory relating to the role of financial institutions in the processes of production, distribution of incomes, and exchange over time within the framework of institutionalism as outlined by Hodgson (1993, 5) and Freeman (1995).

UNVEILING THE MACRO ROOTS OF MICRO THEORY

The lack of analytical rigour inherent in neo-classical theory was explored by Veblen in the early years of the twentieth century. In 1900, Veblen coined the term "neo-classical" to describe economic theory based on the concept of marginal utility (Veblen 1990,171). As Veblen demonstrates, in neo-classical theory money is a mere convenience, and money values have no significance:

> money is simply an expedient of computation. Investment, credit extensions, loans of all kinds and degrees, with payment of interest and the rest, are likewise taken simply as intermediate steps between the pleasurable sensations of consumption and the

> efforts induced by the anticipation of these sensations, other bearings of the case being disregarded. (Veblen 1909,248)

However, this is not what actually happens in business. Variations of capitalization do occur which cannot be explained away as variations in technology or in the sensations of consumption.

> Credit extensions tend to inflation of credit, rising prices, overstocking of market etc,… without basis in those material elements to which the hedonistic theory reduces all economic phenomena. (Veben 1909,249)

It therefore becomes the task of neo-classical economists to explain away the facts as aberrations, oversights, failures of logic, lapses of memory, so that they do not have to appear in the theory. Alternatively, "they are construed and interpreted into the rationalistic terms of the hedonistic calculus by resort to an ambiguous use of the hedonistic concepts" (Veblen 1909, 250).[1]

> So that the whole "money economy", with all the machinery of credit and the rest, disappears in a tissue of metaphors to reappear theoretically expurgated, sterilised, and amplified into a "refined system of barter", culminating in a net aggregate maximum of pleasurable sensations of consumption. (Veblen 1909, 250)

Despite the continued publication and circulation of Veblen's writings throughout the twentieth century, neo-classical "orthodoxy" has dominated career structures, frustrating development of an institutional theoretical framework capable of accommodating the uncompromising realities of time and money. The role of money in developed economies bears no resemblance whatsoever to a "refined system of barter."

FACTOR SEQUENCE THEORY

In neo-classical theory the factors of production are combined through market forces in a timeless continuum. In practice, however, land, labor and machinery remain unemployed until these resources are united through finance capital. This phenomenon has been labelled the "factor sequence theory". Under unregulated free market conditions, "competition tends to maximise the income of capital" (Fountain 1996,8). From its Walrasian inception, neo-classical theory has remained silent on the crucial role of finance in economic activity. Production cannot occur unless finance capital is available so that land can be rented, labor hired and machinery bought. Nevertheless, the logically incoherent practice of considering capital an "abiding entity," a "fund of productive goods" has prevailed throughout the twentieth century. Quoting "Professor Clark's Economics," Veblen observed:

> The phrase itself, "a fund of productive goods," is a curiously confusing mixture of pecuniary and mechanical terms, though the pecuniary expression, "a fund", is probably to be taken in this connection as a permissible metaphor. (Veblen 1908, 196)

As Veblen notes, the notion runs into insuperable difficulties, not least of which is the phenomenon of the transfer of capital from one industry to another. The transfer of investment from a whaling ship to a cotton mill does not involve the transfer of capital goods.

> The continuum in which the "abiding entity" of capital resides is a continuity of ownership, not a physical fact. The continuity, in fact, is of an "immaterial nature", a matter of legal rights, of contracts, of purchase and sale. (Veblen 1908, 197)

"Capital," Veblen concludes, "is a pecuniary fact, not a mechanical one," distinguishable from other "facts" because of its "immaterial character" (Veblen 1908, 197). Recognition of the existence of "intangible assets" operating in the economy brings into question many fundamental neo-classical assumptions, not least of which are those relating to "natural" returns to capital and labor.

MONEY- WHENCE IT CAME

Following Niggle (1990), it is possible to observe the evolution of the debt-based money system in five consecutive stages:

Stage 1: Money is gold, or some other commodity which has value in its own right. It is not created by the financial system, and its supply remains fixed by external circumstances.

Stage 2: When goldsmiths receive gold (already existing money) for safekeeping, they give receipts: they promise to repay the gold in the future. Those receipts can circulate as if they were gold (money) itself. If goldsmiths offer receipts as loans in excess of the amount of gold they hold, they are creating new money *as debt*. A debt-based money system has come into existence, functioning on trust alone.

Stage 3: The practice of banks issuing loan-based money in this way is ratified by the legal system in order to harmonize economic activity- national and international trade. Whether the reserve is gold, or some other form of "currency", is immaterial. Legally sanctioned fractional reserve banking limits the size of total money supply from *outside* the financial system.

Stage 4: Stage 3 places restrictions on the banks. They are limited in the extent to which they can expand their profitable lending activities. They therefore find new ways to make loans. These loans, which include mortgages, overdrafts and credit card facilities, are not even theoretically exchangeable for gold. However, they are profitable to the banks *and* profitable to business enterprise, serving to expand the economy.

Stage 5: For the same reasons as in stage 3, the new forms of loan-created money (credit) are recognized as legal.

In practice, stages 4 and 5 occur simultaneously. It is deemed neither practical nor useful to declare these practices illegal. Such moves would be futile gestures in the path of unstoppable economic progress.

REAL AND FINANCIAL CREDIT

The main focus of Douglas' work was on the processes of credit creation by banks and other financial institutions (Hutchinson and Burkitt 1997). Douglas distinguished between real credit, "the probability of the delivery of goods in their various forms," and financial credit, "the probability of the delivery of money in its various forms," (Douglas 1920, 157). Real credit is "social or communal in origin…it belongs neither to the producer nor the consumer, but to their *common* element, the community, of which they each form a part" (Douglas1920, 159, emphasis original). Real credit is the "joint and common creation" of producers *and* consumers. Money (financial credit) is one remove from goods (real credit), having value only in so far as it in turn is based upon goods. Although there is no *essential* correlation between real and financial credit, in a capitalist economy the latter is the "handmaid" of the former (Douglas 1920, 166).

According to Douglas, real credit is the product of production and consumption, and its source lies in the community as a whole.

> By "cornering" money, and by requiring that no real credit shall be employed save in so far as its employment "makes money"; furthermore, by controlling the distribution

> of money among producers and consumers alike, they [financial institutions] are actually able to control…the whole of real credit, which…is a communal creation and possession. (Douglas 1920, 166)

Douglas proposed the gradual introduction of various forms of producers' and consumers' credits to replace debt-created money. However, in his view, the exact mechanics of credit creation could not be determined until the present nature of the current financial system had been rationally analysed and understood.

THE COMMON CULTURAL HERITAGE

According to Douglas, the financial system has evolved in such a way as to enable a small percentage of economic actors to gain control over productive processes, while laying claim to a vastly inequitable share of the real wealth of the economy. Whether the claim is based upon the ownership of capital or labor, there is no moral justification for the appropriation of the proceeds of collective industry for private individual gain. Production is "95 per cent a matter of tools and process" (Douglas 1919,95). Using Veblenian terminology, Douglas observed that "progress in the industrial arts", ie. the development of "tools and processes," forms the cultural inheritance of the community. Hence the community as a whole is the proper administrator of its resources. The collective "cultural heritage," including natural resources, remains the common property of all citizens. People associate together in collective industry to gain the unearned increment of such association, creating goods and services with far less effort than by "individual endeavour"(Douglas1920, 19).

Each individual becomes a "tenant for life" or shareholder in the common property, and the financial system could be adapted to reflect this fact without the necessity for collectivization and state control. Presently, money is created as debt for private profit, whereas it should be created as credit on behalf of the community.[2]

THE DEBT-BASED MONEY SYSTEM

Supposing I save up my pennies (already existing) to buy an umbrella. I give the umbrella as a present to a friend, ie. ownership is transferred from myself to another person, and that is the end of the matter. No new money is created. In similar fashion, a group of families might agree to set up a "mutual" or "friendly" building society in order to buy their own homes. They pool their savings (of already existing money) and buy the houses one by one. When the last family has bought its house, the society winds up. No debt has been incurred and no money has been created.

Now, suppose a friend passes my house on a rainy day and calls to borrow my umbrella. I hesitate. My friend is not to be relied upon to return it. So I draw up an IOU promising to repay (return) the umbrella in six weeks. The IOU represents the *debt* of another person to me, and I keep it. We now have an entirely different situation. If I were to fall on hard times, I could offer the IOU in return for a loaf of bread, ie. I can hand on the paper promise-to-repay-the-debt to someone else. We have created money. Of course, it is not legally ratified. Nevertheless, this is the principle upon which trade, industry, business cycles and the entire complexity of present-day economic activity is based. It is that simple.

The situation of a *permanent* building society can be used to amplify the illustration. As in the case of the loan of the umbrella, once the society becomes permanent, it is no longer the case that savings are purchasing the houses outright. While some savers are paying *in* to the building society some already existing money (like gold in Niggle's Stage 2), the saved money being paid into a bank (at least, this is the case in the original forms of permanent building societies), now the purchasers take out a mortgage, *a loan which must be repaid.* Again, we are making *new* money in the form of a loan (as in Stage 4, ratified in Stage 5). Whether the newly created money is paid out *through* the building society, or *by* it, is in a certain sense immaterial to the argument. It is the *financial system* which is creating money (credit) for *future* gain as *debt*.

Very confusingly, many building societies continued to call themselves “mutual” long after they became permanent, a process which started in the 1920s. What Stages 4 and 5 indicate is that the financial system is constantly evolving and changing the forms of money creation. It makes new forms of debt, while creating new institutions and mechanisms to burst out of regulations. Meanwhile the common perception, *even among many economists* is that money creation and the control and supply of the total money supply remain in Stage 3.

Using similar examples, Rowbotham draws the same distinction between exchange involving outright transfer of ownership and exchange on the basis of debt (Rowbotham 1998, 68). Figures on mortgages and other forms of consumer debt are startling. By 1996, housing was absorbing almost twice the amount of the average household income as it did in 1960, (up from 9.5 percent in 1960 to 17 percent in 1996). Rowbotham calculates:

> A total of 8.4 million houses were built between 1960 and 1996 at an average cost of £24,000 and a total cost of £208 billion. The current mortgage debt is nearly twice this figure and far exceeds the total original construction costs of all housing in the U.K. (Rowbotham 1998, 19)

Other forms of debt have escalated in similar fashion. In total in the U.K. £411 billion of debt has been raised against the housing stock, £300 billion against industry, including farming and the service sector, and £380 billion against the public assets of the nation through the national debt. As a result, legal title and ownership of these assets rests with the financial system, enabling it to determine production and distribution (Rowbotham 1998, 35).

Douglas maintained that banks (it was mainly banks then) created money as debt against future production, *and at an ever-expanding rate.* The community should issue *social credit* in respect of existing wealth (present production and the potential to produce) so that it would no longer be necessary to seek constant expansion of production in order to maintain employment as the predominant mechanism of income distribution.

FINANCE AS DETERMINANT OF PRODUCTION

In presenting his theories, Douglas relied heavily on guild socialist principles of opposition to wage slavery. Hence he advocated the decommodification of labor and the principle of sufficiency in material production and consumption.[3] To put butter (and bread) on the table it is not necessary to produce guns (see Hutchinson and Burkitt 1997, 159). However, under capitalist finance, as Freeman (1995) notes, the sphere on circulation operates in a dynamic relationship with the sphere of production. Decisions determining which commodities can, or cannot, be made are constantly been taken on purely financial grounds. Those decisions, Douglas argued, should rest in the hands of the community rather than the financial institutions. In words carrying a familiar ring, Douglas observed:

> Whatever may be true or untrue about the present situation, it is certainly not true that the production organisation …cannot produce the goods. In fact, it is very often said that the present crisis is a crisis of over-production; I have never heard it called a crisis of under-production (I have heard it called a crisis of under-consumption, but that is a different thing), and yet financers, or rather the Bank of England, are saying that the crying need of this country is re-organisation of the productive system. Can there be anything more ridiculous than to suggest that a crisis which is on the one hand described as a crisis of unemployment, and is on the other hand described as a crisis of over-production, should be cured or could be cured by making industry more efficient, assuming that were to be done? (Douglas 1934, 272)

If that were done, as Douglas noted, more goods would be produced by fewer people, intensifying over-production while simultaneously increasing unemployment. This was the inevitable result of an over-centralized industrial system operating under the control of a fossilized system of capital finance. Decentralization of the administration of both industry (including not only manufacturing industry but also professions, civil and domestic services) and finance was the only way out of the impasse. Douglas concluded that such reform was unlikely to come about through a political system where the vast majority of the "voters" are "twenty-five years behind the times" (Douglas 1934). That was over sixty years ago. In the meantime little has changed within the economics profession.

The situation referred to by Douglas in the above quotations was the depression of the 1930s, and the solution was World War II. As Kenny observed (Hutchinson and Burkitt 1997, 159) it was not necessary to forego guns in order to put butter on the tables of the poverty-stricken unemployed. Rather, once the production of armaments was considered a profitable investment, the money was "found" (ie. debt-created) to employ people to make guns, and to buy the food, fuel and other necessities they needed. Furthermore, the debt-based financial system continues to dictate policy in all sectors of the economy.

CONCLUSION

Douglas' call for "economic democracy" (Douglas 1919) remains relevant to the contemporary context. At the end of the twentieth century the fragile conventions of representative democracy avail little against the development of a superstate in Europe, while the mixed blessings of "free trade" are forced upon weak nations by the strong, through GATT, NAFTA and MAI. In science, the pursuit of "pure knowledge" is backed by big business, now intent upon genetic engineering and biotechnology.

> And when state, science and capital all get together, the result is what Lewis Mumford called "the Megamachine." Thus the same people who brought you nuclear energy, agribusiness and the drugs and chemical industries are now pursuing the fantastic corporate profits promised by patenting and selling life itself, under the protection of international law. (Curry 1997, 22)

Increasingly, the desirability and legitimacy of such developments are coming under scrutiny as deeper fears and concerns emerge. "Only a fool (or convert, or perhaps employee) would say they are groundless" (Curry 1997,23). Potentially Douglas' work provides the foundation for an institutional theory of money capable of clarifying the relationship between debt-based finance and the processes of production and income distribution. In the absence of this valuable tool, proposals for socially just and environmentally sustainable economic measures will continue to be classed as "unprofitable" and therefore "economically unviable."

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NOTES

[1] Thus Veblen anticipates Gary Becker (1976).

[2] Douglas explained the mechanism through which this could be achieved through the Douglas Credit (Draft Mining) Scheme based upon these premises (Hutchinson and Burkitt 1997, 72-7; Hutchinson 1998, 43-8).

[3] We have explored these topics in greater detail elsewhere (Hutchinson and Burkitt 1994, 1999)