Debt-Free Money: Revisiting Major Douglas' Social Credit Theory and Assessing its Relevance for the Recent Financial and Economic Crises

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With the unprecedented increases in central banks' balance sheets over the past years, attention has been drawn to the nature of money. In this topical essay, Marc Morgan revisits the financial theory laid out by Major Douglas: for the theorist, the system is built on society-wide fraud and deception. The paper then transposes the theory to our contemporary problems.

Introduction

> I am certainly not here as a moralist; but as an engineer. I have an appreciation of the importance of foundations. I find it incredible that a stable society can persist founded on the most colossal lucrative fraud that has ever been perpetrated on society.
>
> (Douglas, 1936)

The name of Clifford Hugh Douglas (or Major Douglas, as he was more commonly known) will not be familiar to many students of economics. But the economic writings of this engineer are of great relevance in coming to terms with what Keynes (1936: 371) labelled 'the outstanding problem of our economic system': the problem of deficient demand. This paper revisits Major Douglas' Social Credit theory and describes how it seeks to solve the problem of insufficient demand, which is a general precursor to economic decline and unemployment. This analysis will have important implications for our current economic predicament, given the nature of the recent financial and economic crises and the proposed remedies to their effects by policymakers around the world. Indeed, it was with the issue of finance that Major Douglas was primarily concerned. Douglas' criticism of the economic system focuses on the financial structure present at the foundations of

the economy. He strongly thought that the structure was ultimately built on false foundations, hence the 'colossal lucrative fraud' imposed on society.

Social Credit, in its entirety, is an expansive theory, covering areas of economic theory, financial economics, political economy, and democratic development. It can be narrowly grasped in its aim to offer proposals for a decentralised and democratically controlled economy through democratising credit and thus policy. Unfortunately, a fair analysis of each of these themes covered by Douglas is beyond the scope of this paper. I will instead focus primarily on Douglas' theory of finance since it provides the foundation for his whole system. One of the theory's most notable conclusions is that of debt-free money, available to finance and ultimately consume the entire production of an economy.

The paper begins by conveying Douglas' underlying motivations for his theory of Social Credit, before going on to expose the different components of the theory itself, including the A+B Theorem, the nature and role of credit, and the justification for a national dividend. The paper will then consider the relevance of Douglas' theory for present economic policy, before drawing conclusions.

The enlightened engineer: motivations for Social Credit

Major Clifford Hugh Douglas (1879 – 1952) was born in Stockport, in England and was by formal training a mechanical engineer. It was while working at the Royal Air Force factory in Farnborough during the First War where Douglas made his original insights that would provide the backbone for his theory of Social Credit. Douglas was tasked to devise a new costing system for keeping accounts at the factory (Mairet, 1934: Back flap). Employing a dynamic new accounting method Douglas discovered that the total costs incurred by the factory each week were greater than money paid out in wages, salaries and dividends in the same week. This curious finding motivated Douglas to study the accounts of more than a hundred large businesses operating in Britain (ibid). The result was the same in every single case. This led Douglas to debunk the mainstream theory which governed company finance, namely that all the costs of a firm are distributed as purchasing power (ibid). As economic undergraduate students may observe, this implies that output does not strictly equal income at any fixed moment in time, thus invalidating the national income identity of neoclassical macroeconomic theory.[1] From this discrepancy arises the chronic problem of insufficient demand, which, as Douglas observed, could only be remedied by constantly injecting new money (credit) into the system.

The way money is created to fulfil its role as credit, and thus debt, was of par-

1 'That the national income equals the sum of the price values of the national production…would be true if all wages, salaries and dividends charged to production were used, at the instant they were earned, to buy the production in respect of which they are earned. But they are not so used; and on this gap between production and delivery, which the complexity of modern co-operative production is widening, a mass of credit-purchasing power is erected which never appears as income at all' (Douglas quoted in Mairet, 1934: 65).

ticular interest to Douglas throughout his intellectual life. From his early experiences dealing with company finance, he came to label the standard credit operation a 'fraud'. In an article on the history of money (1936), Douglas highlights how the relation between money creation and wealth creation has become divorced over time. In its very early stages money was originally created by the producers of wealth, i.e. the owners of livestock. The creation of money then passed on to the custodians of wealth, the goldsmiths, who initiated the fraudulent activity of issuing more paper than the wealth (gold) they guarded, and finally the role was taken up by 'a set of people who neither produce, nor own, nor guard the wealth, but are merely book-keepers' (Douglas, 1936). The banknotes issued by banks essentially represented false documents and information since they amounted to deposited money which did not exist. This, Douglas believed, was plainly factual. The same holds for more modern systems of banking in which banknotes have been replaced by computerised book-keeping entries.

But the important fact resulting from the historical development of money is that the creation of wealth - the production of goods and services necessary to maintain a decent standard of living and essential for the progress of a civilisation – has come to be carried out by entirely separate entities to those involved in the creation of money – necessary to consume the wealth produced. Modern makers of money have 'no real connection with the production of wealth at all, not even as its custodian' (ibid). Douglas compares this unnatural division between finance and production to the equally unnatural situation in a railway industry, if the ticket office were managed by an entirely different organisation to the one providing the trains, the stations, etc (ibid). Therefore, a bank, resembling a ticket office, should not be responsible for determining productive capacity. This implies that the bank has no right to decide the qualifications of producers or the conditions under which they produce, as the ticket office 'has no valid right to any voice in deciding either the qualifications of travellers, or the conditions under which they travel' (Douglas, 1933: 62). The fact that banks do not operate like ticket offices is sufficient proof for Douglas of the systemic fraud involved in modern banking.

The monetary philosopher: the theory behind Social Credit

For Major Douglas, 'the first essential of a stable, peaceful and successful society is to get at the truth and to present – not misrepresent – the truth to everyone concerned' (1936). Therefore, Douglas' theory begins with the true financial dynamics at play at micro-level, informed by his initial observations at the R.A.F factory and formalised in his famous A+B Theorem. It then steadily builds towards the macro sphere, giving credit its true identity, function and form.

A+B Theorem

The first axiom of Douglas' A+B Theorem is that all productive entities (factories or firms)

in an economy have two roles: an economic role as producers of goods and services, and a financial role as distributors of purchasing power through wages, salaries and dividends on the one hand, and as generators of prices, on the other. It is the financial role that is at the heart of the Theorem. It states that a producer's financial payments may be divided into two groups (Douglas, 1920: 21-23):

> Group A – All payments made to individuals (wages, salaries, and dividends).
> Group B – All payments made to other organizations (raw materials, bank charges, and other external costs).

It can be thus deduced that 'the rate of flow of purchasing power to individuals is represented by A, but since all payments go into prices, the rate of flow of prices cannot be less than A+B.' As Douglas' earlier empirical observations informed him, 'A will not purchase A+B' and therefore, 'a proportion of the product at least equivalent to B must be distributed by a form of purchasing power which is not comprised in the descriptions grouped under A'. This additional purchasing power necessary to remedy the problem of insufficient demand can only be obtained from either loan credit or export credit (ibid).

It is the issue of credit in its conventional form that Douglas finds harmful for the economy. This is because 'A' payments are fundamentally dependent on credit, 'as current incomes are dependent upon present production' (Hutchinson and Burkitt, 1999) and present production is induced from past investment which involves credit. Therefore, the goods consumers buy as well as the money used to buy them are ultimately sourced from borrowed money. The value of this credit must 'reappear in selling prices somewhere, and be recovered again from the consumer if banks are to be repaid their advances' (Douglas, 1920: 25). Thus, in this vicious cycle debts are only ever repaid on the back of further credit. 'In other words, the existing financial system increasingly mortgages the future in order to sell the goods existing at present, the most recent and most obvious form of this practice being the installment system of purchase' (Douglas quoted in Mairet 1934: 64). Douglas thought that in order to overcome the problem of insufficient demand and escalating debt a novel source of purchasing power not included in the price of output was essential. This novel source turned out to be a re-interpretation of credit towards its true meaning.

The true meaning and function of credit

Douglas defines credit as 'the substance of things hoped for, the evidence of things not seen' (Douglas, 1936). This evidence must be backed by truthful means, which for Douglas can only be society's present capacity for future wealth creation, and not money which does not exist in bank vaults, which only amounts to 'false evidence' (ibid).

The first premise in Douglas' credit theory is that credit is 'communal property' and therefore should not be managed as if it were the private property of financial institutions. The reasoning for this is deduced from credit being 'the estimated value of the only real capital – it is the estimate of the potential capacity under a given set of conditions including plant, etc., of a society to do work' (Douglas, quoted in Mairet, 1934: 20). Hence, credit originates from the productive needs of society and not from the productive needs of financial institutions since they do not physically produce wealth.

From this premise, Douglas' theory establishes an important distinction between 'financial credit' and 'real credit', a distinction that resembles the difference between what we may today call the 'financial (or fictitious) economy' and the 'real economy'. Real credit, according to Douglas, is a correct credit-estimate of a society's capacity, accounting for all its resources, to deliver goods and services as demanded, at a certain rate. Financial credit is the means by which this capacity can be fully realised (ibid: 19). Therefore, it follows that financial credit should be under the demands of real credit. Neither in Douglas' time nor in our own does this appear to be the case, however. Yet in Douglas' view it lays the foundation for an effective economy[2] (Douglas, 1920: 106-7):

> 'Now, one of the components of the capacity of a society to deliver goods and services is the existence of an effective demand[3] for those goods and services. It is not the very slightest use, under existing conditions, that there are thousands of most excellent houses vacant in this country, when the cost of living in them totally exceeds the effective financial demand of the individuals who would like to live in them. The houses are there, and the people are there, but the delivery does not take place. The business of a modern and effective financial system is to issue credit to the consumer, up to the limit of the productive capacity of the producer, so that either the consumer's real demand is satiated, or the producer's capacity is exhausted, whichever happens first.'

Given these foundations for the workings of a productive economy the next appropriate piece of the theory to be laid out is the notion of interest, which appears under the 'B' payments in the Theorem. As Douglas understood it, credit can either take the form of an interest-bearing loan or an interest-free grant. The difference between a loan and a grant is that with the former an individual or entity is under a 'moral obligation' to return it, of which the rate of interest is just a contractual agreement to pay. In the case of a grant the recipient has a moral right not to pay (Hutchison, 2010: 68-9). Crucially the ownership

2 'Effective', usefully understood in the engineering sense of the word, whereby a structure is effective if it is built on solid foundations and therefore unlikely to collapse.

3 'Effective demand' simply refers to a demand backed by the financial means, i.e. money, to realise it.

right of credit is what determines whether it takes the form of a loan or a grant. Since new credit, according to Douglas, arises from the productive capacity of society, i.e. real credit, then society should be under no moral obligation to pay interest on it. Therefore credit, as Douglas advanced, should be given by the state in the same way as the banking system creates new money. This credit would take the form of a national dividend, paid to all citizens independently of income from employment in order to boost purchasing power or as a subsidy for businesses to expand production as determined by society's effective demand. In such a scheme private banks would be agents of the state in the distribution of credit, 'paid for their services as trustees' by the state (ibid: 69). As such, new money is created debt-free by the rightful owners of credit – productive society, i.e. 'the true state' (Douglas quoted in Mairet, 1934: 105).

The National Dividend

Douglas lays out two further arguments, one economic and the other philosophical, for the issuing of a national dividend to all members of society. I have logically formalised them for clarity. The economic argument runs as follows (Hutchinson and Burkitt, 1997: 55-57):

> 1. Technological progress is the result of machines replacing the work of human labour.
> 2. This facilitates a greater supply of products onto the market, but not enough purchasing power embodied in consumer incomes to purchase all the goods supplied, as human labour is being displaced.
> 3. Therefore a 'national dividend' is justified arithmetically – labour ought to be given a share in compensation for the production done by capital machinery.

The philosophical argument, based on cultural heritage, submerges into the finer detail of the economic argument (Douglas, 1933: 48-50):

> 1. Wealth ought to be distributed to the owners of the factors contributing to its production.
> 2. Technological development is a process mediated by advances made by a long history of human labour [machines are a product of labour power].
> 3. 'No one person can be said to have a monopoly share in technological progress; it is a legacy of countless numbers of men and women, many of whose names are forgotten and the majority of whom are dead.'
> 4. Therefore, 'the rightful beneficiaries of the modern productive system can be shown to be individuals composing the community', who are the

> rightful heirs of past invention.

These two sound arguments taken together imply a different relationship between the individual and the state, to the one we have become used to. According to Douglas, rather than simply being a taxpayer, the individual becomes a direct shareholder in the productive system of the national economy (Douglas quoted in Mairet, 1934: 103):

> Instead of paying for the doubtful privilege of being entitled to a particular brand of passport, its possession entitles him to draw a dividend, certain, and probably increasing, from the past and present efforts of the community of which he is a member.

Contemporary scholars have expanded on this argument, and some have applied it to current political structures. For example in their book Unjust Deserts (2008), the American political economists Gar Alperovitz and Lew Daly also use the cultural heritage argument to claim that society has the inherited right to a larger part of the wealth created from technological progress. Subsequently, they argue that the national tax structure should be altered to more effectively reflect this fact.

The forgotten monetary theorist: the relevance of Social Credit today

Since their conception, Major Douglas' ideas have scarcely been considered, let alone studied, in university economic faculties anywhere in the western hemisphere. Yet his Social Credit theory, while technical and at times grounded in deep philosophy, makes a quite accurate analysis of the workings of the financial system.

Today, our economic system can be said to suffer from the problem of insufficient demand which has its origin in the financial crisis of 2008, and which has kept most western economies in recession since. In this respect the widely adopted policy of austerity is futile, if seen through the prism of Douglas' A+B Theorem. The reduction of costs, especially labour costs, reduces the purchasing power of society. So any resulting reduction in retail prices will be nullified by a reduction in the capacity to consume, 'and we are as badly off as before, with the added complication of the discontent evoked by the reduction of wages' (Douglas quoted in Mairet 1934: 77). If we add to this the mounting problem of debt the situation is starker.

The swift accumulation of high debt levels by sovereigns was partly due to states guaranteeing the substantial losses of the financial system since the crisis. These losses could be said to be sourced from the increased divorce between finance and industry that has occurred over time, with the former creating highly volatile markets of its own to trade in. Douglas' vision of money creators being under the demands of the real economy, and not the reverse (as conveyed above), is of great relevance to the role of finance in

light of recent events. This can be more easily appreciated by the fact that under the present system states can only avail of new money to fund their economies from privately owned financial institutions, which only adds to the sovereign debt problem.[4] With respect to private debt, it is worth noting that in Douglas' time, credit could only be given to entrepreneurs to purchase factors of production (Hutchinson and Burkitt, 1997: 50). The extension of credit to individuals to buy consumer goods was thus a later development. But this development has only worsened problems of private debt, as all money created in the form of loans is debt, which must somehow be repaid. Therefore, Douglas' proposal for a national divided in this case is worth studying more, as it would prevent banks and other money lenders from increasingly mortgaging the future.

It is tempting to argue that Douglas' free-for-all system of credit would be inflationary. However, as Douglas himself emphasises, credit for use as purchasing power in his system has a rational limit: 'the limit imposed by the ability to deliver the goods for which it forms an effective demand, providing that the community agrees to their manufacture' (Douglas, 1920: 102). What is irrational, if we extrapolate from Douglas' theory, is to pursue a policy of inflation in a non-social credit world. This is particularly relevant to the present, as inflationary policy has been voiced by many to be the best remedy for the on-going economic crisis. But, again, if analysed through the prism of Douglas' theory, this policy will not resolve the problem of deficient demand. This is because inflation means the creation and circulation of new money, and this can only be initiated under prevailing structures by private banks in the form of loan credit. Given the origin of this new money 'it can only reach the general public through the medium of costs', in other words as interest on loans, '…and must therefore be reflected in prices' (Douglas, 1933: 102-103). In Douglas' terminology this means an increase in 'B' payments, as these include bank charges. As 'B' payments increase, 'A' payments (purchasing power) will be less able to buy the goods presently available. The reasoning behind this is that the loan is an investment by the bank in future production and so part of that future production is returned in principle and interest to the bank and part is paid out as 'A' payments; the distribution determined by the size of future production and on the present rate of interest. Crucially, the cost of the loan is reflected in current prices while a potential increase in 'A' depends on future production. Therefore, what is certain is that purchasing power (A) will always lag behind prices (A+B). As a result, an inflationary policy will mainly increase A+B through B and this will 'reduce any financial and economy system to ruins…since it taxes the purchasing power of those who obtained it by work, for the benefit of those who

4 To finance their needs, national governments issue bonds on the bond market, which are turned into currency by private banks and then lent back to the government in the form of a standard loan, earning compound interest. With this process the financial institutions determine how much new money is to enter into the real economy, a development which radically distinguishes them from the ticket offices they should resemble, as alluded to by Douglas.

obtain it by financial manipulation' (ibid).

Conclusion

This paper sought to shed light upon Major Douglas' radical theory of Social Credit by relaying its motivations, theoretical underpinnings, and potential relevance to the present. An engineer by profession, Douglas could only aspire to be an amateur economist among his peers. Yet his engineering mind, attracted to the finer details of systems of structure, was probably his greatest economic asset. This is clearly portrayed in how he came to construct his Social Credit theory, from analysing how a business' cost system is structured and how it subsequently results in distributing insufficient purchasing power to individuals, which forms one of the greatest problems in economic science – the problem of deficient demand. In explaining the most notable theoretical aspects of Social Credit, this paper finds them appropriate to the story of deficient demand. It must be acknowledged, however, that the paper could not cover the complete extensiveness of the theory. What the paper did focus on was on the financial implications of the theory. This culminated in the idea of debt-free money issued by banks as agents of the state, and solely representing the demands of the productive economy. The justification for a national dividend necessary to boost demand is logically well founded. The systemic structure presented by Social Credit thus allows the community to be in control of production, and not the financial sector. Moreover it allows all citizens to have a share in the productive economy of which they form a part.

Finally, the paper discussed the relevance of Douglas' theory for policy today. It can be concluded that Social Credit has important implications for current policymakers in how to understand the financial and economic crises and how not to proceed under the current financial system, even with liberal-minded policies like inflationary policy. This paper, therefore, concludes that Major Douglas is an important monetary theorist whose theory is due careful appreciation by students and policymakers alike.

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