Latvia’s Cruel Neoliberal Experiment

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Latvia is being devastated by two global wars. On the geopolitical front is the Cold War’s coup de grâce. Neoliberals have managed to de-industrialize Russia and the rest of the former Soviet Union, persuading parliaments to dismantle government support for economic renewal. The “Washington Consensus” has backed a policy of giving away public enterprises and land to a newly minted oligarchy of insiders, and helped them sell shares to Western investors. The ensuing economic wreckage has helped avert future military rivalry to U.S. hegemony.

Western investors are waging their own social war of finance and property against labor. Initiated by the Chicago Boys in Chile in 1973, sponsored in Britain by Margaret Thatcher’s Conservatives after 1979 and by Ronald Reagan’s Republicans in the United States after 1980, this class war was capped by “Rubinomics” under Bill Clinton and the Democrats after 1992. Rejecting the classical distinction between earned income (wages and profits) and unearned income (economic rent, financial charges and land-price gains or other asset-price gains), this global war seeks to rationalize privatization of the land and key resources of the former Soviet Union and China as well as those in Third World debtor countries. Its aim is to roll back a century of Progressive Era regulatory reforms and taxation of rentier wealth. So over and above being on the losing side in this victory over Communism, Latvia has been swept up in this war of oligarchy against democracy.

Western Europe has viewed the post-Soviet economies as markets for its surplus exports (especially those subsidized by the Common Agricultural Policy) and bank credit. The last thing the West wants is to help potential competitors develop in the way that it has developed itself – by protectionist tariffs, public subsidy of industry and agriculture, infrastructure spending, social-democratic regulation, and progressive taxation. The strategy is for global conglomerates to buy up property (with tax-deductible credit), while European banks extend loans to fuel debt bubbles. This policy has left the Baltics and other post-Soviet countries economically dependent beyond their ability to pay down the debts they have run up so rapidly over the past decade.

From time immemorial, wealth has borne an obligation to support overall social welfare. But over the past few decades the vested interests have refined their strategy for reversing this principle. Led by financial lobbyists, they have sponsored a campaign to shift the tax burden off real estate and monopolies onto labor, privatize the public domain and break free of public regulation to extract rents and fees without constraint. The result is a change in the direction in which Western civilization has been moving for centuries.

The International Monetary Fund (IMF) and European Union (EU) are key players in this about-face. They demand that governments impose austerity plans, scaling back employment and public spending on such basic necessities as schools and hospitals, and

selling off public assets and enterprises to pay creditors. This extractive effort has polarized economies. Creditors have backed politicians pledged to rewrite the tax laws, deregulate government oversight, and to bail out banks (even foreign banks) with public funds when loans go bad, as they must do as the debt overhead shrinks economies.

Latvia and its Baltic neighbors are victims of this counter-revolution. Since dissolution of the Soviet Union in 1991 they have been used as a laboratory to break from liberal European tradition. For starters, a radical tax policy (a heavy flat tax on labor, almost none on property) has replaced the tradition of progressive taxation. A philosophy of privatization with no recapture of the rental value created by public investment and general prosperity has replaced the tradition of a mixed economy, while financial policy encourages borrowing in foreign currency despite local income being in domestic currency.

Finally, there is no "public option" in the form of basic infrastructure, banking or other natural or legal monopolies. Nor is there public regulation to keep prices in line with actual costs of production. Instead, neoliberals have disabled Latvia's government and turned the economy over to foreign owners, creditors and suppliers. This policy drains the economic surplus, while foreign economies also receive Latvia's labor and flight capital unable to find employment at home.

As a result of this policy, the nations that dominated Latvia in past centuries by military power are now doing so financially, as illustrated by its recent capitulation to European Union and IMF loan conditions. This war against the post-Soviet economies imposes economic austerity similar to the dictates the IMF has imposed on Third World countries for the past half-century. The result is debt peonage and neofeudal privileges creating dependent "tollbooth economies."

No countries outside of the post-Soviet sphere have tried such an experiment. It aims at testing how far an economy can be depressed before its population dies off or emigrates. What is so remarkable is that this is being done in the name of free markets, and even in the name of Adam Smith. Yet Smith and other classical economists defined free markets as ones free of land rent, monopoly rent and financial overhead. They developed classical value and price theory as a tool to endorse taxing this unearned income, which they deemed to be unnecessary charges in excess of cost-value, headed by land rent.

Economic rent is the proverbial free lunch: income without a corresponding cost of production. Instead of taxing away this "empty" pricing without cost value, the flat tax is levied on labor, and the value-added tax to the sale of consumer goods. These taxes raise the cost of living and doing business, making Latvia's labor and industry uncompetitive. Rather than taxing the land's site rent to minimize the cost of living and doing business by holding down property prices, and rather than limiting the prices that monopolies can charge, "neoliberal" policy has forced the economy into deepening trade and debt dependency on foreign countries to finance the chronic structural trade deficit that this policy has caused.

Latvian faces the problem of how to earn the foreign exchange to pay the foreign-currency debts it has taken on, and how to pay for the imports on which its open economy, high flat tax on employment and dismantling of government support have left it dependent.

What has financed Latvia's trade deficit and rising foreign debt service has been mortgage credit borrowed in foreign currency. Some 87 percent of real estate mortgages are reported

to be in euros and other foreign currencies, mainly from Swedish banks and their affiliates. These lenders have not asked how this debt can be repaid. The price of this irresponsibility no doubt will be to suffer defaults that threaten to wipe out their own capital.

Latvia's neoliberal planners also have been remiss. Their policy of financing a trade deficit by borrowing against property already in place (rather than to invest in new means of production to increase exports or displace imports) could last only as long as property prices kept on rising and sufficient rental income remained unpledged to pay debt service. Mortgage borrowers turned over this currency to the central bank, which used it to cover domestic spending on imports. But this situation could last only as long as the real estate bubble was expanding. But since the financial and real estate bubble burst, foreign bank lending has dried up. The currency is now being supported by borrowing from foreign official agencies – on destructive terms that direct Latvia to shrink its economy even more! This shrinkage makes Latvia even more dependent on foreigners for its imports, and indeed for employment.

So how is the economy to recover? Neoliberals have no answer. The culmination of what they call "free market" doctrine (a travesty of what "free markets" meant to Adam Smith) is to centralize planning in the hands of creditors: the European Union, IMF and Scandinavian bank lobbyists on behalf whose creditor interests the prime minister and central bank heads have represented as against those of indebted Latvians. This is the function of neoliberal policy, after all: to shift planning out of the hands of elected officials (economic democracy) into those of the financial sector (oligarchy), mediated by international financial agencies (dollar hegemony).

This cruel experiment must end. Latvia must escape the economic and demographic death spiral into which its politicians have steered it. By indebting Latvia to foreign creditors beyond its ability to pay – and crippling its competitiveness with a regressive flat tax – neoliberal "reform" (more accurately, a reaction against the 20th century's Progressive Era reforms) is causing emigration and social collapse. It is time for Latvia to rejoin the course along which Western civilization has been traveling for the past eight centuries and reject the road to debt peonage and neoserfdom.

Latvia's radical flat-tax experiment

Every Western economy has financed in public education, transportation and other infrastructure investment first and foremost by a property tax, followed by a progressive income tax that initially fell on the highest wealth brackets. In the United States the original 1913 income tax required only the wealthiest 1 percent of the population to file tax returns. Capital gains were taxed at the same rate as wages and profits, on the logic that the effect of a capital gain is the same as earning income: both served to increase net worth.

Fighting back, the rentier classes have spent nearly a century trying to reverse progressive taxation. The fiscal shift onto labor has been promoted by financial investors and property owners seeking to avoid their traditional fiscal obligations. Capital gains in the United States (mainly price increases for land sites) are now taxed at only half the rate levied on earned income. Many countries do not collect such taxes at all, or enable them to be easily avoided. Labor pays a regressive concealed tax in the form of paycheck withholding for Social Security and medical insurance, whose costs are removed from the general budget where they would fall on the higher tax brackets. (Higher-earning managers are exempted from these taxes.)

At the state and local level, property taxes have been gradually but steadily replaced by income and sales taxes falling on labor and consumers. This has caused a tax squeeze that has forced cutbacks in public services, reversing the funding of local prosperity. Counter-intuitive as it may seem, high tax rates and protective tariffs tend to go hand in hand with high growth rates – as long as the tax revenue is invested in infrastructure and other economic support. In recent American and British economic history, periods of relatively high income tax rates have also been those with the highest-growth rates and least finally polarized imbalance.

The reason is easy to understand. Whatever rental revenue the tax collector relinquishes is available to be pledged to banks as debt service on loans to buy property. Homeowners thus end up paying the bankers the income that they used to pay in taxes. But the government for its part still have has to raise tax revenue, which is levied on wage income and consumption. Housing prices rise in proportion to the tax burden being shifted off property onto employees.

Until the 1990s no economy ever had sought so radical a counter-reform as to abolish the property tax. It would seem at first glance that no democracy would vote for an anti-labor tax as extreme as that with which Latvia and other post-Soviet economies have saddled themselves. In the United States in 2000 a billionaire right-wing Republican candidate, Steve Forbes, was laughed out of the presidential primaries for proposing a flat tax. In Western Europe such a tax would run against democratic tradition. But it is no laughing matter in the Baltics. This seemingly anti-democratic situation has been maintained by misrepresenting the tax as efficient rather than destructive of the domestic market.

So the first Latvian experiment was how to persuade the country to adopt this tax policy and keep it in place, while leaving real estate and wealth virtually untaxed. In the face of the rising tide of indebtedness and emigration, the second stage of this experiment was to see how far this policy could shrink the economy without voters demanding a change. No one can know the answer until voters actually push back by electing a party or coalition with a less corrosive policy.

The American Economy of High Wages doctrine vs. Latvia’s low-wage policy

Latvia’s high tax on labor is averse to the rise labor productivity that requires rising living standards, educational levels and health as a precondition. The nation’s anti-labor policy is antithetical to that of every economy that has achieved world-class industrial status. The U.S. economy, for example, built itself up not by grinding down its wages to compete with Britain and other industrial nations, but by just the opposite strategy. The American System of Political Economy, wrote E. Peshine Smith in 1852, rests “upon the belief, that in order to make labor cheap, the laborer must be well-fed, well-clothed, well-lodged, well instructed, not only in the details of his handicraft, but in all general knowledge that can in any way be made subsidiary to it. All these cost money to the employer and repay it with interest.”[1]

This became U.S. development policy after the Civil War (1861-65) freed the nation from Southern anti-industrial trade policy. Undertaking a study of international wage and productivity comparisons in 1884, the U.S. Deptartment of Labor concluded: “It is not by reducing wages that America is making her conquests, “but by her superior organization, greater efficiency of labor consequent upon the higher standard of living ruling in the

country. … High-priced labor countries are everywhere beating ‘pauper-labor’ countries.”[2]

Latvia has achieved the worst of both worlds. It has raised the price of its labor by levying a higher flat tax on employment than is found in any other country (over 50% from the combination of social tax, employer tax an wage tax), while leaving employees with too little disposable income to raise their productivity to Western European standards. Cutbacks in public spending on education and public health shift the economic burden further onto labor, leaving an economy in which only the very rich are able to survive. This is why so much of Latvia’s working-age population has emigrated or plans to leave. Without reversing this austerity policy toward its labor force and improving workplace conditions, Latvia will suffer further capital flight and emigration, and its trade deficit will deepen.

Latvia’s radical privatization policy

Western Europe’s and North America’s investment in public infrastructure has provided their economies with a head start. Failure to invest – or to do so on a privatized basis – results in higher costs. Neoliberal privatization thus put the post-Soviet economies at a cost disadvantage. The Washington Consensus has had the effect of “pulling up the ladder,” preventing Central Europe and other post-Soviet regions from catching up to become serious competitors with the West.

Latvia’s leaders have told voters that public enterprise is antithetical to private enterprise. But what they are criticizing is Soviet bureaucratic planning. They miss the more successful American and Western European social democratic tradition of public enterprise, and indeed leave out the long sweep of the history of civilization itself. It is now recognized that every commercial and entrepreneurial practice known today, ranging from the development of money and coinage, standardized quality, weights and measures, pricing and the charging of interest to profit-sharing commercial contracts and partnership arrangements, were developed in the temples and palaces of Sumer, Babylonia and their Near Eastern neighbors as early as the Bronze Age, 3200-1200 BC. The private sector adopted these techniques, starting with members of the palace bureaucracy acting on their own account. Privatization of credit and other basic infrastructure – and governorship of provinces under the Romans – created social imbalance as creditor oligarchies gained power and disabled royal checks and balances.[3]

Near Eastern rulers proclaimed Clean Slates to annul the overgrowth of debts that polarized society between creditors and debtors. These royal debt cancellations contained three basic dimensions: a wipeout of personal and consumer debts (but not commercial business debts); liberation of individuals pledged as bondservants to creditors; and a return of land and crop rights to the debtors, to free the land from creditor claims on its usufruct.[4]

Every successful economy in history has been a mixed public/private symbiosis. America’s first professor of economics at the nation’s first business school – Simon Patten at the University of Pennsylvania’s Wharton School of Business – explained that public infrastructure and enterprise is a “fourth” factor of production. It differs from labor, capital and land in that its aim is not to obtain income. Labor earns wages, capital earns profits and land receives rent, but the aim of public enterprise is to minimize the economy’s cost structure – the price of living and doing business. Public enterprise operates on a break-even

level to provide essential services at cost (in the case of the post office), at subsidized rates (health care, research and development patents, and phone and broadcasting systems) or even freely (roads, public education, police and fire departments). Likewise, a classical tax system is levied on the land's site rent so as to avoid avoiding taxes that raise the price of labor and capital, while preventing this rent from being capitalized into bank mortgages that raise the price of housing and commercial real estate.

Privatization raises the price of doing business, by charging fees to cover the payout of profits and dividends, interest and other financial fees, soaring management salaries and bonuses, and stock options. The aim of privatizers is to make gains by rent extraction, turning the economy into a conglomeration of tollbooths charging access fees. Outsiders borrow money from banks to buy the privatized infrastructure and raise access fees all the more – gaining support from the financial lobby by becoming one of the largest markets, inasmuch as public infrastructure is the largest capital investment in most economies and hence the largest bank market.

Appropriators of natural monopolies and other public enterprises translate their economic gains into political influence to free themselves from taxes and disable price regulation and anti-monopoly laws. Their idea of a "free market" is to shift the tax burden onto labor, off themselves and their special privileges – and off the interest charges paid to banks for the purchase of such privileges. The aim is to leave the maximum amount of revenue "free" to be paid to high finance.

History's greatest fortunes have been carved out of the public domain, often by military conquest and more peacefully by political insider dealing. What distinguishes recent privatization is the role played by the financial sector, acting internationally. Revenue from privatized property rights is capitalized into financial securities and bank loans, on a scale large enough to drive a global stock market boom highlighted by post-Soviet stock markets and real estate. The tragedy of our time is that this financing and debt leveraging has been managed in a predatory and extractive way – by loading existing assets down with debt and financial claims without creating new means of production, export earnings or other means to pay.

From the 1950s through the 1970s the World Bank headed financial consortia lending to Third World governments to build roads and ports, power plants and other infrastructure – mainly the "external" costs of foreign-owned raw materials production. The financial sector and its clients got rich on extending credit for these projects. Then, in the 1980s, they made yet bigger fortunes selling off this public capital. From Britain to Latin America, public infrastructure and government enterprises were the largest asset category apart from real estate. Global bankers and financial institutions made money twice, first by funding this investment and then transferring it into public hands on credit, mainly by leveraged buyouts and the subsequent flurry of mergers and acquisitions.

For many decades privatization was imposed mainly on debt-strapped Third World economies forced to relinquish their policy-making power to the IMF and World Bank. But the Baltics had no debt at all when they emerged from the Soviet Union. All the post-Soviet economies were debt free – and had no property claims. Yet instead of becoming the most competitive economies in the world, they succumbed voluntarily to Western European bankers loading their economies down with debt, and to investment advisors telling them to create and give away property rights to insiders. The latter then were advised as to how to sell large chunks to Western money managers, turning the subject post-Soviet economies

into the world's leading stock market vehicles. Instead of advising these economies to build themselves up the way that North America and Western Europe had done, by public investment in infrastructure to minimize the cost of living and doing business, the Washington Consensus dictated the creation and sell-off of rent extraction privileges.

This was by applied with almost religious fervor – or more accurately, a superstitious enthusiasm best characterized as neoliberal cultism. Russia's central bank even paid 100% interest for U.S. dollar loans to needlessly back its own domestic currency issue – only to have this borrowing siphoned off and dissipated subsidizing capital flight to the West, in a flood estimated at $25 billion annually for over a decade! The myth that domestic currency had to be backed by foreign exchange – as under the old gold standard – was bought as if it were a religious teaching from on high, not a ploy to stymie and stifle Russian development.

Latvia's experiment in free-trade dependency

All the leading industrial and financial economies, from Britain in the 17th century to the United States after 1860 (when its Civil War freed the country from Southern anti-industrial trade policy), Germany and France, Japan and modern China have built up their industry and agriculture – and hence their foreign trade, which in turn has made them financial powerhouses – by means of protective tariffs, subsidies and public infrastructure.

Agricultural protectionism has been particularly successful in the United States (based on the Agricultural Adjustment Acts of 1933 and 1938, supported by import quotas and systemic opposition to Third World food independence) and the EU's Common Agricultural Policy (CAP). Price supports for crops have enabled farmers to invest in capital and increase farm productivity as sustained as that in manufacturing. This protectionist policy has made crop exports the mainstay of the U.S. trade balance, while European protectionism likewise has produced rising farm surpluses.

Rolling back tariffs and other taxes makes countries less competitive by slowing capital investment, blocking their rise in living standards and productivity. Their lead in protectionist policy has enabled the most developed nations to benefit from capital flight and emigration from countries that have failed to achieve a mixed economy. The resulting fiscal deficits have forced governments into debt, increasingly to foreigners. Their loss of autonomy has enabled the industrial, agricultural and creditor bloc to operate via the IMF and EU and demand austerity that makes indebted "free market" economies even less competitive, locking them into an economic and even demographic death spiral of debt and poverty.

This is the prospect facing Latvia today. It has bought into an anti-government faith that specializing in banking and transport services – while becoming more industrially, agriculturally and financially dependent on foreign suppliers – is the way to make it richer most rapidly. The reality is that by increasing dependency on (and payments to) foreign bankers and international financial institutions, this policy leaves less opportunity for most Latvians to make a living.

Policy conclusion

Fifty years ago Stalin dispersed some 50,000 members of Latvia's propertied middle class

by force, seizing their property and arresting many, exiling some to Siberia and driving others to emigrate to save their lives. Latvians understandably recoil from this destructive behavior and go to the opposite extreme, only to discover that this produces a similar effect. Latvia and the other Baltic nations have been caught in the backwash of the Cold War. "Market forces" have replaced military force, but the effect is equally harsh: to dismantle post-Soviet industry and drive labor – especially skilled labor – and capital out of these countries.

The U.S. logic was that any industrial capability was potentially military in character. It followed that manufacturing and high technology should be dismantled throughout the former Soviet Union. Russia's economy was rolled back to make it more of a Third World country – what the Americans long called "a hewer of wood and drawer of water" in Biblical language. In Russia's case this meant living off oil and gas, along with nickel, aluminum, platinum and other metals. But the Baltic States do not enjoy this fallback position.

Western self-interest was predatory in promoting the economic regime that led to today's financial disaster. The West has subdued the post-Soviet population and appropriated the economic surplus from the property it had built up, along almost identical lines that had occurred in Latin America in the 16th and 17th centuries, and Africa in the 19th century, replete with client chieftains, tax "freedom" for the predators and debt peonage for the local labor force.

Latvia's radical neoliberal experiment is testing the degree to which this kind of destruction of labor, public enterprise and government policy can be wielded by non-military means. The question is, how long will Latvia succumb to the Stockholm syndrome, identifying with the parties that have captured its economy and self-imposed anti-labor, anti-industrial and anti-agricultural policies democratically. The effect is to reduce the population to a state of debt peonage to foreigners, and indeed to Latvia's old feudal master, Sweden.

What keeps Latvians in this subservient position is the travesty they have been taught regarding the tax policy, wage and labor policy and trade policy that has guided the most successful nations. Europe and America have told Latvia, "Do what we say, not what we do."

Latvia could have become a low-cost producer by transferring housing and office sites freely to their occupants and users at the time of independence or soon thereafter. It could have provided public infrastructure at cost. Its manufacturing and other enterprise was free of debt, and could have used productive credit to expand operations. The post-Soviet economies had no debt at all when they obtained their political independence from Russia in 1991 –no property claims for rent or interest. Yet over the past decade they have become the world's most debt-ridden countries. Having borrowed against real estate, public enterprises, natural monopolies and mineral deposits, they now have to beg from the IMF and EU for loans to stabilize their teetering exchange rates.

This borrowing is mainly to serve foreign bankers, not Latvians, just as Latvia's tax system is designed to serve these bankers. The effect of Latvia's bank borrowing has been to enable – indeed, oblige – buyers to bid up prices for housing and other assets. Latvia's perverse tax system, insider property dealings, failure to tax economic rent, and relinquishing credit creation to foreign institutions have made it a high-cost economy. Its real estate bubble, applauded for turning it into a "Baltic Tiger," was achieved by taking on foreign-currency debt for loans to bid up the prices that homebuyers and businesses have to pay for the space they need to live in and conduct business. The World Bank endorsed the Baltic Miracle

as insiders and other appropriators got rich by selling off the assets inherited from Soviet times.

The flat tax, dismantling of state support for industrial and agricultural employment, withdrawal of public subsidies for production that every European Union nation enjoys under the Common Agricultural Policy (CAP) and centuries of industrial protectionism, the dismantling of public budgets to serve a new rentier class such as the Physiocrats, Adam Smith and other classical liberals sought to free industrial capitalism from – all this was designed to dismantle Russian industry and thereby end its potential Cold War threat to NATO.

Lacking a raw-materials base to support them even at Latin American standards, Latvia needs to end the neoliberal experiment and adopt the policies that made Western Europe and America rich. Fortunately, this can be done with the stroke of a pen. Just as the neoliberal dismemberment of Latvia was bloodless, so the recovery of markets does not require a revolution. It can be done by rewriting the nation's tax law and financial law along more progressive lines.

To make this start, Latvia needs to free itself from the anti-industrial, anti-labor tax system that neoliberal managers have imposed, and from the foreign-currency debt burden with which foreign banks have loaded the country down. The problem is that income that is not taxed will end up being pledged for debt – and paid out as interest charges. Contrary to what bank lobbyists and neoliberal propagandists argue, land taxes reduce the price of real estate. It is taxes on labor and capital that add to the cost of living and doing business.

The post-classical road to neofeudalism and debt peonage

Designed to serve the creditor nations, inter-governmental loans tend to be injurious to the countries. These sacrifice policy-making autonomy to the International Monetary Fund and, in Latvia's case, to the European Union bureaucracy. The EU and IMF view debtor countries as vehicles to extend credit to their own banks and exporters. Over the past two years they have "helped" the post-Soviet countries maintain their exchange rates by sacrificing their domestic economies in order to sustain the payment of mortgages to European banks that otherwise would have to take heavy losses on their loans to real estate debtors unable to pay the higher domestic-currency carrying charge that would result from their local revenue falling against the euro.

The EU has made it clear that its credit is not to finance domestic investment or spending, but just the opposite. It requires debtor governments to impose austerity and even run budget surpluses to squeeze out foreign exchange by limiting the population's ability to afford imports and presumably "free" output for export. (This never works.) This policy of economic shrinkage is just the opposite of Keynesian counter-cyclical spending such as Mr. Obama's Stimulus Plan to help pull the United States out of its own downturn. Austerity plans are only for export to economic dependencies – and make them even more dependent on the financial core.[5]

Latvia's GDP fell by 18 percent in 2009, and is forecast to shrink altogether by nearly 30 percent from the crisis' onset in autumn 2008 until the end. More people already are out of work (the yearend 2009 unemployment rate is reported to be 16.8 percent), so default rates

are rising. Housing and other real estate prices have plunged by about 50 to 70 percent in most markets, and new construction has all but stopped.

In the public sector where shrinkage is most drastic, Latvia had over 150 hospitals and clinics when the Soviet period ended in 1991. It now has only around 40, and the IMF and World Bank demand that it close down half of them. Many needed services were closed, including trauma centers and ambulance services. Public health standards have worsened and life spans shortened by several years for men, as has been the case in Russia. There has been an exodus of doctors and health specialists, especially to the richer neighboring Scandinavian countries – part of a serious emigration of highly skilled and unskilled workers alike. According to a recent poll, about a quarter of the male population aged between 20 and 35 years old plans to emigrate during the next five years. And as for the training of new professionals, formerly free universities are now charging tuition, so money rather than talent now obtains higher education. This is the result of financialization as Latvia shrinks its economy to pay foreign creditors.

One motive for emigration is to avoid a lifetime of debt peonage. Homeowners find themselves frozen into their homes almost as serfs as property prices plunge below the amount of their mortgage debt. They cannot move out, because they would have to pay banks the balance due on their negative equity. They, not the banks, must absorb the loss on the bad loan. Unable to find a buyer at a price that covers their mortgage, debtors remain personally liable to save the Swedish bankers from taking a loss, by making up the difference out of their own future earnings. And the situation is getting worse as rents fall in the shrinking economy. There is no way to find renters to cover the mortgage debt. Many debtors are deciding that it is easier to leave the country. This is what many parents are urging their children to do today.

So the economy seems to be in a death spiral – not only economic death but a demographic crisis as well. Matters threaten to worsen if Latvia's trade deficit forces the currency to be devalued. Carrying charges on the 87 percent of Latvian mortgages denominated in foreign currency would soar. But the only way to stave off devaluation is to keep on borrowing from the EU and IMF. And their financial dictate calls for rolling back wages and living standards, taxing labor all the more and slashing public spending and investment even further! Instead of coming up with a plan to extricate the economy from this debt peonage, Latvia's neoliberal government can only repeat its faith in "restoring equilibrium" by tightening the fiscal and financial screws.

An economic program to renew Latvian development

Banks must share responsibility for keeping loans within the debtor's ability to pay. This basic rule has been violated throughout the world in recent years. This has been largely a result of the banks' greed in making loans more than limited to 70 percent of the property's value, as was long the rule in the United States. In view of the fact that Latvia's currency is under pressure to be devalued – with 87 percent of mortgage debts being denominated in foreign currency – banks should only able to take the house itself when they foreclose. This is the collateral that was supposed to back the loan, and it is what makes mortgage loans different from personal loans. Personal liability should not be permitted for mortgage debtors. There is no better way to prevent banks from making irresponsible loans, and then trying to make the debtor's pay.

Second, all loans and obligations should be re-denominated in domestic currency. This is

similar to what U.S. President Franklin Roosevelt did in the in 1932 when he overruled the gold clause in most loan contracts. (The clause stated that if the price of gold changed, the debt had to paid in gold equivalence.) This was intended to prevent creditors from obtaining a windfall gain and indeed, a gain beyond the ability of debtors to pay and hence at the expense of economic recovery. The economy comes first, not the bankers. This is especially important in today's world, where there is no longer a constraint on the banking system's ability to monetize credit.

A third plank of the program to renew Latvia is designed to cope with the problem of abandoned housing, squatters and crime that has plagued foreclosures in the United States. Upon insolvency or foreclosure of residential and commercial property, the foreclosing bank must put it up for auction within one month, to be sold at a market price. The current occupant (either the indebted owner or renter) will have the right to match the bid. Our plan is for the government to set up a bank to lend the occupant funds to buy the property, converting its current rental value into mortgage debt service. At current prices, the new mortgage may be about 30 percent of the existing debt – and it will be denominated in domestic currency. The oligarchs seem happy with this, because loans on the large public utilities and other assets they have taken over and borrowed against also will be redenominated in domestic currency.

In October 2009, Latvia's Prime Minister endorsed the first plank of this program, saying that there should be no more personal liability for mortgage debt. The Swedish finance minister became furious and said that this would break all tradition. The Harmony Centre ("Concord") Party replied that the tradition to which Sweden seemed to be referring was feudalism, and reminded Sweden that Latvia threw off the Swedish yoke back in the 17th century – and threw out the German land barons in 1905.

There is a case of cognitive dissonance when it comes to structural financial and fiscal reform. Most people are not aware that a workable alternative exists, one that was viewed for a century as being the free market alternative – a market free of unearned income and "empty" pricing. Students no longer are taught that economic thinkers have spent the last seven centuries discussing better modes of taxation, banking and pricing, based on the ability to distinguish between economically necessary costs and income, and unnecessary costs.

The classical reformers sought to complete what they viewed as the economic program of industrial capitalism: to throw off the remaining legacy of feudalism, above all the landlord aristocracy that used to be called the idle rich, and also predatory bankers – a cosmopolitan interest typically working with absentee owners, monopolists and other rent-extracting parties. Landowners, privatizers and monopolists are now backed by their international bankers, joining forces to become a new aggressive power as financial speculators. Their activities are not necessary for the industrial economy to operate, but are a rentier overhead that slows it down.

The most important plank of our program concerns the tax system. Like most other post-Soviet economies that have been neoliberalized, Latvia has a dysfunctional flat tax on employment – a total tax burden (labor, employer, and social tax) of over 50%. This is the major factor pricing Latvian labor out of global markets. We urge that the tax be shifted off labor and its employers onto where the classical economists urged it to be placed: on the land and natural resources, presently taxed at less than 1% of their value.

This would "reform the reformers." We expect that the EU and its commercial bankers will fight against this tax shift, fearing that it might spread to other countries. That ultimately is the economic and financial war in which Latvia is caught up as prime victim. Fiscal reform must be a key element in financial reform, because the two prongs of reform are symbiotic. Taxing the land will save its rental value from being capitalized into bank loans. Our aim is to limit bank credit to the financing of creating new means of production, not merely to bolster the price of unproductive, extractive privileges and property claims.

Our recommendations are those of centuries of classical liberal economics, from the French Physiocrats through Adam Smith, John Stuart Mill to America's Progressive Era reformers. In rejecting their classical economic and fiscal logic, Latvia's neoliberal planners are much like fundamentalist believers in Genesis were offended when Thomas Huxley defended the theory of evolution. "Respectable churchgoers were appalled. 'Let us hope it is not true,' cried one horrified lady upon hearing that humans were descended from apes, 'but if it is, let us pray that it will not become generally known.'"[6]

This is the attitude taken today by Latvia's neoliberal taliban. They would like to hope that the ideas of the men they cite as their intellectual patron saints – Adam Smith, et al. – did not really say what they did. But facts are facts. The dysfunctional tax system, financial system and dismantling of public enterprise and a public banking option run counter to the idea of free markets held for centuries by the classical liberals. Their idea of a free market was a market free of unearned income, free of land rent and predatory financial charges. Latvia's neoliberal rulers have been busy loading down the economy with these charges during their entire time of office. The result has been an economic and demographic death spiral for Latvia.

Latvia's financial and economic problems are not natural, nor are they inevitable. Latvia can still become a highly competitive industrial and agricultural producer with a high standard of living. All it needs to do is end the radical neoliberal experiment – an experiment which, after all, was designed to destroy Russian Soviet military power, sweeping up Latvia's unfortunate economy in the backwash.

Notes

[1] E. Peshine Smith, "The Law of Progress in the Relations of Capital and Labor," *Hunt's Merchants' Magazine*, XXVI (1852), p. 42.

[2] U.S. Labor Secretary Jacob Schoenhof, *Wages and Trade in Manufacturing Industries in America and in Europe* (New York, 1884), p. 19. I discuss both the above authors in *America's Protectionist Takeoff, 1815-1914: The Neglected American School of Political Economy* (ISLET, 2010).

[3] Michael Hudson, "Entrepreneurs: From the Near Eastern Takeoff to the Roman Collapse," in David S. Landes, Joel Mokyr, and William J. Baumol, eds., *The Invention of Enterprise: Entrepreneurship from Ancient Mesopotamia to Modern Times* (Princeton: Princeton University Press, 2010):8-39.

[4] Readers of the Bible will recognize this as the essence of the Jubilee Year of Leviticus 25, which Jewish religion took out of the hands of rulers and placed at the center of their religion as a covenant under Mosaic law. And when Jesus gave his first sermon in the synagogue, Luke 4 describes him as unrolling the scroll of Isaiah and saying that he had come to

proclaim “the Year of our Lord,” that is, the Jubilee Year, *deror*. This Hebrew word that the prophets and Leviticus used was cognate to Babylonian *andurarum*. I describe the details in “Reconstructing the Origins of Interest-Bearing Debt and the Logic of Clean Slates,” in *Debt and Economic Renewal in the Ancient Near East* (ed. Michael Hudson and Marc Van De Mieroop, CDL Press, Bethesda, 2002):7-58.

[5] I provide a history of theorizing along these lines – and of alternatives – in *Trade, Development and Foreign Debt* (1992; new ed. ISLET 2009).

[6] Cited in Brian Fagan, *Cro-Magnon: How the Ice Age Gave Birth to the First Modern Humans* (2010, Bloomsbury Press), p. 44.

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