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Basic Income and Financial Instability

Abstract

Basic income is a simple solution to a simple problem: how to provide money to consumers. Every large-scale economy must provide consumers with money. In the absence of basic income, we use less reliable and less efficient mechanisms for this purpose.

Instead of basic income, today's governments attempt to provide consumers money through expansionary monetary policy that stimulates the financial sector and keeps people employed. This arrangement causes an unstable expansion of private credit that leaves the economy susceptible to financial crises.

In a world with basic income, a global pandemic need not trigger an economic crisis. Basic income allows us to bring the economy into a state of orderly hibernation in which we minimize employment and only produce the necessaries.

The pandemic has called attention to the reality that the way we get people their money is broken. By providing money directly, basic income bypasses the financial sector, eliminates the need to over-employ people, and allows us to stabilize credit conditions.

A Simple Problem

If basic income supporters understand one thing, it is that our economy could do a better job of serving the people.

Money gives people access to the economy's products. Without an efficient money distribution mechanism, the economy will fail to generate the maximum benefit for the people.

A Simple Solution

Basic income—a regular income unconditionally paid to every person—is a straightforward way to get people their money.

It can be hard to see how a simple basic income fits into our complicated economy. But the very complexity that makes basic income difficult to reason about stems from the far-reaching negative consequences of our failure to distribute money efficiently.

Unsurprisingly, basic income is often criticized as a naïve attempt at a blanket fix for a whole host of complex social and economic problems that we fail to fully understand.

There are indeed problems that basic income does not solve. But it can fix the way we get people their money.

The Nature of Money

Money is our shared pricing and payments standard. Markets set prices in terms of the standard money unit that everyone understands. Standard-value money tokens provide a convenient means to pay those prices—that is to claim the economy's output.

To buy things, people must have a source of money. A money source, such as basic income, allows people to claim the goods and services that the economy produces for their benefit.

Serving the People

The economy exists to serve the people, not the other way around. It produces goods and services that people want and need. This means that the most important role that people play in the economy is the role of consumer.

Economists sometimes imagine a world in which everyone produces something useful, and then they all make themselves better off by trading the products of their labor with each other. In this world, money merely serves to facilitate efficient trade and the market plays matchmaker for producers who seek to buy each other's products. People buy each other's products using money they receive from selling their own products.

In the real world, it is convenient for some people to produce more than they consume. These producers are happy to continue to accumulate money as they churn out goods and services. But this implies that money is always flowing toward producers and away from consumers. Consumers therefore need a source of money to sustain their spending.

People can reap the product of the economy only to the extent that they have the money to claim it.

The Flow of Money and Goods

Consumers spend money to claim economic output. They activate production by pumping money through the economy.

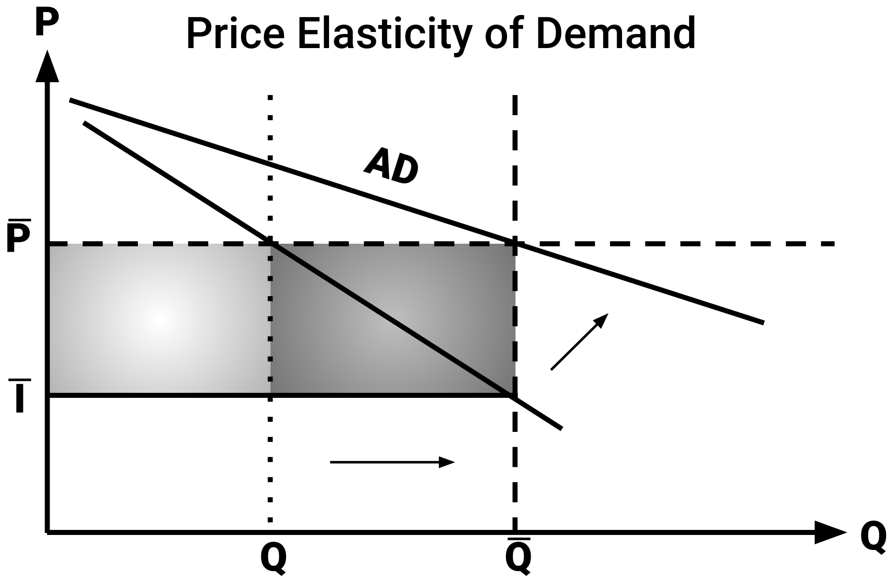
The flow of money from consumers to producers corresponds to a flow of goods and services moving in the opposite direction. The economy's overall pattern of money flow is too complicated to make complete sense of. But to ascertain how well the economy serves the people, we need only consider the flow between consumers and producers.

We can call the cross-section—or slice—of the economy that exists between consumers and producers the "productive slice." What happens outside the slice matters insofar as it affects what happens within the slice.

The Price Stability Constraint

To serve its function as a pricing and payments standard, the purchasing power of money must remain reasonably stable over time—especially the short term. The flow of consumer spending through the productive slice of the economy must therefore remain balanced with the flow of goods and services that it claims.

Producers generally try to set the prices that earn them the most profit. Price-level stability at the level of the macroeconomy implies that, in aggregate, it is profitable for producers neither to raise nor lower their prices.



AD**: Aggregate Demand**
P**: Price Level Axis**
$\overline{P}$**: Output Price Level**
$\overline{I}$**: Input Price Level**
Q**: Economic Output**
$\overline{Q}$**: Maximum Output**

In the above diagram, the shaded area represents profit. Producers choose the price/quantity combination along the aggregate demand curve that maximizes this area.

Because the price level is fixed, only the quantity can adjust. The sensitivity of aggregate demand to changes in price is what determines the total level of economic output. In turn, the distribution of consumer income is what shapes aggregate demand. The economy will only produce goods and services for the people who have the money to buy them.

This is true even if we allow the nominal price level to move. The real price level is always fixed.

The Resource Constraint

There are finite resources (e.g. materials and labor) available to produce the goods and services that people want and need. The economy is providing the maximum possible benefit to the people when the resource constraint is the constraint that binds.

While it is true that economic output is constrained by resource availability, it is *not true* that using up (fully employing) all of our available resources implies that we have achieved maximum economic output. Unless we can promise that all resources are always employed to maximum efficiency, using up inputs does not automatically translate into producing output.

As I showed in the diagram, price-level stability—or the absence thereof—depends on the price sensitivity of aggregate demand. The presence of inflation implies neither that the economy is employing all of its resources nor that it is producing goods and services at full capacity.

Price-level instability is a symptom of the economy's money being improperly managed. The price level moves around when institutions fail to maintain the balance between the flow of consumer spending and the flow of goods and services within the productive slice of the economy.

Where Money Comes From

Money comes from promises. Bank deposits are IOUs for cash issued by a bank. Cash, in turn, is an IOU for goods and services issued by the government on behalf of the economy as a whole.

When the government spends money—in the form of basic income or otherwise—they are supplying claim tickets on the economy's output. The underlying promise is that there will be goods and services for the money to claim. This is the promise of price-level stability.

As is the case with bank deposits, the private sector issues money too. Private-sector borrowing generates most of our economy's money. Privately issued money is a claim on government-issued money and therefore a claim on goods as well.

Regardless of which kind of money consumers spend, the promise of price-level stability requires an ongoing balance between consumer spending and the economic output it claims.

Money is Debt

Because money is a promise for something, it is a form of debt. The money that the government issues is public-sector debt. This is why, when the government spends more than it taxes, the national debt increases.

Similarly, money issued by financial institutions is private-sector debt.

Private vs. Public Debt

The money that consumers spend into the productive slice of the economy ultimately derives from some combination of private debt and public debt. The market allocates private debt according to the profit-seeking behavior of individual actors in the private financial sector. By contrast, political motivations determine where the government directs its spending.

The balance between private and public debt, together with the allocation of public spending, ultimately determines the distribution of consumer income, the shape of aggregate demand, and hence the distribution of economic output.

Monetary vs. Fiscal Policy

Government institutions actively push back against market forces that would otherwise move the price of money itself. They use macroeconomic policy to modulate the flows of consumer spending and economic output to ensure a stable price level.

Typically, the central bank's monetary policy is tasked with maintaining price-level stability. Whatever pattern of taxing and spending (fiscal policy) the government chooses to undertake, the central bank must respond in a way that keeps consumer spending balanced with economic output.

A limitation of monetary policy is that it operates entirely through the private financial sector. Although the central bank can stimulate a flow of money through private credit expansion (i.e. borrowing), it has no control over the distribution of that money flow to consumers.

Profit-driven financial institutions have no reason to allocate money in a way that ensures an optimal flow of goods and services toward consumers. To the extent that the government uses monetary policy and private credit expansion to get people their money, the economy will produce below its potential and leave people behind.

Price Stability vs. Financial Stability

The government is a single monolithic borrower. For the government, issuing more money is merely a quantitative difference. This is not true for the private sector. The expansion of private credit depends on many different private actors making promises whose fulfillment depends on the promises of other actors.

As private credit expands, the complexity of interconnected debt obligations grows. The credit structure becomes ever more brittle until one broken promise triggers a cascade of further broken promises. This is a financial crisis. Private credit expansion is inherently unstable.

Sufficiently tighter credit conditions can prevent an unstable build-up of private credit. But the price stability constraint leaves the central bank without a choice. If the fiscal position of the government would otherwise cause deflation, monetary policy must stimulate private credit expansion to compensate.

Because the central bank is responsible for price-level stability, it is unable to ensure stability in the financial sector.

Basic Income Ends the Business Cycle

By providing money directly to consumers through basic income, the government can allow the central bank to tighten credit conditions. Through the automatic monetary tightening it induces, a sufficiently high basic income prevents the unstable expansion of private credit and eliminates the familiar cycle of booms and recessions (i.e. the business cycle) that we tend to take for granted as a normal part of how the economy works.

The financial system can help us fund productive investment. But by using it as a tool for pushing money to consumers and propping up demand, we have caused the financial system to spin out of control. The business cycle is a consequence of the broken way in which we get people their money.

With an optimal basic income in place, recessions can only occur as a result of changes to the real (i.e. non-monetary) side of the economy. If our economy can activate fewer resources than previously, that means its potential to produce goods and services has decreased.

The fact that economic stimulus was an effective response to the Covid-19 crisis is an indicator that our economy was underperforming *prior* to the onset of the pandemic. If our economy had been operating at its full potential going into the pandemic, there would have been no room for stimulus. We would have focused instead on shutting down as much of the economy as possible while keeping people safe and healthy.

Trade-Offs with Basic Income

The obvious alternatives to basic income are other money sources for consumers. In the absence of basic income, the economy will do something else get people their money—perhaps inefficiently. The more we use basic income to provide consumers their money, the less we have to resort to other mechanisms—such as pumping up the financial sector or creating make-work jobs.

Neither the financial system nor the labor market exist to provide consumers with money. Using them for this purpose distorts them away from efficiently funding productive investment and efficiently allocating labor. Basic income allows us to rein in the financial sector and eliminate unnecessary jobs and wages.

Basic income also trades off against other government spending to the extent that the other spending allocates resources that would have otherwise been available to the market. The more resources the government takes for its purposes, the fewer resources left to the market for basic consumer spending to allocate. Less room for consumer spending implies a lower possible basic income.

Conclusion

Basic income is a way of getting people money. Using basic income as our primary money distribution mechanism can remove unnecessary constraints on our economy's potential.

Basic income serves a primary function in the economy: how to get money to consumers. By choosing to forgo basic income, we are implicitly choosing other, less efficient, less effective ways of getting people their money. The problems that basic income addresses are ultimately caused by our failure to distribute money to consumers efficiently.

The 2008 financial crisis was caused by the absence of basic income. Basic income is a critical piece of economic infrastructure that we happen to be missing. The absence of basic income prevents our economy from serving the people to its full potential.

Basic income is a precondition for a maximally prosperous economy. Its absence makes our economy more complicated than it otherwise would be. Financial instability is but one manifestation of this complexity.