

# Systematic Legal Foundations for Monetary Economics

An Essential Step Towards a New Paradigm for  
Political Economy

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# The Heterogeneous Field of Heterodox Monetary Economics 2016

Modern Monetary Theory (Wray 2012), Stock-Flow Consistent Modelling (Godley/Lavoie 2007), Money View (Mehrling 2011, 2012), Monetary Circuit Theory (Graziani 2003), Monetary Keynesianism (Riese 2001), **Ownership Economics (Heinsohn & Steiger 2013)**, Agent-Based Keynesian Economics (Bruun 2005), Long Cycles Theory (Schulmeister 2014), Mechanics of Balances / Saldenmechanik (Stützel 1978, Schmidt 2012), Horizontalism (Moore 1988), Verticalism ...

*“None of these is at present strong enough or complete enough to declare itself a contender for the title of ‘the’ economic theory of the 21st century.” (Keen 2004, 300)*

*“Heterodox economic schools such as the post-Keynesians fail to provide a comprehensive paradigmatic alternative to mainstream economics, which is a necessary precondition for ... paradigmatic change.” (Dobusch&Kapeller 2013, 63)*

# New European Political Economics Overview

## 1. Legal Foundations

- a. **Property&Contract:** *Private Law* (core of law / european civilization)
- b. State: *Public Law*, Contradiction w. Private Law, Mediation: *Constitutional Law*
- c. Non-Law (informal Reciprocity)

## 2. Accounting (for legally enforceable “monetary” rights/obligations)

- a. Micro: individual
- b. Macro: Mechanics of Balances & Micro-Macro-Paradoxes (Stützel 1978/1979)

## 3. Free Citizens as Actors

- a. Bourgeois (Private Law, Business): Business Strategy, Intentional / Monetary Theory of Value & Inherent Instability of Credit
- b. Citoyen (Public Law, Politics): Power&Wealth Maximizing by Political Rhetoric

## 4. Credit, Means of Payment & Banking System (Nicolas)

## 5. Long Cycles: Cycles of Credit, Class Struggle, Policy Regimes

## 6. Comparative Historical Research

# 1. Legal Foundations

<b><u>P</u>restate</b>			<b>State Centralized Authority</b>				<b><u>I</u>nterstate</b>
<b>Reciprocity informal/oral</b>			<b>Religion Theocracy</b>	<b>Rule of Law Republic ← Dialectic →</b>			<b>Reciprocity International Public “Law” <u>EU-“Law”</u></b>
Positive	Balanced	Negative	Heavenly Order on earth Salvation	<b>Private Decentral [Freedom]</b>	<b>Constitution. [Constraints on Power]</b>	<b>Public Central [Order]</b>	Diplomacy War
Kinship	Neutrality	Foreign- ness	Dues for <b>holy</b> order & Salvation	<b>Property Rights Contract Business</b>	Democracy Federalism Politics	Command Dues for <b>legal</b> order <b>Taxation</b>	Hegemony Power
<b>Non-Law Custom</b>				<b>Law Europ. Civilization Political Economics</b>			<b>Non-Law</b>

## 2. Accounting

# Assets are not “Things”



*“The material things have no value for economics except as they can lawfully be owned and their ownership lawfully transferred.*

**Other sciences deal with things – economics deal with legal rights over things.”**

*John R. Commons 1934, “Institutional Economics”, 400*

# Accounting for ... legally enforceable “monetary” rights and obligations!

Stock-Flow-Consistent Models (Godley & Lavoie 2007, 31)

<b>Rights Assets</b>	<b>Obligations + Net Worth Liabilities</b>
<b>Claims Financial Assets</b>	<b>Obligations Loans</b>
<b>Property Rights Tangible Capital</b>	<b>Net Worth</b>

Modern Monetary Theory (Wray 2012, 24)

<b>Rights Assets</b>	<b>Obligations + Net Worth Liabilities + Net Worth</b>
<b>Claims Financial Assets</b>	<b>Obligations Financial Liabilities</b>
<b>Property Rights Real Assets</b>	<b>Net Worth</b>

# Balance Sheets in Terms of Law

<b>Rights</b>	<b>Obligations + Net Worth</b>
<b>Claims</b>	<b>Obligations</b>
<b>Property Rights</b>	<b>Net Worth</b>

**Net Worth = Rights - Obligations = PR + C - O**

**NW > 0 : Net Rights / Net Beneficiary**

**NW < 0 : Insolvency (Inability to completely serve all obligations)**

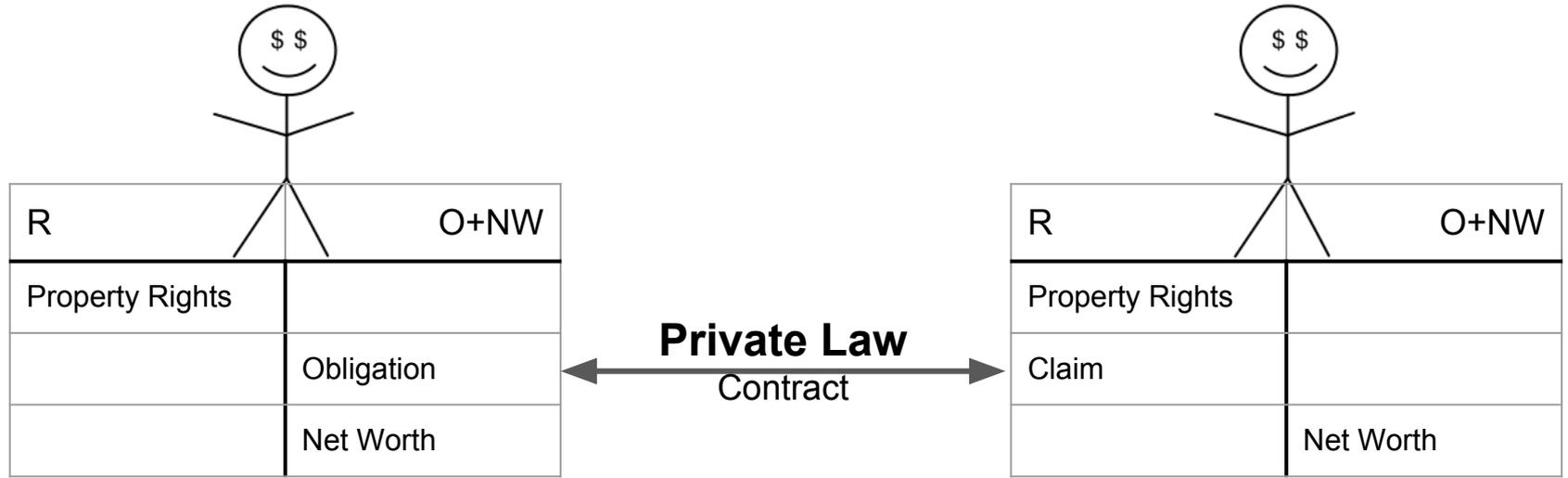
**Claims - Obligations Balance = C - O**

**COB > 0 : Net Claims / Net Creditor**

**COB < 0 : Net Obligations / Net Debtor**

***NW = PR + COB***

# Ownership Economics (Heinsohn & Steiger)



# Sovereign State



guarantees / enforces

guarantees / enforces

R	O+NW
tax claim	

guarantees / enforces

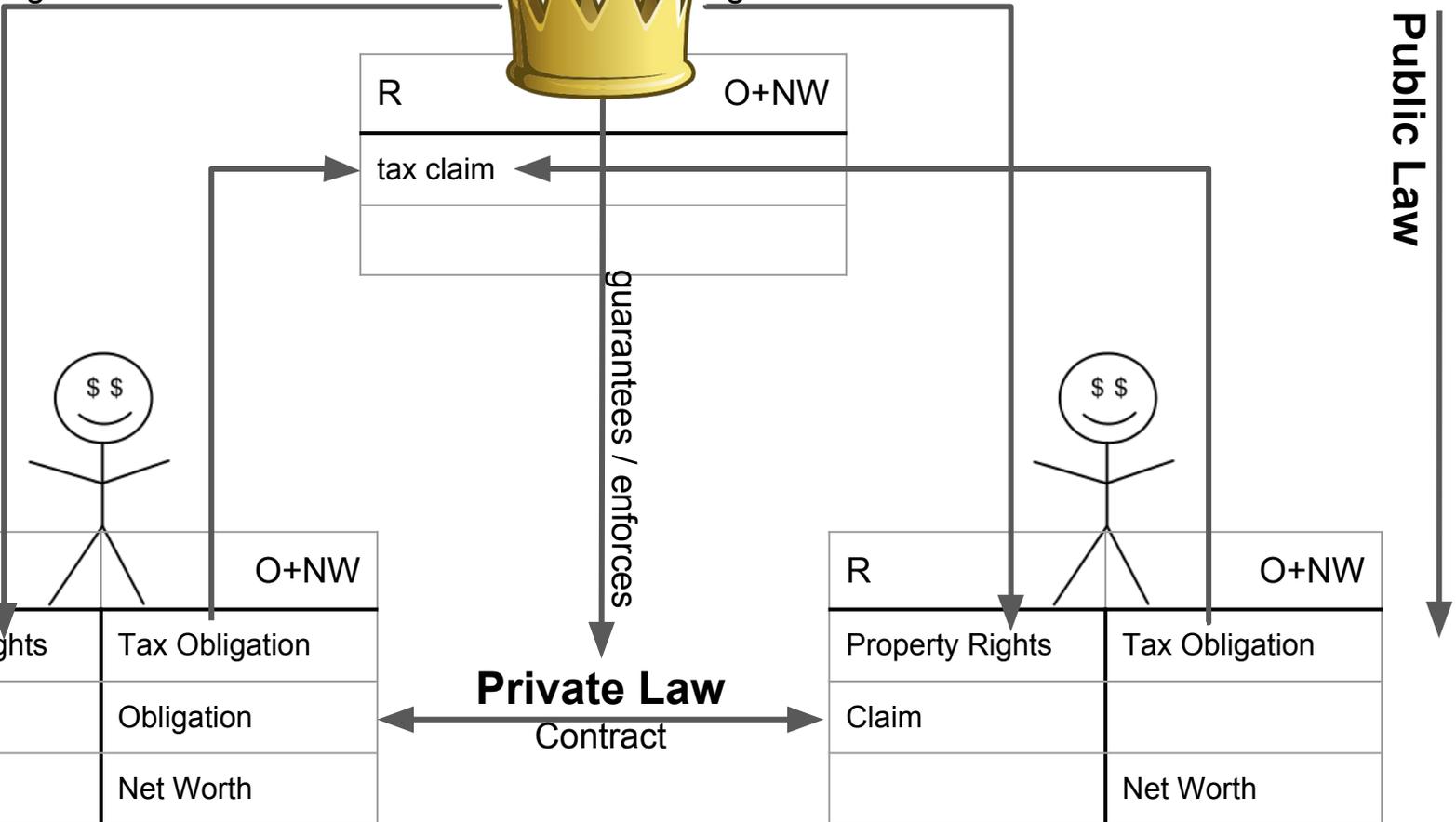
Public Law

R	O+NW
Property Rights	Tax Obligation
	Obligation
	Net Worth

R	O+NW
Property Rights	Tax Obligation
Claim	
	Net Worth

## Private Law

Contract



# Private/Public Law Dialectic

## → Market/State Dialectic

### Contradicting Principles:

**Private Law:** Contractual Claims/Obligations created **by Consent** of free and equal Citizens (-> Ownership Economics)

**Public Law:** Tax Claims / Obligations created **by Command** of a Sovereign over unfree Subjects (->Modern Monetary Theory)

*“All private law is connected to a right of acknowledgement and protection by public law.*

***Thus, all private law rests on the foundation of public law.”***

*(Jellinek 1905, 372-373, my translation)*

**System oscillates historically between market and state dominance**  
**1933 (New Deal) - 1971 (End of Bretton Woods System) state domination;**  
**1975-2008 market domination**

Instead of Market or State Fundamentalism,  
“Liberalism” or “Socialism”:

**Conceptualize Legal Mediation of Dialectic:**  
***Political Economics***

# Republic

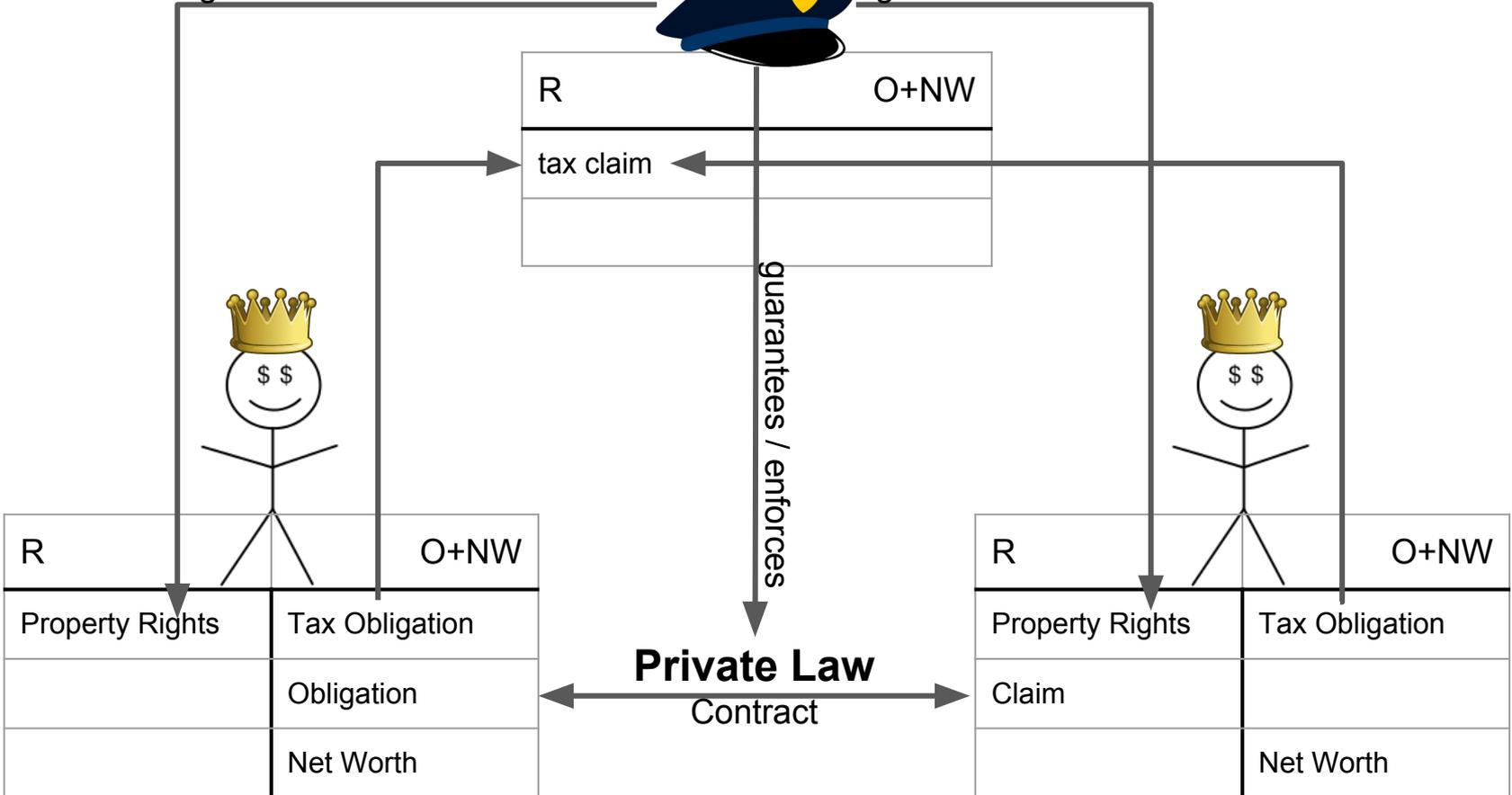


guarantees / enforces

guarantees / enforces

Constitutional Law

Public Law



R	O+NW
tax claim	

R	O+NW
Property Rights	Tax Obligation
	Obligation
	Net Worth

R	O+NW
Property Rights	Tax Obligation
Claim	
	Net Worth

## Private Law

Contract

guarantees / enforces

# Constitutional Law: Republican Principles

(~~Absolutist Monarchy 1789, Colonial Ruler 1776~~)

## **Citizens Retain Public Law, but Subordinate it to Private Law Principles!**

1. Popular Sovereignty & Democracy (Free Citizens = Partial Sovereigns)
2. Rule of Law (not people) over Citizens AND the State
3. Division of Power: Free Citizens apply “divide et impera” to State
  - a. Public / Private Law Division (Civil Liberties: Freedom *from* the state *within* the state)
  - b. Horizontal: Legislative, Judicial & Executive Branches of Gov't
  - c. Vertical: Federalism (Federal, State and Community Gov'ts)

# 3. Free Citizens as Actors

Economics



**Political**  
**Economics**



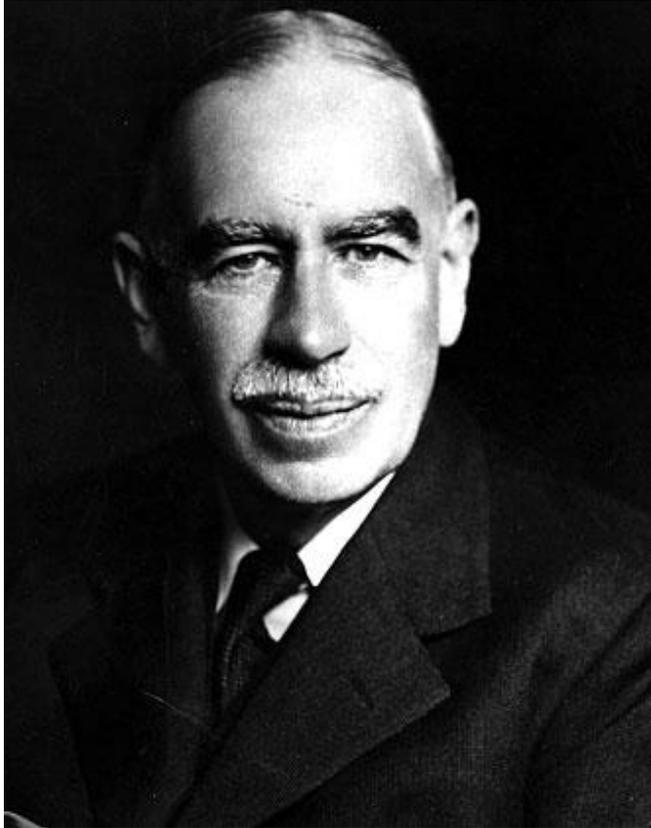
Private Balance Sheet	
Rights	Obligations + Net Worth
Claims  Claims ag. State (Subsidies, bailout money, social security payments...) - Claims ag. Private Subjects	Obligations - Tax Obligations  - Private Obligations
Property Rights	Net Worth 

**Free Citizens' Double Roles:**

**Citoyen (Sovereign Legislators):** optimize public claims-obligations-balance: Associations, Public Discourse, Lobbyism: Political Rhetoric / Propaganda (economic theories!) to portray partial interests as general interest: economic **Class Struggle** by rhetoric!

**Bourgeois (Business Contractors):** optimize private property+ claims-obligations-balance

# Paradigm Change: 1857 - 1890s - 1929 ... 1975 ... 2008



*„The ideas which are here expressed ... are **extremely simple** and should be obvious.*

*The difficulty lies, not in the new ideas, but in **escaping from the old ones.**”*

*John Maynard Keynes. 1936. The General Theory of Employment, Interest and Money, Preface*



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an Essential Step towards a New Paradigm for Political  
Economy

Paper for WINIR 2016

**(Draft! Condensed Version to follow ...)**

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Dedicated to Otto Steiger,

John R. Commons,

and Wilhelm Lautenbach.

Abstract<sup>1</sup>: Analyzing and solving today's eurozone crisis with its flawed institutional design (including national legal systems differing greatly in their capability to reliably enforce contract and tax law) poses an insurmountable challenge to both orthodox and heterodox economics. Both fields are working with corrupted basic conceptual distinctions and lack a precise legal and institutional foundation that could serve to systematically detect these flaws. Fundamental rethinking of the type Keynes attempted during the 1930s in response to the great depression is in order. A unified paradigm for a political economy of capitalism that provides conceptual precision, integrative power and analytical depth can be created empirically by (1) using precise basic conceptual distinctions made by codified continental (private and public) law, international law and business accounting, (2) taking into account basic micro-macro paradoxes (such as the paradox of thrift) stemming from simple accounting identities and (3) noting the inherent instability of credit resulting from financial claims and liabilities being nominally fixed while "real assets" (property titles) are nominally variable and thus, subject to constant re-evaluation in light of expected future returns. In order to understand problems of creating capitalism in post socialist, developing and eurozone countries (like greece) with weak legal institutions, the perspective of standard insights from (4) legal and economic anthropology and (5) comparative history have to be added. Within this paradigm, existing approaches within economics can then be re-interpreted and integrated, creating a powerful, coherent and differentiated synthesis that has the potential to challenge the hegemony of the neoclassical paradigm. Some of the potential of this approach will be demonstrated by example: using basic concepts of private and public law and simple balance sheet logic, the controversy between property economics (Heinsohn/Steiger) and modern monetary theory (Wray) regarding "state money" can be resolved empirically.

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<sup>1</sup> This project is essentially work in progress, and a write-up of personal research that started in 2011, after the eurozone crisis hit. Besides running a small business, in my role of *citoyen* I had to become an armchair economist for the simple reason that the explanations for the eurozone crisis given by economists seemed somewhat incoherent and unsatisfying to me, and I was not prepared to accept that. In the preface to his 1936 *General Theory*, Keynes wrote, "*The ideas which are here expressed so laboriously are extremely simple and should be obvious. The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.*" Since our minds over the past 40 years have been clouded by the same theory that Keynes had to intellectually fight against – neoclassical economics – I suspect that what he said in 1936, 7 years after 1929, also applies to 2016, 8 years after 2008. I think it is about time that Keynes' unfinished project of a coherent "monetary theory of production" should be completed. To achieve that, monetary macroeconomics needs a legal / institutional foundation in a context of cross-cultural comparison and history, and this is finally being addressed now finally by various people. This essay is meant as a small contribution towards that goal. Of course, any mistakes that may have slipped in are my own. I hope to shed some light on what seems to me a grey area within economics, at the crossroads between law, business, macroeconomics and political science. It seems that not many people conceive of the basic structure of law and european civilization as one based upon conflict, yet it seems to me that this can be a useful and illuminating perspective that may help to devise sensible, neither utopian or fundamentalist nor defeatist practical strategies to deal with the eurozone crisis.

Many people have contributed questions, discussions, comments and support to this project over the past few years. Special thanks to Nicolas Hofer (Vienna), Matthias Garscha (Frankfurt) and everyone at ANEP Economics, Robert Fischer (Romanshorn), Christoph Brandstetter at [saldenmechanik.info](http://saldenmechanik.info) (Vienna), Heiner Flaßbeck, Jörg Buschbeck, and the readers of *Das gelbe Forum*. Thanks, Guys! And keep on asking those questions. And special thanks to my family for their continued support in spite of my business with this project, and for putting up with my selfish pursuit of "social science".

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# I. Introduction: The Financial Crisis 2008, the Eurozone Crisis and the State of Contemporary Economics

## A) The financial crisis and renewed interest in keynesian monetary economics

The Global Financial Crisis has demonstrated the limitations of the orthodox mainstream of neoclassical economic theory and neoliberal economic policy legitimated by it. Obviously, a model that has “no room for money” (Hahn 1981, 1) can neither predict nor explain financial crises, let alone politically manage them sensibly, which has long been known but has become obvious again in 2008.

As a result, interest in heterodox approaches – mostly developed in response to the great depression of the 1930s – have received more attention. One unified focus of the heterodox field is on *monetary economics*, following Keynes’ original intent for his *General Theory of Employment, Interest and Money* (1936), which he had described as a “monetary theory of production” in a short 1933 article in the Spiethoff Festschrift (Keynes 1933).

Yet, despite this shared focus and explanations for financial crises clearly superior to neoclassical economics, the field of heterodox economics is very heterogenous and remains divided. A large number of individual approaches are being discussed: Modern Monetary Theory (Wray 2012), Monetary Circuit Theory (Graziani 2003), Monetary Keynesianism (Riese 2001), Ownership Economics (Heinsohn & Steiger 2013), Stock-Flow Consistent Modelling (Godley/Lavoie 2007), Agent-Based Keynesian Economics (Bruun 2005), Money View (Mehrling 2011, 2012), Long Wave-Theory (Schulmeister 2014a), Mechanics of Balances / Saldenmechanik (Stützel 1978, Schmidt 2012), there are Horizontalists (Moore 1988), Verticalists, Endogenous and Exogenous Theories of Money, etc.

But communication between them is unsystematic, difficult and often less than fruitful. A shared solid and coherent paradigm, consisting of basic concepts that could be easily agreed upon and bridge communication, is still lacking. This not only hampers communication within the field, but also leaves it powerless to challenge the completely unrealistic, but logically coherent orthodox neoclassical paradigm:

*“Heterodox economic schools such as the post-Keynesians fail to provide a comprehensive paradigmatic alternative to mainstream economics, which is a necessary precondition for ... paradigmatic change.” (Dobusch&Kapeller 2013, 63)*

Wynne Godley and Marc Lavoie note along similar lines that there is

“... a lack of theoretical cohesion in the various pieces which emerged from the Keynesian school, which paid scant attention to the fundamentals on which an alternative, but coherent, paradigm could be built.” (Godley & Lavoie 2007, 3)

In summing up his discussion of various heterodox approaches, Steve Keen concludes:

“None of these is at present strong enough or complete enough to declare itself a contender for the title of ‘the’ economic theory of the 21st century” (Keen 2004, 300).

Some of the approaches in that field have explicitly made reference to *partial* features of the legal system as the foundation for credit, money, and the financial system: Modern Monetary Theory, in line with the Keynesian tradition, has stressed the taxing power of sovereign states as enabling it to act as an employer of last resort, while taking Private Law mostly for granted and leaving it implicit (Wray 2012). This puts it on a bad footing in detecting problems stemming from a lack of enforceable property and contract law in countries like Greece, some central european transition countries and many developing countries (in which in many cases, also lack taxing power due to generally weak and unreliable state institutions). Ownership Economics (Heinsohn&Stegier 2013) has shed some light on partial aspects of Private Law and their constitutive function for the credit and financial system. But it has largely taken for granted and left implicit the state and public law and the contradictory interplay between both types of law in constituting the financial system.

One of the consequences of this paradigmatic confusion is that the heterodox field is unable to provide a comprehensive, convincing *policy* alternative to current practice, which has prompted national governments – especially in europe - to return to “business as usual” after a brief initial phase of post-2008 keynesian “firefighter style” activism on the G20 level, with international cooperation again deteriorating, international tensions mounting and another crisis building and lingering just around the corner (Temin & Vines 2013). Rebuilding the partially burned house with at least temporarily more fireproof material has not even been seriously considered yet.

## **B) The Eurozone Crisis: macroeconomic and institutional aspects**

The crisis of the eurozone poses additional *institutional* challenges both orthodoxy and heterodoxy are ill-equipped to systematically detect, assess and address. While the heterodoxy is clearly superior in explaining financial crises and deflationary depressions, it typically overlooks and thus fails to analyse problems like unreliably enforceable property, contract and tax law in parts of the eurozone and the

lack of a central government with the capacity to apply fiscal policy to the eurozone as a whole in a differentiated way.

We find these institutional challenges at the edges of reliable state enforceable law<sup>2</sup> in the core states of the eurozone and zones where this capacity is weak or lacking: in the transition economies in eastern europe, in the southern periphery, but also in the structure of the EU and Eurozone itself, which is not (yet?) based upon state enforceable law, but on treaties of international law which are *not* enforceable by a centralized authority that is bound by law itself<sup>3</sup>.

The southern periphery is known for its unreliable legal institutions: property rights are often undocumented as cadastral land registries are lacking, contracts are often unenforceable due to lack of documented property rights and unreliable state legal institutions, the rate of tax evasion is high, and government officials are often recruited on the basis of personal kinship networks (Fukuyama 2014, Chap. 6-7)<sup>4</sup>.

Such problems are typically only addressed, if at all, by neoclassical institutional economists. But they typically overlook that a deflationary crisis needs more expansionary fiscal and wage policy, directly stimulating productive investment by specific demand as opposed to ultra-loose monetary policy directly countered by ultra-tight fiscal policy, but first and foremost, a new cooperative policy vision for the economy as a whole that can take people out of their savings depression.

The Keynesians typically emphasize public demand but generally overlook institutional flaws and simply take functioning states and state enforceable law simply for granted. They typically do not explicitly consider in their models how a weak state and weak legal institutions change the way the credit and financial system functions under such circumstances, and which type of action strategies a

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<sup>2</sup> we use the term “law” only for formal, written social rules that are reliably enforceable by a sovereign state, following Max Weber’s definition of a state: a centralized institution claiming the legitimate monopoly of force over people within the confines of its territory. The underlying idea of the term *law* is that equality means justice (Aristotle). This is the basic principle of *private* law, that is, the law of property and contract. Thus, the idea of law is closely tied to property and contract. Thus, we do not use the term “law” for theocratic states that lack a sphere of private law, but subsume such religious orders to the concept of customary rules. We also choose *not* to use the term “law” for so-called international law, because it lacks a centralized state monopoly of force that is bound by law itself and could enforce international “law”. The international order is *de facto* not a *legal* order, but a *hegemonial* one.

<sup>3</sup> the EU is not a sovereign state with a unified capacity to act, but merely a tight confederation of states constructed on the basis of international law, as can be verified by any introductory textbook on law (Kühl&Reicholdt&Ronellenfisch 2011, 268-269; Oppermann&Classen&Nettesheim 2009, 62-63).

<sup>4</sup> one of the obvious consequences is that in Greece, for example, for lack of secure contract enforcement, credit transactions are not widespread but people resort to cash purchases in the majority of their transactions – a phenomenon typical in social contexts where contract law is not reliably enforceable.

weak legal system provokes: reverting to direct, personal reciprocity, which viewed through the lens of a functioning enforceable legal order, appears as “corruption”; creation of bad debt that weakens bank’s balance sheets and then provoke bailout threats by big creditor banks which have to be met by creditworthy governments in order to avoid a banking crisis (Stadermann 2014) etc. But such institutional flaws simply cannot be addressed by means of purely economic policy alone, no matter if it is harsh deflationary austerity or inflationary government spending for a New Deal. Both schools of economics, orthodox and heterodox, fail to see that serious state and institution building is what is needed here (Fukuyama 2011, 2014), which takes – among other things – legal know-how and an ability for intercultural communication (Knieper 2006, 2009).

From our perspective, the fundamental institutional construction blunder of the eurozone was to put the monetary union (and in effect giving up flexible exchange rates) *before establishing a legal union* and a federal state. Only a federal state with unified action capacity would have established the necessary shared legal foundations of all member states needed for a working currency union. To give two prominent historical examples: the Confederation of the 13 North American Colonies formed the United States of America with the constitution of 1787, with a central bank following in 1791; the German Confederation formed the German Reich in 1871, with the Reichsbank following only in 1876.

Besides a harmonized legal system with comparable levels of enforceability of legal rights and obligations, a currency union needs some kind of mechanism of “surplus recycling” between economically strong and economically weak confederated states of the union that can be reliably enforced by the central federal state. An example of such a mechanism would be the equalization payments system between the Bundesländer (federated states) in Germany, Article 107, Paragraph 2, Sentence 1 of the German Grundgesetz (Constitution). It includes those federated states that joined the Federal Republic of Germany – and thus, a currency union with fixed exchange rates - in 1990. This currency union avoided problems like those of the eurozone between the core and the southern periphery in the long run because the newly joined federated states joined not only the currency union and adopted the D-Mark, but also joined the area of application of the *Grundgesetz* and Legal System of the Federal Republic of Germany in general, including its private law (*Bürgerliches Gesetzbuch*, the German civil code). Even so, the union was and is difficult enough, but at least it has remained manageable. The challenge within the eurozone and the EU is a much bigger one, as the cultural differences are much wider than they were between the Federal Republic of Germany and the formerly socialist eastern part.

The EU lacks the institutions and the unified action capacity to provide such legal harmonization and a surplus recycling mechanism in a legally institutionalized, democratically legitimated way: since the

Eurozone is not a state but instead, a loose confederation with a hegemonic order in which sovereignty is partially given to the center but in the last instance, remains with the national member states of the Union, it is the hegemon who would have to provide such a mechanism.

As we have witnessed over the past few years, though, the hegemon – Germany – is caught up in macroeconomic fallacies of composition and a macroeconomic policy that serves not to unite, but to divide the eurozone by pro-cyclical fiscal austerity and wage moderation in a deflationary situation that is compensated for by beggar thy neighbor “export surplus imperialism”, systematically violating German macroeconomic legislation which prescribes external balance, growth and full employment as well as monetary stability as goals for responsible macroeconomic policy.

The current EU and Eurozone arrangements consist of treaties of international “law”. International law, however, is not effective law simply because it lacks a central attribute of effective state law: enforceability by a centralized monopoly of force that is bound by law itself. Neither the EU nor the Eurozone are states (Oppermann/Classen/Nettesheim 2009, 62-63). And, as legal anthropologist E. Adamson Hoebel succinctly put what can be found in virtually any introductory textbook on law (cf. Braun 2007, 323-332),

*“International (public, WT) Law, so-called, is but primitive law on the world level.” (Hoebel 1954, 331)*

In effect, the EU – just like the global order - remains a *hegemonial* order in which the strongest state tends to assert its particular interests, and within the eurozone, this is clearly Germany which is in the process of severely endangering the union<sup>5</sup>.

Moreover, both private contract law and tax law in large parts of the southern periphery is not reliably enforceable (Fukuyama 2014, Chap. 6-7), with a much wider gap between written law and lived law than in the northern core of the eurozone, which under normal circumstances (without the euro) would lead to a highly inflationary currency.

A reason for this misguided construction may have been that the economists responsible for advising politicians on the construction of the eurozone used orthodox and heterodox theoretical models that lack any kind of systematic and realistic state and legal foundations that would be connected to the

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<sup>5</sup> There is also the possibility of a hegemon acting benevolently in his own interest, but that presupposes macroeconomic insight and an astute assessment of the situation. To help with that at least a little bit, on the basic level of conceptual tool building for an analysis that captures the essence of the problems, is part of the purpose of our work.

micro-and macroeconomic aspects of the credit and financial system. They also for the most part lack systematic comparative reference to essential episodes of the history of ancient and modern capitalist republics, such as state formation, development of confederations into federal states, and major deflationary depressions induced by financial crises, such as the ones of 1857 and highly inflationary situations as well. At least, Post-Keynesians are still aware of the great depression of the 1930s and of some of the learning that resulted from it<sup>6</sup>, which in mainstream economics, has been marginalized in mainstream economics by the generation of economists born after 1945 (who, contrary to the generation of its professors, did not experience the great depression personally).

The construction of the eurozone is at least partially flawed economic theory put into practice just as much as the failed post-socialist “shock therapy” was theoretically misguided by ignoring the necessity of establishing the legal foundations of capitalism as a first step of a successful transformation (Knieper 2006, 2009; Woodruff 1999). This was done in the name of the so-called “Washington Consensus” – a strategy that cost many russians years of their lives (Eberstadt 2005). It should not come as a surprise that economic theories that lack an explicit understanding of the legal foundations of capitalism typically fail in guiding the attempt to successfully *establish* capitalism. But this is one of the major problems Europe is facing today – not just in parts of the southern periphery, but also further “south of the border” (“development aid”).

Current economics (the shortcomings of which are pervasive in public discourse as well) that lacks an explicit understanding of the legal system underlying capitalism and a historical perspective on its origin seems to represent a *deterioration* compared to the Political Economy of the 19<sup>th</sup> century. The currency union of the German Reich had used as its guide the german historical school of economics (see, for example, List 1941), which today is largely forgotten (Chang 2006). China, however, used it to guide their gradual transformation from socialism to capitalism, which proved a much more successful strategy than the “shock therapy” Russia was hit with.

This mental confusion – which from our point of view is partially a result of analytical failure, partially a result of power struggles in society - is at the very heart of the economic problems europe is facing today in both the western and the eastern part<sup>7</sup>: the Eurozone, the EU as a non-state, and transformation in the post-socialist states of eastern europe:

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<sup>6</sup> It may even be that their approval of the monetary union on the basis of a central bank with no corresponding treasury was partially inspired by Keynes' plan for an international clearing union he proposed at the 1944 Bretton Woods Conference. But could such an institution really work reliably without a corresponding law enforcing institution on the same level?

<sup>7</sup> I will not even *begin* to talk about family, demography and migration patterns here, as appropriate historical analogies would be found not so much in the 19<sup>th</sup> century as for state building or in the 1930s for a major financial crisis, but rather, in late antiquity. (Heinsohn & Knieper & Steiger 1979)

*“ ... there was a very deep intellectual incoherence at the core of the Eurozone's reaction to the crisis.” (Woodruff 2014)*

We need to replace this confusion with clarity. We need a realistic and comprehensive theory of Political Economy, starting from the legal and institutional foundations of capitalism. A major step towards clarity can be taken by systematically providing Post Keynesian monetary macroeconomics with such a foundation, integrating the field and providing it with realistic analytical tools that highlight the essential links between the legal and financial system in private, public and constitutional law. This will also allow for a better understanding and cooperation between lawyers and economists in devising a sensible strategy for macroeconomic policy and institutional development of the eurozone.

There is no question that a vision and a new regime of economic policy is needed, within states and on the international level. The depression is not just a metaphor, but a phenomenon of social psychology of a deflationary crisis, and of a major change in the general regime of political regulation and social power constellations. At present, there is still search for orientation. Once this can be provided, a new vision can be developed, using comparative historical research as an inspiration as well. We cannot offer a complete and coherent strategy yet, but we are working towards it. And we hope to contribute essential clarifications that will support the process of developing a coherent analysis and strategy.

There are a number of predecessors to a legal approach to political economy. We name Sir Henry Dunning MacLeod, John R. Commons, and Gunnar Heinsohn and Otto Steiger. Most recently, Katharina Pistor (2013) and Geoff Hodgson and colleagues (Deakin et. al. 2015) have taken up the task with their project of developing a Legal Theory of Finance and Legal Institutionalism. We support these new approaches and would like to make a small contribution to that debate.

### **C) Summary**

The Eurozone suffers from a combination of misguided, deflationary macroeconomic policy based upon fallacies of composition and institutional failures in private law and public law in the southern periphery, and of a lack of genuine state law at the eurozone level. In effect, it is a currency union without a reliably enforceable surplus recycling mechanism. There are zones of “non-law” and “weak law” (in the sense of state enforceable law) in the southern periphery and in Brussels, as well as around the ECB (the most powerful central bank in the world since it does *not* have a corresponding

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state and treasury) that would have to be addressed either by state and institution building *coupled* with fiscal expansion for a new deal or by disbanding the union. The latter would give international markets a lever over particularized political regulation capabilities of the european nation states.

Post-Keynesian monetary economics are better equipped than orthodox neoclassical economics to explain and address financial crises and deflationary depressions. But they lack a systematic legal and institutional foundation which precludes detecting and addressing the institutional problems within the eurozone, as well as successful applications in development economics. A systematic legal and institutional foundation could not only help to create a unifying paradigm for these models. It could also enable them to see that for the EU and many so-called developing countries, some problems require not only macroeconomic policy change and a sensible strategy to balance international trade, but also *state building* (Fukuyama 2004, 2011, 2014). And it would enable Post-Keynesian economists to systematically adress these institutional problems in cooperation with lawyers, who still typically lack a macroeconomic understanding of the financial system.

We hold that rather than constructing a completely “new paradigm”, systematically reconstructing fundamental *legal foundations* of capitalism and modern european states which are well known to lawyers but have not been taken into account systematically by economists is needed as a first step. The systematic connection to the existing tradition of postkeynesian monetary economics can then be made via accounting, starting by clarifying that accounting for assets and liabilities is really accounting for *legally enforceable rights and obligations in terms of a “monetary” unit of account* (MacLeod 1893, Commons 1934, Heinsohn&Steiger 2013, Deakin et.al. 2015). This theoretical paradigm then will have to be backed up by a comparative look at the history of modern european states and capitalisms from the standpoint of state and legal history in connection to financial history (as recently attempted anew for the state – but with a lack of focus on the law-credit-money-connex - by Fukuyama 2011, 2014)<sup>8</sup>.

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<sup>8</sup> The remaining obstacles to implementing such a solution in Europe’s current situation will still be enormous, as in times of a deflationary crisis, international cooperation is the thing that is needed the most, but also gets thrown out the window the quickest. Deflationary depressions intensify international paradoxes of competition that are structured analogous to a “prisoner’s dilemma”, so conflicts tend to intensify and undermine cooperation.

Nevertheless, the attempt at developing the necessary insight must be made first on a theoretical level, followed up by developing a specific alternative policy strategy on that basis, so at least the mental confusion can be cut through an a more rational discussion of the situation becomes even possible.

## II. Paradigm: New European Political Economics. The Private-Public Law Dialectic and Constitutional Law as Legal Foundations for Accounting based Monetary Macroeconomics

### A) Paradigm Structure

Essentially, the paradigm we will suggest includes - in its current, incipient stage of development - 4 „layers“ or levels of abstraction / description. The *first*, most essential layer is made up of the legal foundations of capitalism in private and public law – the “bare bones” and core dialectic of the “anatomy” of western civilization<sup>9</sup>. Constitutional Law as an (optional, historically relative) mediating set of legal concepts constraining centralized state power will be added, including Popular Sovereignty, Rule of Law and horizontal and vertical division of power<sup>10</sup>. The idea of law – “equality is justice, so people should be equal before the law” – is a foundational idea of european civilization. So is the idea of the rule of law. Both were first developed in ancient greece. We simply have to remember them, and describe precisely how specifically they have been institutionalized. We will then embed this description in a comparative context with (both pre- and inter-state) non-law, in order to be able to explicitly and systematically address problems of understanding the historical origins of capitalism, state-building and economic development.

The *second* layer is made up of basic micro and macro accounting, and the mechanics of balances involved (Stützel 1978, 1979), which we systematically and explicitly reconnect to layer 1 – to the legal distinctions and law-enforcing institutions accounting is empirically based upon and was, in fact, developed for. When people do accounting, they are *accounting for legally enforceable rights and obligations*. It is only the legal enforceability by a central institution that makes rights and obligations systematically accountable for, since debtors can be *held* accountable by force. Monetary wealth or “value” is a bundle of rights and obligations made comparable and accountable for by a unit of

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<sup>9</sup> we deliberately borrow Marx’ well-known analogy here. Marx, on the grounds of his “materialist” fallcy which he had adopted in his critique of Hegel’s philosophy as early as 1843, completely missed the significance of the legal system for accounting, monetary value, credit and the financial system and thus never was able to coherently explain business cycles and financial crises. His final dogmatization of the “theorem” can be found in his Introduction to his 1859 “A Contribution to the Critique of Political Economy” (Marx 1859).

<sup>10</sup> the foundational, most important form of division of course being the division between private and public law, which is based upon the concepts of property, freedom (of contract) and equality (before the law) as core “anti-state” concepts of private law.

account (called “money” of account)<sup>11</sup>. Individual balance sheets are connected by means of monetary claims and obligations.

Up to this point, we can concentrate on model-building using logical statements and abstract from human intentionality and action because the law itself is based upon logical structures, and mechanics of balances is built upon the logic of accounting identities. This basic legal and accounting structure represents the foundation not just of our paradigm, but the paradigmatic structure of legal premises – the legal “cage” (to borrow a metaphor from Max Weber) – for the everyday experience and action of “free” citizens.

Contrary to neoclassical economists, however, we are aware, that the “logical” systems of law and accounting which form the core of our paradigm for Political Economics do not stand on its own as “a priori” concepts that are valid at all times for all types of human communities. They are of course themselves products of history and culturally and historically specific forms of social relations, that is, they were invented by intentionally acting persons socially organizing themselves in some form of cooperative collectives, acting in and reacting to specific historical situations. Our approach is not universalist. We clearly see the cultural and historical relativity and specificity of the abstract, general legal and accounting categories that dominate european civilization.

We are not asking whether theories in the social sciences can be general theories of human nature (or indeed even encompassing non-human animals and inanimate complex systems) or whether they have to pay attention to the details of concrete circumstances such as history, geography, culture, institutional set up and so on. Posing the question this way would already presuppose that this is an either/or choice, which it is not. Rather, we distinguish different levels of generality and accept the responsibility to specify for each statement its appropriate level of generality and applicability. The process of research is one of constantly generating generalized hypotheses by empirical investigation, followed by an intentional search for counterexamples which then force to modify the initial generalization and form new hypotheses: a method of constantly comparing new observations with already existing theories in order to modify, specify and refine the theories. Our focus for *political economics*, however, is on generalizations that are applicable to capitalist republics. And the most characteristic type of such generalizations are to be found in capitalism’s legal institutions, which are based upon the principle of universal equality before the law, thus generating abstract legal rules by definition.

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<sup>11</sup> both existing theories of value, classical economics’ labour theory and neoclassical economics’ marginal utility theory, entirely miss this. They are not theorizing about value as accounted for in business (Commons 1934, Chap. IX and Nitzan&Bichler 2009).

Legal institutions are, of course, instruments of power and themselves subject to change through power constellations. Our foundational overall concept is conflict, clearly demonstrating that we are using a fundamentally dialectic and historical approach. Our approach with its focus on law and intentional action in historically specific situations is clearly not *materialist*, however<sup>12</sup>. Conflict plays out in human social actions in different ways. One type of games that are being played in that arena are power games. One set of historically developed institutional rules for such power games are the European legal system of private law, public law and constitutional law.

The *third* layer of our paradigm then adds *intentional human actors* – legal persons who act in their dual role as businesspersons (bourgeois) and political subjects (citoyen). The institutions of law and the accounting identities implied in contractual relations form the social premises for individual actions directed at fulfilling fundamental human needs according to the rules prescribed by the legal “cage” of freedom (private law) within a state (public law). Free Citizens then have to plan their actions within the confines of the institutionally prescribed “rules of the game” and develop strategies to play and “win” the game they choose to play within the given system of socially prescribed legal rules.

Thus, within this layer, we introduce business strategies, including strategies of valuing property rights (“real assets”) in light of an unknown future, and strategies of estimating discounts for claims if they are to be sold before maturity<sup>13</sup>, covering the theories of value and of interest. On this level, the basic form of the inherent instability of private credit and a state’s capacity for choosing between anti-cyclical and pro-cyclical fiscal policy is illuminated. We also include basic *political* strategies citizens typically use to improve their net wealth and to deal with the dialectic of equality (Braun 2007, 75-81) vis a vis the rest of society by way of controlling the state via legislation. This involves organizing themselves into associations doing lobbying work and influencing public discourse by way of political rhetoric, using economic “theories” as rhetorical weapons to achieve their political goals and to legitimate their special interests as being in the “general/public interest”. Citizens do this in order to mobilize voter majorities for their partial goals so they can use the power of the state in addition to private business strategies in order to achieve them. These strategies are grounded in the legal institutional structure of capitalism itself and help to explain some distortions and biases in economic

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<sup>12</sup> from our point of view, it was Marx’ early decision for “materialism”, connected to regarding the sphere of law as a mere appendix (“superstructure”) to the “sphere of material production” that eventually led him to completely miss the significance of the legal system for capitalism. This also precluded him from understanding the law-accounting-credit-finance connection. For Marx’ original description of this “materialist” dogma, see Marx (1859).

<sup>13</sup> This includes a discussion of both existing theories of value, the labour theory and the marginal utility theory of value, both of which are incapable of illuminating the strategies businesspeople actually use to determine the value of their assets (for a detailed critique, see Nitzan&Bichler 2009).

theories, as well as the changes of fashion and dominance of different theories in economics independently of how realistic their explanations may be.

Once these three basic levels are laid out, the basic framework of our paradigm is complete and can now be applied to re-interpreting existing economic theories, to analyzing current economic problems and to help to illuminate certain episodes of the history of western civilization. First candidate for re-interpretation is the tradition of heterodox Post-Keynesian monetary economics, which is basically toothless on a paradigmatic level (see quotes above), but far superior to neoclassical economics in explaining financial crises and business cycles (which has obvious applications to analyzing the post-2008 world).

Consequently, the *fourth level* of specification then introduces credit, money and the banking and financial system. Its basic workings can be understood by showing how it historically developed from merchants solving practical problems they encountered as legal subjects in their property- and contract-based transactions (Heinsohn 1984). On this level, we can integrate and re-interpret some of the most developed approaches to monetary economics in existence today, Perry Mehrling's money view (Mehrling 2011, 2012), Godley & Lavoie's stock-flow consistent models (Godley&Lavoie 2007), Randall Wray's modern monetary theory (Wray 2012), and Heinsohn & Steiger's "Ownership Economics" (Heinsohn & Steiger 2013). We will also take a more detailed look at free citizen's typical business and political strategies, and introduce the distinctive category of citizen that is unique to *modern* capitalism and responsible for its dynamics both in its rise and its fall: the free wage labourer, his specific role for modern technical progress, his organization by worker's unions and parties, his family structure and its fate in modern capitalism.

The *fifth level* looks at macroeconomics from a standpoint of large scale social interest groups, illuminating collective strategies free citizens develop to further their interests in their roles as *citoyen* (partial sovereigns). Long cycles of power constellations within patterns of class struggles come into view, with corresponding regimes of economic policy and patterns of sectoral balances, serving the interests of different groups of the population. On this level, we will re-interpret Schulmeister's theory of Long Cycles (which takes the law for granted just as much as othe post-keynesian approaches) from the perspective of our legally grounded paradigm (Schulmeister 2010, 2013, 2014a).

To summarize, then, the three basic levels of description of our paradigm are:

1. Law (private, public, constitutional) and the state, in contrast to non-law
2. Basic micro and macro accounting for legally enforceable rights and obligations, mechanics of balances and aggregation paradoxes

3. Intentional actors: legal persons in their roles as *bourgeois* (subjects of private law) and *citoyen* (subjects of public law)

The next levels of development include

4. Money and Banking; wage labour.
5. Long Waves: patterns of sectoral balances, large scale interest group conflict, and regimes of economic policy / regulation

In this paper, for limited space we will only introduce the first three layers.

## **B) Theory and History**

What is the relationship of our theoretical paradigm to history? From our point of view, all meaningful social science research is comparative and historical research in the sense that we are attempting to understand patterns of collective human action within the context of social institutions, which are themselves products of foregoing collective action and can be changed through future collective action. The legal institutional system of capitalism is a result of history itself, that is, a result of humans intentionally “creating stories” within social networks of kinship, state and contract relations which, taken together, form history (*hi-story*). Every legal or accounting category we discuss and use has a history that can (and should) be traced.

The main reason we do need an *abstract, formal* theory to describe the foundational structures and processes of western civilization / capitalism as well as historical research is that this civilization is in itself based upon a “theoretical” abstraction which forms the central concept of the idea of *law*: the culturally and historically relative idea of *equality before the law*, which is right at the heart of private (property and contract) law. It represents one of the core tenets of “natural law” and human rights and, besides freedom (first and foremost, of contract) one of the core values of european civilization ever since classical antiquity. It implies that the law has to treat all subjects the same way, regardless of their actual differences in social status, age, health, personality, situation etc<sup>14</sup>. In order to do this, it needs to abstract from all specificity of persons and their specific social, historical and biographical situative context, and instead treat them as abstract legal persons. The core proposition, “justice = equality” (Aristotle) necessitates laws being general, abstract statements, either explicitly (as in codified systems of continental law, which focus on abstraction and subsumption as core parts of their

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<sup>14</sup> an ideal which by way of the dialectic of equality (Braun 2007, 75-81) provokes further legislation – an essential aspect of the dialectic of law we cannot go into in detail in this paper.

method) or partially explicitly and partially implicitly (as within the common law family, which focuses on analogy as core method of reasoning)<sup>15</sup>.

We thus need to start with a general theory because the law itself places subjects into an institutional “iron cage” (Max Weber) of abstract legal rules it enforces by way of the state monopoly of force. To start with the abstractions of law and accounting for legally enforceable rights and obligations in terms of an abstract “monetary” unit of account (assets and liabilities) thus is the obvious starting place for political economics. Nevertheless, the generalities of law and money, regardless of the general applicability they claim in the form of human rights / natural law and universalist economics, are social rules culturally and historically specific to (antique and modern) European civilization. They are not “natural” – their historical origins can and should be traced, and the history of their development can be written and told. Many historians and anthropologists of law have attempted to do that (cf. Wesel 1985, 2006), and we rely on their work of cross-cultural comparison and historical reconstruction.

We then describe the general patterns of action this institutional structure provokes in free and equal citizens, and use the resulting “theory” as a lens through which to look at specific historical situations, their pre-history, structure and development.

This is not to say that in doing historical or ethnographic research we cannot generalize and eternally remain confined to so-called “thick descriptions” (Clifford Geertz) of supposedly singular, arbitrary and basically random stories, resembling no more than ODTAA – “one damn thing after another” (Fukuyama 2011, 33). Like any other type of research and any kind of perception in general, historical research is basically *comparative* in nature. Just like there are the disciplines of comparative linguistics, comparative mythology, comparative religion, comparative law, comparative anatomy, comparative zoology or comparative anthropology, historical research can and should be done in a methodically comparative manner if one is interested in systematically discovering historical *patterns* of varying levels of generality by way of drawing historical analogies. History *does* repeat – but, like good music, it never repeats without variations. There is a dialectic of sameness and difference at work here, and the term “variation” implies both<sup>16</sup>.

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<sup>15</sup> Both abstraction/subsumption and analogical reasoning are part of an integrated cognitive process. They simply verbally highlight different aspects of that integrated process, which always includes “lateral” analogical mappings and general/specific “top down” mappings and “blends” as well (Fauconnier/Turner 2002). While common law practice focuses on analogy as the primary method, it cannot do with (albeit less explicit) general statements altogether; and as much as continental law practice focuses on abstraction and subsumption as a methodical ideal, it cannot do without comparing cases to precedent cases by way of analogy, especially when it comes to the process of developing new legislation (Kischel 2015, .

<sup>16</sup> some of the epistemological background for this approach came from Marx (1867), my teacher Klaus Holzkamp (1985, 1993), Gregory Bateson (1979, 1987), Arthur Koestler (1964), Mark Turner (1996), Gilles Fauconnier and Mark Turner (2002), George Lakoff and Mark

Depending on *what specifically* we choose to compare for which specific purpose, we will get different levels of generality of descriptions<sup>17</sup> useful for the aspects of “reality” we wish to explore, understand and ultimately, change. An important strategy is striving for balancing out details and generality by zooming in and out, each time drawing new comparisons at different levels, focusing on picking up new distinctions, and then placing them in the context of a picture of the whole while zooming back out. Again, there is a dialectic at work here, this time between details or parts and the whole, between singular specifics and shared generalities at various levels of description.

We will introduce the categories making up our paradigm for political economy in a systematic, not historical sequence, even though we are well aware that each category has a history. We plan to include overviews of the history of core categories, such as the state, property and freedom of contract, basic credit instruments, accounting methods (and specifically double-entry bookkeeping), banking, wage labour, central banking etc. at decisive steps in developing the categories systematically, taking again inspiration from Marx’ methodical approach. Such a detailed presentation is out of the scope of this paper, however, which can only attempt to provide an overview of the overall structure of the first two levels of our proposed paradigm. We concentrate on these basic levels because we feel they are the most neglected fundamental structures by monetary economists today, but could help the most to provide the integrating paradigm post-keynesian monetary economics are lacking so far.

### **C) Legal Foundations for Political Economics**

In the following section, we will give a brief and very general map of the basic legal structure of modern european capitalism in comparison with customary non-legal orders on a pre-state and inter-state level. We provide sources for further detail from the disciplines of the social sciences we draw upon: continental law, legal anthropology and – history, history of the state and comparative law.

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Turner (1989), Mark Turner (1996) and Anselm Strauss’ Grounded Theory, which in its incipient stage he aptly called a “constant comparative method”. And last but not least, from Lenny Bernstein (1976). For Marx’ outline of his methodical approach, see his Introduction to the *Grundrisse*, his 1859 rough draft of his “Critique of Political Economy” (available online at <https://www.marxists.org/archive/marx/works/1857/grundrisse/ch01.htm>).

<sup>17</sup> Marx was – as a result of having studied Hegel - clearly aware of this and made use of a comparative strategy of research and concept formation. Compare his notes on Method in the *Grundrisse* (“Einleitung zur Kritik der Politischen Ökonomie”). Recently, Fukuyama has followed a similar approach in trying to understand the problem of state building by way of comparative historical analysis (Fukuyama 2011, 2014), which we see as a very useful effort. Unfortunately, today’s collection of widely use social scientific methods is often rather confused and lacking an understanding of basic epistemological categories like comparison, identity, difference, analogy, blending, metaphor, etc. One approach that exhibits awareness of the basically comparative character of *any* type of research (measurement is a form of comparison as well) is Glaser/Strauss’ “Grounded Theory” (which Strauss aptly used to call “constant comparative method” in an early phase of development).

We will then introduce the fundamental principles of private (property and contract) law and public law in context to a standard instrument in financial accounting - balance sheets, which will function as the systematic connection between the sphere of law and the spheres of business (individual balance sheets) and macroeconomics (described as a system of interconnected aggregated balance sheets).

We will describe the contradictory relationship between private and public law which we term the private-public-law dialectic. This inescapable conflict is at the very heart of the legal construction of capitalist republics. We will then introduce basic principles of constitutional law as an attempt to mediate the private-public-law dialectic by essentially subordinating public law to the will of the free citizens themselves, constraining centralized state authority without eliminating it.

**Comparative Overview: A Typology of Forms of Social Relations**

The following table provides an overview of the set of basic distinctions we use to map out the basic legal structure of capitalism in a comparative context with other, non-legal forms of social relations<sup>18</sup>:

<b><u>P</u>restate</b>			<b>State Centralized Authority</b>				<b><u>I</u>nterstate</b>
<b>Reciprocity informal/oral</b>			<b>Religion Theocracy</b>	<b>Rule of Law Republic ← Dialectic →</b>			<b>Reciprocity International Public "Law" <u>EU-"Law"</u></b>
Positive	Balanced	Negative	Heavenly Order on earth Salvation	<b>Private Decentral [Freedom]</b>	<b>Constitution. [Constraints on Power]</b>	<b>Public Central [Order]</b>	Diplomacy War
Kinship	Neutrality	Foreign- ness	Dues for <b>holy</b> order & Salvation	<b>Property Rights Contract Business</b>	Citizens' government Politics	Command Dues for <b>legal</b> order <b>Taxation</b>	Hegemony Power
<b>Non-Law Custom</b>				<b>Law Europ. Civilization Political Economics</b>			<b>Non-Law</b>

This basic "map" of european law in context to non-legal forms of social relations draws on standard textbooks on continental law (Braun 2007, Kühl & Reicholdt & Ronellenfitsch 2011, Oppermann & Classen & Nettesheim 2009), comparative law (Kischel 2015), and the anthropology and history of

<sup>18</sup> notice that this is *not* a typology of "historical social formations" of "production", as in Marx' case, but rather a means of distinguishing different forms of *institutionally organizing social relationships*.

law and the state (Seagle 1941, Hoebel 1954, Wesel 2006, 2010; Fukuyama 2011, 2014). It differs from similar typologies used by Marx (1867), Polanyi (1944) or Heinsohn & Steiger (2013) mainly by providing a more precise perspective on the three different big areas of european law: private, public and constitutional.

For a summary on pre-state reciprocity in english, the best source we could find is in Fukuyamas big comparative study on the state, “Origins of Political Order”, Part I: “Before the State” (Fukuyama 2011, 3-94). We recommend that section as a highly illuminating summary of what we present in an extremely condensed form here. This paper does not allow for more detail, as we – contrary to Fukuyama – will focus on systematically connecting law and macroeconomics by way of basic accounting concepts. A more specific background on legal anthropology and -history, especially on roman law, however, is indispensable to understand our argument<sup>19</sup>.

This condensed overview we offer as an integrating perspective on law is not, of course, a description of empirical reality or historical development, but a set of distinctions – a conceptual tool of perception that creates a certain perspective by drawing attention to a set of similarities and differences while leaving others in the dark, and allows for certain sets of questions to be asked, while it precludes others. The key idea is to use the core ideas of private law – property, equality before the law, freedom to enter state enforceable contracts as the core ideas of european civilization – as the focal point for a comparative look at other forms of social relations. We use this set of distinctions as a lens and an initial orientation to look at various specific historical situations. The lens itself then has to be differentiated and corrected in the process of future comparative historical research.

It is a set of distinctions designed to be useful in developing a theory of capitalism that could be used as a guide to actually *creating* capitalism – or conversely, removing it. For such a change, no matter in which direction, it has to highlight those elements of capitalism that are specific to it and have to be put in place in order to create or remove this type of social order. Our set of distinctions simplifies a great deal and indeed, too much – but it definitely simplifies less than the universalist approach of conventional economics, which is not useful as a guide to transformation. It is subject to constant modification if necessary, and of course, there are countless variations of the basic themes described here. None of these forms of social relations are exclusive. Rather, there usually will be an overlay of different types of relationships in any specific historical situation. We are all part of families and in that role, embedded in kinship relations of positive reciprocity. Some of us are churchgoers and thus, part of some religious community. Finally those of us who live in western europe are also citizens,

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<sup>19</sup> For law, we have used the textbooks on continental law and comparative law given above. We will give references to introductory literature about continental law and international law in english in the final draft.

and as such, subjects of private law doing business (even if only as consumers) and subjects of public and constitutional law doing politics (even if all we do to take part in governing by legislation is watching the news and voting once every 4 years). Only kinship relations can stand on their own, without being superimposed by any of the others (as in hunter and gatherer or segmentary communities).

### ***Reciprocity***

Where no state exists, people have to rely on informal, non-state-enforceable mutual relations of exchange. We all are familiar with the basic forms of such exchange, which is based upon kinship solidarity. Within families and extended families, people have to support one another. Legal and economic anthropologists have studied such relations of exchange in stateless communities and found surprisingly similar patterns in most of them.

We cannot possibly summarize the findings of legal anthropologists here, nor can we give a history of anthropology and cross-cultural studies, a tradition that has existed for about 150 years now. All we can do here is to give you an inkling on the differences of pre-legal and pre-state forms of social relations (that in one way or another, we are all familiar with to some degree from our own biographies) by citing a few secondary sources who have attempted to summarize the tradition of legal and economic anthropology, and provide some hints for further reading. We want to encourage you to explore and read up on that tradition, as it will provide a comparative *empirical* context and contrast which not only allows for a clearer view of the historical and cultural specificity of property rights and the legal system of private contract law built on them; it will also enable you to see more clearly the problems and conflicts involved in trying to *create* a “modern society” in the first place. That is the primary problem of what is vaguely called “development” economics today. This is not a problem in “distant lands” for most of us, but it is one that Europe has to deal with directly within the EU and its neighbors.

We recommend Part I of Fukuyama’s 2011 study on “Origins of Political Order” as a useful starting place to become familiar with the tradition of cross-cultural, anthropological studies of stateless communities.

To provide some initial hints, Marshall Sahlins has developed a typology for such relations, distinguishing three types of reciprocity: generalized, balanced and negative reciprocity. Legal Historian and –Anthropologist Uwe Wesel has adopted this classification, substituting the term “positive reciprocity” for Sahlins’ “generalized” reciprocity:

*"Positive Reciprocity is based on solidarity, friendship and close kinship. A gift does not necessarily have to be reciprocated immediately, and not always to the same extent. If there is no reciprocation, the relationship is maintained further for a long time. An extreme example would be the sucking child, which will reciprocate his mother's help only much later, and possibly not at all." (Wesel 2007, 24), my translation)*

In contrast to property and freedom based societies (business societies), Francis Fukuyama notes in his summary of anthropological studies that

*"Many of the moral rules in this type of society are not directed against individuals who steal other people's property but rather against those who refuse to share food and other necessities." (Fukuyama 2011, 54)*

It's not "all sweetness and light" in "good old primitive communism", however besides blood feuds within such communities, in confronting other "foreign" communities and strangers, reciprocity often is practiced negatively:

*Negative reciprocity represents the opposite extreme. It is completely impersonal. In early communities, there was trading as well, long-distance trading with "alien" strangers. With them, it is morally okay to bargain and haggle. It is even allowed to deceive them. Both of these would be unthinkable within the solidarity of a small community. It is even allowed to steal from strangers. An extreme example would be robbery. " (Wesel 2006, 24-25, my translation)*

### ***The Law and the Non-Law***

We choose to use a fairly narrow definition of "law", reserving the term for secular written social rules that can be enforced by a centralized state holding the legitimate monopoly of force within the confines of its territory. Since the term "law" implies generality and presupposes equality before the law, we reserve it to a social order that contains some form of private (property and contract) law; we connect it to the idea of the "rule of law", which means that any form of personal rule, be it an enlightened monarch or a democratically elected government) is to be constrained by the law.

This means that we do not classify a primarily religious order such as islamic sharia as law, but rather as a customary order. Social orders lacking a centralized authority we describe as customary rule

based systems<sup>20</sup>. This classification does *not* imply any normative judgement. A customary social order can be just as legitimate (or, depending on historical circumstances, illegitimate) to its members as a law based order.

The relationship of pre-state non-law and law has been summed up by legal historian Uwe Wesel as follows.

*"Law emerges together with centralized authority during transition from segmentary to early state-level societies. Custom and Law are not, as Henry Maine believed, continual forms of basically the same kind of rules that could be seen as developing in an evolutionary sequence from custom via customary law to Law. They are contradicting opposites. Not only do they differ in enforceability, but also by fundamental conditions and content. Law does not evolve the customs of the old order, it destroys them and creates a new order. Law ... emerges, subordinates, absorbs and finally destroys the old order of custom, expands to dominate more and more realms of social order and can determine the entire lives of people, like in capitalism, which is totally dominated by law. Custom, in contrast, the old egalitarian order, is static, more or less peaceful, self-regulating, consensually striving for mediation, informal settlement and compromise, not just by consent of two parties, but based on the consent of the entire community. Law, by contrast, is the subordination and destruction of custom by centralized authority ... the history of law is the history of centralized state authority, of*

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<sup>20</sup> Another, more common way of drawing the line between custom and law would be to define law as state-enforceable rules in general. This definition of law then would include state-based, religious rule systems such as sharia in the term law. To delineate the differences between religious and secular law, then, the term law would have to be specified: religion-based legal orders vs. secular, european style legal orders based upon property rights and freedom of contract.

*developing inequality and of the destruction of a customary, egalitarian and free order."*  
(Wesel 1979, 233-252, my translation)<sup>21</sup>

On the other hand, if state and law are weak or non-existent, either because they have not been built up successfully in the first place or because they have deteriorated, people typically resort to pre-state forms of organizing social relationships, as Francis Fukuyama notes as a central result of his big, cross-cultural comparative historical study on the origin and development of the state. Realizing that informal reciprocity based upon kinship is a default mode of human behaviour, Fukuyama notes that

*"To behave differently – to choose, for example, a highly qualified employee over a friend or relative, or to work in an impersonal bureaucracy – is a socially constructed behavior that runs counter to our natural inclinations. It is only with the development of political institutions like the modern state that humans begin to organize themselves and learn to cooperate in a manner that transcends friends and family. When such institutions break down, we revert to patronage and nepotism as a default form of sociability." (Fukuyama 2014, 88-89)*

Such a breakdown was the case, for example, in post-socialist Russia during the so-called “shock therapy” years of the 1990s Jelzin era. Russians and East Europeans had to deal with a situation which anthropologist Caroline Humphreys experienced and described as one where

*“ ... there is widespread uncertainty about government and law at “higher” levels of the body politic; (...) it is not possible to rely on the law, or even know what it is ... and at the same time government, which used to regulate flows of goods and allocation of labour – including decrees by Soviets and plan-orders by Ministries – has ceased to be universally or even generally obeyed. The social structures which are ... toughening themselves are in*

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<sup>21</sup> orig. "Recht entsteht mit Herrschaft am Übergang von segmentären zu kephalen Gesellschaften. Gewohnheit und Recht sind nicht, wie Henry Maine meinte, kontinuierliche Formen, von im übrigen inhaltsgleichen Regeln, also in einer Reihe zu sehen als Entwicklung von custom über customary law zu law. Sie sind Gegensätze. Sie haben nicht nur verschiedene Geltungskraft, sondern auch verschiedene Grundlage, Bedingungen und verschiedene Inhalte. Recht ist nicht die kontinuierliche Weiterentwicklung von Gewohnheiten der alten Ordnung, sondern ihre Zerstörung, die verbunden ist mit dem allmählichen Entstehen einer neuen. (...) Recht ist nicht nur ein qualitatives, es ist auch ein quantitatives Element menschlicher Existenz. Es entsteht, breitet sich aus, überlagert, absorbiert und zerstört schließlich die alte Ordnung der Gewohnheiten, erfasst ständig neue Bereiche gesellschaftlicher Ordnung und kann im Extremfall das ganze Leben der Menschen bestimmen, wie in der bürgerlichen Gesellschaft, die total verrechtlich worden ist. Custom dagegen, Gewohnheit, die alte egalitäre Ordnung, ist statisch, eher friedlich, selbstregulierend, konsensual auf Einigung gerichtet, nicht nur auf die Einigung zweier Parteien, sondern auf den kollektiven Konsens aller, Gemeinschaftlichkeit. (...) Recht dagegen ist die Überlagerung, Absorption und Zerstörung von Gewohnheit durch zentrale Herrschaft, die es zunehmend und bewußt als Instrumentarium von außen einsetzt ... . (...) Die Geschichte der Entstehung von Recht ist also auch die Entstehung von Herrschaft als zwangsausübender Macht. Sie ist die Geschichte der Kephalität, der Entstehung von Ungleichheit und der Zerstörung einer egalitären und freiheitlichen Ordnung." (Wesel, Uwe. 1979. Zur Entstehung von Recht in frühen Gesellschaften. Kritische Justiz 1979, 233-252, available online at [http://www.kj.nomos.de/fileadmin/kj/doc/1979/19793Wesel\\_S\\_233.pdf](http://www.kj.nomos.de/fileadmin/kj/doc/1979/19793Wesel_S_233.pdf) (Feb. 13, 2016))

*contradiction with the goal of a free market, even with that of a regulated but all-USSR market.” (Humphrey 1991, 8)*

In an article they wrote in the mid-1990s, Kororev and Remizov give a very specific example as to how people tend to deal with credit under circumstances where enforceable property and contract law (including enforceable liability) have not been established:

*„In concluding a credit agreement, naturally, any lender will try to additionally secure his interests by vesting himself with the right to seize material assets in the event of nonpayment or by transferring real estate or equipment to himself as security. However, the practice of attaching a debtor's property or of seizing an immovable or large movable pledge has not become very common in Russia. (...) It is... sufficient (for the debtor, WT) ... to turn credit into cash through a dummy firm, to disappear from the field of view of the bank's special services, and then to disappear from the field of view of law enforcement organs.“ (Kokorev/Remizov 1996, 49f.)*

*Corruption or nepotism* are thus terms that depict this default form of social relationship – informal reciprocity – as deviant behavior *from the (non-neutral, normative!) standpoint of state-enforced law*:

*"Patronage and clientelism are sometimes treated as if they were highly deviant forms of political behavior that exist only in developing countries due to peculiarities of those societies<sup>22</sup>. In fact, the political patronage relationship, whether involving family or friends, is one of the most basic forms of human social organization in existence. It is universal because it is natural to human beings. The big historical mystery that has to be solved is thus not why patronage exists but rather why in modern political systems it came to be outlawed and replaced by impersonal organization." (Fukuyama 2014, 88)*

We agree with Fukuyama, and note that the results of his big comparative study are in line with the results of legal anthropology and –history Wesel summarized in the quote given above. We have to conclude that there is a basic conflict between kinship based forms of social relations and state enforceable social relations that is a permanent given, and constantly plays out in different forms in the history of states:

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<sup>22</sup> from the standpoint of law, still seen by most Europeans in the (learned) tradition of European enlightenment as "natural law", which of course is highly normative and Eurocentric.

*“Once states come into being, kinship becomes an obstacle to political development, since it threatens to return political relationships to the small-scale, personal ties of tribal societies. It is therefore not enough merely to develop a state; the state must avoid retribalization or what I label repatrimonialization.” (Fukuyama 2011, 81)*

Thus, gift exchange, which we value for birthdays or Christmas but regard as nepotism in the political arena, is a constant theme in corruption research (Ledeneva 1998, 2006). Seen from the perspective sketched above, then, it is not all too surprising that within the continuum of law and non-law (reciprocity) we find “nepotism” and “corruption” to a higher degree in regions where a weak state or a pre-state confederate order predominates. Only the existence of rudimentary state and law institutions creates a perceptual lens through which previously “natural” and perfectly moral forms of social relationships – kinship based reciprocity – then appear as unethical, which is sure to create perplexity and internal conflicts of motivation for kin that are exposed to state law for the first time in their life. Dealing with this conflict, then, represents one of the core problems in trying to create institutions expected to “trigger” (or better, enforce) “economic development”.

Within Europe, the level of “corruption” and nepotism thus rises when moving from the western core states of the Union towards the southern and eastern periphery – or, for that matter, to Brussels, which hosts no state government, but the headquarters of a confederation of states that is not a state, but an organization based upon treaties of international law (the legal character of which is disputed for its lack of a central enforcing authority bound by law). But would anyone ever consider members of a tribe of Australian Aborigines who never had any contact with civilization as “corrupt” in any way?

The conflict between a kinship-based social order based upon informal reciprocity and a social order based upon law and a central law-enforcing authority is similar in structure to the conflict between the basic principle of public law (subordination, command) and private law (equality, consent) which we describe below. Yet, private law is based upon state enforceable contracts and freedom of contract, both of which do not exist in exclusively kinship based social orders. The conflict between private and public law is a conflict *within* the sphere of enforceable law. The conflict between kinship based reciprocity and state enforceable law is a conflict between non-law and law.

In light of the insights above, it does not come as a big surprise any more that a number of enlightenment thinkers have used references to kinship based structures in their criticisms of monarchic state authority. It is a well known pattern used by Rousseau, many Anarchists, Marxists (who depicted their communist utopia as a recurrence of the “original communism” of kinship-based tribal communities on a “higher plane” in which the state would wither away), and today, by quite a number of anarcho-capitalists like Milton Friedman’s son David (Friedman 1971).

Fukuyama draws an important generalizing conclusion from his detailed comparative studies of state emergence and state development, which he undertook with an eye to development economics after having collected practical experiences in the field of development consulting:

*“Political Institutions are necessary and cannot be taken for granted. A market economy and high levels of wealth don’t magically appear when you “get government out of the way”; they rest on a hidden institutional foundation of property rights, rule of law, and basic political order. A free market, a vigorous civil society, the spontaneous “wisdom of crowds” are all important components of a working democracy, but none can ultimately replace the functions of a strong, hierarchical government.” (Fukuyama 2011, 13)*

In concluding his broad inquiry into the origins, building and development of states, Fukuyama arrives at a remarkable conclusion that runs counter to many intuitive or “received wisdom” accounts of “development aid”:

*"A number of the most successful modern states were created under authoritarian conditions, often by countries facing severe national security threats. This is true of ancient China, Prussia/Germany, modern Japan, and a handful of other countries. By contrast, when democracy is introduced prior to the consolidation of a modern state, it often has the effect of weakening the quality of government. The prime example of this is the United States, which invented clientelistic party government after the opening up of the democratic franchise in the 1820s and was thereafter saddled with a patronage-riddled bureaucracy for much of the next century. This is also the story of Greece and Italy, both of which developed sophisticated clientelistic systems that impeded the growth of modern state administrations. Clientelism remains pervasive among democratic countries in the developing world and undermines the quality of governments from India and Mexico to Kenya and the Philippines.*

*And finally, the idea that public officials should be constrained by strict rules and stripped of administrative discretion runs contrary to the most common complaint about government, namely, that it is too rule bound, rigid, and lacking in common sense. (...)*

*All of this suggests that state building and democracy building are not the same thing, and in the short run they often exist in a great deal of tension with one another. There may be other routes to good government, and indeed democracy may under certain circumstances be an obstacle rather than an advantage. We need a more sophisticated theory of public administration, one that pays particular attention to the interface among state administration,*

*law, and democratic accountability." (Francis Fukuyama, Political Order & Political Decay, 2014, 508)*

John R. Commons, one of the few pioneers in a legal theory of political economics, understood very clearly that property rights and freedom of contract do not come naturally but rather presuppose a state monopoly of force. I would like to conclude this section with a beautiful quote of his in which he points out the historical relativity of natural law and human rights:

*"When the science of Political Economy began to emerge in the Eighteenth century, it fell in line with the theory, then dominant, of an original state of liberty and rationality of human beings. It was Rousseau, in his famous book The Social Contract (1762), who popularized the theory. Man was originally free but government had made him a slave. Man was also a rational being who would act according to reason if only he were free. This was the theory of the Declaration of Independence and the French Revolution. It remained the primary assumption of the classical, optimist and psychological schools. They based their theories on an absolutely free individual who knows his own interest, and, if allowed freely to act, then the sum total of all acts would be a harmony of interests.*

*These theories of liberty and rationality accomplished extraordinary results in overthrowing absolute monarchies, abolishing slavery, and establishing universal education. But it was not because they were historically true – it was because they set up ideals for the future. Historically it is more accurate to say that the bulk of mankind lived in a state of unreleasable debts, and that liberty came by gradually substituting releasable debts. And historically it is more accurate to say, as Malthus said, that man is originally a being of passion and stupidity for whom liberty and reason are a matter of the slow evolution of moral character and the discipline enforced by government.*

*With the modern development of historical research, and especially with the aid of the modern sciences of sociology, anthropology, and historical jurisprudence, it is possible to reverse the Eighteenth Century illusion of an original state of liberty and reason, and to show the actual but resisted steps by which, out of the practices and aims of subordinate classes, releasable debts became the foundation of modern capitalism. Political Economy becomes, not a science of individual liberty, but a science of the creation, negotiability, release, and scarcity of debt." (Commons 1934, 390)*

"Unreleasable debt" here refers to kinship solidarity and reciprocity which is a permanent duty and claim that ties relatives together in permanent ways, whereas "releasable debt" refers to contract

relationships in which both contract partners become free of any mutual claims and obligations once their contractual obligations have been fulfilled. A relative cannot choose which people he has duties and rights of solidarity with, he is born into that network and can never leave it, except he/she chooses intentionally to leave the network, thereby getting rid of “unreleasable” duties and (unenforceable) claims for solidarity and security. A free citizen can enter a contract with one person who is a total stranger today, and after it has been fulfilled, with another total stranger tomorrow. You can buy your lunch today at Wendy’s, and tomorrow at McDonald’s, a Greek Restaurant or at a local supermarket, and you don’t have to visit any of those ever again any time of your life, because after the obligations of the sales contract have been fulfilled, you are free towards them and they are free towards you. But could you ever say you are totally free to never contact your parents, brother or children again without feeling at least a little strange about it?

In 2011, 77 years after Commons wrote the above in 1934, and with a global economic situation that despite important differences exhibits remarkable parallels to that of the 1930s (Temin & Vines 2013, Eichengreen 2015), the similar insights are resurfacing again. Francis Fukuyama echoes Commons’ insight in almost identical words:

*“We might label this the Hobbesean fallacy: the idea that human beings were primordially individualistic, and that they entered into society at a later stage in their development only as a result of a rational calculation that social cooperation was the best way for them to achieve their individual ends. This premise of primordial individualism underpins the understanding of rights contained in the American Declaration of Independence and thus of the democratic political community that springs from it. This premise also underlies contemporary neoclassical economics, which builds its models on the assumption that human beings are rational beings who want to maximize their individual utility or incomes. But it is in fact individualism and not sociability that developed over the course of human history. That individualism seems today like a solid core of our economic and political behavior only because we have developed institutions that override our more naturally communal instincts.”*  
(Fukuyama 2011, 29)

We can conclude that a state and law based social order is in fundamental conflict with stateless, kinship based social order. We call this contradictory relationship the kinship / state dialectic. A similar dialectic exists between state law and international “law”, that we plan to inquire in more detail from a comparative historical perspective in later publications.

For further details on our basic typology of legal and non-legal forms of social relations, we refer you to the literature given at the beginning. We will now begin to introduce basic categories of private and

public law in a context of financial accounting on balance sheets, and in the process draw out explicitly that accounting for assets and liabilities is essentially accounting for state enforceable rights and obligations that were made comparable and calculable by way of a monetary unit of account.

#### **D The Law-Accounting Connection: Legal Concepts viewed from the standpoint of Accounting**

The purpose of the following section is to make explicit the connection between business accounting and the public and private legal system. This connection is sometimes clouded in physical metaphors implying a conflation of material objects and enforceable rights with respect to those objects.

Accounting is a core part of business strategy and is by now a standard basis of Post-Keynesian monetary macroeconomics as well (Godley & Lavoie 2007, Wray 2012). But monetary macroeconomics lacks a paradigmatic foundation as well as an explicit legal and institutional foundation. Both of these can be provided by systematically and explicitly reconnecting basic accounting categories to existing law.

We do this in order to make explicit and clarify the basic legal framework from which monetary theory (which is dealing with different forms of means of payment, the banking system and the state and their roles, functions and goals in money creation and –destruction) then can be re-interpreted and clarified. Quite a lot of confusion of terms in monetary theory – isolated terms such as “commodity money” or “fiat money” – result from simply not making explicit the legal aspects of monetary transactions, failing to distinguish between what Larenz (below, p. 33) calls first order objects of law (objects, ideas, etc.) and second order objects of law (rights). From the legal and accounting standpoint we will develop here, a number of seeming contradictions and confusions in monetary theory can be cleared up in a very simple, strictly empirical and uncontroversial way.

In explicitly reconnecting the terminology used in accounting to legal categories, we propose no theory of any kind, but simply use the conceptual precision of existing law. We re-apply the linguistic precision directly taken from the actual practice of lawyers and existing legal systems to basic accounting categories to explicitly draw out the empirical fact that what accountants do is to *account for state enforceable legal rights and obligations*.

What is called “monetary wealth” is a bundle of legally enforceable rights and obligations, each of which is quantified in terms of a “monetary” unit of account. Business practitioners call this quantitative aspect of rights *monetary value*. For now, it is enough to avoid the highly ambiguous term “money” and the often misleading question, “what is money?” altogether and simply work with legal categories and *one* monetary function, that is serving as a *unit of account* in which the “value” of

rights can be compared and quantitatively measured, which includes the function of a “standard of deferred payment”:

*“A money of account comes into existence along with debts, which are contracts for deferred payment, and price lists, which are offers of contracts for sale or purchase. Such debts and price lists, whether they are recorded by word of mouth or by book entry on baked bricks or paper documents, can only be expressed in terms of a money of account.” (Keynes 1930, 3)*

The unit of account is used to quantify the abstract “value” of property rights and the amount owed by way of a contractual or tax obligation in a common abstract unit that can be used for all rights and obligations in general, independent of what specific object they may refer to, and regardless of these object’s differences. The function of a unit of account is to unify rights and obligations, make different rights referring to different objects (or, in the case of trademarks, patents, or goodwill, ideas or complexes of ideas) comparable and quantifiable, thus, calculable, accountable and generally negotiable. The additional functions of “money” (means of payment, generalized means of exchange) will be introduced in the context of a precise legal framework at a later point of developing our paradigm, step by step and with specific historical examples.

### ***Property Rights***

Property rights are the owner’s right of exclusion and of sale vis a vis everyone else in society, including the state/government. But since it can be only a state with a monopoly of force who guarantees and enforces property rights, there is an apparent contradiction right from the start: the state protects property rights against everyone else, *including* the state itself. So in the case of the state, the person property is supposed to be protected from and the protector are one and the same legal person. So even at this basic level, a basic contradiction and an important aspect of the private-public-law dialectic becomes apparent right away: property owners – free and equal citizens – must have an interest in *retaining*, but also in *constraining* the state’s monopoly of force. They both *need* the state to *protect* their freedom, but the state can also *endanger* it, and the free citizens want to rule out that possibility. Thus, there is a constant tension between private (property and contract) law and the state.

From a business standpoint, it is essential that property rights are *nominally variable* assets: their “monetary value” is subject to constant re-valuation (estimation of value) by their owners and their creditors. *Price-setting* is a special case of valuing nominally variable property rights<sup>23</sup>.

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<sup>23</sup> in the case of financial assets – contractual claims – there is no price, but a nominal sum of immaterial wealth due at maturity. Before maturity, the creditor can transfer his claim to others only if he accepts a discount, i.e. a claim maturing in 60 days over 1000 € may be

And from a macroeconomic standpoint, it is essential that property rights are assets that are no one else's liability. Thus, they are net assets for the owner as well as for economy as a whole.

Note that the fungible asset (or disposable right with an ascribed monetary value) consists in the *property rights*, not in the actual objects that are owned.

To cite Scottish lawyer-economist Sir Henry Dunning MacLeod from his "Theory of Credit" (1893),

*"When we understand the true and original meaning of the word **Property**, it will throw a blaze of light over the whole Science of Economics: and clear up all the difficulties which the word Wealth has given rise to. In fact, the meaning of the word Property is the key to the whole sciences of Jurisprudence and Economics.*

*Most persons, when they hear the word Property, think of some material things, such as lands, houses, cattle, corn, money etc. But that is not the true and original meaning of the word **Property**.*

*Property, in its true and original meaning, is not any Thing at all material or otherwise: but it is the Ownership or **Absolute Right** to something. Savages have very feeble notions of abstract Rights. Their ideas of Wealth are something which they can lay hold of: something which they can only acquire by violence, and which they can only retain by bodily force. They have not idea of abstract Rights separated from anything material.*

*So in archaic Jurisprudence, Wealth, or Property, is described as anything material, which can only be retained by manual force and transferred by manual delivery.*

*In early Roman jurisprudence a person's possessions were called **Mancipium**: because they were supposed to be acquired by the strong hand: and if not held with a very firm grasp would probably be lost.*

*But as civilisation and firm government succeed, men's ideas are transferred from the actual material things to the **Personal Rights** in them.*

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transferred to another legal person only in return for 900 € cash, which implies a 10% discount. To call the nominal sum due at maturity minus the discount or the discount itself a *price* represents a potentially misleading metaphorical use of the term. We should beware of vague metaphorical uses of terms and stick to literal precision as much as possible, or, when we *do* use metaphorical descriptions, be aware of our purposes in doing so.

*Thus in the course of time the word **Mancipium**, which originally meant the material things which were held by the hand, came to mean the absolute **Right** to them: and in early Roman Law, Mancipium came to mean **Absolute Ownership**. (...)*

*In process of time the word **Property** came to be denoted by a term which meant a pure **Abstract Right**. (MacLeod 1893, 33-34)*

John R. Commons, one of the few economists who adopted this insight from MacLeod, clearly recognized this. In discussing MacLeod's work, he states:

*"Most persons," he says, "when they speak or hear of Property, think of some material things, such as lands, houses, cattle, money, etc." But that is not the true meaning of Property. the word "Property, in its true and original sense, does not mean a material thing; but the absolute right to use and dispose of something .... Property .... in its true sense means solely a Right, Interest, or Ownership; and, consequently, to call material goods Property is as absurd as to call them Right, Interest, Ownership". (Commons 1934, 400)*

Contrary to most economists, lawyers are familiar with these distinctions from day one of their legal studies. Legal scholar Karl Larenz, in a standard textbook on German Private Law, draws the distinction with some added precision as follows:

*"Total assets are a sum, an aggregation of rights and legal relationships a specific person or company is entitled to. Again, we notice the misleading identification of the thing or object with the property rights in the thing or object: usually, we find on a typical balance sheet a list containing: land, immobile objects, mobile objects, accounts receivable and other claims. From the perspective of law, we should clearly and precisely distinguish between things as first order objects of law and rights as second order objects of law. In consequence, it would be correct to say: property rights in land, property rights in immobile objects, property rights in mobile objects, accounts receivable and other claims. V. Tuhr correctly states: "The objects of the property rights belonging to someone's assets do not represent the assets. The assets consist of the property rights in the things/objects, not in the things themselves; and in the claims of the creditor themselves, not in the objects which can eventually be legally claimed on their grounds." (Larenz 1987, 306, my translation<sup>24</sup>)*

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<sup>24</sup> orig. "Das Vermögen ist eine Summe, eine Zusammenfassung von Rechten und Rechtsverhältnissen, und zwar im Hinblick auf eine bestimmte Person, der sie zustehen. Auch hier begegnet uns wieder die Gleichsetzung der Sache mit dem Eigentum an der Sache; so, wenn in einer Vermögensaufstellung nacheinander angeführt werden: Grundstücke, bewegliche Sachen, Forderungen und andere Vermögensrechte. Rechtlich gesehen sind Sachen, als Rechtsgegenstände erster Ordnung, nicht mit Rechten als Rechtsgegenstände zweiter Ordnung auf den gleichen Nenner zu bringen. Es müsste daher heißen: Eigentumsrechte an Grundstücken, Eigentumsrechte an beweglichen

Owners can dispose of their property rights *independently* of whom specifically they have entitled to legally *possess* the actual object. Owners can transfer *possessional* rights – that is, rights to physically use the actual objects - to others while still retaining the property right. The example of an owner renting his house to a tenant provides a simple example. By way of a lease contract, the tenant gets to possess the house, that is, sit inside and physically use it. The Ownership or Property Right, however, is retained by the owner. If we compare the tenant's and the owner's balance sheets, we will of course find the house as a balance sheet entry not on the tenant's, but on the owner's balance sheet. This underlines the point that it is the property right, that is, the right to *legally* dispose of the use or ownership of the object, not the physical control over the object itself, that represents an economic asset (an enforceable right that the rightholder and his creditors ascribe a specific monetary value to).

Thus, *possessional* rights refer to 1<sup>st</sup> order objects of law only, while *property rights* represent 2<sup>nd</sup> order objects of law and economic assets with an ascribed monetary value. In pre-state communities, only possessional rights exist, enforceable and exclusive property rights – and thus, monetary assets – being absent, as legal historian / anthropologist Willam Seagle notes:

*“The concept of “possession” rather than ownership is far more suitable in describing the primitive institutions. The concept of ownership develops only from long and undisturbed possession, and even then only when possession begins to be frequently surrendered in the development of such legal transactions as pledges of personal property. Until the creation of legal obligations becomes habitual there is no need for any claim of ownership.” (Seagle 1941, 51-52).*

Consequently, relationships such as lease contracts that leave the right to dispose of the property right – the asset with an ascribed monetary value – with the owner while transferring possessional rights to someone else is absent in pre-state communities without a civil legal order (private law):

*“Even more emphasis is to be placed upon the fact that absentee ownership is unknown in most primitive societies. The owner is also the occupant. Possession is the whole law.” (Seagle 1941, 55)<sup>25</sup>.*

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*Sachen, Forderungen und sonstige Rechte. Mit Recht sagt v. Tuhr: „Keine unmittelbaren Bestandteile des Vermögens sind die Objekte der zum Vermögen gehörenden Rechte; das Vermögen besteht aus dem Eigentum an den Sachen, die dem Berechtigten gehören, nicht aus den Sachen selbst, aus den Forderungen, nicht aus den Leistungsgegenständen, die vermöge der Forderung verlangt werden können.“*

<sup>25</sup> even possession does not mean the same in pre-state communities, compared to property-based civil societies. Fukuyama notes that *“Many of the moral rules in this type of society are not directed against individuals who steal other people's property but rather against those who refuse to share food and other necessities.” (Fukuyama 2011, 54)*

Moreover, the typical business motifs of property based societies are missing in “primitive”, kinship-based communities:

*“Many of the moral rules in this type of society are not directed against individuals who steal other people’s property but rather against those who refuse to share food and other necessities.” (Fukuyama 2011, 54)*

To guarantee and enforce private (property and contract) law, the legal foundations for markets, a sovereign state monopolizing the legitimate use of physical force is required. To facilitate providing this service, the state needs to levy tax claims against its citizens. Thus, from their very inception, contract relations between property owners necessarily are not bi- but trilateral, involving a triangular arrangement between free and equal citizens (contract law) and a sovereign state: citizens are free only towards each other (Private Law), but subordinates towards the state and its tax claims (Public Law). Democratic constitutions are an attempt to mediate between the two contradictory principles of private law (decentralized market, freedom and consent) and public law (centralized state, subordination and command). The principle of subordination to a sovereign (Bodin, Hobbes, Machiavelli) is replaced by popular sovereignty (Montesquieu), i.e. sovereignty of the free citizens over themselves, turning former tributary subjects into *citoyens*, that is, self-governing citizens. In practice, this means sovereignty of the majority over the minority of voters. Thus in a democracy, public discourse by *citoyen* becomes the primary avenue for power struggles between different interest groups in society<sup>26</sup>.

To sum up, we again quote John R. Commons who, discussing the work of Sir Henry Dunning MacLeod, states:

*“It is not “land, houses, cattle, corn,” he goes on, but it is “property” in land, houses, cattle, and corn “and all other material things,” that economics deals with. Property is the same as property rights; the material things have no value for economics except as they can lawfully be owned and their ownership lawfully transferred. Any other kind of holding or transferring is embezzlement, robbery, theft. Other sciences deal with things – economics deal with legal rights over things.” (Commons 1934, 400)*

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<sup>26</sup> Herman & Chomsky (1988) have described some of the specific processes involved. Schulmeister (2014b) analyzes a recent specific example: the struggle over a financial transaction tax. While today, we see a lot of propaganda by the financial industry and big business, going back to the late 1960s, we would find similar strategies employed by worker’s unions. Decades of full employment during the post-war “golden age of capitalism” (Hobsbawm) had strengthened their power and influence, which was then broken by the neoliberal revolution (are you old enough to still remember Thatcher’s iron fist in the UK miner’s strike 1984/85?) We will go into more detail when discussing “long waves” of credit cycles, power struggles, political regulation models and economic theories/ideologies in further development of our paradigm. For now, compare Schulmeister (2014a).

*“Therefore the right of corporeal property ... is the right, not to use the thing, but is the right to alienate the ownership of the thing and to give a good title to the buyer. (ibid., 405)*

## **Legal Claims**

*“There is nothing new or original in the Juridical principles of Credit ... . The great Roman Jurists elaborated the Juridical principles of Credit: and they were incorporated in the Pandects of Justinian and in the Basilica: and are set forth in every Continental treatise on Jurisprudence. Moreover, hundreds of years ago Jurists warned their students against a series of blunders into which numerous Scholastic Economists, both literary and mathematical, have fallen in modern times in treating a subject which they have never carefully studied.” (MacLeod 1893, viii)*

Legal Claims – a general category we use to include both private contractual claims and public tax claims for monetary value - are rights to a specific, nominally fixed amount of “monetary value” and have a specific due date<sup>27</sup>, at which they mature and thus, become legally enforceable:

*“The Roman law had a wonderful phrase which suggested the unlimited possibilities created in the life of the law by contract. Distinguishing between the nude pact and the pact which the law enforced, it defined an obligation as a *iuris vinculum*. The legal obligation rested upon an *ad bond of law*. Law to really flourish needs a *vinculum*.” (Seagle 1941, 265)*

From the standpoint of the debtor, the enforceability of claims means that in principle, he is liable towards his creditors with his total assets, which include both “real assets” (property rights) and “financial assets” (legal claims)<sup>28</sup>. Claims can thus be understood as claims against the debtor’s total assets (which include both property rights and claims against third persons)<sup>29</sup>.

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<sup>27</sup> one subcategory of legal claims, so-called „bank money“ or „demand deposits“ at commercial and central banks – do *not* have a specified due date, but are due „on demand“, that is, any time. They can be claimed *immediately* – or held for an *indefinitely long period of time*. The special consequences of this simple difference are important, but out of the scope of this paper.

<sup>28</sup> Heinsohn and Steiger seem to think liability is limited to property rights, which is incorrect. Possibly, they *mean* property rights + claims when they talk about “property”, which would be incorrect as well. There is no such thing as a property right in a claim. The right is the claim itself: „*To think of disposing of a claim as a sale of a property right in the claim only means an unnecessary and confusing doubling of rights.*” (Larenz 1987, 573, my translations) orig: “*Die Verfügung über die Forderung als Veräußerung eines an ihr bestehenden Eigentums aufzufassen bedeutet nur ein unnötige und verwirrende Verdoppelung des Rechts.*“

<sup>29</sup> liability can be limited through a variety of legal constructions which are important, but beyond of the scope of this paper.

We distinguish enforceable legal claims from informal claims based upon different forms of pre-state reciprocity. These are *not* enforceable by a centralized authority that monopolizes the legitimate use of force by taking it out of the hands of its citizens, as again legal anthropologists tell us:

*“Civil law is necessarily scant in primitive societies ... this is the result of the prevailing group solidarity.” (Seagle 1941, 57)*

*“The legal vinculum, the claim of obligation, the bilateral and multilateral bonds which unite individuals in legal transactions, with all their endless possibility for disputes, are still lacking. “(Seagle 1941, 57)*

Any legal claim (an asset) is someone else’s legal obligation (a liability). Conversely, any legal liability is someone else’s legal claim. Claim and obligation (liability) are two ends of the same social creditor-debtor relationship: my claim is your obligation / liability.

Claims are assets for the creditor only, while being liabilities for the debtor. The creditor adds the nominal value of the claim to his net wealth (equity). The debtor, subtracts the corresponding liability from *his* net wealth. Thus, for the economy as a whole, claims and liabilities always net out to zero: in a closed economy, all existing claims and liabilities add up to the same amount since for every claim there is a corresponding liability. In the consolidated balance sheet of the whole economy, claims minus liabilities (net claims or net financial assets) will always equal zero by definition.

John R. Commons had explicitly realized that in his “Institutional Economics”:

*“ ... the credit exists as the identical quantity on the “asset” side of one firm and the “liability” side of another firm. (...) Cernuschi had said: “The balance-sheet of every individual contains three accounts: existing goods, Credits, and Debts. But if we collected into one all the balance-sheets of everyone in the world, the Debts and the Credits mutually neutralize each other, and there remains but a single account: existing goods.” (Commons 1934, 410)*

Note that we should correctly substitute the term “property rights with an ascribed monetary value” (2<sup>nd</sup> order object of law) for the misleading term “goods” (1<sup>st</sup> order object of law), and thus can state, in a more precise way:

*“The balance-sheet of every individual contains three accounts: property rights with an ascribed monetary value, legal claims (credits), and legal obligations (debits). But if we collected into one all the balance-sheets of everyone in the world, the debits and the credits mutually neutralize each other, and there remains but a single account: **existing property rights** with an ascribed monetary value.”*

This basic principle of macroeconomic accounting (Stobbe 1966, 47) is now being recognized as foundational to macroeconomics by a number of Post-Keynesian monetary economists (Wray 2012, Godley/Lavoie 2007). It provides the empirical key to understanding the aggregation problem and micro-macro-paradoxes typical for contract-based monetary economies including the paradox of thrift (Stützel 1978, 1979). Stützel's teacher Wilhelm Lautenbach used to remind his students and colleagues to avoid fallacies of composition by telling them,

*“If you are a macroeconomist, always take into account the other person's counter-entry.”*  
*(Stützel 1978, X)<sup>30</sup>*

Lautenbach was referring to balance sheet entries of claims, which always have two sides, one on the liabilities/obligations side of the debtor and a counter-entry on the assets/rights side of the creditor who holds the claim). This simple principle of accounting identities will serve as the (strictly empirical) systematic connecting element between micro- and macroeconomics, between an individual balance sheet and the rest of the economy (see below, p. 57).

Claims and Liabilities, though, come in two basic categories<sup>31</sup>: contractual claims / liabilities and tax claims / liabilities.

Contractual claims and liabilities are subject to private law. They are created by *consent between legally free and equal citizens* (the basic principle of private law). Any free citizen can have those on his balance sheet. Tax claims and liabilities are subject to public law. They are created by *command of a sovereign over its subjects* (the basic principle of public law). Thus, tax claims are to be found only on the balance sheet of the holder of the legitimate monopoly of force, the state (more generally speaking: public households); tax liabilities are to be found only on private legal subjects' balance sheets - more precisely, on the balance sheets of ALL private legal subjects within the legislation of a sovereign state.

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<sup>30</sup> orig. “Bist du Volkswirt, beachte stets des anderen Gegenbuchung”.

<sup>31</sup> we will not include tort at this point of our presentation.

Being able to levy claims against the plurality *all citizens by command* is a monopolist capacity of the state which no private subject has. It is based upon the monopoly of legitimate use of force of a sovereign state, and represents the basis of the superior creditworthiness of a state whose monopoly of force and legal and administrative system is intact. It clearly and simply explains the reason why a state is *not* subject to the same business constraints as a private economic subject. It is also what gives him the option for anti-cyclical fiscal policy (Keynes' insight), while current practice shows that the state of course also has the choice of *pro-cyclical* fiscal policy. And it brings into view the workings of democratic organization of sovereignty (popular sovereignty), that is, constitutional law and the political process. Systematically taking this into account, then, transforms "economics" back into a decidedly "Political Economics".

The distinction between claims based upon private contracts (private law) and claims based upon public taxation (public law) again points to an essential contradiction at the heart of western legal systems based upon property rights and freedom of contract. Property rights cannot exist without a state monopoly of force guaranteeing and enforcing them, and in order to be able to provide that service, the state must tax its citizens. Tax law is part of public law, the basic principle of which is command of a sovereign over his subjects, which is in fundamental contradiction with the basic principle of private law, consent between free and equal citizens.

We call this the *private/public law dialectic* to make clear that this contradiction at the very heart of the legal structure of capitalism is an inevitable part and basic structural conflict of western society. Market fundamentalists who want to do away with the state altogether by "privatizing" *all* of his functions (Friedman 1971) miss this dialectic just as much as state fundamentalists who want to do away with the market altogether by eliminating private property. Ironically, both anarcho-liberals and socialists-communists in their attack against the state (which anarcho-liberals want to "privatize" and of which socialists hope it will "whither away"), are using the same combination of idealizing pre-state, tribal societies and analytical incompetence with respect to capitalism to construct their utopian fantasies.

## **E) Accounting for enforceable legal rights and obligations: Balance Sheets "made in law"**

### ***Purpose***

The purpose of the following section will be to clarify and unequivocally define basic categories of financial accounting that are by now standard in monetary macroeconomics in terms of existing law. We will accomplish this in two steps. First, by relating the terms that have become common in business accounting and in monetary macroeconomics (Godley & Lavoie 2007, Wray 2012), back to

the precise legal terms they are empirically based upon. And second, by reclassifying typical specific balance sheet entries into our legally redefined general accounting categories<sup>32</sup>.

We add some precision to Commons’ terminology by referring to conceptual distinctions used in continental, codified law. Additionally, we make explicit another overlooked distinction that will be crucial to understand the inherent instability of credit: the distinction between nominally variable property rights and nominally fixed claims and obligations.

Our intention in doing this is fourfold. First, we want to clarify basic accounting categories by simply substituting precise legal concepts, which also provide essential distinctions for macroeconomic analysis. Second, we want to rebuild the conceptual bridges between lawyers, accountants and macroeconomists that have been degenerating over the past few decades and probably have been used in a systematized way only by business and banking practitioners, not by academic economists. As we will see, accounting, macroeconomics, law and political science can be conceptually integrated that way, resulting in a not just interdisciplinary, but also conceptually coherent approach to political economy. Third, we want to provide the (mostly Post-Keynesian) tradition of monetary macroeconomics with an explicit legal foundation, thus providing an essential step towards a solid paradigm. And finally, we want to provide historians of capitalism an integrated model of the political economy of capitalism that allows them to write its history in a new way, illuminating the core relationships between property and contract law, public law, credit, accounting and the financial system.

***Typical balance sheet***

To start, let’s look at a typical balance sheet of a small business.

Small Business (productive sector)	
Assets	Liabilities + Net Worth
<p><b><u>Current</u></b>            Cash            Demand Deposits            Accounts Receivable            Inventory</p>	<p><b><u>Current</u></b>            Accounts Payable</p>
<p><b><u>Non-Current</u></b>            Long Term Credit</p>	<p><b><u>Non-Current</u></b>            Long Term Debt</p>

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<sup>32</sup> In this, we follow a path outlined by Sir Henry Dunning MacLeod (MacLeod 1893) and John R. Commons (Commons 1934). We also take up partial suggestions in this directions suggested by Heinsohn & Steiger (2006) for property and contract (private law) and Wray (2012) for tax law (public law), and recent proposals for a more systematic legal approach (Pistor 2013; Deakin et. al. 2015).

Trademarks Goodwill Copyrights Patents Tools and Equipment Immobiles Land	Net Assets / Equity
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Anyone ever having had his or her own business will be familiar with this way of classifying balance sheet entries. From a practical perspective of daily needs in business, it is useful to classify assets and liabilities by their time horizon in order to see at first glance the cash obligations that will have to be met in the near future, vis a vis the cash and liquidifiable assets available to fulfil them.

By now, there are a number of approaches in monetary macroeconomics who work from a balance sheet approach. Three examples would be Modern Monetary Theory (Wray 2012), Stock-Flow consistent modeling (Godley&Lavoie 2007) or agent-based keynesian economics (Bruun 2005). We will look at the concepts these approaches use for balance sheet reasoning, point out where we see their essential weakness and propose a simple conceptual solution that forms a core part of our proposed paradigm.

For purposes of macroeconomic accounting and monetary macroeconomics, these entries are usually categorized the following way:

Small Business (productive sector)	
Assets	Liabilities + Net Worth
<u><b>Financial Assets</b></u> Cash (bank notes) Demand Deposits Accounts Receivable Long Term Credit  <u><b>Real Assets</b></u> Inventory Tools and Equipment Immobiles Land	<u><b>Financial Liabilities</b></u> Accounts Payable Long Term Debt  Net Worth

The general form of a balance sheet used in today’s macroeconomic accounting (Stobbe 1966, 43) monetary macroeconomics (Wray 2012, 24; Godley/Lavoie 2007, 28) thus typically includes the following general categories:

Any economic subject	
Assets	Liabilities + Net Worth
<u><b>Financial Assets</b></u>  <u><b>Real Assets</b></u>	<u><b>Financial Liabilities</b></u>  <u><b>Net Worth</b></u>

$$\text{Net Financial Assets}^{33} = \text{Financial Assets} - \text{Financial Liabilities}$$

Godley & Lavoie (2007, 26) substitute the term “Tangible Capital” for the term “Real Assets”.

In our view, these terms -“real assets” and “tangible capital” are ambiguous and potentially misleading, leaving unnecessary possibilities for confusion. Semantically, they potentially carry a “materialist fallacy” similar to the one we described above in discussing the distinction between property and possession. Not only do they leave the old problem of the dichotomy between the “real” sphere and the “nominal” sphere conceptually unsolved that has plagued the theory of value ever since it got started (Nitzan&Bichler 2009). They also omit important assets like Trademarks, Patents, and goodwill, which – representing intangible property - could certainly not be classified as “real assets”

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<sup>33</sup> net financial assets, just like net worth, are *balances* in terms of accounting. Balances are calculated terms that do not denote any particular right, but summarize the monetary value of a bundle of rights and obligations into one mathematically calculable term.

or “tangible capital<sup>34</sup>”. Rather, they suggest a misleading classification of different assets that clouds a core distinction we were making above between claims and property rights, since it could be understood the following way:

Small Business (productive sector)	
Assets	Liabilities + Net Worth
<p><b><u>Financial Assets</u></b>            Cash            Demand Deposits            Accounts Receivable            Long Term Credit</p> <p>Trademarks            Patents            Goodwill            Copyrights</p> <p><b><u>Real Assets</u></b>  <u>Tangible:</u>            Inventory            Tools and Equipment            Immobiles            Land</p>	<p><b><u>Liabilities</u></b>            Accounts Payable            Long Term Debt</p> <p><b><u>Net Worth</u></b></p>

Drawing the lines of distinction between “material” (“real assets”, “tangible capital”) and “immaterial” (“financial assets”) might suggest classifying Trademarks, Patents and Goodwill as “financial assets” because they are clearly not “material, that is, “real” or “tangible”.

This, however, clouds the economically crucial difference between claims and property rights:

*Property rights are nominally variable and subject to constant re-valuation by the owner and his creditors. Claims entitle the claimant (creditor) to the payment to nominally fixed sum by the debtor, and have a specific date of maturity at which they become due and enforceable.*

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<sup>34</sup> Note that in this way of classifying, *immaterial* assets like goodwill, patents, trademarks, and copyrights are typically simply omitted. It may not be clear whether to classify them as “real” or “financial” assets. This is because the choice of the category pair, “real” vs. “financial” assets implicitly (semantically) suggests that “real” assets are “material” assets, that is, “goods” or “objects”, while financial assets are *immaterial* assets (merely represented on paper).

Goodwill, Trademarks or Copyrights are clearly not *material* but rather *immaterial* assets. They are certainly not “real” in the sense that they can literally be touched, sliced, or put in a wheelbarrow (although *metaphorically*, all of that is possible of course; we should avoid stepping into the trap of failing to distinguish metaphorical from literal expressions. That is not to say we should never use any metaphor. We just need to know what we are doing and which type of expression is useful for which purpose. Nobody ever literally washed his hands or took a swim in liquidity (cash), except Dagobert Duck ...

How can we relate these balance sheet entries to the legal concepts that we have introduced above? The solution we propose is partially inspired by John R. Commons (1934, particularly Chapter IX.), Heinsohn (1984), Heinsohn & Steiger (1996, 2006, 2013) and parts of Wray (2012), but attempts to integrate the partial insights of these authors by providing a systematic foundation taken from basic legal concepts.

This way, we not only accomplish conceptual clarity regarding balance sheet approaches. We also systematically connect the disciplines of business management and macroeconomics with the discipline of law, and, as we will see, via basic concepts of Public and Constitutional Law with political science, thus opening a door to an integrated *Political Economy of Free and Sovereign Republics*.

We can classify all of the specific business balance sheet entries above into just three of the basic legal categories we have introduced above. The solution consists simply in using a classification of balance sheet entries made up of categories referring not to 2<sup>nd</sup> order, but exclusively to 1<sup>st</sup> order objects of law (rights): All assets – and not just claims and liabilities – are enforceable rights (2<sup>nd</sup> order objects of law) and not things (1<sup>st</sup> order objects of law). In other words, a necessary precondition of the “value” of the assets is the force by which they can be enforced – the state monopoly of force.

With this simple adjustment, our balance sheet now looks like this:

**Clarified Categorization of Balance Sheet entries by legal category:**

Assets ( <b>Rights</b> )	Liabilities ( <b>Obligations</b> ) + Net Worth
<p><b><u>Claims (credits)</u></b>            Cash (bank notes)            Demand Deposits            Accounts Receivable            Long Term Credit</p> <p><b><u>Property Rights</u></b>  <u>Tangible:</u>            Cash (commodity money)            Inventory            Tools and Equipment            Immobiles            Land  <u>Intangible:</u>            Trademarks            Patents            Goodwill            Copyrights</p>	<p><b><u>Obligations (debits)</u></b>            Accounts Payable            Long Term Debt</p> <p><b><u>Net Worth</u></b></p>

Thus, the general form any balance sheet looks like this:

Any <b>legal</b> person	
<b>Rights</b>	<b>Obligations + Net Worth</b>
<b>Claims (credits)</b> <b>Property Rights</b>	<b>Obligations (debits)</b> <b>Net Worth</b>

Note that we have not specified yet whose balance sheet specifically we were talking about. The Balance sheets of different kinds of economic actors will differ in detail.

A typical balance sheet of a small business in the productive sector will of course have a different set of typical specific entries than the typical balance sheet of a private bank. A private bank’s balance sheet will look different from a central bank’s balance sheet. All these will differ from the typical balance sheet of a private household. These differences are important, as they are connected to the respective legal person’s different business and political strategies. We will introduce more of the relevant differences at a later point of our presentation. For example, a comparative look at the balance sheets of firms in the productive sector, firms in the financial sector (commercial banks, insurance companies, etc.) and central banks will be necessary to clarify key distinctions in monetary theory.

At this point, however, it is important to note that all specific balance sheet entries on *any* balance sheet, including all different forms of means of payment, with the exception of net worth will be in one of the three legal categories described above:

1. Property Rights
2. Legal Claims
3. Legal Obligations

Property Rights and Legal Claims can be grouped together as enforceable rights. These rights are economic assets (with an ascribed monetary value). While they are both rights, they differ in important ways. Property rights are nominally variable, their current value depends on subjective valuation by the owner and his creditors. Claims are claims for a fixed sum of immaterial monetary wealth and the creditor’s side of some other legal person’s obligation (debt). In essence, they are claims for other people’s rights. Claims’ market price will differ from their nominal value because before they mature, they can be sold only for a sum less than the nominally fixed sum that can be claimed from the debtor at maturity. The difference between the sum due at maturity and what others will pay to acquire the claim before maturity is called a discount (Commons 1934, 431). This discount

is a primary form of interest. Obligations are any form of debt. Net Worth is not a right in itself but represents a sum of abstract monetary wealth that is calculated by subtracting total obligations from total assets/rights and thus represents *net wealth*.

***Equity and Net Financial Assets: Net Wealth and the Claims-Obligations-Balance (Net Financial Assets)***

We need three more accounting concepts to be able to understand and work with balance sheets and to understand social systems made up of actors whose balance sheets are interconnected by way of claims and obligations:

$$\begin{array}{lll} \text{Total Assets} & = \text{Property Rights} + \text{Claims} & \text{TA} = \text{P} + \text{C} \\ \text{Net Claims}^{35} & = \text{Claims} - \text{Obligations} & \text{NC} = \text{C} - \text{O} \\ \text{Net Worth (Equity)} & = \text{Total Assets} - \text{Obligations} & \text{NW} = \text{TA} - \text{O} \end{array}$$

From these two definitions it follows that

$$\text{Net Worth (Equity)} = \text{Property Rights} + \text{Net Claims} \quad \text{NW} = \text{P} + \text{NC}$$

Thus, net worth can be positive even if net claims (“net financial assets”) are negative (i.e. the legal person is a net debtor) as long as Property Rights > - net financial assets.

The following example will make this clear:

Rights/Assets	Obligations/Liabilities + NW
<b>Claims (credits) 10 000</b>	<b>Obligations (debits) 20 000</b>
<b>Property Rights 100 000</b>	<b>Net Worth 90 000</b>

$$\text{TA} = \text{P} + \text{C} = 10\,000 + 100\,000 = 110\,000$$

$$\text{NW} = \text{TA} - \text{O} = 110\,000 - 20\,000 = 90\,000$$

Claims (10 000) minus obligations (20 000) = Net Claims (- 10 000) = Net Liabilities (10 000).

As soon as liabilities come due, the entity will have to sell off some property rights (finished products, for example) for cash in order to be able to pay down that debt.

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<sup>35</sup> we will also call this the claims/obligations balance. If it is positive, it amounts to net claims and puts the owner into a net creditor position, if it is negative, it amounts to net obligations (debt) and puts the owner into a net debtor position.

At this point, it is essential to understand that a legal person's A's *total obligations* (*total liabilities*, *total debt*) are claims of other legal persons B ... X against A's *total assets*, which are comprised not just of A's property rights, but of total property rights + total claims. Only if A has a negative claims-obligations-balance, that is, if his total obligations exceed his total claims, these *net obligations* can be understood as claims against A's property rights. This crucial distinction is not drawn by Ownership Economics (which seems to conceptualize a debtor's obligations as the creditor's claims against the debtor's property *only*, ignoring the debtor's claims which are part of his total rights/assets) and invites typical fallacies of composition. Thus, it is essential to distinguish:

A legal person A's *total obligations* = other's claims against A's total assets;

A legal person's *net obligations* = claims against A's property rights.

It also follows that net wealth can change if the total value of property rights changes (either by re-valuation or production of new property) while net claims remain the same, or if net claims change while the total value of property rights remain the same (as, for example, in the case of obligations being forgiven, which will raise net wealth, or if a claim for indemnification can be added to the assets side as a result of a court decision). Net wealth can also change if net claims and property rights change in the same direction. If they change in the opposite direction, the change in net wealth will be equal to the positive and negative change added up, i.e. a change of + 100 in property rights and a change of -200 in net claims add up to a change of  $100-200 = -100$  in net worth.

### Summary: Comparative Table of Basic Economic/Legal Concepts

Everyday Thinking Convent. Economics	Business Accounting	Precise Legal Term
Goods (material things)	Real Assets / Tangible Capital / Property	enforceable Property Rights
-	Financial Assets	enforceable Claims
“debt”	Liabilities	enforceable Obligations
-	Net Financial Assets	Claims-Obligations-Balance Net Claims / Net Obligations
-	Net Worth	Net Worth

This may all be very clear and self-evident to a businessperson or a lawyer. But to someone from a stateless society who has never encountered any of it, these will appear as alien concepts. That is essentially correct. They are not “natural”, but socially constructed and presuppose a centralized authority guaranteeing and enforcing private law.

### ***Balance Sheets of Private vs. Public Entities***

At this point, we will introduce just one foundational distinction: the distinction between balance sheets of private (market) and public (government) entities. Unfortunately, monetary economists have either entirely missed the precise *legal* aspects and significance of this distinction, or – as in the case of Modern Monetary Theory (Wray 2012) – they have only accounted for it systematically in balance sheet operations while *not* explicitly specifying the fundamental legal differences between private claims (created by consent based contract, i.e. private law) and public claims (created by command based taxation, i.e. public law).

<b>Public Entity</b> (State, Government)	
Assets	Liabilities
<b>Tax Claims (ag. <u>all</u> citizens!)</b> <b>Contract Claims (credits)</b> <b>Property Rights</b>	<b>Contract Obligations (debits)</b>

All private Entities of this Polity (Market)	
Assets	Liabilities
<b>Contract Claims (credits)</b> <b>Property Rights</b>	<i>Contract Obligations (debits)</i> <b><i>Tax Obligations</i></b>

We put tax claims and tax liabilities in red print because they constitute a distinct category of claims that are fundamentally different from contract based claims. Tax claims and liabilities are subject to *public* law, not – like contractual claims and liabilities – subject to private law. They are not created by contract and consent between free and equal citizens, the basic principles of contract law. They are created by command of a sovereign government<sup>36</sup>, the basic principle of public law<sup>37</sup>.

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<sup>36</sup> of course, there can be different *forms* of government, some democratic, some not.

<sup>37</sup> the distinction between public law based upon command (public order) and private law based upon consent (private contract) was developed in antique roman law and was effectively suspended in late antiquity, when private law was done away with by transforming the large latifundia of the empire into feudal estates (Weber 1896). Reception of roman law did not restart before the 12<sup>th</sup> century in northern Italy, when it started to become institutionalized again in the form of city law. The distinction has become a basic one in codified continental law developed mainly in the 18<sup>th</sup> and 19<sup>th</sup> centuries in continental europe. While originally not being part of the common law tradition, which also is based upon roman law but using a different methodological approach (a focus on reasoning by analogy rather than reasoning by abstraction and subordination, as is common practice in continental law), the common law tradition has recognized the significance and usefulness of the distinction and has adopted it.

To cite Georg Jellinek, a classic continental public legal scholar, whose work is still being referenced in many continental introductory textbooks of law (for example, Kühl/Reicholdt/Ronellenfitsch 2011, 256-259):

*„In order to understand the system of public law, the essence of private law has to be considered in contrast to the essence of public law. The contradiction between public and private law can be traced to the basic idea that in private law, individuals are treated as equals. Private law thus regulates the relationships between equals whereas public law regulates ... the organization and function of governing bodies and their relationship to the subordinated subjects. (...) All private law is connected to a right of acknowledgement and protection by public law. Thus, all private law rests on the foundation of public law.” (Jellinek 1905, 372-373, my translation)*

This is *not* specific for *germanic* law, as some people who are unaware of the history of law might spontaneously suspect. The distinction between private law and public law originates in ancient *roman* law (*ius privatum* vs. *ius publicum*) and is part of the basic structure of *all* continental legal systems based upon roman law<sup>38</sup>; the common law family also uses this distinction (Zoller 2008).

Modern monetary theory correctly states that monetarily sovereign states are not subject to the same economic restrictions as a typical private business, and thus have the capacity and choice to act in a different way. Governments can choose to act anti-cyclically (or pro-cyclically, for that matter, as during the 1930s and presently in europe) because of the privileged position they have compared to the individual businesses within their jurisdiction. Modern monetary theorists explain this by the government’s monopoly of force and its power to tax all citizens, which is descriptively correct, but lacks context. It is the basic principle of public law, which runs counter to the principles of private law, and the monopolist position of the state with respect to the legitimate use of force, which provides the government with that power.

This is true in a “pure” way for a closed economy. Within an international system of nation states (some more sovereign than others), it is true only in a modified way, since this capacity is constrained by the international economy and international relations between states. Since the international system, for lack of a centralized monopoly of force that is constrained by law and could enforce international

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<sup>38</sup> which by now, includes the formerly socialist countries of europe, who had for the most part eliminated private law in their socialist period. There is, however, and understandably so for historical reasons, still a wider gap between written law and lived law in those countries than in western countries, and a higher level of legal nihilism than in northwestern european countries (Kischel 2015).

law, is not a true and effectively legal order<sup>39</sup> (although, for purposes of rhetoric, it is called legal), there exists a hierarchy of state capacity for intervention that is clearly based upon power. To give just one example, a country like Greece (under the present regime) has to endure a Troika treatment for its external debt while the biggest debtor country in the world, the United States of America with its famous twin deficit, of course has to fear no such thing.

The basic principles of public law – bondage, command and subordination - run directly counter to the basic principles of private law - freedom, consent and equality. To describe the relationship using a common spatial metaphor, private law creates horizontal, lateral relationships in which free citizens meet eye to eye “on the same horizontal plane”, to use a spatial metaphor, whereas public law creates vertical, hierarchical top/down relationships between a sovereign (“up there”) and his subordinated subjects (“down below”).

Without a context of public law including a state monopoly of force, however, private (property and contract) law could not exist because it could not be guaranteed and enforced in a reliable and unified way. This service of protecting the equal rights of all citizens in a unified way can only be provided by a *monopoly* of force; notice again the dialectic of the one and the many, of the whole and its parts here. This service of guaranteeing property rights and enforcing contracts cannot, however, simply come from nowhere or as a free lunch. Of course, it has to be funded – the citizens have to pay taxes to be able to act as free citizens in a context of state-guaranteed and -enforced private law (civil law). No state, no market; no monopoly of force no pluralist business. Thus, from the very start,

*“Private Property is a legal convention, defined in part by the tax system; therefore, the tax system cannot be evaluated by looking at its impact on private property, conceived as something that has independent existence and validity. Taxes must be evaluated as part of the overall system of property rights that they help to create. (Murphy&Nagel 2002, 8)*

The contradiction of principles of private law with those of public law is thus an inescapable one. We call this contradiction the *private/public law dialectic*: the basic principles of private law and public law are *inherently in conflict with one another*<sup>40</sup>. This dialectic of private and public law was clearly

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<sup>39</sup> this is not true for international private law, the law of collision. International business can be done on the basis of enforceable law, although in practice, it can often be difficult to enforce claims against a foreign debtor. Although this is an important topic for international political economy, we will not go into this topic here.

<sup>40</sup> this is one of the basic reasons for the historical oscillation of capitalism, that is, state-based societies with a sphere of private (property and contract) law, between state dominance and market dominance, which is closely related to power struggles (“class struggle”) between sub-groups of the population, and different forms of government they need in various stages of the “power cycle”. We will not go into this any further at this point, but will illuminate it in more detail in later publications. Of course, Marx had to entirely miss this point (and, for

known to ancient roman lawyers but today, outside the field of legal studies, seems to have dropped out of public consciousness after the cold war decades of state fundamentalists' and market fundamentalists' propaganda. Nevertheless, this dialectic is, to borrow a metaphor from Marx, at the very heart of the *anatomy* of western civilization or capitalism<sup>41</sup>; and the anatomy of capitalism is –

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that matter, the inner workings of capitalism altogether) because early on in his life in his attempt to get over Hegel with the help of Feuerbach, he declared the legal system as an irrelevant part of the “superstructure” of a supposedly strictly “material” base.

<sup>41</sup> As much as radical market fundamentalist libertarians such as Milton Friedman's son David (Friedman 1971) love to believe and suggest otherwise, doing away with the state monopoly of force and substituting plural private forces (as explicitly demanded by Friedman) will not *implement*, but instead *destroy* and *do away with* capitalism and freedom. It may come as a surprise that this is even worth mentioning. But a failure to recognize the public/private-law dialectic and the implied dialectic of whole and parts, of the one and the many, seems to be extremely widespread. Governments themselves have, after 40 years of libertarian propaganda, taken this position and are now acting in a way that undermines the foundations of the state and the law. To provide just one specific example: in a city in southern germany, nearby where I live, the local city government has partially privatized and “outsourced” security from the police to different private “security companies”, with personell recruited from balcan countries with a weak culture of law and a high level of legal nihilism (Kischel 2015, 583). Just a few weeks ago as of the time of this writing (March 2016), in fights of these different security companies against each other over territory, one man has been killed. Fighting for territory was an activity that under a state monopoly of power, was typical for sovereign states who saw their task in providing peace internally by means of a a monopoly of force, taking force, violence and the right to use weapons out of the hands of their citizens and monopolizing it in the hands of the state in order to exercise it according to law that applies to all citizens and the state as well. Thus, radical libertarianism *put in practice* more resembles a dark alley back to a Hobbesian world rather than a golden road to a libertarian utopia. In a short section of his 2011 book “Origins of Political Order” dealing with “fantasies of statelessness”, Francis Fukuyama aptly comments:

*“The kinds of minimal or no-government societies envisioned by dreamers of the Left and Right are not fantasies: they actually exist in the contemporary developing world. Many parts of sub-Saharan Africa are a libertarian's paradise.” (Fukuyama 2011, 13)*

It is ironic that radical *libertarians* end up destroying freedom in the name of radically implementing it just as much as radical *socialists* destroyed it in the name of radically implementing *equality*. In both cases, failing to conceptualize the basic public/private law dialectic led to an utopian fundamentalist strategy which achieved the radical opposite of what it claimed it would achieve. Another nice dialectic. No wonder the russian people, having been subjected to failed large-scale social experiments on the grounds of these two western fundamentalist ideologies from 1917-1989 and then from 1990 to the 2000s, have reason to doubt western intentions and competence in “advising” them on their social affairs. David Woodruff (Woodruff 1999) and others (Humphrey 1991, Verdery 1996, Vinogradova 2005) have documented the total failure of the libertarian so-called “shock therapy”, which had pushed aside the necessity to build reliable legal institutions as a first step of transformation, something western lawyers had always recommended (Knieper 2006, 2009). This led to catastrophic chaos with the life expectancy of rusian people declining by years (Eberstadt 2005). Vladimir Putin has recognized that this is an illusory way to go and changed course (Woodruff 2013). China wisely chose not to fall into the trap of mistaking western libertarian ideology of the last quarter of the 20<sup>th</sup> century for reality. Instead, it took an empirical approach to guide their transformation towards capitalism. Rather than buying into the abstract models constructed by western academics long *after* their countries had established capitalism, Chinese officials relied on the practical historical experience of a country who had managed to successfully go through that transition, namely, 19<sup>th</sup> century germany. Relying on Friedrich List and the historical school of german economics proved to be a much more successful way of organizing the transition from socialism to capitalism than relying on the abstract models of neoclassical economics. Borrowing a metaphor from Friedrich List, Korean scholar HaJoon Chang has argued that one of the functions of the unrealistic economic theories of contemporary western academia is to “kick away the ladder” which western industrialized countries themselves used to climb to the top (Chang 2003). In the west itself, however, libertarian ideology has succeeded to infiltrate the minds not just of economists, but of social scientists more generally. Even historians of the state now proclaim the “End of the State” as a supposedly inescapable given of history: *„Instead of a central state, a community with many intermediary authorities seems to be emerging, a “new middle ages” lacking the shared values of the european middle ages. Society as a whole does not have a shared will any more and is kept together by nothing but the remaining rest of state power or economic interests.” (Reinhard 2007, 123; see also vanCreveld 1999)*. We have to conclude with Fukuyama that fundamentalist libertarian

contrary to Marx' materialistic belief – to be found in the idea of law, the state and legal system, and the systematic interconnection of balance sheets (which were explicitly developed to systematically account for state enforceable legal rights and obligations with an ascribed monetary value) by contract and accounting identities, which would not exist without state and law.

Failing to understand the dialectic relationship between private law and public law, which is then mediated by constitutional law (popular sovereignty and democratic government, rule of law and division of power), impedes a clear understanding of capitalism, and invites either market or state fundamentalism, the most extreme forms being anarcho-capitalism (Friedman 1971) or state socialism (Lenin 1917).

Ironically, both fundamentalist positions dream of a utopia in which the state will disappear altogether, modelled upon an idealized form of pre-state communities creatively constructed either as “original communism” or “original liberalism”. This type of fantasy echoes the globally widespread mythology of an original “golden age” (in jewish-christian tradition, “paradise”) and, if coupled with future visions of some kind of “return” to this original state which is then imagined either as “original pure communism” (because markets and wage labour were not present) or “original pure liberalism” (because no state existed), represents a form of secular “enlightenment” eschatology (Eliade 1954). According to anarcho-capitalists, the state should be dismantled and “privatized” in *all* functions, including legislation and law enforcement (Friedman 1971) to achieve total freedom and efficiency. According to state socialists, the state is simply an instrument of class rulership that will eventually “whither away” (Lenin 1917) to supposedly yield ultimate freedom and wealth. Such “fantasies of statelessness” (Fukuyama 2011, 10-14) exhibit a lack of empirical understanding of the basic legal structure of capitalism, and of the dialectic of private law and public law, of freedom and authority.

Sir Edmund Burke, who clearly understood this dialectic, put the problem of constitutional law this way:

*“To make a government requires no great prudence. Settle the seat of power, teach obedience, and the work is done. To give freedom is still more easy. It is not necessary to guide; it only requires to let go the rein. But to form a free government, that is, to temper together these*

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ideology of the David Friedman kind is a danger to the law and civilization itself and, practiced to its extreme as in post-socialist russia, will yield anarchy and chaos. In that sense, it is clearly anti-constitutional even though it supposedly simply radicalizes basic constitutional principles of any free society. The basic problem of such (libertarian or socialist) fundamentalisms seems to be an inability to recognize the *dialectical* nature of reality, that is, the basic and inescapable role of conflict and contradiction (in this case, regarding the inherent conflict between the principles of private law and public law). A dialectical perspective is fairly widespread in traditional world views (Eliade 1958, 419 passim) and has been a stream in western thinking (Heraclitus, Hegel, Marx) as well.

*opposite elements of liberty and restraint in one consistent work, requires much thought, deep reflection, a sagacious, powerful, and combining mind.” (Edmund Burke: Reflections on the Revolution in France)*

Here, then, is one of the basic problems constitutional law has attempted to solve by way of the concepts of popular sovereignty, democratic government, the rule of law and horizontal and vertical division of powers.

#### **F) Replacing Market or State Fundamentalism in Monetary Economics with a legal Understanding of the Private/Public Law Dialectic: Principles of Constitutional Law**

Property and contract law form the core of private law. They guarantee personal freedom, institutionalizing core human rights of European civilization and fundamentally decentralize power. Yet, free citizens can institutionalize private law only within the context of public law, which presupposes a centralized sovereign state that monopolizes the use of physical force in order to make both private and public legal rights and obligations enforceable and thus, reliable.

This paradox of seemingly contradictory principles of decentralized private law (freedom/equality, consent, market) and centralized public law (subordination, command, state) has, after an absolutist phase of state building (Hobbes, Machiavelli), historically been mediated through the concepts of popular sovereignty (Rousseau), the rule of law (Montesquieu) and democratic government (taken from the ancient *polis*) as core ideas of Western constitutional law.

The basic idea behind these core institutions of Western civilization is to constrain the centralized power of the state by way of three principles. Democracy (in its modern form: popular sovereignty) the division of power and the rule of law.

The idea of democracy and its modern, generalized form of popular sovereignty is to do away with an absolute monarch and instead, to subordinate the state and public law to the will of the free citizens. This is achieved by turning the free citizens - subjects of private law - into partial little sovereigns ("popular sovereignty"). As partial sovereigns, they are subjects of public law as well ("law-givers") and are governing themselves by means of the state's legitimate monopoly of force.

This places free citizens into a double role. As subjects of private law or *bourgeois*, citizens create legally binding, enforceable rights and duties by *contract*. As subjects of public law or *citoyen*, they

create legally binding, enforceable rights and duties by *public legislation - either directly, or, in representative democracies, through an elected parliament.*

The division of power comes in three basic forms. The first division is the basic division of law into the spheres of private law guaranteeing individual freedom, and public law. This is usually not thought of as a form of division of power, but is probably its most fundamental application. The second form is to divide government horizontally into three branches, the legislative, executive and judicial branch. The third form, federalism, divides up the power of a centralized government vertically into different levels of government who share sovereignty with the central government. Typically, three levels are used: federal, state and community level. The EU, should it ever develop into a federal state, would then constitute a 4-level-system.

Taking into account the *hybrid* and *contradictory* - and thus, *dialectical* - nature of the system helps to recognize the different principles that individual business strategy and economic policy have to follow, to decipher the central bank as the mediating, hybrid institution between private and public credit money creation. Constitutional law and the democratic procedures bring into view the public political process through which the dominant economic policy is decided. Thus, how private interest groups use economic theories and ideologies (traditionally, Marxism, Neoclassic, Keynesianism, back to Neoclassic) to gain power over government policy by influencing public opinion through campaigning and politicians through lobbying comes into view.

This helps to understand the cyclical change of fashion in economic theory, from classical economics to marxism (1867-ca. 1900), to neoclassical economics (ca. 1900-1936), to Keynesianism (ca. 1936 - 1975) back to neoclassical economics (ca. 1975-today):

*"Economics has been in crisis many times – usually at times when it was consulted because developments of the national and global economy were less than satisfying. It appeared to be successful only at times when it “proved”, that the view currently dominating public discourse anyway represents a “true” description of empirical economic reality. If Economics is a servant like other sciences, then it did not provide orientation. Quite the contrary: it provided the “conditional clauses” that allowed the majority in society to believe that what it did anyway was also “rational”.*

*Economics has always been “political” in this sense. It was political in another sense than is commonly believed: out of the existing economic models, the actors in the economy have promoted and financed that theory that supported their own goals and plans. Thus, the economic theory that best served the interests of the majority parties tended to dominate. This*

*explains its temporary success and crises (i.e. after the first world economic crisis of 1857, Marxism; from about 1900 to the great depression, neoclassical economics; after the great depression of the 1930s, Keynesianism; from the mid-70s until about 2008 Neoclassical Economics; right now, we are in the midst of another “paradigm shift”, A.N.). A theory is accepted as long as it justifies circumstances and politics that a majority of voters sees as being in their interest - not because it is a sufficient explanation of the economy. A theory remains marginal if that is not the case.” (Stadermann & Steiger 2001, 13; my Translation )*

## **G) Micro-Macro Paradoxes: the Aggregation Problem, Fallacies of Composition and Division and Stützel’s Mechanics of Balances**

### ***Property Rights and the Aggregation Problem***

Not surprisingly, Property Rights are traditionally the core topic of Liberalism. Quite often, this is coupled with methodological individualism, leaving the aggregational problem unsolved. If at all, Adam Smith’s vague version of Mandeville’s paradox is used to legitimate private property and free markets: “private vices (such as the “love of money” and striving for monetary profit) lead to public benefits (the wealth of nations)”.

On the other hand, macroeconomic approaches have often left the aggregational problem unsolved as well by ignoring microfoundations and individual behavior, and by typically simply ignoring or taking for granted property rights. The clash between market fundamentalists and state fundamentalists during the cold war era was carried out on the shared basis of not being able to systematically solve the aggregational problem in a way that could have been agreed upon.

What do we mean by “aggregational problem”? The observation that “what is true for the parts of a system is not necessarily true for the system as a whole”. Direct inference that what is true for the parts must also be true for the whole is known as the *fallacy of composition*. The reverse inference, that what is true for the whole must also be true for the parts is known as the *fallacy of division*<sup>42</sup>.

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<sup>42</sup> a comprehensive discussions of the various types of fallacies of composition and fallacies of division in economics and social theory would be needed, but is beyond the scope of this paper. We will only provide some hints. While the Paradox of thrift on the level of net claims, Smith’s paradox (private vices, public benefits) on the level of material wealth and the free rider problem on the level of property rights are important cases for property and contract based societies, the free rider problem and the “economics of shortage” (Janosz Kornai) are important cases for societies exclusively based upon central planning (for a summary of Kornai’s study, see Verdery 1996, Chap. 1). In this paper, for reasons of historical applicability to the present situation of an imminent deflationary depression (which the ECB has trouble countering with monetary policy alone), we will focus on the paradox of thrift and demonstrate its workings on the basis of accounting for claims and obligations.

Keynes had briefly discussed fallacies of composition by way of Mandeville's "fable of the bees" in the *General Theory* (Keynes 1936/1964, 359-362), but his analysis to fallacies of composition in the form of the *paradox of thrift* has remained ambiguous and has probably been

*"... that element of Keynesianism which has been most often misunderstood by its opponents"*  
(Stützel 1978, 17, my translation<sup>43</sup>).

During the 1950s and 1960s, when the experience of the great depression was still fresh in the minds of contemporary economists, who had themselves lived through it, it was quite common to think about aggregational paradoxes, since the great depression had been a massive practical example for the paradox of thrift "at work". An economic textbook published in 1961 states that

*„It is essential for understanding the credit mechanism in a national economy to precisely distinguish between partial processes and processes regarding the totality of the economy. Theorems accurately describing processes within partial units of the economy do not necessarily apply to the economy as a whole as well. The ability to recognize how theorems valid for partial units are changed when applied to the economy as a whole is essential for any macroeconomist. Without an understanding for the actions and strategies of partial units (individual businesses) it is not possible to understand the economy as a whole. But statements valid for partial units cannot simply be applied to the economy as a whole in the same way."*  
(Schneider 1961, 63-64, my translation)<sup>44</sup>

Naturally, the experience of the financial crisis of 2008 has rekindled the interest in aggregational paradoxes. Katharina Pistor has now begun to relate insights into aggregational paradoxes from the tradition of monetary economics to *legal* categories, describing them as "paradox of law" (Pistor 2013). We would like to contribute to that debate and will attempt to suggest some ways in which the "paradox of law" may be illuminated in more detail, using our legal reinterpretation of basic accounting terminology.

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<sup>43</sup> orig. „... das Element des Keynesianismus, das am häufigsten mißverstanden wurde.“

<sup>44</sup> orig. "Es ist für das Verständnis des Kreditmechanismus in der Volkswirtschaft von entscheidender Bedeutung, genau zwischen den einzelwirtschaftlichen und gesamtwirtschaftlichen Vorgängen zu unterscheiden. Theoreme, die sich auf die einzelne Wirtschaftseinheit ... beziehen, sind nicht ohne weiteres übertragbar auf eine Gesamtheit von Wirtschaftssubjekten. (...) Die Fähigkeit zu volkswirtschaftlichem Denken zeigt sich gerade darin, zu erkennen, welche Änderung einzelwirtschaftliche Theoreme erfahren, wenn sie auf die Volkswirtschaft übertragen werden. Sehr viele Fehlschlüsse in manchen volkswirtschaftlichen Rasonnements rühren daher, daß einzelwirtschaftliche Theoreme einfach auf die Volkswirtschaft übertragen werden. (...) Ein wirkliches Verständnis volkswirtschaftlicher Zusammenhänge ist ... nur möglich, wenn man auf die Einzelwirtschaften als wirtschaftliche Dispositionen treffende Einheiten zurückgeht. Aber diese durch das Studium der Einzelwirtschaften gewonnenen Theoreme bilden nur die Grundlage für die Analyse der gesamtwirtschaftlichen Zusammenhänge. Sie können nicht ohne weiteres auf die Gesamtwirtschaft übertragen werden." (Schneider 1961, 63-64)

Specifically, one of our primary goals in this article is to systematically relate property rights and legal claims (both contractual/private and tax/public) to monetary macroeconomics by using an elegant and simple solution to the aggregational problem involved: Wolfgang Stützel's "mechanics of balances" (Stützel 1978, 1979), one basic principle of which has also become standard in a branch of Post-Keynesian monetary economics called "stock-flow consistent modelling" (Godley & Lavoie 2007).

Stützel embeds his analysis of aggregational paradoxes based upon accounting identities (in legal terms: the identity of nominal claims and obligations) within a more comprehensive discussion of aggregational paradoxes. He develops a typology of aggregational paradoxes (Stützel 1988, 156-165), using three categories: classical paradoxes (including Smith's paradox of private vices leading to public benefits), marxian paradoxes (private virtues leading to public problems; Stützel 1979, 375-398) and monetary circuit paradoxes based on accounting identities, some of which have been discussed in the Keynesian tradition (Stützel 1978, 1979)<sup>45</sup>. For this last category of paradoxes, Stützel develops a detailed approach of study which he terms "mechanics of balances"<sup>46</sup>.

Charlotte Bruun describes one of the most important uses of this approach:

*„Using Stützel's scheme we no longer have to choose between doing macroeconomics that has no microfoundation and microeconomics that ignore macro-relations.” (Bruun 2005, 84)*

Stützel's goals, however, are broader than that:

*“We intend to show that a number of controversies in the history of economic theory is rooted in a lack of insight into the central significance of the transition from partial statements to global statements; that some of those controversies can be solved while preserving the intentions of both parties; and that this can be achieved not by lame compromises, but by precise conceptual work.*

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<sup>45</sup> Stützel's main work (Stützel 1979) was first published in 1958. We will cite from the 2<sup>nd</sup> edition which appeared in 1979.

<sup>46</sup> Unfortunately, Stützel's work has not been translated into English yet. We are aware of only one publication written in English that has systematically used Stützel's approach, Charlotte Bruun's dissertation "Logical Structure and Algorithmic Behavior in a Credit Economy" (Bruun 2005). Chapter 3 entitled "The Logical Structure of a Monetary Economy" contains a brief introduction to Stützel's work, but also contains some imprecise translations of accounting terms which invites misunderstandings. We consider Stützel's work a substantial and original contribution to monetary economics that would be a very helpful and stimulating contribution to the Anglo-American debate among monetary economists around the search for a new economic paradigm. This debate is much livelier and more productive than the debate in the German-speaking world. We plan to find a publisher who is willing to make Stützel's work available in English.

*The main purpose of this project is to remove from economics the burden of unnecessary controversies – especially controversies which appear to be based upon a political bias, but actually simply rest on a lack of insight into the relationship between partial and global statements. This applies mainly to the controversy between Keynesians and anti-Keynesians, but also to the controversy between the orthodox and the modern theory of credit, many controversies about capital formation, about “residual income”, “business gains”, the theory of interest and finally the theory of profit.” (Stützel 1979, 81, my translation)<sup>47</sup>*

### **Aggregation of balance sheets**

The basic principle of both stock-flow-consistent modelling and Stützel’s mechanics of balances are *accounting identities*: my legal claim always is identical to someone else’s obligation, in terms of accounting: the creditor’s asset (the claim) which adds to his net wealth is someone else’s – the debtor’s - liability and subtracts from his wealth. Thus, in the aggregate, the claim and the liability net out to zero: they do neither add nor subtract from the total assets of creditor and debtor seen as a whole.

To illustrate this, we will start with a simple example of a closed economy of only two economic subjects, describe it in precise mathematical terms, and then generalize it to state the aggregational paradox for property and contract-based (and thus, credit-based) economies.

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<sup>47</sup> orig. “Wir haben ... die Absicht zu zeigen, daß in mangelnder Klarheit über das Wesen und im mangelnden Bewußtsein der tragenden Bedeutung des logischen Problems des Übergangs von Partialsätzen zu Globalsätzen eine ganze Reihe dogmengeschichtlicher Kontroversen ihren Ursprung hat, daß sich einige solcher Kontroversen völlig bruchlos beheben lassen, daß häufig das Anliegen jeder der streitenden Parteien völlig widerspruchlos gewürdigt werden, und dies alles nicht durch weichlichen Kompromiß, sondern durch konsequente Fortführung der scharfen Unterscheidungen geschehen kann. (...) Der Hauptzweck dieses ganzen Unternehmens ist, die wirtschaftstheoretische Diskussion von unnötigen Auseinandersetzungen zu entlasten, vor allem von solchen Auseinandersetzungen zu entlasten, die mit dem Anschein (und dem Pathos) geführt werden, als ginge es um einseitige Verhaltensvermutungen oder gar wirtschaftspolitisch parteiliche Akzentverschiedenheiten, während sie in Wirklichkeit nur auf mangelnder Einsicht der streitenden Partner in das Wesen ökonomischer Globalmengengefüge beruhen. Dies betrifft in erster Linie die Kontroverse Keynesianer versus Antikeynesianer, dies betrifft aber auch die Kontroverse zwischen orthodoxer und moderner Kredittheorie, zahlreiche Kontroversen um das Kapitalbildungsproblem, um „Residualeinkommen“, „Unternehmergewinn“, um die Zinstheorie und endlich auch noch um die Profittheorie.“ (Stützel 1979, 81)



Liabilities:                      Obligations O

Net Worth/Equity:             $NW = C + P - O$

Net Claims :                     $NC = C - O$

To distinguish between the balance sheets of the two individuals and the aggregated balance sheet of the total economy, we will use subscripts, for example: Net Claims of Subject 1:  $NC_1$ , Net Claims of subject 2:  $NC_2$ , Aggregate Net Claims:  $NC_A$ .

For a closed economy containing subjects 1 ... n:

$NC_1 + NC_2 \dots + NC_n = 0$ , thus

$NW_1 + NW_2 \dots + NW_n = P_1 + P_2 \dots + P_n$

**Conclusion: For a closed economy containing subjects 1 ... n, net worth equals total property rights since claims and obligations will always net out to zero by definition.**

Or, to restate what we stated above, citing John R. Commons:

The balance-sheet of every individual contains three accounts: property rights with an ascribed monetary value, legal claims (credits), and legal obligations (debits). But if we collected into one all the balance-sheets of everyone in the world, the debits and the credits mutually neutralize each other, and there remains but a single account: existing property rights<sup>49</sup> with an ascribed monetary value.

### ***Basic Macro Accounting: Sectoral Claims-Obligations-Balances***

Just as we can aggregate all individual balance sheets into one global balance sheet for the closed (global) economy as a whole, it is possible to divide up the economy as a whole into different parts or sectors. This is common practice in macroeconomic accounting, which states use to collect

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<sup>49</sup> From the standpoint of the whole system of a closed economy, however, *values* cannot exist because by definition, values presuppose exchangeability. For a closed economy as a whole, there is no external subject that rights could be exchanged with. We have to conclude that concepts like *value, price, property right, claim, exchange*, etc. are *partial concepts*, i.e. concepts that apply only to legal persons (parts of the whole), but not to the system as a whole. It would be correct to say that for a closed economy as a whole, there can be no financial statement / balance sheet, only an inventory of goods without a monetary value or a price, representing merely what Marx called *specific use values*. At the level of the economy as a whole, wealth does not consist in monetary values or rights, but indeed only in physical goods, human abilities, knowledge, etc. (cf. Stützel 1979, 47-51) Application of concepts like value, price, etc. to the *system as a whole* implies a fallacy of composition. Of course, in the real world, a national economy cannot be viewed as a closed economy in that sense any more as soon as it has some form of external trade. In today's globalized world, only the global economy can be viewed as a closed, total economy.

information about their economy that can be used as a basis for making policy decisions (Stobbe 1966, 46-54; Wray 2012, 1-38).

The bipartite division into a domestic and a foreign sector, for example, is used to determine the balance of trade for a national economy. If a country exports more in (terms of monetary value) than it imports, it runs a surplus on its balance of trade. That means it acquires monetary claims against the foreign sector, i.e. becomes a net creditor to it (two of the biggest international creditors are China and Germany). Conversely, if a country imports more (in terms of monetary value) than it exports, it runs a deficit on its balance of trade. That means that it builds up monetary obligations vis a vis the foreign sector, i.e. becomes a net debtor to it (the biggest international debtor is the United States of America)<sup>50</sup>. The “international paradox of thrift” resulting from the fact that the domestic and the foreign balance always equal zero by definition (because for every creditor’s claim, there is a corresponding debtor’s obligation) Keynes discovered and tried to address with the plan he proposed at the 1944 Bretton Woods Conference will be described below in more detail, in terms of Stützel’s mechanics of balances.

A further division that is common in macroeconomic accounting is the division of a national economy into 3 sectors: the private sector, the government sector and the foreign sector (the national economy vis a vis the rest of the world). The private sector is usually further subdivided into private businesses and private households, so we end up with 4 sectors: private businesses, private households, government, and foreign.

Since the government’s balance sheet is connected to all other balance sheets in the economy by way of tax claims which are subject to public law, the government balance can only be judged in any sensible way in context to the balances of the other 3 sectors and their constellation, and by explicitly taking into account the specific nature of tax claims (created by legislation and command) in comparison to private claims (created by contract and consent) on the government balance sheet. The isolation of the government deficit from the balances of the other sectors, i.e. looking at the government as if it were the same as a small individual business, is a core part of current ideology and austerity practice, in which restrictive fiscal policy is pitted against ultra-expansive monetary policy<sup>51</sup>.

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<sup>50</sup> in connection with the dollar as international currency, the U.S. economy plays a special role internationally that has been described as functioning as a “global minotaur” (Varoufakis 2010).

<sup>51</sup> during the “long upswing” (Hobsbawm’s “golden age” of the 1950s-1960s) and the “long downturn” (1971-2008/2016), typical contrary constellations of sectoral balances (including the government deficit) have developed in conjunction with the typical (keynesian vs. neoliberal) models of political regulation (Schulmeister 2013, 2014). In Germany, for example, during the 50s, the private household sector was a net creditor to the private business sector (net debtor), the government and foreign balances were more or less around 0. Starting in the 1970s, the private business sector balance has turned into a net creditor balance, with the private households still remaining in a net creditor

### ***Stützel's approach to describing aggregational paradoxes: partial, relational and global statements***

In the next section, we will briefly introduce Stützel's general scheme of systematically describing aggregational paradoxes (Stützel 1979, 21-27). We will start with an illustrative example, and then apply the same scheme to the framework of accounting for rights and obligations we have developed above. We will demonstrate the aggregational "paradox of thrift" on the level of net claims (the claims/obligations balance), in terms of stocks and in terms of flows of abstract wealth.

#### *Introduction of Terms*

Stützel introduces his scheme for describing aggregational paradoxes with the example of a cinema situation. If all spectators are sitting on their chairs, each single one of them can improve his own view of the cinema screen by standing up. If *all* spectators try to improve their view at the same time, however, *none* of them can improve their view. Rather, the only change they achieve is that they now all have to stand. As it turns out, single spectators or a partial group of spectators can improve their view only inasmuch as the rest of the spectators (the complimentary group) remain seated.

To describe situations of this type, Stützel distinguishes three type of statements:

#### Partial Statement (valid for individuals or partial groups):

By standing up, individual spectators can improve their view compared to what it would have been had they remained seated.

#### Relational Statement (valid for individual or partial groups in relation to the complimentary group):

For an individual spectator or a partial group of spectators, the view is improved only if the complimentary group has heightened their view less than the individual or group in question.

#### Global Statement (valid for the system as a whole):

For the group of spectators as a whole, it is not possible to improve its view by standing up.

Stützel distinguishes between the totality of all subjects  $T$ , a partial group  $PG$  (which can be made up of  $1 \dots (T-1)$  subjects) and a complimentary group  $CG$ , which comprises all those subjects within the totality that are *not* contained in the partial group (and thus, can comprise  $(T-1) \dots 1$  subjects), so that  $PG + CG = T$ . Partial group and complimentary group can be divided further into subgroups (Stützel 1979, 16). Common divisions within macroeconomic accounting are those between domestic sector

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position, whereas the government balance turned negative (net creditor), which in germany was compensated for by a positive foreign balance via germany's permanent export surpluses.

(PG) and foreign sector (CG), to describe national current account balances; the domestic sector is typically subdivided further into public and private sector; additionally, the private sector is divided into the private households and the private businesses. The balances of claims and obligations of all sectors add must up to zero, i.e. if a national economy has a foreign balance of 0, a negative government balance (net obligations) implies a positive balance of the private sector (net claims).

This is standard practice in macroeconomic accounting (Stobbe 1966, 46-54) and is becoming standard in monetary macroeconomics as well (Wray 2012, 4-14; Godley&Lavoie 2007, Chap. 2).

### ***Aggregational paradoxes on the level of stocks of net claims/net obligations: Mechanics of Balances I***

We will now apply this scheme of description to stocks of net claims (claims-obligations-balances or net financial asset positions) within a closed economy as described above, in which the economic actors account for legally enforceable rights and obligations.

Logically consistent statements that are valid *independently* of intentional human behavior can be made only at the level of net claims / net obligations, because they represent nominally fixed assets. Stützel thus calls these patterns “trivial-arithmetic” patterns.

We can *not* make logically consistent statements regarding net worth. Net worth equals property rights + net claims, and property rights represent nominally variable assets that are subject to constant subjective valuation/revaluation by its owners and their creditors. Thus, net worth is always influenced by intentional human actors – the owner and his creditors - and their subjective strategies of and decisions about valuing and pricing the nominally variable property rights on the assets side of the owner’s balance sheet. On the level of claims and obligations, however, which are nominally fixed<sup>52</sup>, we *can* describe logically consistent patterns of macroeconomic accounting that resemble “mechanics” in so far as they do not depend on intentional human action. As long as we describe this type of pattern, we are abstracting from human behavior and thus, from actors’ strategies of valuing and pricing nominally variable property rights. In a later step, we will undo that abstraction and explicitly introduce human actors to the model.

In other words, Stützel does not follow a “mechanistic” approach here, using the machine metaphor in an inappropriate way. He consciously chooses to *temporarily* abstract from intentional human perception and action in order to first focus on precisely describing the paradox micro-macro-relationships of accounting patterns that *are* independent of human action. Stützel is fully conscious

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<sup>52</sup> i.e. are claims and obligations for a fixed amount of monetary wealth once they mature and become enforceable

that at a later point in developing a model of the economy, human behavior will have to be re-introduced to make any kind of meaningful statements about typical patterns of property and contract based monetary economies, such as business cycles<sup>53</sup>.

*„We will consciously limit ourselves to analyzing relationships between variables that are independent of economic subjects' actions and reactions. We will call these relationships “direct” relationships. We explicitly abstract from all relationships that depend on any subject's intentions, so the pure arithmetic and mechanics of direct relationships is brought out more clearly. We aim at separating*

*a) parts of and statements in economics that are true because they are based on pure arithmetic independent of any subjective experience (economic arithmetic)*

*b) part of and statements in economics that depend on human actions and decisions (complete economic statements)*

*c) statements, which depend on normative implications (statements about economic policy).”  
(Stützel 1979, 20)*

With that in mind, let's apply Stützel's scheme for describing aggregational paradoxes to an economy on the level of claims-obligations-balances (net financial asset positions):

Partial Statement:

Any economic subject or partial group of economic subjects can achieve a positive net balance of claims and obligations (claims minus obligations =  $> 0$ ) or “positive net financial assets”, in other words, achieve a status of net claimant or net creditor. For any economic subject, C-O can be  $> 0$ .

Relational Statement:

Any economic subject or partial group of economic subjects can achieve a positive net balance of claims or a status of net claimant/net creditor only if the complimentary group accepts or achieves a negative net balance of claims (claims minus obligations  $> 0$ ), i.e. achieves or accepts a status of net obligor or net debtor.

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<sup>53</sup> Stützel provides a brief discussion of the relationship of trivial-arithmetic mechanics of balances and the theory of business cycles in Stützel 1987, 82-83

### Global Statement:

*It is impossible that all subjects – in the sense of each and every one, at the same time – achieve positive net claims, i.e. become net creditors. It is also impossible that all subjects achieve negative net claims (net obligations), i.e. all – again in the sense of each one without exception - become net debtors. A closed economy as a whole can never achieve a positive or negative net balance of claims - obligations, i.e. never become a net creditor or net debtor, since all claims and obligations always net out to zero by definition. In other words, the world as a whole can never be “rich” in terms of net claims (net financial assets), neither can it be in net debt or “overindebted”; these are partial terms which are valid only for partial groups, but never for all subjects taken as a whole.*

In other words, on the level of net financial assets (the claims-obligations balance), business is a zero-sum game by definition; on the level of physical goods (1<sup>st</sup> order objects of law), however, it can be a win/win situation for everyone, if the macroeconomic process is managed sensibly and wisely (which in democratic states is a goal that can be hard to achieve in the long run, since partial interests tend to dominate public opinion and politics).

This insight can now be applied to the global economy with respect to the net creditor / net debtor positions of nation states, which result from accumulated surpluses or deficits in the balance of trade.

If *all* nations strive for positive net financial assets at the same time (or, in terms of flows, for improving their trade balance, that is for greater trade surpluses or reduced trade deficits), it is clear that not everybody can be successful at that. If such a mercantilist race for export surpluses between states develops by way of policy, it can become a race to the bottom, all states beggaring their neighbors. This was a typical strategy during the mercantilist era.

Keynes painfully learned this during the great depression (Temin & Vines 2013; Keynes 1936, Chap. 23). His German colleague Wilhelm Lautenbach, Stützels' teacher, was aware of it as well: if *all* countries want to achieve a positive balance of trade,

*„... it is a priori clear that they cannot all (at the same time, WT) reach this goal. There are two possibilities. Either all states foster exports and allow for unrestricted imports. In a frenzy of international lust of exchange, the total volume of exports (and thus, imports as well) will increase, without anyone individually having exported more than they imported. Or – and this is the likely and historically recurring possibility: all countries will limit imports in order to achieve a positive balance of trade. In effect, no country can increase its exports. On the contrary. The general striving for a positive exports/imports-balance will cumulatively reduce the total volume of exchange. The result is a fight for markets, international envy, war*

*of everyone against everyone and finally, maybe, “imperialism as the highest state of capitalism.” (Lautenbach 1952, 9)<sup>54</sup>*

Even Adam Smith had already seen the problem of this mercantilist strategy:

*“The sneaking arts of underling tradesmen are thus erected into political maxims for the conduct of a great empire ... . By such maxims as these, however, nations have been taught that their interest consisted in beggaring all their neighbours. Each nation has been made to look with an invidious eye upon the prosperity of all the nations with which it trades, and to consider their gain as its own loss. Commerce, which ought naturally to be, among nations, as among individuals, a bond of union and friendship, has become the most fertile source of discord and animosity.” (Adam Smith: An Inquiry into the Nature and Causes of the Wealth of Nations, Book IV, Chapter III (part II))*

To expect *all* states to follow such a strategy either in a closed economy or within a confederation of states that as a whole, has a pretty much balanced trade with the rest of the world represents a fallacy of composition, since it means to pose a goal that is impossible to reach by definition. Yet, it is Germany's politicians and public that is continually pushing such misguided expectations, trying to fend off legitimate international criticisms of Germany's beggar thy neighbor “export imperialism” that is a big part of Europe's current instability and deflation.

The plan for an international clearing union that Keynes brought to the Bretton Woods Conference in 1944 had envisioned a financial mechanism designed to avoid such beggar-thy-neighbor-races to the bottom he had experienced during the 1930s (Keynes 1980, 170-195). The clearing union would not only charge net debtor countries with interest. Because for each net debtor, there must be a net creditor

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<sup>54</sup> „Es ist ... von vornherein klar, daß sie nicht zum Ziel kommen werden. Grundsätzlich theoretisch gibt es hier zwei Möglichkeiten. Entweder betreiben alle Staaten aktive Exportförderung und lassen die Importe frei: In einem Taumel internationaler Austauschlust wird das Gesamtexportvolumen steigen, ohne daß in summa irgend jemand mehr exportiert als importiert hätte. Oder aber – und das ist das Wahrscheinlichere und leider immer wieder historisch Gegebene: Man wird zur Gewinnung eines aktiven Leistungsbilanzsaldos die Importe zu beschränken suchen. Damit kann auch kein Land mehr seinen Export steigern. Im Gegenteil. Das allgemeine Streben nach einer Differenz zwischen Export und Import wird das Gesamtaustauschvolumen kumulativ zurückgehen lassen. Das Ergebnis ist Kampf um Absatzmärkte, internationaler Konkurrenzneid, Krieg zunächst aller gegen alle und schließlich vielleicht «Imperialismus als höchstes Stadium des Kapitalismus»!“ „Alle Länder wollen...mehr exportieren als importieren. Es ist wieder von vornherein klar, daß sie nicht zum Ziel kommen werden. Grundsätzlich theoretisch gibt es hier zwei Möglichkeiten. Entweder betreiben alle Staaten aktive Exportförderung und lassen die Importe frei: In einem Taumel internationaler Austauschlust wird das Gesamtexportvolumen steigen, ohne daß in summa irgend jemand mehr exportiert als importiert hätte. Oder aber – und das ist das Wahrscheinlichere und leider immer wieder historisch Gegebene: Man wird zur Gewinnung eines aktiven Leistungsbilanzsaldos die Importe zu beschränken suchen. Damit kann auch kein Land mehr seinen Export steigern. Im Gegenteil. Das allgemeine Streben nach einer Differenz zwischen Export und Import wird das Gesamtaustauschvolumen kumulativ zurückgehen lassen. Das Ergebnis ist Kampf um Absatzmärkte, internationaler Konkurrenzneid, Krieg zunächst aller gegen alle und schließlich vielleicht «Imperialismus als höchstes Stadium des Kapitalismus»!“

somewhere else, the debtors can only get rid of their debt if the creditors get rid of their credit – by buying nonfinancial assets (property) from the debtors. If the creditors refuse to get rid of their credit, it is impossible for the debtors to get rid of their debt. It's a symmetrical relationship. To take away the desire to hoard net financial assets from nations, Keynes envisioned that not only the debtor countries had to pay a fee as an incentive to get rid of their debt. Creditor countries would have to pay a fee on their credit to the clearing union as well – as an incentive to get rid of their credit. The goal of the clearing union was to achieve a near balance of current account of all countries – to avoid another race to the bottom like the one he lived through during the great depression. Of course, creditor nations will be reluctant to make such sacrifices – at the time, the U.S. was not ready to accept such an ambitious plan. Keynes proposal was based directly upon his insight into the paradox of thrift – which is directly based on the simple accounting identities sketched above<sup>55</sup>.

Keynes' vision represents an elegant solution to the prisoner's dilemma set up by accounting identities implied by legal claims that merits more research and attention. From our legal standpoint sketched above, it stands to reason that it may be difficult to implement such a clearing union without a corresponding state with a legitimate monopoly of force that could actually enforce Keynes' quotas on an international level. Within a non-legal, hegemonial order of international "law" only, it would seem much more unlikely such a plan could get off the ground, because the paradoxes of competition between individual nations will then have to be managed by the hegemon, who may not be wise enough to subordinate his partial interests to a sensible management of the global system as a whole. There is, however, a historical counterexample of a clearing union along the lines Keynes had envisioned that successfully operated without a corresponding state monopoly of force for the geographical confines of the clearing union: the european payments union, which existed between 1950 and 1958 (Amato & Fantacci 2012, 110-121). It may be useful to reconstruct this period of the history of european currency systems to see if there may be lessons to be learned for today's organization and management of the eurozone.

Keynes' vision received renewed attention after the 2008 financial crisis. The world bank produced a study on it (Pifaretti 2009) and the Governor of the People's Bank of China (Zhou 2009) suggested a reform of the international monetary system echoing parts of Keynes' Plan (for a critical assessment, see Amato & Fantacci 2010). For the first time, the story of the "Battle of Bretton Woods" (Steil 2014) was told in german and made available to a larger public (Zoche 2009). There have been suggestions to reconstruct the European Central Bank as a Clearing Union in order to counter the

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<sup>55</sup> It seems that Keynes developed this insight between 1936 (when he published his *General Theory of Employment, Interest and Money*) and the 1940s, since the *General Theory* is not systematically based upon the insight into the nature of the zero-sum game posed by accounting identities yet.

imbalances within the Eurozone (Troost 2011, Fantacci 2014), and to use clearing unions as an instrument for developing nations (Kregel 2015)<sup>56</sup>.

From our perspective, Keynes' vision deserves more contemplation and research, and we feel the legal perspective on finance we sketched above may help in developing some more clarity about the potential and also the potential problems Keynes' idea holds. We will deal with this conception in more detail when developing level 4 or our paradigm, the banking and financial system. Bi- and multilateral clearing are among the most basic and pervasive transactions within property- and contract based legal systems.

#### **H) The Inherent Instability of Private Credit**

The inherent instability of private credit, as well as cycles of regulation and deregulation in response to it, has been described aptly by a number of economists who are aware of the credit based structure of the financial system (to name a few: Minsky 1979, Soros 1987, Chap. 5; Mehrling 2011, 12-18 and 66-70, Bruun & Heyn-Johnsen 2009b, and many others). We plan to reconnect their analyses to the legal sphere and the framework we developed above, a process that Pistor (2013) has already started. For obvious reasons, a special focus will be on clarifying the theory of value, studying strategies of asset valuation of economic actors, and of banks and other large actors within the financial industry in their role as political subjects trying to influence public opinion and lobby politicians in furthering their special interests, a field of research that is included within our general approach of bringing the *political* process back into economics in a systematic way.

### **III. Re-Interpretation of Existing Models**

Our plan is to show that from the perspective of our integrative paradigm based upon law, accounting, and mechanics of balances, many controversies still hovering in monetary economics can be solved and integrated (similar to, but hopefully more comprehensive as Mehrling's integrative solution to a number problems in the history of monetary theory by way of his description of the inherent hierarchy of money, see Mehrling 2000a, 2012). This should help to unify and solidify the field, enabling it to develop a more coherent, stronger and thus more convincing alternative to neoclassical economics.

We will give one example: the controversial treatment of government debt in three approaches within the field of Post-Keynesian monetary economics: Randall Wray's Modern Monetary Theory, Perry Mehrling's Money View, and Heinsohn & Steiger's Ownership economics.

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<sup>56</sup> it would seem that especially this development application would urgently need to be based upon an understanding of banking that rests on a solid legal foundation as suggested above.

## **A) Government Debt: Modern Monetary Theory, Perry Mehrling and Ownership Economics**

Unfortunately, contemporary monetary economics that is so badly needed to understand the post-2008-situation has no clear understanding of this private/public law dialectic and its mediation by constitutional law as well. In monetary theory, there is a long history of controversy between “private money creation” theories and “state money creation” theories. These controversies can be solved if they are approached from the standpoint of law and the private/public-law dialectic.

### Modern Monetary Theory – Randall Wray

Randall Wray (2012) vaguely understands the significance of public law when he asserts that the “monetary sovereignty” of states – their superior creditworthiness – is based upon taxation, but he fails to provide any explicit reference to the legal basis of taxation: public law, and the state’s monopoly of legitimate use of force, as opposed to private law based upon property, freedom of contract, which is the foundation of business and the market. Wray does not provide any explicit reference to contract law as the basis for markets and accounting, but simply takes that for granted as well, which leaves MMT unfit to understand the situation in countries with weak state and legal systems – developing countries and parts of the southern periphery of Europe.

### Money View – Perry Mehrling

Another one of the great monetary economists of our time, Perry Mehrling, in his critique of Wray’s Modern Monetary Theory, *also* fails to clearly understand the similarities, differences and dialectic relationship between public law and private law and their mediation by constitutional law, and simply conceptualizes the state as a big business:

*“The significant point is that our government is our creation. It is only able to tax us to the extent that we allow it to do so. Its taxing authority arises not from its raw power but from its legitimate authority. Further, our state arises out of a thriving private civil society, not the reverse, as the colonial parable would have it. Our state is not a king demanding bounty.”*  
(Mehrling 2000c, 402)

So far, so good. This is an apt description for constitutional states based upon popular sovereignty. Nonetheless, Mehrling falsely identifies public law that is controlled and restricted by principles of constitutional law (popular sovereignty, democratic government, rule of law), with private law. The concepts of rule of law and popular sovereignty are indeed an attempt to subordinate public law to the principles of private law – but not by replacing public law altogether, which would be impossible and destroy private law as well. Rather, constitutional law restrains state power, controls it by a system of

checks and balances, and subordinates it to the citizen's will (popular sovereignty) – but if it would do away with public law altogether, the result could neither be a Republic (roman “res publica” – concerns of the community as a whole), nor could private law be guaranteed and enforced, thus, markets could not exist.

How Mehrling confuses tax claims (public law) with claims arising from contract (private law) becomes most apparent in the following quote from the same article:

*“For monetary theory, so it seems to me, the significant point about the modern state is not its coercive power but the fact that it is the one entity with which every one of us does ongoing business. We all buy from it a variety of services, and the price we pay for those services is our taxes.” (ibid.)*

Mehrling conceptualizes taxes as a *price*. But what is a *price*? A price is part of an *offer of contract*, i.e. a term that makes only sense in the context of freedom of contract, in which legal claims are created by consent through agreeing upon a contract. An offer that has a price can always be refused by potential customers. But is taxation really an *offer* of a government to its people? Of course not. You cannot refuse to pay your tax bill, no matter which specific party or president you voted for. Mehrling implicitly conceptualizes tax claims as *contractual* claims and thus entirely misses the crucial difference between private law and public law<sup>57</sup>. Instead of distinguishing between private law, public law and constitutional law, the latter being an attempt to mediate between their contradicting basic principles (consent vs. command) and to subordinate public law to principles of private law by way of popular sovereignty and the rule of law, Mehrling falls into the trap of mistaking public tax claims of a state that is constituted as a democratic republic for contractual claims, thus entirely blurring the crucial legal distinction between public and private law that every law student learns about during the first semester of their studies and that has been at the very *heart* of the anatomy of capitalism and *any* republic ever since roman antiquity. He goes on to state that

*“Just as we are each individually willing to extend temporary credits to individual business associates to whom we expect to be making payments in the future, so too we are all willing to extend credit to the government. It is the universality of our dealings with the government that gives government credit its currency. The point is that the public “pay community,” to use an apt phrase from Knapp that Wray likes, is larger than most any private pay community, not*

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<sup>57</sup> it may well be that Mehrling uses the expression, “taxes are the price we pay” in a *metaphorical* sense, whether he is aware of it or not. But even a metaphorical use would be misleading here, or vague and ambiguous at the least. What we need here, however, is the same kind of precision legal scholars use, as it is those precise concepts that law-based societies are *empirically* based upon. Again, this is not theory, but simply precise description of distinctions that guide the action of people within the jurisdiction.

*that the state is more powerful than any other private entity. Consequently, the state is ideally placed to be the issuer of the ultimate domestic money.” (ibid., 402-403)*

Speaking about “dealings” of citizens with the government, Mehrling conceptualizes *all* relationships of citizens to their government as *business* relationships (“deal(ing)s”), that is, relationships based upon private law (property rights and freedom of contract). While it is true that in many cases that democratic states *do indeed* act as private legal persons *as well* (when, for example, a city or state government is operating a public transportation company, a public swimming pool, or public museums), this is clearly *not* so and *cannot* be so in the case of *taxation*. The fact that government debt (government bonds - a special kind of obligation of a state towards citizens who choose to become creditors of the state by contract, that is, by buying government bonds), other than tax debt (public law obligations of each citizen to the government which governments create by command), are *indeed* subject to private law, makes this even more difficult to notice at first sight.

The fact that a state can *choose* in which area he operates as a public authority, or as a legal personality of private law, that is, as a free and equal subject offering and accepting offers of contract (as in the case of government bonds or operating state owned companies for public transportation), does not change the fact that taxation is clearly part of *public* law, and that no state can give up his public authority and his monopoly of force altogether without also destroying the legal order of private law, and, in consequence, efficient markets as well.

For lack of space and time, I will give only one short quote to substantiate this claim:

*“The state and the government administration are not only only public authorities, but also non-authoritative economic subjects that operate as legal persons according to private law. It depends on the specifics of a given legal order to draw the line between the action of a public authority in its role of a public authority and its role as a private economic subject. The state can avoid acting as a private legal subject completely, or subordinate itself to private law in a more extensive way than the nature of the legal relationships he enters would actually allow.” (Jellinek 1905, 373)*

In a most extreme case, a state can completely give up his central authority, thus, basically choose to cease to exist. This was the way “privatization” and “transformation” was approached in post-socialist russia, under the influence of western libertarian ideology promoted by western “advisors” in the name of the so-called “Washington Consensus”, which at the time was also promoted by the international institutions (Knieper 2006, 2009). The catastrophic results of this “approach” are well known and well documented (see Footnote 41 and bibliography).

Mehrling, despite his excellent work in rehabilitating the “money view” that even includes an awareness of *dialectics*<sup>58</sup>, apparently simply does not hit upon the idea to make any specific empirical reference to the state and the law whatsoever, but instead for some reason chooses to work with vague, preconceived everyday notions of “the state” as a “business” who provides services for which taxes are “the price”. This may be unintentional and purely habitual. But is this really precise empirical work? It would take no more than a walk to the law bookshelf in any library and picking up any first semester textbook of law to precisely and empirically clarify those notions<sup>59</sup>.

While Wray, as Mehrling notes, conceptualizes the government as an omnipotent, quasi-absolutist entity, Mehrling conceptualizes it as merely another business which differs from other businesses by size only. Wray implicitly and vaguely takes the standpoint of public law as absolute, which Mehrling correctly criticizes as using a “colonial governor parable”. But in return, Mehrling implicitly and vaguely poses the standpoint of private law as absolute and universal. They both step into the (habitual?) trap of the old cold war market vs. state fundamentalism debate, instead of simply referring to existing law and conceptualize the dialectic, which in reality has long been mediated by constitutional law.

Since both fail to make any *specific* reference to legal structures but use vague, partly metaphorical terms, they simply ignore constitutional law and do not even attempt to conceptualize the public political decisionmaking process about a specific regime of taxation in so-called liberal democracies, which evidently is subject to a struggle between different social interest groups that plays out in the arena of public discourse by means of rhetoric. This may be because they believe this is not within the scope of economics but rather, of political science. But this exclusive focus of economics on markets instead of the *political economy* of the state-market-system, may in itself be ideological, because

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<sup>58</sup> we find Mehrlings discussion of the *dialectic of finance* (Mehrling 2000a) excellent and highly illuminating, and have learned some of our most valuable insights in monetary economics from this exceptional scholar, to whom we feel deeply indebted. Thus, our criticism is not to be misunderstood, we undertake it in the spirit of the shared goal of developing a new political economics for the 21<sup>st</sup> century that aptly captures the *essence* of capitalism. Mehrling states, „Of all the deep features that may be found in most monetary systems, it is the last-mentioned dialectic of finance that economists find most difficult to accept.” (ibid., 6) We might add, then, that unquestionably another dialectic that economists have apparently had a tough time coming to terms with analytically and historically is the public-private-law dialectic.

<sup>59</sup> Apparently, it’s not part of institutionalized academic culture to seriously look beyond the confines of what seems to be a “discipline” (in this case, economics), even if the nature of the phenomenon studied requires it – institutionalized habits running their course. Of course, such disciplinary borders have their history and functions as well and would make for interesting studies in the history and sociology of modern social science.

political power struggles are simply left out of the analysis and it is instead suggested that economy is a value-free science serving the interests of *all* citizens – a promise often too good to be true.

The controversy between Mehrling and Wray is another example of seemingly controversial discussions among economists that could be resolved empirically, simply by reference to the precise conceptual distinctions of existing law. In order to do so, one simply has to become familiar with the precise distinctions law is based upon. It seems amazing that only so few economists would ever bother to make this effort – there is ample material for possible future studies in the history and sociology of science. Economics *cannot* do without at least *basic* empirical knowledge of the empirical legal and institutional foundations of capitalism in private, public and constitutional law, or deal with it on a “first semester memorize for the finals” basis, then followed by forgetting about them or pushing them aside as soon as it comes to macro models. If legal foundations are lacking, the solutions they propose on the basis of their incorrect theoretical conceptualizations are bound to become unrealistic, and their understanding of european civilization remains superficial and misleading.

#### Heinsohn and Steiger (“Ownership Economics”)

Heinsohn and Steiger’s treatment of government debt seems contradictory (Heinsohn & Steiger 1996, 2006; see also Spahn 2010). An avid reader will probably suspect that the authors – Steiger being a post keynesian economist, Heinsohn being a sociologist – may have had an unresolved argument here. We can show from our perspective that this argument can be resolved by using legal and accounting categories in an empirically correct way, and by distinguishing a *microeconomic* perspective from a *macroeconomic* perspective that places government debt in the context of sectoral balances.

In their 2006 book, “Eigentumsökonomik”, Heinsohn and Steiger notice that

*„Indeed, in an Ownership Society a government bond can be the most secure and liquid asset of all.“ (Heinsohn & Steiger 2006, 144)<sup>60</sup>*

How do they explain this?

*„They [Government Bonds] become highly liquid assets by way of the fact that domestic and foreign buyers voluntarily buy them because they trust in the power of the state to tax its citizens’ property.“ (ibid., 144)<sup>61</sup>*

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<sup>60</sup> “In der Tat kann in einer Eigentumsgesellschaft ein staatliches Wertpapier der sicherste und liquideste Titel überhaupt sein.“

They conclude that,

*“It could be said that the state’s most important property potency consists in its fiscal sovereignty, which means that he is allowed to lay hands on his citizens’ property.” (145)<sup>62</sup>*

This is clearly not the case. The government must *protect* the citizen’s property rights – tax claims are claims not against the citizens’ property rights but against citizens’ *total assets*. Heinsohn and Steiger mistakenly identify “citizens’ property rights” with citizens’ *total assets*, which consist of their property rights *plus* their claims against other legal subjects, including the government.

If we compare the balance sheet of a government with the consolidated balance sheet of the private sector, presupposing a closed economy, we can see the following:

<b>Public Entity</b> (State, Government)	
Assets	Liabilities
<b>Tax Claims (ag. <u>all</u> citizens!) Property Rights</b>	<b>Contract Obligations: Government Bonds<sup>63</sup> Net Worth</b>

<b>Private Sector consolidated</b>	
Assets	Liabilities
<b>Government Bonds Property Rights</b>	<b><i>Tax Obligations</i> Net Worth</b>

Tax claims are claims against the private sector’s *total assets*, and part of those assets are government bonds. The government can, in principle, reduce his net debt by taxation any time it chooses to, in effect neutralizing his net debtor position vis a vis the private sector. This will in turn take the private

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<sup>61</sup> „Erstklassige Vermögenstitel (assets) werden sie dadurch, daß sie vom einheimischen und internationalen Publikum im Vertrauen auf die Besteuerungsmacht des Staates über das Eigentum der Bewohner seines Territoriums freiwillig angekauft werden.“

<sup>62</sup> „Man könnte also sagen, daß die wichtigste Eigentumspotenz des Staates in seiner Steuerhoheit besteht, die gerade darin besteht, daß er in das Eigentum der Bürger eingreifen darf.“

<sup>63</sup> contrary to tax claims which are regulated by public law, government bonds are subject to *private* law.

sector out of its net creditor position vis a vis the government, i.e. reduce the liquidity of the private sector.

Conversely, the government can choose to sell more bonds without immediately taxing its citizens by the same amount, thus building a net debtor position vis a vis the private sector, while improving the liquidity situation of the private sector which is put into a net creditor position that way.

This underlines the fact that the government has the capacity to use taxation and bond emission as means of influencing the *liquidity* situation of the private sector (fiscal policy) while fully respecting and protecting citizens' property rights which is a constitutional obligation of states with a private law order. Thus, fiscal sovereignty based upon the government monopoly of force is key to the governments superior position to influence the macroeconomy by way of fiscal policy – a capacity that can be used anticyclically as well as pro-cyclically (as during the great depression, and currently in europe).

Since the government by definition deals with *all* citizens and taxes them, its balance sheet is necessarily connected to all other balance sheets within the economy by way of public law. Thus, it makes no sense to look at the government's balance sheet or its claims-obligations balance in isolation from the sectoral balances of the economy as a whole. The government's creditworthiness also needs to be looked at in relation to the relative power of the government's monopoly of force. It is the government monopoly of force that is behind any legal title, giving it its "value" in the first place. This means, with respect to its citizens, the power to enforce private and public law by means of a reliably functioning legal, administrative and executive system. A weak legal and administrative system will reduce the creditworthiness of a state.

In the case of international debt, that also means military power. On the international level, what we call an order of international public law is de facto an international hegemonial order. How else would you want to explain the differences in the way greece is treated for its government and external debt, in comparison with the world's biggest debtor nation with a double deficit that is legendary – the United States of America, who in 1944 made the dollar the international means of payment at the very top of the hierarchy of money?

This underlines the common sense observation that beyond pre-state reciprocity, behind the law (private and public) and the non-law (international "law"), there is a shared pattern that all law (including property law and accountable legal titles) is derived from as well: *ordering by power*.

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