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To preserve the independence of the people, we must not let our rulers load us with perpetual debt. We must make our election between economy and liberty, or profusion and servitude. Considering the general tendency to multiply offices and dependencies, and to increase expense to the ultimate term of burden which the citizen can bear, may it never be seen here that ... government shall itself consume the residue of what it was instituted to guard. To take from one, because it is thought that his own industry and that of his fathers has acquired too much, in order to spare to others who, or whose fathers have not exercised equal industry and skill, is to violate arbitrarily the first principle of association, "the guaranty to every one of a free exercise of his industry, and the fruits acquired by it."

Thomas Jefferson
Letter to Samuel Kercheval (12 July 1816)

[I]f experience teaches us anything at all it teaches us this: that a good politician, under democracy, is quite as unthinkable as an honest burglar. His very existence, indeed, is a standing subversion of the public good in every rational sense. He is not one who serves the common weal; he is simply one who preys upon the commonwealth.

H.L. Mencken, "The Politician"
Prejudices: A Selection (4th Series, 1924)

The largest employer in the world announced on Dec. 15 that it lost about \$450 billion in fiscal 2006. Its auditor found that its financial statements were unreliable and that its controls were inadequate for the 10th straight year. On top of that, the entity's total liabilities and unfunded commitments rose to about \$50 trillion, up from \$20 trillion in just six years. If this announcement related to a private company, the news would have been on the front page of major newspapers. Unfortunately, such was not the case – even though the entity is the U.S. Government.

To put the figures in perspective, \$50 trillion is \$440,000 per American household and is more than nine times as much as the median household income. The only way elected officials will be able to make the tough choices necessary to put our nation on a more prudent and sustainable long-term fiscal path is if opinion leaders state the facts and speak the truth to the American people ... We hope the media and other opinion leaders do their part to save the future for our children and grandchildren.

David M. Walker
Comptroller General of the United States
"America's Red Ink" (*The Washington Post*, 24 December 2006)

Avoid the Rush: Prepare Now for America's Bankruptcy

Grahamite investors analyse companies and securities. They focus upon businesses and their operations rather than markets' and economies' fluctuations. Hence their decision to purchase a given security stems from an analysis of the underlying company's past and present. This decision does not hinge upon any specific prediction about the security's future price; still less does it include detailed assumptions about the overall market's or economy's prospects.

These points are widely misunderstood – even among people who purport to be value investors. Grahamites do not, as is often asserted, ignore market and economic conditions; nor do they exclude these considerations from their analyses. Instead, they ask questions such as: “how unusual are the results (profits, dividends, etc.) that X Ltd has generated over the past 5-10 years? Have monetary and overall economic conditions given these results an artificial or unusually favourable boost? Given general corporate “base rates” and those for similar companies, how likely is it that these results can continue? Are there grounds to believe that X's results in the future will regress towards some long-term mean? If so, does a purchase at today's price provide a margin of safety that sufficiently offsets the risk that X's future operations might not match those of the present and recent past?”

Precisely because they draw conclusions about the prices of many securities, Grahamites also hold views, which are rough and prone to error, about market indices today and several years hence. And because they form judgements about the normality or otherwise of today's economic conditions, they also develop opinions about booms and busts down the road.

Graham, for example, famously warned in the late 1950s about unduly and perhaps dangerously high asset prices (see, for example, his articles “The New Speculation in Common Stocks” and “Stock Market Warning: Danger Ahead!”). Conversely, he rejoiced when in the mid-1970s he detected attractively cheap prices (see “The Renaissance of Value” and “The Future of Common Stocks,” all of which appear in Janet Lowe, ed., *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend*, John Wiley & Sons, 1999). Similarly, citing implausibly high prices and correspondingly meagre prospects, in 1969 Warren Buffett closed his investment partnership. And at several points since the late 1990s he has warned investors to temper their expectations about the results they might reasonably expect during the years and decades to come (for examples, see the references on [Leithner & Co.'s links page](#)).

Grahamites' views about markets, interest rates, overall profitability, etc., thus play a distinctly second fiddle to their analyses of individual companies and securities. They incorporate these views into their individual analyses; but within these analyses, company-specific factors and figures always predominate. Their approach resembles that of Lawrence Sloan, who in *Every Man and His Common Stocks* (McGraw-Hill, 1931) posed three questions about the funk then gripping the U.S. (and most other countries). First, was the country in the midst of a severe and possibly prolonged slump? The answer, he believed, was “yes.” Second, could astute observers have discerned signs of trouble ahead of time? Sloan thought that they could have; and one economist, Ludwig von Mises, certainly did (see in particular Percy Greaves, ed., *The Causes of the Economic Crisis and Other Essays Before and After the Great Depression*, Ludwig von Mises Institute, 2006).

Sloan's third question is perhaps the most important. Could investors have protected their portfolios from the Depression's worst effects? Maybe – but only if they were prepared to ignore the crowd and think for themselves. The problem was that during the boom, signs of bust were apparent only to those who sought them. As the Depression unfolded, mixed and positive signs remained numerous enough to persuade investors with optimistic and even neutral views of the world that all would soon be well. Then and now, the most sensible stance – particularly when one's analysis of the past yields the conclusion that today's prices and profits are improbably high, and that tomorrow's harvest might be rather thin – is to expect ructions, adopt a rather dour attitude and incorporate cautious macro possibilities into one's micro analyses. Mind the downside, in other words, and the upside will mind itself.

How to apply this mindset to the conditions prevailing early in 2007? First, disregard high and possibly rising international tensions. They are real, but much less severe than those prevailing during most of the 20th century. Most notably, [the risk of terrorism in Oz is trivial](#). Also, forget about the bird flu scare. As Jeffrey Tucker shows in [Bush's Fowl Play](#), it is largely the concoction of budget-maximising bureaucrats. Finally, ignore global warming. It's a possibility; but so too, as Lawrence Solomon shows ([Will the Sun Cool Us?](#)), is global cooling. And perhaps warming is a good thing. Whatever it is, it's not a hard fact. It is, rather, an accelerating barrow energetically pushed by (a) scientists whose status and income depend upon the state and (b) politicians and other zealots eagerly grasping the latest opportunity to aggrandise themselves and plunder everybody else (see, for example, [Climate Chaos? Don't Believe It](#) by Christopher Monckton). Even if global warming exists, says [Bjorn Lomborg](#) in [The Sceptical Environmentalist](#), the interventions demanded to combat it will likely produce more harm than good.

Put out of your mind, in short, the exotic and hypothetical risks that are stirring ever more people into a collectivist frenzy. Instead, focus upon a danger that is much more pedestrian, whose evidence is much firmer, whose consequences politicians are doing their best to ignore, and that has thus come to few investors' attention. Why wait? Be the first on your block to recognise that the U.S. Government likely is – or before long will probably become – bankrupt.

Also, prepare financially and psychologically for the fallout that might occur if and when people realise that Uncle Sam is broke. One unambiguously good result would be the abandonment of the idiotic (in its conception), inept (in its execution) and disastrous (in its results) “war on terror.” Even better would be the consignment of America's interventionist foreign policy, which has wrought so much damage upon so many people, including Americans, to the same historical junkyard littered with the relics of Roman, British, French, Russian and other imperialisms. Only people with a material or reputational interest in warfare, such as the laptop bombardiers on the editorial page of *The Australian* and The Decider's lapdogs in Canberra, have anything to fear from the resurrection of George Washington's [Farewell Address](#) and America's return to its Jeffersonian roots. The power the anointed lose is the liberty the benighted recover.

Another positive (younger people are more likely to enjoy its benefits) of America's bankruptcy would be the drastic pruning of and the weaning of people from Social Security, Medicare and other alleged government “benefits.” The bad news for all Americans is that their taxes may well rise steeply; and for everybody, Americans and non-Americans, Uncle Sam's lurch towards insolvency implies significantly higher inflation and interest rates. That, in turn, augurs poorly for most financial assets.

Let's Define and Quantify Our Terms

Laurence Kotlikoff, in a must-read paper entitled [Is the United States Bankrupt?](#) and published in 2006 by the St Louis branch of the U.S. Federal Reserve, concludes that “countries can go broke, that the United States is going broke, that remaining open to foreign investment can help stave off bankruptcy, but that radical reform of U.S. fiscal institutions is essential to secure the nation’s economic future ... Unless the United States moves quickly to fundamentally change and restrain its fiscal behaviour, its bankruptcy will become a foregone conclusion.” Fed Chairman Benjamin Bernanke, in his testimony to the Committee on the Budget of the U.S. Senate ([Long-term Fiscal Challenges Facing the United States](#), 18 January 2007), used much more diplomatic and less apoplectic language, but did not reject or even question Kotlikoff’s conclusion.

Is the American Leviathan destitute? Clearly not: it continues to possess an impressive ability to confiscate from Peter, lavish much booty among its legions of vassals and mascots, and distribute the rest among the Pauls whom it wishes to control. How, then, can one possibly contend that Uncle Sam is or is going bankrupt? Beginning in the 1930s, with another spurt in the 1960s and climaxing during George W. Bush’s presidency, he has made promises to his growing hordes of dependents and foreign creditors that, as time passes, he will be less and less able to fulfil. The U.S. Government is insolvent in the sense that the net present value (NPV) of its liabilities greatly exceeds the NPV of its assets (or the assets it can be expected to raise in order to meet these liabilities). Leviathan is bust in the sense that, given its vast present and growing future shortfall of assets relative to liabilities (“fiscal gap”), at some stage it must acknowledge reality, liquidate and retrench. It is broke in the sense that, as occurs in many workouts, it will pay its dependents and creditors less than it originally promised them (see also [Broken Army, Broken Empire](#) by Pat Buchanan).

Although it doesn’t explicitly say so, the U.S. Government – or, rather, a recent (15 December 2006) Treasury/OMB report entitled [Financial Report of the United States Government](#) – concurs (see also [GAO Chief Warns Economic Disaster Looms](#) and [Demographic Reality and the Entitlement State](#) by Ron Paul). During 2006, the fiscal gap continued to swell rapidly and now stands at ca. \$53 trillion. And that’s just at the federal level. One could increase it by adding various local and state shortfalls. Further, this figure assumes the continuation of short- and medium-term economic sunshine, i.e., that nominal GDP will grow at a rate of least 5% per annum during the next five years. In other words, because the Treasury’s projections do not incorporate economic weakness, this estimate of \$53 trillion could easily err on the low side.

As a related matter, it’s important to emphasise that there’s – literally! – no accounting for the U.S. Government. Its internal auditor, Government Accountability Office, found for the tenth year in succession that Uncle Sam’s financial statements are unreliable and that his financial controls are inadequate (see the Comptroller General’s [comment](#) on this year’s Financial Report). The U.S. Government is bankrupt in the sense that, by private sector standards, its financial condition is not just unaudited: it is simply unauditable.

The Pentagon’s balance sheet, for example, is laughably crude. It does not emerge from standard methods: instead, an estimated list of liabilities is simply subtracted from a vague list of assets. A report compiled in 2003 by its own Inspector General stated “we identified \$1.1 trillion [yes, that’s a “t” and not a “b”] in department-level accounting entries to financial data used to prepare DoD component financial statements that were

not supported by adequate audit trails or by sufficient evidence to determine their validity. In addition, we also identified \$107 billion in department-level accounting entries to financial data used to prepare DoD component financial statements that were improper because the entries were illogical or did not follow accounting principles. . . . [In conclusion], DoD did not fully comply with the laws and regulations that had a direct and material effect on its ability to determine financial statement amounts.”

More generally, the financial management of most (up to 20) of the federal government’s 24 largest agencies fails to meet requirements enacted by Congress in 1996. Uncle Sam resembles nothing so much as an inept, hopelessly spendthrift and disorganised man who hurriedly stuffs a shoebox full of whatever documents and receipts he can find – and then throws the mess into a bewildered accountant’s lap. In the private sector, people who generate waste and loss face the ire of shareholders are usually denied access to capital, often receive pink slips and running shoes and sometimes find themselves in gaol. In the coercive sector, however, mismanagement is virtually never punished: indeed, it is typically lauded and rewarded.

Also note that this fiscal gap does not incorporate the costs associated with the invasions and occupations of Iraq and Afghanistan. In [The Economic Costs of the Iraq War](#), Joseph Stiglitz and Linda Bilmes estimate that its NPV is \$1 trillion or more, and growing (see also [Inflation: The Hidden Cost of War](#) by Ron Paul). This, to put it mildly, is [somewhat higher](#) than the initial and breezily confident estimates of Administration and neocon insiders. Defence Secretary Ronald Dumsfeld, for example, opined (19 January 2003) “well, the Office of Management and Budget has come up with a number that’s something under \$50 billion . . . How much of that would be the U.S.’s burden, and how much would be other countries’, is an open question.”

A study by Jagadeesh Gokhale and Kent Smetters ([Measuring Social Security’s Financial Problems](#), NBER Working Paper No. 11060, January 2005) concluded that the U.S. Government’s “fiscal gap” is closer to \$65.9 trillion. That’s more than 500% of America’s annual GDP and 200% of its accumulated wealth. The \$53 trillion estimate equates to ca. 400% of America’s GDP in 2006, and has increased from about \$20 trillion – an amount equivalent to 200% of GDP in 2000. (As a comparison, the net debt of Her Majesty’s Government is £490 billion. That’s equivalent to \$US950 billion and to 38% of Britain’s GDP. Adding the NPV of “off balance sheet” liabilities produces an amount that approximates 100% of its GDP.)

Finally, note that Treasury has expressed this \$53 trillion fiscal gap as a net present value. To make it disappear tomorrow, tonight Uncle Sam must confiscate that amount from his subjects and deposit it in bank accounts earning hefty rates of interest (the GAO uses 5.7% as the assumed long-term rate of return). But in Main Street U.S.A., these deposit rates do not exist. Because they didn’t collect interest on the money that they didn’t deposit into these hypothetical accounts this year, Americans will have to “deposit” even more next year. As a matter of elementary maths, 5.7% of \$53 trillion is a bit more than \$3 trillion – an amount ca. 15 times greater than Uncle Sam’s present annual budget deficit. Even if the deficit suddenly became a very large surplus of, say, \$500 billion and remained at this level (a very unlikely proposition), the fiscal gap would still continue to rise relentlessly. Accordingly, during the next year it will likely swell by at least another \$3 trillion – plus whatever additional outrages the Racketeers in the White House and on Capitol Hill can devise. So for the sake of argument let’s add another \$4 trillion, making a total of \$57 trillion, as an early guess of the fiscal gap in 2008.

In last year's Financial Report, the Treasury downplayed the gap. But this year their talk is tougher. They state "the net social insurance responsibilities (scheduled benefits in excess of estimated revenues) indicate that those programs are on an unsustainable fiscal path and difficult choices will be necessary in order to address their large and growing long-term fiscal imbalance." Further, "delay is costly and choices will be more difficult as the retirement of the 'baby boom' gets closer to becoming a reality with the first wave of boomers eligible for retirement under Social Security in 2008."

What do the present magnitude, the growth in the recent past and the plausible rate of growth in the near future of the U.S. Government's fiscal gap mean? As Chris Martenson notes in the [United States Is Insolvent](#), they imply three things.

- *First, it's unlikely that America can "grow out of the problem."* Uncle Sam's financial position has deteriorated by over \$22 trillion in 4 years and by \$4.5 trillion during the last 12 months (see the table below, extracted from this year's Report). The economic sunshine of the past three years has not reduced the gap to narrow. Quite the contrary: it has widened and is deteriorating ever more rapidly.

Table 4. Comparing Current Net Liabilities to Future Social Insurance Responsibilities					
billions of dollars	2002	2003	2004	2005	2006
Liabilities Net of Assets (balance sheet)	\$ (6,820)	\$ (7,094)	\$ (7,710)	\$ (8,467)	\$ (8,916)
	The balance sheet presents a 'snapshot' of an entity's current financial position (net of assets and liabilities as of the end of the current fiscal year).				
Social Insurance Responsibilities, Net (closed group - - off-balance sheet)	\$ (24,219)	\$ (26,858)	\$ (37,279)	\$ (40,038)	\$ (44,147)
	The Statement of Social Insurance presents the present value of estimated future revenues and expenditures under current law.				
Combined Net Liabilities (current) and Social Insurance Responsibilities (future)	\$ (31,039)	\$ (33,952)	\$ (44,989)	\$ (48,505)	\$ (53,063)

If the fiscal gap can balloon so quickly during allegedly good times, what might happen if and when the economic horizon darkens? It is unlikely, to put it mildly, that any economic weakness will alleviate it.

- *Second, for many Americans, particularly younger ones and those completely dependent upon Leviathan, the future portends stagnant and perhaps much lower standards of living.* How to close the fiscal gap? According to Laurence Kotlikoff, "the answers are terrifying. One solution is an immediate and permanent doubling of personal and corporate income taxes. Another is an immediate and permanent two-thirds cut in Social Security and Medicare benefits. A third alternative, were it feasible [as if the first two were politically palatable!] would be to immediately and permanently cut all federal discretionary spending by 143% [i.e., to eliminate all such spending and run a mammoth and unprecedented budget surplus]." When pigs fly ...
- *Third, history shows us that every government that has so incompetently managed its finances has tried to "print its way out of trouble."* Do American politicians possess generous amounts of the courage required to fix this mess? Given their country's fiscal problems, the prancing and babble of its presidential hopefuls, and the posturing and preening of politicians more generally, is at best a self-deception and at worst a cruel hoax upon the public. If they truly sought, in Ms Pelosi's words, "to build a better future for all of America's children," then they would drastically prune – if not completely abolish – the welfare-warfare state.

The truth, of course, is that the Fed cannot painlessly inflate, nor the polities prattle, America's way out of this predicament. But no matter: because draconian cuts of expenditure are not realistic solutions to its impending bankruptcy, inflation is a much more likely possibility. Inflation today – that is, the central bank's expansion of the money supply – reduces the purchasing power of money tomorrow. Thanks to the central bank's inflation, the extent of debts (measured in nominal dollar amounts) may remain unchanged or even rise; but as purchasing power falls, so too do real values. Inflation thus imposes a hidden tax upon its victims. What's the *material* difference between (a) 0% inflation and the confiscation of x% of your money and (b) x% inflation and no overt confiscation? Nothing: in each case, your purchasing power falls by x%.

The *rhetorical* difference, of course, is that (a) is political suicide and (b) is ignored or misrepresented in the mainstream media. (Its demand that the central bank deliver "low interest rates" is, in effect, a demand that the bank generate high inflation; and the phrases "steady inflation" and "the gradual destruction of the purchasing power of money" are virtual synonyms.) Do not, therefore, expect that you will rise one morning to headlines proclaiming that Uncle Sam is broke. Instead, anticipate that it will be an extended and covert affair. The central bank's inflation can promote only two things: the size and waste of the welfare-warfare state and the penury of the middle and battler classes. Indeed, to the extent that the U.S. Government's bankruptcy takes the form of an enrichment of privileged "insiders" and the gradual impoverishment of benighted "outsiders," it commenced years ago and is proceeding silently apace.

The reality, then, is that Americans and non-Americans are likely to face a future of uncomfortably high inflation – and possibly worse if somewhere down the track the \$US loses its privileged status as the world's reserve currency.

In the Beginning, There Was Debt

Laurence Kotlikoff notes correctly that solvency need have nothing to do with indebtedness. A particular government, for example, might year after year maintain its budget in surplus and never borrow a penny. It might laud itself as a model of fiscal prudence. But if its liabilities outstrip its assets, and if it cannot raise the assets required to meet its liabilities at 100 cents on the dollar when they fall due, then this alleged model of rectitude is actually insolvent. "To summarise," says Kotlikoff, "countries can go bankrupt but whether or not they are bankrupt or are going bankrupt can't be discerned from their 'debt' policies. 'Debt' in economics, like distance and time in physics, is in the eyes (or mouth) of the beholder."

Well said. Yet Kotlikoff overreaches when he says "the focus on government debt has no more scientific basis than reading tea leaves or examining entrails." Quite the contrary: although one must infer cautiously, the source, timing and growth profile of the U.S. Government's "on-balance sheet" debt can teach us much about America's rise and fall, the causes of its present pickle and the possible source of its redemption (see also William Bonner and Addison Wiggins, *Empire of Debt: The Rise of an Epic Financial Crisis*, John Wiley & Sons, 2006). America's founder knew the lesson, but their descendents have ignored it. In James Madison's words, war is the most serious threat to liberty and solvency "because it comprises and develops the germ of every other. War is the parent of armies; from these proceed debts and taxes; and armies and debts and taxes are the known instruments for bringing the many under the domination of the few."

Wars and economic “emergencies” are catnip to politicians because it is during these times that the government’s powers and patronage can be extended most rapidly – and thus the individual harnessed most securely to the yoke of the state. According to H.L. Mencken (*Notes on Democracy*, Knopf, 1926), “the whole history of the [U.S.] has been a history of melodramatic pursuits of horrendous monsters, most of them imaginary: the red-coats, the Hessians, the monocrats, again the red-coats, the Bank, the Catholic, the slave power, Jeff Davis, Mormonism, Wall Street, the rum demon, John Bull, the hell hounds of plutocracy, the trusts, ... Pancho Villa, German spies, the Kaiser, Bolshevism. The list might be lengthened indefinitely: a complete chronicle of the Republic could be written in terms of it, without omitting a single important episode.” In this respect, the “war on terror” is simply the most recent display in a long catalogue of deceptions. Monroe concludes that during wars and emergencies, an “inequality of fortunes, and the opportunities of fraud, growing out of a state of war, and . . . degeneracy of manners and of morals [develops] . . . No nation could preserve its freedom in the midst of continual warfare.” Certainly the U.S. hasn’t (see in particular Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government*, Oxford UP, 1987).

The trouble is that, since time immemorial, rulers have sought to wage war. And to do so, they must confiscate their subjects’ property. Since the 1720s, when Sir Robert Walpole revolutionised the financial basis of the British Government, a government able to command the confidence of lenders has also been able to issue debt that need never be repaid. It needs only to create a regular and dependable source of revenue – a “tax base” – and then use a part of it to pay the annual interest and the principal of maturing bonds. For every bond it retires, it also issues a new one. In this way, a “national debt” becomes a perpetual debt. It thereby becomes an instrument of unending war. The Royal Navy extended British sovereignty and influence around much of the world during the 18th and 19th centuries, and Walpole’s innovation underwrote its activities. The establishment of a national debt not only overturned the fear of Stuart tyranny: ironically, it entrenched Jacobite objectives into the heart of British government. HMG, in other words, could now maintain a permanent military establishment and finance its wars without the regular and bothersome application to Parliament. The British Empire, then, was built upon more than the blood of soldiers, sailors and civilians: it was a superstructure, and a permanent national debt was its foundation. This debt had the added benefit (to politicians) of harnessing creditors to the government.

These developments did not escape the attention of the America’s founders. In January 1789, when General Washington mounted the steps of Federal Hall (close to the top of Wall Street and opposite today’s New York Stock Exchange), took the oath of office and became the first President, his newborn country’s Treasury was virtually empty. It was also burdened by debts of \$77 million – an amount equivalent to ca. 30% of the new country’s rudimentary GDP (this and subsequent historical debt-to-GDP ratios have been derived from Donald Stabile and Jeffrey Cantor, *The Public Debt of the United States: An Historical Perspective, 1775-1990*, Praeger, 1991). The rebellion against Britain had cost treasure as well as blood, and the colonists were only slightly more willing to submit to local than to Imperial taxes. Under the Articles of Confederation, the admirably loose-fitting constitutional garment that had joined the rebellious colonies, the nascent federal government possessed no power to tax. The states could levy taxes and forward them to the Continental Congress; but they too were hobbled by debt, and popular hostility towards taxes was pervasive. Hence little more than a trickle of funds flowed into the Congress’s coffers (see also Stabile’s *The Origins of American Public Finance: Debates over Money, Debt, and Taxes in the Constitutional Era, 1776-1836*, Greenwood, 1998).

Alternative means were therefore sought to finance the war. As it is doing today, Congress resorted to external creditors and the domestic printing press (see in particular Murray Rothbard, *A History of Money and Banking in the United States: the Colonial Era to World War II*, Ludwig von Mises Institute, 2002). As a result, by the time Washington vanquished Cornwallis in 1783, American governments owed large sums to King Louis of France, to Dutch bankers – and the thousands of American soldiers, farmers and merchants who had lent their labour, goods and capital to the cause. Virtually all agreed that it had been right and proper to borrow in order to secure their political independence.

But what about the new country's financial sovereignty? Over the next two decades, how – indeed, *whether* – the debt would be repaid and the budget balanced became the subject of a ferocious debate between two leading lights: Thomas Jefferson and Alexander Hamilton. “Hamilton was indeed a singular character,” Jefferson wrote of his rival. “Of acute understanding, disinterested, honest, and honourable in all private transactions, amiable in society, and duly valuing virtue in private life, yet so bewitched and perverted by the British example, as to be under thorough conviction that corruption was essential to the government of a nation.” It is only a slight exaggeration to say that their fiscal contest was the seed that germinated “factions” and party politics in the U.S. Washington sat uncomfortably between them at the cabinet table and lamented the “internal dissensions” that were “tearing our vitals.”

To most early Americans, the very existence of public debt and deficit was inexcusable. Many likened it to the seizure of property without the owner's consent. Amassing debt to finance grandiose national projects, and then extending this debt into perpetuity, was widely regarded as monarchical, English and corrupting. But to a few élites, most notably Hamilton and his mentor, Robert Morris, debt was just another word for money; money was a potent form of power; and power, they believed, was their birthright. “The [national] debt was a tremendous source of power,” wrote William Anderson in *The Price of Liberty: The Public Debt of the American Revolution* (University of Virginia Press, 1983), “for whoever controlled it would in all likelihood possess not only the chief taxing power but the prime allegiance of a large segment of the American population” (see also [Perpetual Debt: From the British Empire to the American Hegemon](#) by Scott Trask, which inspired the structure of the next couple of pages).

Jefferson, whom Washington appointed as America's first Secretary of State, agreed – and hastened to add that the very existence of a national debt, to say nothing of its growth, would centralise political and economic influence into a small number of privileged hands. It would thereby foment some of the very injustices that had prompted people to migrate to America – and had prompted Americans to rebel against George III. Legally and ethically, said Jefferson, “we should consider ourselves unauthorised to saddle posterity with our debts, and morally bound to pay them ourselves.”

Hamilton, America's first Secretary of the Treasury, on the other hand, believed that if a budget deficit and national debt were used wisely they could promote social harmony and economic growth. The states seldom saw eye-to-eye, he observed, and so bundling their financial burdens into a single national debt would help to unify them. If all citizens felt equally beholden to the country's debt, then they might begin to regard themselves more as Americans and less as Virginians or New Yorkers. “A national debt, if not excessive, will be to us as a national blessing ... It will be a powerful cement of our

union.” Hamilton prophesied that his young country would need to borrow – probably heavily – before many years would pass. Maintaining a perpetual national debt and reliably paying interest, he maintained forebodingly, would “establish a public credit that could be drawn and expanded during economic crises or wars.”

Jefferson, Madison and the Injustice of Binding Children

In a letter written in 1789 to James Madison, Thomas Jefferson asked whether “one generation of men has a right to bind another.” He denied that it did. Further, he also believed that this principle has “very extensive application and consequence, in every country.” Applying it to borrowing by the government, he argued that it was “unjust and unrepugnant” for one generation to encumber the next. Jefferson reasoned that the younger generation had no means to consent to the decisions of their parents; nor did they necessarily benefit from their forebears’ debt-financed expenditures. Quite the opposite – he believed they typically suffered the consequences of their elders’ follies. If, as the rebels at the Boston Tea Party had cried, there could be “no taxation without representation,” then Jefferson added that logically there could be no representation without gestation. Accordingly, the old should not encumber the young, and the young bore no obligation to honour their parents’ debts.

Later in 1789, Jefferson specified this principle. He suggested that the French, who were mired in the throes of revolutionary violence, would be wise “to declare, in the constitution they are forming, that neither the legislature, nor the nation itself, can validly contract more debt than they may pay within their own age, or within the term of 19 years” – and that whatever portion of the debt that should remain unpaid after that time should be cancelled. In effect, Jefferson thought such a provision would, by raising government bonds’ risk premium and thereby lifting the cost of borrowing, restrain the profligacy of governments and reduce the frequency of their wars and severity of their bloodthirstiness. It “would put the lenders and the borrowers also, on their guard. By reducing too the faculty of borrowing within its natural limits, it would bridle the spirit of war, to which too free a course has been procured by the inattention of money-lenders to this law of nature, that succeeding generations are not responsible for the preceding.”

Madison did not agree. The present generation, he believed, does indeed benefit from the “productive labour, discoveries, capital improvements, and defensive wars” of its parents. He believed that it was just that they should help to pay for “improvements or endeavours” whose expenses were too great to discharge within one generation. “The improvements made by the dead,” reasoned Madison, “form a charge against the living who take the benefit of them.” He therefore concluded “debts may be incurred for purposes which interest the unborn, as well as the living.” Foremost in his mind were “debts for repelling a conquest, the evils of which descend through many generations.” With the successful but expensive rebellion against Britain clearly in mind, he added “debts may even be incurred principally for the benefit of posterity ... which far exceeds any burdens which the present generation could well [bear].”

Madison allowed that he opposed “imposing unjust or unnecessary burdens” upon succeeding generations. But his accommodating position, Jefferson, provided plenty of room through which reckless politicians could drive profligacy, corruption, imperialism and war. What government, he noted, can accurately foresee the effects of its “improvements”? And what government has *ever* described its extravagances and follies as anything other than just and necessary?

The Jeffersonian Triumph

Between 1789 and 1797, interest payments on debt accumulated during the rebellion consumed more than half of the federal government's budget. Reflecting the stalemate between Jefferson's and Hamilton's factions, George Washington and his like-minded successor, John Adams, left the government with roughly the same amount of debt (\$80m) they had inherited. After the "Revolution of 1800" and Jefferson's inauguration as president in 1801, he immediately and resolutely began to reduce the national debt. Within six years – and despite borrowing \$11 million in order to finance the Louisiana Purchase (whose constitutionality he knew was doubtful) – Jefferson's Administration repaid \$25 million of debt. In seven of its eight years, taxes were reduced, the government spent less than it taxed and the resulting budgetary surplus was used to retire debt.

Jefferson's successor, James Madison, reduced the debt further (to \$45m) by early 1812. Alas, a drastic spurt of borrowing to finance the War of 1812 (denigrated as "Mr Madison's War" by his critics in New England and dubbed "the greatest military and financial debacle in American history" by James Savage in *Balanced Budgets and American Politics*, Cornell University Press, 1990), coupled with the precipitous decline in tariff revenue that accompanied the war, increased the debt to \$125m by 1816.

In mid-1813, a year after the recommencement of hostilities against England, Jefferson wrote a remarkable letter to the chairman of the House Ways and Means Committee. The ex-president recommended that if "America were determined to make war" then a special and very visible tax should be imposed in order to finance it. This tax should be sufficient to pay the annual interest on the new war debt and also to repay a portion of the principal, and should remain in force until the entire debt was retired. Reaffirming his long-held view, Jefferson also urged that the tax be high enough to repay the principal within one generation (which he defined as 19 years). He thought that stiff taxes should be imposed in order to make as clear as possible to Americans the real financial cost of the War of 1812. By reminding them that war means debt, debt means taxes and taxes mean subjection, Jefferson that hoped that his countrymen would think twice before they plunged again into war.

Further, and equally importantly, a "redeeming tax" would act as "a salutary warning" of the consequences that flow from the accumulation of debt. It would establish "a salutary curb on the spirit of war and indebtedment [sic], which, since the modern theory of the perpetuation of debt, has drenched the earth with blood, and crushed its inhabitants under burthens [sic] ever accumulating." Jefferson conjectured that if the principle that all public debts must be retired within 19 years "been declared in the British bill of rights [of 1689], England would have been placed under the happy [inability] of waging eternal war, and of contracting her thousand millions of public debt."

America's next president (1817-25), James Monroe, another protégé of Jefferson, reduced the debt to \$85m, an amount equivalent to 10% of the country's GDP; and during his one term of office (1825-29), John Quincy Adams reduced it further to \$60m. Notice then, that as a result of the second war with England, a conflict that brought not a single benefit to the people of the United States (unless one considers military and naval prestige, "national honour," etc., to be worth the sacrifice of blood and treasure), Americans paid taxes for 20 years just to return the national debt to the level where it had stood when Jefferson left office in 1809.

The Glorious Jacksonians

Andrew Jackson brought the Jeffersonians' work to its logical conclusion. (No man is perfect, and Jackson was certainly far from it. Even by the standards of his day, he was extremely cruel to Native Americans.) During his second administration, the last outstanding government bond was retired and in 1835 the national debt stood at a paltry \$38,000. The U.S. remained virtually debt-free for one more year; alas, it would never again enjoy this status. Even so, the debt-to-GDP ratio hovered barely above 0%.

The debt was \$15m when James K. Polk took office in 1845. On the positive side of the ledger, Polk was a hard-money and a low-tariff man; alas, and like Jefferson and Jackson, he was also a continental expansionist. He coveted California and Mexico's other northern provinces; and to obtain them he resorted to war. The Mexican War (1846-47) increased America's national debt four-fold (to \$65m). The next presidents, Taylor and Tyler, were Whigs; the Whigs were the inheritors of Hamilton's mantle and the predecessors of the mercantilist Republican Party; and as such, they were indifferent to debt. Under their administration (Taylor died shortly after taking office), debt rose to \$80m by 1851. Fortunately, his successor was a Jeffersonian Democrat – and therefore a resolute practitioner of free trade, hard money and frugal government. The last of the Jeffersonians, Franklin Pierce, retired two-thirds of the national debt such that it fell to \$30m (an amount less than 5% of GDP) when he left office in 1857. Neither in absolute amount nor as a percentage of GDP would the national debt ever again fall so low.

Hamilton's Revenge: the Civil War and Its Disastrous Legacy

The War of Northern Aggression was not only a humanitarian tragedy: Abraham Lincoln's vast edifice of distortions and misrepresentations also caused an explosion of borrowing that would have driven Thomas Jefferson to despair – and perhaps secession and rebellion. Debt rose from \$75m in March 1861 to \$28,000m (that is, \$2.8 billion, an amount equal to almost 65% of GDP) in August 1865. The debt, which was \$2 per capita in 1861, was now \$75 per capita (and now considerably fewer able-bodied people existed to service it). Such was the human and financial cost of transforming what had hitherto been a voluntary confederation joined by natural sentiment and natural law into a centralised union cemented by bald lies and brute force (see in particular John Denson, *A Century of War: Lincoln, Wilson and Roosevelt*, LVMI, 2006; Thomas DiLorenzo, *The Real Lincoln: A New Look at Abraham Lincoln, His Agenda, and an Unnecessary War*, Three Rivers Press, 2003; [European Views of the War To Prevent Southern Independence](#); and Jeffrey Rogers Hummel, *Emancipating Slaves, Enslaving Free Men: A History of the American Civil War*, Open Court, 1996).

The federal government, once bound by the Constitution, thus broke its chains – but not completely or (yet) permanently. In 1869, the Supreme Court ruled that the Legal Tender Acts of 1862 and 1863 – the financial underpinnings of Evil Abe's military aggression – were unconstitutional. In 1872, the income tax expired and was not renewed (and for good measure, in 1895 the Supreme Court ruled that it had been unconstitutional all along). In 1879, Grover Cleveland restored America to the gold standard (from which Lincoln had suspended it). As a consequence of these salutary developments, for a generation after Lincoln's fortuitous assassination the amount of America's national debt fell significantly and then stabilised, and – thanks to capitalism and entrepreneurship – the debt-to-GDP ratio fell without interruption. By 1880, the debt stood at \$2.1 billion (15% of GDP); by 1890, \$1.1 billion (10%); and by 1900, \$1.2 billion (8%).

Hamilton Rampant: Big Government, Total War and Astronomical Debt

As occurred at the opening and middle of the 19th century, so too at the beginning of the 20th: an utterly pointless and ruinously expensive war, built upon an edifice of monstrous lies, quickly negated the fruits of years of patient but cumulatively significant debt reduction. President Woodrow Wilson – who, next only to Lincoln, was America’s worst – bamboozled, harangued and deceived America into the Great War (see in particular Thomas Fleming, *The Illusion of Victory: America in World War I*, Basic Books, 2003). As a result, in little more than two years its national debt skyrocketed from \$3 billion to \$25 billion (25% of GDP). But all was not yet lost: in a last gasp of rectitude, after the war fiscally sane presidents (who were, by the way, the last to respect the Constitution and therefore the most recent on the list of greats), Warren Harding and Calvin Coolidge, reduced the debt to \$15 billion (18% of GDP) by mid-1930.

Alas, American and British governments and central banks transformed the slump that commenced in 1929 into the Great Depression. Worse, Herbert Hoover was a typical Republican and thus no friend of frugality: in just two years he increased the national debt from \$15 billion to \$22 billion. Worst of all, Franklin Roosevelt (America’s third-worst president) was no Jeffersonian. Never mind that his platform of 1932 emphasised laissez-faire, the gold standard and retrenchment of expenditure and debt: the New Deal accelerated Hoover’s awful policies. The Depression thus lengthened and deepened, and debt increased more than three-fold (to \$72 billion, 38% of GDP in 1940).

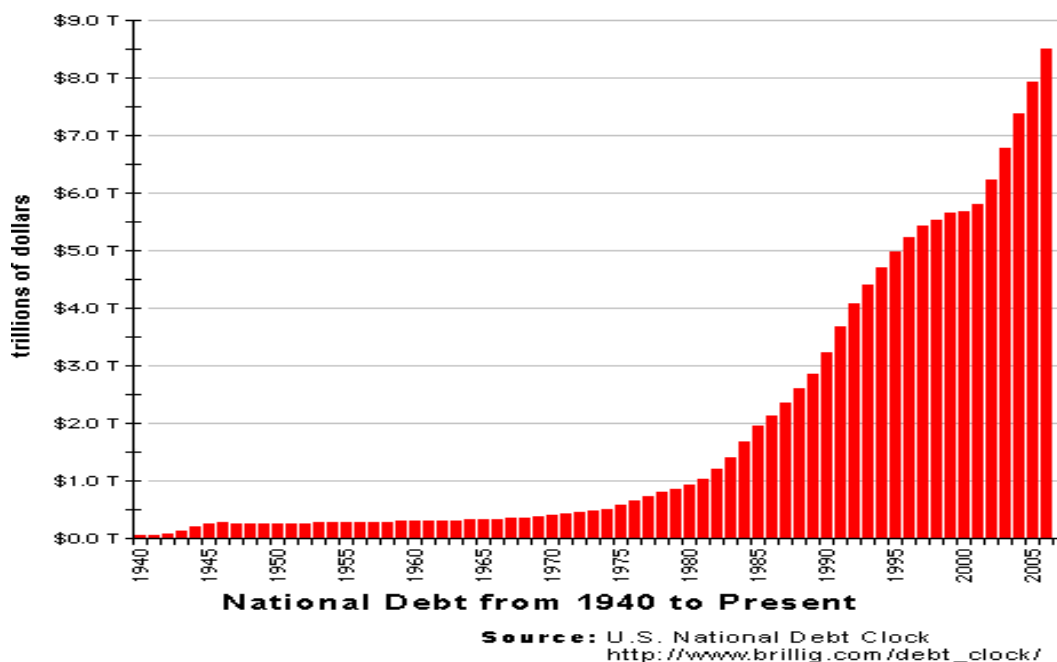
The culmination of the damage FDR wrought were the deceptions that provoked the country’s entry into the Second World War (see in particular Thomas Fleming, *The New Dealers’ War: FDR and the War Within World War II*, Basic Books, 2001; and Robert Stinnett, *Day of Deceit: The Truth About FDR and Pearl Harbour*, Free Press, 2000). The New Dealers’ War caused the national debt to increase 3.6-fold (to \$260 billion and 110% of GDP) by September 1945. And all for naught: as Robert Higgs shows in *Depression, War and Cold War* (Oxford University Press, 2006), neither the New Deal nor the Second World War vanquished the Great Depression. What did? Read Higgs, and also chaps. 9 and 10 of Thomas DiLorenzo, *How Capitalism Saved America: The Untold Story of Our Country, from the Pilgrims to the Present* (Crown Forum, 2004).

The problem, alas, was that virtually everybody thought that welfare and warfare had rescued the country from the Depression. Hence regimentation, war and profligacy replaced liberty, peace and frugality as the hallmarks of life (see Robert Higgs, *Crisis and Leviathan*; and Figures 1 and 2 below). Abolished was the venerable tradition of post-war retrenchment. The new practice was a relentless increase of expenditure and piling of debt upon debt. Apart from slight declines in 1947-48 and 1956-57, America’s national debt, like a NASA space probe, commenced an upward trajectory into outer space. Fortunately, from 1945 to 1970 GDP grew faster than the national debt, and so the debt-to-GDP ratio fell modestly (to 95% of GDP in 1950 and 70% of GDP in 1960).

But not for long. The removal in 1971 of the \$US’s last remaining (albeit tenuous) link to gold freed Uncle Sam from any semblance of restraint. In 1970, the debt reached \$390 billion and a post-war low of 28% of GDP. In 1980 it was \$930 billion and 30% of GDP. And then came the deluge: under Ronald Reagan and a Republican Senate, debt rose to \$2,700 billion (\$2.7 trillion); under George H. Bush, Bill Clinton and a Republican House, it reached \$5.7 trillion; and under George W. Bush and a Republican Senate and House (until January 2007), it has risen to \$8.7 trillion (as of 25 January 2007).

According to the [U.S. National Debt Clock](#), since 26 September 2006 America's national debt has increased by an average of \$1.5 billion per day. (Recall that the national debt refers to "on balance sheet" liabilities, as opposed to the ca. \$53 trillion of net on- and off-balance sheet liabilities.) Any time an American politician, particularly a Republican, utters words like "prudence," "responsibility" and "conservatism," the appropriate response is uproarious laughter and withering derision (see also [Republican Debt](#) by George Giles). Indeed, anytime anybody in Washington except [Ron Paul](#) (see also his [articles](#)) says anything, the appropriate response is a deaf ear and a hard kick.

Figure 1: Read It and Weep



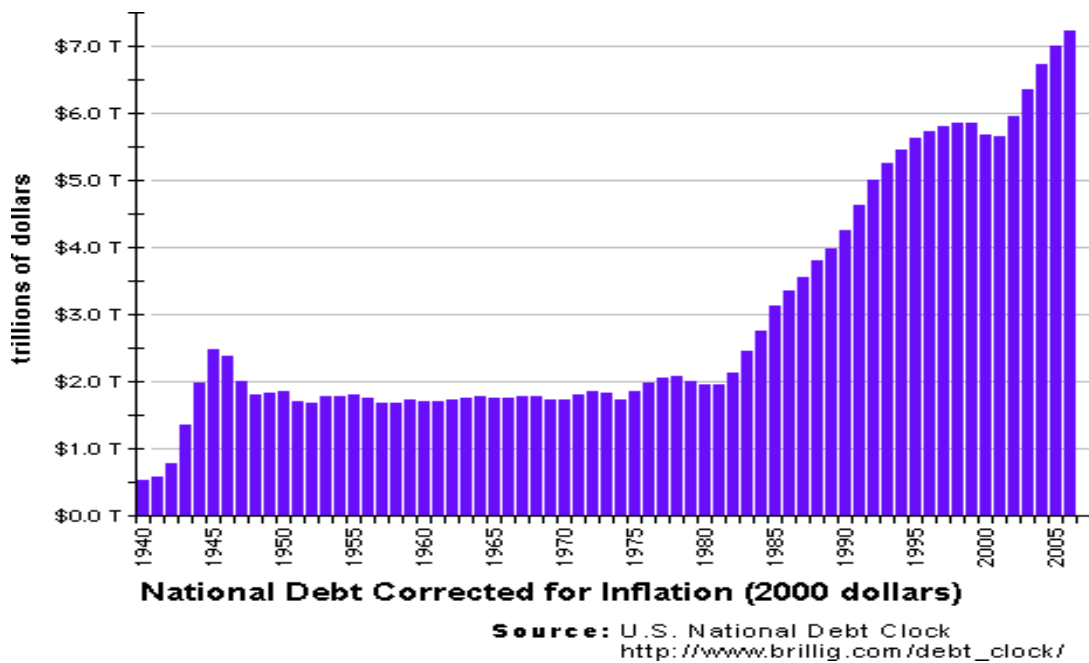
In *Crisis and Leviathan*, Robert Higgs summarised America's past half-century:

The mixed economy that has prevailed in the United States since World War II, a uniquely American form of participatory fascism, has lent itself to a substantial expansion of the governmental authority over economic decision-making. Given capitalist colour by the form of private property rights, the system has denied the substance of any such rights whenever governmental authorities have found it expedient to do so. No individual economic right whatever, not even the right to life, has been immune from official derogation or disallowance; besides interfering in countless economic transactions, the government has sent tens of thousands of men to their deaths bound in involuntary servitude as conscripts in the military adventures embarked upon by ruling elites. The potential for government to set aside private rights has now been plenary for over [sixty] years, even if governments have yet to exercise the potential fully. Real reaction never materialised ... and regardless of the political swings the fixed point has remained a fundamental abrogation of private economic rights ... Whatever the so-called Reagan Revolution may have done, it certainly did not bring about an ideological revolution.

Assuming that the trends established during Reagan's presidency remain in place, America's national debt will breach \$10 trillion (and more than 60% of GDP) by 2010.

According to the Congressional Budget Office, whose projections *The Wall Street Journal* (19 January 2007) has summarised, under present budgetary settings the debt-to-GDP ratio will rise to 100% in 2030 and to 200% by 2040. On 18 January Mr Bernanke commented that “a vicious cycle may develop in which large deficits lead to rapid growth in debt and interest payments, which in turn add to subsequent deficits.” He added that similar “debt spirals” in other countries have either provoked or deepened financial emergencies. “Ultimately, this expansion of debt would spark a fiscal crisis, which could be addressed only by very sharp spending cuts or tax increases, or both.” He forgot to mention that sharply higher interest rates and a sharply weaker \$US might well accompany such a crisis.

Figure 2: Bloody Ronald Reagan: Read It and Shed CPI-Adjusted Tears



Intelligent Investing in an Era of National Bankruptcy

What, then, does this survey of America’s national debt tell us? In order to feed their egos, interventionist politicians wage war. To do so, they must incur debt and receive the support (or at least the acquiescence) of their subjects; and to obtain money and loyalty, time and again they resort to deceptions and outright lies. Truly, war is an entitlement program for neoconservatives; and in order to get a free hand to wage war abroad, they happily concede New Dealers’ demands to wage war at home. [Welcome to Fascist America!](#) Neocons and socialists are the conjoined twins of modern American statism. As Ludwig von Mises (*Omnipotent Government*, Arlington House, 1969) put it:

Durable peace is only possible under perfect capitalism, hitherto never and nowhere completely tried or achieved. In such a Jeffersonian world of the unhampered market economy, the scope of government activities is limited to the protection of lives and property of individuals against violence or fraudulent aggression ... All the oratory of the advocates of government omnipotence cannot annul the fact there is but one system that makes for durable peace: a free-market economy. Government control leads to economic nationalism and thus results in conflict.

America's forgotten heroes, the Jeffersonians, were right. The policies of that country's evil quartet, Hamilton, Lincoln, Wilson and FDR – namely welfare, warfare and debt-financed big government – have regimented thought and life. They have created a zero-sum climate whereby politicians' and bureaucrats' privileges wax, and individuals' autonomy wanes. The pageantry of Imperial Government spawns a Leader (or should that be "Decider"?) who much more closely resembles a Caligula than a Cincinnatus. Within an empire, subjects exist in order to serve the central state: in Lord Acton's apt phrase, passengers exist for the sake of the ship and its hands. "When the people fear their government," said Jefferson, "there is tyranny; when the government fears the people, there is liberty." Today in the U.S., Jefferson is barely a memory, people rightly fear their rulers, and bureaucrats and politicians regard their subjects contemptuously.

Not just in America but also in most Western countries, people fear their overlords not because of what the latter *already do to* the former, which is plenty, but because of the "services" and "benefits" that rulers *might withhold from* their subjects! The good news is that, around the developed world, state-run schemes of social security face crises. The symptoms of problems include greater longevity, declining ages of retirement and below-replacement fertility rates. But symptoms are not causes. The welfare state's creators did not anticipate the extent to which, and the manner by which, their interventions would affect incentives to work, save and bear children. In this way, social welfare schemes have sown the seeds of their own bankruptcy (see, for example, [Making Kids Worthless: Social Security's Contribution to the Fertility Crisis](#) by Oskari Juurikkala). Happily, to the extent that the welfare-warfare state disintegrates, individual liberties regrow.

Our survey also tells us, in Henry Ford's words, that "history is bunk." By this he meant that the received historical record and its conventional interpretation are usually false. When analysed and interpreted without statist lenses, however, history – bolstered with the laws of economics – provides a rough but reliable guide with which to navigate the future. If one studies the past in order to trace the consequences of the ideas that people implemented (as opposed to the desire to worship the state), then one can see for oneself what these ideas and actions wrought, what worked and what didn't – and what lessons we can draw in order to repeat the achievements and avoid the mistakes of our forebears.

Armed with these insights, let us return to the types of questions that Lawrence Sloan posed in *Every Man and His Common Stocks*. Do the U.S. and, more generally, Britain, France, Germany and Japan, face crises of public finance? The answer, I believe, is "yes." Can today's investors discern signs of trouble ahead of time? Yes – albeit crudely. Can they take steps now that in the years to come might evade the crises' (if that's what transpires) worst effects? Can they, in other words, build portfolios whose streams of income rise as inflation, CPI and interest rates rise, GDP and incomes stagnate and the prices of many stocks and bonds fall? Can they maintain the purchasing power of their capital, and perhaps even augment it, in the face of these headwinds? Possibly. But the trouble is that, during the boom, signs of bust are apparent only to investors who seek them. Today, positive signs are numerous enough to persuade investors with an optimistic and even neutral view of the world that all is – and always will be – swell. A more sensible stance, it seems to me, is to adopt a general attitude that is sceptical and cautious, incorporate unfashionably dour assumptions into one's analyses, and rejoice if bad things don't eventuate. As in the past, so too today: mind the downside and the upside will mind itself.

Chris Leithner