

**The trillion dollar question:**

**Should the national debt be repudiated?**

by Jeffrey Rogers Hummel

The total debt of the national government currently exceeds \$900 billion. That figure is greater than one third of the gross national product of the U. S. In the last ten years, since 1970, the national debt has more than doubled from a meager \$383 billion. Earlier this year, Congress raised the debt ceiling to \$985 billion, and on April 6th, the House Budget Committee recommended raising the ceiling again still higher to \$994 billion for fiscal year 1981. Thus, despite his promise to balance the budget, Ronald Reagan will probably go down in history as the first U. S. President to preside over a *trillion dollar* national debt. When that happens, interest alone on the national debt will approach \$100 billion per year.

The debt of the national government is only part of the problem. The recent near-bankruptcy of New York City brought home the fact that the debt of local and state government is also reaching staggering proportions. State governments owe more than \$100 billion, while local governments are in debt to the tune of nearly another \$200 billion. The total debt of government at all levels within the United States, consequently, is already well over a trillion dollars, or more than half the GNP.

The ability to borrow is extremely important to government. Government obtains revenue in one of three ways: taxing, issuing money, and borrowing. At first glance, borrowing may seem much less harmful than the other two means of government financing. Borrowing is voluntary and does not involve the coercion of taxation, nor does it cause the inflationary discoordination within the economy that result from governmental monetary expansion.

Government borrowing is nevertheless detrimental. It depends upon the power to tax. No one would voluntarily loan money to government unless it had some means of paying the interest and repaying the principal. Government, in effect, uses its coercive power to guarantee its own loans. The result is that loanable funds are enticed away from other uses more desired by consumers. This diversion of savings from productive investments drives up interest rates and lowers the capital structure of the economy. Consumers are poorer than they otherwise would be.

Borrowing, furthermore, inevitably increases the tax burden. Borrowing may appear to be an alternative employed in lieu of taxation, but it obligates the government to pay interest and repay the principal, increasing the future tax load. Even if the debt is never repaid, but continuously refinanced, the perpetual stream of future interest payments involves a net tax increase larger than the amount borrowed. Through borrowing, government takes money out of the loan market which it replaces subsequently with tax money. Government borrowing plunders the economy twice over. First it misallocates savings; then later it raises taxes.

Libertarians wish to reduce significantly, if not totally eliminate, the power of government. The libertarian position on taxation and government monetary expansion is clear and unambiguous. Taxation is theft, or more precisely, extortion, and should completely cease. Government monetary expansion should be brought to a halt by denationalizing money, making money into a good provided solely by the market. There is, however, no generally accepted libertarian position on the third source of government revenue: borrowing.

Yet, anyone who is serious about rolling back the state must do something about government debt. It will not magically disappear. There are only three possible alternatives with regard to government debt. (1) Government debt can be paid back. (2) Government debt can be maintained in perpetuity, with interest

payments going on forever. (3) Government debt can be repudiated. These three alternatives, or some combination of them, are inescapable. Those who advocate substantial reductions in the size of government must decide which of the three they prefer. I believe that the only proper and defensible position of on government debt is total and immediate repudiation.

### **The Moral Case**

The strongest argument for the repudiation of government debt is moral. Repaying the debt, or interest payments, would require continued taxation. Since taxation is coercive, this course is clearly unjust. No one has a legitimate claim to stolen tax money, especially not the owners of government securities.

The government's creditors bargained in good faith, it will be answered. Repudiating the debt is a breach of contract and therefore also unjust. This is a peculiar rejoinder at best. If taxation is indeed theft, then the owners of government securities are morally no different than a group of investors who loaned money to finance the operations of a gang of thieves.

No one would seriously argue that private thieves should go on stealing until they pay off their creditors. But this is precisely the position of those who would use tax money to repay government debt.

All other investments entail risk. Why should investing in government be uniquely risk free? Indeed, those who loan money to the government are, in reality, investing in a criminal organization. The risk they face should be many times greater than that faced by investors in private, non-coercive, legitimate businesses. If the holders of government securities suffer huge losses as the result of repudiation, it will be no less than they deserve. The agreement between the government and its creditors is indeed voluntary, but voluntary agreements to commit theft and murder are not worthy of respect and ought not be carried out.

The fact that the owners of government securities may not believe that taxation is a form of aggression is irrelevant. They do know that the government taxes, regardless of their opinions that taxation's moral status. Should we excuse those who, prior to the Civil War, invested in slavery if they honestly believed that enslavement was the proper station for black people? If investors in a gang of thieves believe that stealing is a moral activity, they are still not entitled to the proceeds from theft. Government creditors have less of an excuse, because it is possible to loan money to thieves without knowing the source of their income, but hardly anyone is ignorant of the fact that the government collects taxes.

Admittedly, the government victimizes more than it benefits many owners of government securities, such as the elderly who put their life savings into government bonds only to see their capital wiped out by inflation. The state induces others to invest in its securities with various regulations. Commercial banks, in practice, must hold some government securities, while anyone wishing to receive the tax breaks from trust funds faces a similar requirement. The government, at times, even coerces individuals into loaning money, as for instance when new Army recruits are advised that allocating some of their pay to savings bonds would be a "good idea." And some lost souls may conceivably go through life oblivious to the fact the government is an engine of taxation.

The moral case for repudiation, however, does not depend upon the culpability of the government's creditors. Opinions can vary about the level of guilt or innocence of each of these groups, but this does not alter the coercive nature of taxation. The plight of these groups may make them legitimate objects of either voluntary charity or enforced compensation from their oppressors, but it cannot justify taxing innocent third parties.

Some have suggested that an alternative to taxation would be to retire the debt with the revenue obtained from the sale of those government assets--such as national parks, public buildings, and streets and highways--that become available as the state is dismantled. First, there is a practical difficulty with this option. Suppose the sale of government assets does not yield sufficient funds to cover the entire debt?

Then do you use taxation to repay the remainder, or do you permit partial repudiation? If you're willing to allow partial repudiation, on what grounds can you object to total repudiation?

Much more important that this practical difficulty is still the moral objection. The government is an institution that has both voluntary and involuntary relationships with its citizens. The involuntary relationships have visited untold damages upon those whom the government has taxed, regulated, and in general, exploited. The revenue from the sale of government assets should compensate for these involuntary damages rather than reimburse them for their voluntary dealings with the state. A gang of thieves should be required to repay their past victims before they repay those creditors who knowingly invested in robbery.

Consider the victims of the social security system. Year after year, they have been forced to pay taxes in to a government retirement fund that is not nearly as lucrative as alternative private schemes. Surely, they have a much better claim to the proceeds from the sale of government assets than do the owners of government securities. In fact, I would argue that all taxpayers should be reimbursed, with interest, for every cent they ever paid in taxes, long before consideration is given to the claims of the government's creditors.

Taxpayers are only one of the groups due compensation. The direct victims of numerous other government interventions, from drug laws to licensing restrictions, also have valid claims. Including them makes it obvious that all of the government's assets are hardly sufficient to fully compensate the victims of the state, much less pay back the state's voluntary allies. Even if every past and present government official were made personally liable for the damage, there still would not be enough money. It is a cruel fact of reality that the very existence of government has resulted in a massive waste of resources which are no longer around for any kind of compensation. To let the allies of government feel this loss would be fairer than to inflict it on the state's victims. Since most owners of government securities have also been, in one respect or another, exploited by the state, they would be entitled to some compensation anyway.

Any plan for maintaining the debt by perpetually paying interest on it encounters similar problems. A totally voluntary government could just not afford the \$100 billion yearly interest payments on a trillion dollar debt, or even a substantial fraction thereof. The total liabilities, including both bonds and stocks, of the largest U. S. corporation, General Motors, equal only a little more than \$30 billion, and one would hope that a voluntary night watchman state would be much smaller.

One last principled objection to debt repudiation remains. Does not the repudiation of government debt imply that government should never go into debt? If so, this indicates an error in my reasoning, since there is obviously nothing wrong with a completely voluntary government contracting debt. For the anarchist libertarian, of course, this objection poses no problem, since the anarchist wishes to see the state abolished. Even for the advocate of limited voluntary government, there is a crucial distinction between a debt contracted by a government once it has, in fact, started to rely on voluntary financing, and a debt contracted by a government which still retains the power to tax. The latter debt is guaranteed through the coercive power of the state; the former is not.

The distinction is analogous to that between a loan that Chrysler obtains voluntarily on the market, and a loan that Chrysler secures because the government has guaranteed repayment. Suppose Chrysler defaults on the coercively guaranteed loan? Would a true advocate of voluntary government endorse using tax money to pay off the loan? If not, then why confer an identical privilege to those who have loaned money to the government directly? As long as the government collects taxes, all loans it negotiates will be tainted with the stigma of coercion. Not until the government converts to voluntary financing will its loans be worthy of the same respect due the loans contracted between private individuals and institutions.

## Economic impact

One reason that people oppose government debt repudiation is that they fear it will lead to economic dislocations and hardships. They also automatically assume that the major beneficiary of repudiation will be the government itself. A little economic analysis will show that both of these worries are unfounded.

Over 40 percent of the national debt is held not by private citizens but by government agencies at various levels. Of the \$934 billion national debt outstanding at the beginning of this year, U.S. government agencies and trust funds held \$190 billion, the Federal Reserve held \$117 billion and state and local governments held \$73 billion. That portion in the hands of U.S. government agencies and trust funds is money the government owes to itself, and repudiating it would merely eliminate an accounting fiction. Repudiating that portion owed to states and local governments, while affecting the solvency of those governments, and perhaps forcing them to repudiate as well, will not have a direct impact on the welfare of private citizens.

Repudiating those government securities owned by the Federal Reserve System would have the added advantage of exposing the true source of inflation. Many conservatives charge that the national debt is inflationary. Strictly speaking, this charge is false. If the government borrows from the public, purchasing power is merely transferred from the public to government. When the government borrows from the Federal Reserve System, in contrast, the Federal Reserve creates new money to cover the loan. This process is called monetizing the debt. What seems on the surface to be a simple loan transaction is, in reality, an act of governmental monetary expansion. In this respect, and in this respect alone, the national debt is inflationary.

Repudiating the national debt will technically bankrupt the Federal Reserve System. The Federal Reserve will no longer have sufficient assets on one side of its balance sheet to match all the outstanding Federal Reserve notes and deposits on the liabilities side of its balance sheet. This apparent bankruptcy, unfortunately, would amount to another accounting fiction. Since the Federal Reserve creates money, it cannot go bankrupt. It would simply be forced to admit that what it really does is issue fiat money.

To understand the economic impact of repudiating those government securities held by the public, we must first examine the nature of non-government debt. Every loan transaction has two parties, the lender who forgoes the current use of money in exchange for a financial asset, and the borrower who gains the current use of money in exchange for a financial liability. No new wealth is created. Purchasing power is transferred. For every asset created, there is an offsetting liability. Thus, on the macro-level, the repudiation of private debt (which I do *not* advocate) leaves unchanged the net wealth of society. For every liability repudiated, an asset is destroyed. On the micro-level, in contrast, repudiation has a distribution effect. Debtors gain at the expense of creditors.

Now let us apply these principles to government debt. The holders of government securities have acquired assets, but where are the offsetting liabilities? It may superficially appear that government itself holds the liabilities, and while technically correct, this impression misses the underlying economic reality. The ultimate liabilities that the creation of government debt brings into existence are tax liabilities, since it is taxation that supplies the revenue to pay interest and, on infrequent occasions, the principal on government debt. Just as private debt creates no new wealth, neither does government debt. For every financial asset created by government borrowing, a corresponding tax liability also exists. The discounted present value of this stream of future tax liabilities exactly equals the present value of government securities.

To the extent that individuals perfectly anticipate their tax liabilities, the repudiation of the national debt will cause, on the macro-level, no change in new wealth. More important, on the micro-level, the existence of these offsetting tax liabilities serves to mitigate the distribution effects of repudiation. Opposition to government debt repudiation is based upon the understandable but superficial impression that the gains from repudiation accrue to the government. Instead the real gainers are the taxpayers.

Since nearly everyone pays taxes or owns assets whose value is reduced by taxation, it is impossible to predict, without additional information, whether a particular owner of government securities will, on net, gain or lose from the repudiation of government debt. Those who have an investment portfolio consisting of some government securities plus a selection of other assets, will find that, as their government securities are wiped out, their other assets rise in value because of the reduction in the anticipated tax burden.

People will tend to gain or lose not on the basis of whether they own government securities but on the basis of whether, over the entire range of their economic activities, they are net tax consumers or net taxpayers. The correspondence between net tax consumers and losers from repudiation on the one hand and net taxpayers and gainers from repudiation on the other will not be exact. Government debt is not the only means by which the state dispenses the benefits from taxation. The correspondence, however, will be close enough to ensure that large numbers of the government's creditors will be helped more than they are harmed. These offsetting gains, because they result from the lifting of *future* tax liabilities, would be *in addition* to any compensation that the state's victims might receive for *past* deprivations.

To what extent people actually anticipate the tax liabilities generated by government debt is a technical issue debated by economists and one of the more obscure points in the monetarist-fiscalist controversy. We need not resolve this question here. Even if people do not *perfectly* anticipate their tax liabilities, they clearly anticipate a major part of them. Despite the complexity of the income tax, nearly all wage earners know the difference between their nominal wage and their take-home pay. Businesses that consistently underestimate their future tax bite are soon driven out of the market by losses.

The major influence of incorrect anticipations upon government debt repudiation would be on the macro-level. If individuals underestimate their future tax liabilities, the assets brought into existence by government debt exceed the anticipated liabilities. Suffering from what is sometimes called "bond illusion," people think they are wealthier, overall, than they actually are. Government debt repudiation will lower people's perception of their net wealth, bringing it into greater consistency with reality. On the micro-level, the mitigating influence of offsetting tax liabilities will remain, although in some cases, individuals will be relieved of future taxes they never thought they had to pay.

None of these effects will occur instantaneously. If a policy of repudiation is ever implemented, it will first have to gain public acceptance. This fact will ensure that the destruction of the value of government securities will be spread over time. As more and more people predict what will happen, they will try to unload their government securities before the rest catch on. Government securities will gradually fall off in value, while other assets rise. Those who continue to put their faith in government will be caught holding government securities when they are finally repudiated.

The government, of course, could conceivably repudiate its debt and raise taxes at the same time, thus confiscating the gains to taxpayers of repudiation. To argue, however, that we should not eliminate one form of government oppression because another *might* take its place is invalid. I could just as logically object to the repudiation of government debt because the government might simultaneously decide to exterminate all libertarians. The fact of the matter is that debt, by its nature, obligates the government to make future payments. That obligation will ultimately be met through taxation or monetary expansion. Repudiation, by definition, eliminates that obligation.

If after considering the moral arguments and the mitigating economic impact, anyone still worries about the fate of government creditors, that individual is perfectly free to give his or her own money to the most deserving losers from repudiation, and to persuade others to do likewise. I am continuously amazed at those gradualist libertarians who acclaim the efficacy of voluntarism in the long-run, but are afraid to try voluntarism during the transition period. If private charity is sufficient for a free society, then it ought to also be sufficient to help those few, if any, who are undeservedly harmed by the transition to a free society.

## Historical Cases

A look at the early history of the United States provides additional evidence for the repudiation of government debt. If this historical survey is representative, it contradicts the prediction that debt repudiation brings dire consequences. It also shows that debt repudiation is associated with decreasing state power, while a rigorous adherence to the sanctity of government obligations tends to centralize power.

The first case involves beneficial debt repudiation. After the War of 1812, New York State began the construction of a canal connecting the Hudson River with the Great Lakes. The Erie Canal, completed in 1825, was unfortunately one of those rare and curious cases where a state-run enterprise actually made a good profit, and it encouraged other states to emulate New York. An orgy of canal building resulted. Usually, state governments owned and operated these new canals. In those few instances where the canals were privately owned, the states contributed the largest share of the financing.

By 1840, the canal boom had blessed the United States with 3326 miles of economically unjustified canals at an expense to the states of \$125 million, a large sum in those days. This massive state investment in canals, when added to the budget growth stimulated by the War of 1812, led to a huge outstanding debt for most of the states.. Virtually all of the new canals were a total waste of resources and did not bring the returns for which the state governments hoped. The states consequently faced financial stringency, and during the Panic of 1837 most of them became desperate. By 1844, \$60 million worth of state improvement bonds were in default. Six states--Mississippi, Louisiana, Maryland, Pennsylvania, Indiana, and Michigan--repudiated their debts outright, while several others defaulted temporarily.

Rather than having disastrous consequences, this repudiation brought on a widening circle of benefits. States became very wary of investing money in internal improvements or in anything else, while investors became very cautious about loaning money to the states. This ensured that when railroads came into prominence, the states left financing to the market. Although the states continued to subsidize railroads in subtle ways, through special monopoly privileges or land grants, state-owned railroads or state investment in railroads was negligible.

The heaviest state involvement in railroads came prior to the Panic of 1837, and nearly all the state-owned railroads were unloaded during the subsequent financial hard times. The states not only left the development and expansion of the railroad network to the market, but also during this period, they finally threw off their mercantilist and interventionist heritage and, for the first time, instituted a reign of near *laissez-faire* at the state level. Not surprisingly, the period prior to the Civil War witnessed some of the most rapid economic growth in the nation's history.

The second case involves government debt that clearly should have been repudiated, but was not, with pernicious consequences. During the American Revolution, when the members of the Continental Congress made the fateful decision to keep George Washington's puny Continental Army in the field, rather than relying totally upon the militia with its guerilla tactics, they locked themselves into a financial bind. They had to find a way to supply and pay Washington's army. Since taxation was out of the question, Congress resorted to printing unprecedented amounts of paper money and to borrowing. With the Revolution won, Congress had no qualms about virtually repudiating the \$226 million in paper money it had issued during the war, much of it forced upon citizens through impressment of goods and services, legal tender laws, and wage and price controls. In contrast, it considered the \$35 million it had borrowed from various sources to be a sacrosanct obligation.

Very few of the loans to Congress had been coerced. Only a portion of the \$4 million in civilian claims against primarily the Quartermaster and the Commissary Departments could conceivably fall into that category. Of the remainder, \$12 million represented claims of the officers and men of the Continental Army or claims of other public officials, while \$8 million had been borrowed from foreign governments. Worst of all, the final \$11 million in debt resulted from loans that had been made to the Continental Congress in its own depreciated paper currency. The specie value of the \$11 million had been deflated

from a face value of \$67 million for these loans, but this still represented a clear overestimate of their real specie worth and, thus, a generous subsidy to the creditors. Certainly, once Congress had repudiated its paper money, which was morally the more pressing of its obligations, there should have been no obstacle to repudiating the debt. Unfortunately, this did not happen, although Congress did have to suspend interest payments for a while.

Because Congress failed to repudiate its debt, the debt became a political weapon which was skillfully manipulated by such nationalists as Alexander Hamilton in order to bring about a statist counter-revolution, and replace the more libertarian Articles of Confederation with the Constitution. When the new government went into operation, the debt had grown from \$35 million to over \$55 million, mostly through accumulating interest payments. Hamilton increased the debt further by having the national government assume \$20 million worth of the states' war debts, which also had not been repudiated. The interest on this \$75 million debt accounted for approximately *one half* the total expenditures of the new government. Because of this heavy interest payment, Hamilton was able to expand his Treasury Department into the largest in the government, employing 2000 customs officials and revenue agents who swarmed across the land collecting tariffs and an onerous array of excise taxes.

I do not intend to simplistically imply that everything would have happened differently if only Congress had repudiated its debt. Nonetheless, the debt was a major factor in generating pressure for the increasing centralization of state power that took place in this era.

### **Conclusion**

Those who favor big government have good reason to oppose the repudiation of government debt. The opposition to repudiation on the part of the foes of state power, on the other hand, involves a moral and practical contradiction. This contradiction remains unnoticed because the opponents of debt repudiation refuse to specify their alternative. As I stated at the outset, government debt will not just go away. Repayment, perpetual maintenance, or repudiation are the sole options. The repayment or perpetual maintenance of a trillion dollar government debt, or of the half trillion that is actually owed to the public, would necessitate a powerful government imposing heavy taxes. The complete repudiation of this debt is the only course consistent with the goals of justice and liberty.