

# WILL "NATIONAL DEBT" END PROSPERITY AS WE KNOW IT?

by Edward Dodson, Cherry Hill, NJ

The statistics are staggering. The government of the United States has an outstanding indebtedness of \$7.228 trillion and growing by over \$1.7 billion daily. In 2003 alone, debt service costs amounted to \$318 billion. As interest rates rise over time, the amount required to service this debt will also rise. The only other areas of government spending that exceed what is required to service the debt are defense and social welfare (i.e., HUD, Agriculture).

The opinion of many economists seems to be that we need not be overly concerned about the rising debt (at least not yet) because of the size of the economy. They point out, for example, that at the end of the Second World War the U. S. national debt was nearly 125 percent of Gross Domestic Product. Not all economists have signed on to this perspective. Murray Rothbard, for one, warned against a long-term reliance on borrowing by government to pay for public goods and services:

"Deficits and a mounting debt ... are a growing and intolerable burden on the society and economy, both because they raise the tax burden and increasingly drain resources from the productive to the parasitic, counterproductive, 'public' sector. Moreover, whenever deficits are financed by expanding bank credit—in other words, by creating new money—matters become still worse, since credit inflation creates permanent and rising price inflation as well as waves of boom-bust 'business cycles.'"

Knowing of Rothbard's libertarian philosophical views, one should not be surprised he would see most government spending as counterproductive. Another economist, certainly more mainstream in reputation than Murray Rothbard, is Martin Feldstein. Recently, in a paper delivered in India, he stated:

"The appropriate size of the national debt, like the ideal weight for an individual, is a complex question. But basic common sense tells us that the ratio of debt to GDP should not be allowed to rise year after year. ...In fiscal terms, a country should recognize that it is in trouble if it sees its ratio of debt to GDP rising year after year."

Feldstein then offered some insight into the gradual acceptance by elected officials of the continuous expenditures by government above receipts. Only a very determined and highly publicized opposition by economists might have prevented this outcome:

"In retrospect, it is quite remarkable that the political process supported the opposition to budget deficits and national debt for such a long time. Without a strong intellectual and moral opposition to deficits, powerful populist political pressures can lead to large budget deficits. Budget deficits are potentially popular because they allow higher levels of government spending and lower levels of taxation. Deficits shift the fiscal cost to future generations that are not yet voters. And deficits impose burdens on the economy that, unlike the very tangible benefits of more spending and lower taxes, are not directly visible to current voters.

"It is unfortunate therefore that, starting with the 1940s, economists developed a series of different arguments that encouraged the political process to accept larger and larger peacetime deficits. These analyses started with simple Keynesian arguments and were followed by new theories of economic growth, theories of household saving behavior, and models of the global capital markets. The arguments were intellectually quite different from each other but they all lead to the same conclusion: that budget deficits in peacetime were not a problem for the economy."

"In my judgement, the theoretical attempts over the past 60 years to minimize the impact of budget deficits on capital accumulation, on economic growth, and on real incomes have been unpersuasive. Deficits reduce national saving and capital formation. That lowers the growth rate for a long period of time and permanently lowers the level of real income and the real standard of living. This adverse effect is reinforced by the deadweight loss that results from the need to raise substantial amounts of revenue to service the national debt."

The Bush economic team apparently holds to rather different conclusions regarding the effects of huge debt service costs on the economy. It is true that a good percentage of the government's creditors are required to pay income taxes on the interest received, so that the net cost of servicing this debt is less than the nominal cost. And, we have enjoyed a remarkably long period now of modest interest rates. Unfortunately, an increasing portion of the U.S. government debt is held by foreign nationals and governments. Government borrowing competes with private sector borrowing, putting pressure on the supply of credit and on interest rates. The traditional process of refunding maturing debt with new debt is likely to occur at higher interest costs in the future. Of even greater concern is that as interest rates are pulled upward, the Federal Reserve is under pressure from the U.S. Treasury to issue new Federal Reserve Notes in exchange for government debt. By this process the Federal government expands the supply of currency (i.e., creates its own credit) with the resulting tendency of prices to rise. We must not forget that on top of this escalating global demand for fossil fuels is driving up energy costs.

In an effort to stimulate investment and job-creation, President Bush and his economic team urged the U.S. Congress to pass a significant reduction in marginal tax rates. Doing so increased the disposable income to the nation's wealthiest 2-3 percent. The nation's stock market stabilized and some stocks increased in market value. Huge amounts of financial reserves came into the real estate sector, with investors paying premiums for partially-vacant office buildings and income-producing residential properties. Owner-occupied residential properties also have been increasing in price all over the country. We are now experiencing record levels of foreclosures, personal bankruptcies (cont'd on p. 9)

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and homelessness. With the costs of carrying on the military occupation of Iraq continuing to escalate, the Federal government is actually reducing the level of financial support to states and local governments to meet social welfare needs. The bottom-line question is whether, how soon and how deep might be a crash in this credit-fueled and speculation-dominated economic cycle.

While the national debt has never been higher in absolute terms, as a percentage of GDP the national debt at the end of World War II was considerably higher -- 122% of GDP. Never mind that this measurement - GDP - tells us almost nothing substantive about the state of well-being of people in a society. Conditions were rather different then. Full employment during four years of war production created a vast pool of savings available for investment and to satisfy pent-up demand. Veterans were provided with financial support to earn a college education. Housing construction surged in response to the millions of new households being formed and the availability of long-term mortgage financing at low rates of interest and no down payment requirements. Providing credit to European countries kept exports flowing out of U.S. factories. Today, the majority of countries around the globe successfully compete with U.S. producers on some level.

GroundSwell readers who attended the 2003 CGO conference in Bridgeport, Connecticut may recall my presentation on "The Wealth of our Nation and our Cities" (still available online at the conference website). In that paper, I provided up-to-date data on who owns what in the United States. As I wrote, "the top 1% of income-recipients enjoyed greater income than the 100 million people at the bottom." For the overwhelming majority of those who possess any physical or financial assets, the homes and land parcels thereunder represent most or all of their net worth. Conversely, the top 1% of families own nearly half of all financial wealth. Thus, only a small number of U.S. households are holders of U.S. government debt. This minority receives the interest payments the cash for which must come from taxing the millions of other households who are unable to afford to loan funds to the government.

The most charitable interpretation of the Bush tax cuts is an expectation that a supply-side effect would be generated far more effectively from that experienced during the Reagan Presidency. The Bush team seems to believe that the real mistake made by the Reagan team was to reverse the reduction in marginal tax rates before the economy grew sufficiently to generate enough tax revenue to balance the budget and begin a gradual reduction in total government debt. Yet, the benefits of the tax cuts have been to those in the highest income group. Individuals with an income over \$1 million experienced an average tax reduction of well over \$100,000. The median tax cut for U.S. taxpayers, generally, was less than \$500.

Perhaps the U.S. economy has become so large, so complex and so dynamic that increasing productivity will outrun the stresses described above. And, then, of course, there are the spiraling land markets to worry about.

(Ed Dodson invites readers to get back to him, [ejdodson@comcast.net](mailto:ejdodson@comcast.net), with their thoughts. His paper presented at the 2003 Geogist conference in Bridgeport, CT, "Affordable Cities: Bringing the Cost of Living Down to Earth," was published in the July-August 2003 issue of GroundSwell.) <<

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