Repudiating the National Debt

by Murray N. Rothbard

In the spring of 1981, conservative Republicans in the House of Representatives cried. They cried because, in the first flush of the Reagan Revolution that was supposed to bring drastic cuts in taxes and government spending, as well as a balanced budget, they were being asked by the White House and their own leadership to vote for an increase in the statutory limit on the federal public debt, which was then scraping the legal ceiling of one trillion dollars. They cried because all of their lives they had voted against an increase in public debt, and now they were being asked, by their own party and their own movement, to violate their lifelong principles. The White House and its leadership assured them that this breach in principle would be their last: that it was necessary for one last increase in the debt limit to give President Reagan a chance to bring about a balanced budget and to begin to reduce the debt. Many of these Republicans tearfully announced that they were taking this fateful step because they deeply trusted their President, who would not let them down.

Famous last words. In a sense, the Reagan handlers were right: there were no more tears, no more complaints, because the principles themselves were quickly forgotten, swept into the dustbin of history. Deficits and the public debt have piled up mountainously since then, and few people care, least of all conservative Republicans. Every few years, the legal limit is raised automatically. By the end of the Reagan reign the federal debt was $2.6 trillion; now it is $3.5 trillion and rising rapidly [ed. Note: $6.9 trillion, Jan. 13, 2004]. And this is the rosy side of the picture, because if you add in "off-budget" loan guarantees and contingencies, the grand total federal debt is $20 trillion.

Before the Reagan era, conservatives were clear about how they felt about deficits and the public debt: a balanced budget was good, and deficits and the public debt were bad, piled up by free-spending Keynesians and socialists, who absurdly proclaimed that there was nothing wrong or onerous about the public debt. In the famous words of the left-Keynesian apostle of "functional finance," Professor Abba Lernr, there is nothing wrong with the public debt because "we owe it to ourselves." In those days, at least, conservatives were astute enough to realize that it made an enormous amount of difference whether—slicing through the obfuscatory collective nouns—one is a member of the "we" (the burdened taxpayer) or of the "ourselves" (those living off the proceeds of taxation).

Since Reagan, however, intellectual-political life has gone topsy-turvy. Conservatives and allegedly "free-market" economists have turned handsprings trying to find new reasons why "deficits don't matter," why we should all relax and enjoy the process. Perhaps the most absurd argument of Reaganomists was that we should not worry about growing public debt because it is being matched on the federal balance sheet by an expansion of public "assets." Here was a new twist on free-market macroeconomics: things are going well because the value of government assets is rising! In that case, why not have the government nationalize all assets outright? Reaganomists, indeed, came up with every conceivable argument for the public debt except the phrase of Abba Lerner, and I am convinced that they did not recycle that phrase because it would be difficult to sustain with a straight face at a time when foreign ownership of the national debt is skyrocketing. Even apart from foreign ownership, it is far more difficult to sustain the Lerner thesis than before; in the late 1930's, when Lerner enunciated his thesis, total federal interest payments on the public debt were one billion dollars; now they have zoomed to $200 billion, the third largest item in the federal budget, after the military and Social Security: the "we" are looking ever shabbier compared to the "ourselves."

To think sensibly about the public debt, we first have to go back to first principles and consider debt in general. Put simply, a credit transaction occurs when C, the creditor, transfers a sum of money (say $1,000) to D, the debtor, in exchange for a promise that D will repay C in a year's time the principal plus interest. If the agreed interest rate on the transaction is 10 percent, then the debtor obligates himself to pay in a year's time $1,100 to the creditor. This repayment completes the transaction, which in contrast to a regular sale, takes place over time.

So far, it is clear that there is nothing "wrong" with private debt. As with any private trade or exchange on the market, both parties to the exchange benefit, and no one loses. But suppose that the debtor is foolish, gets himself in over his head, and then finds that he can't repay the sum he had agreed on? This, of course is a risk incurred by debt, and the debtor had better keep his debts down to what he can surely repay. But this is not a problem of debt alone. Any consumer may spend foolishly; a man may blow his entire paycheck on an expensive trinket and then find that he can't feed his family. So consumer foolishness is hardly a problem confined to debt alone. But there is one crucial difference: if a man gets in over his head and he can't pay, the creditor suffers too, because the debtor has failed to return the creditor's property. In a profound sense, the debtor who fails to repay the $1,100 owed to the creditor has stolen property that belongs to the creditor; we have here not simply a civil debt, but a tort, an aggression against another's property.

In earlier centuries, the insolvent debtor's offense was considered grave, and unless the creditor was willing to "forgive" the debt out of charity, the debtor continued to owe the money plus accumulating interest, plus penalty for continuing nonpayment. Often, debtors were clapped into jail until they could pay—a bit Draconian perhaps, but at least in the proper spirit of enforcing property rights and defending the sanctity of contracts. The major practical problem was the difficulty for debtors in prison to earn the money to repay the loan; perhaps it would have been better to allow the debtor to be free, provided that his continuing income went to paying the creditor his just due.

As early as the 17th century, however, governments began sobbing about the plight of the unfortunate debtors, ignoring the fact that the insolvent debtors had gotten themselves into their own fix, and they began to subvert their own proclaimed function of enforcing contracts. Bankruptcy laws were passed which, increasingly, let the debtors off the hook and prevented the creditors from obtaining their own property. Theft was increasingly condoned, improvidence was subsidized, and thrift was hobbled. In fact, with the modern device of Chapter 11, instituted by the Bankruptcy Reform Act of 1978, inefficient and improvident managers and stockholders are not only let off the hook, but they often remain in positions of power, debt-free and still running their firms, and plaguing consumers and creditors with their inefficiencies. Modern utilitarian neoclassical economists see nothing wrong with any of this; the market, after all, "adjusts" to these changes in the law. It is true that the market can adjust to almost anything, but so what? Hobbling creditors means that interest rates rise permanently, to the sober and honest as well as the improvident; but why should the former be taxed to subsidize the latter? But there are deeper problems with this utilitarian attitude. It is the same amoral claim, from the same economists, that there is nothing wrong with rising crime against residents or storekeepers of the inner cities. The market, they assert, will adjust and discount for such high crime rates, and therefore rents and housing values will be lower in the inner-city areas. So everything will be taken care of. But what sort of consolation is that? And what sort of justification for aggression and crime?

In a just society, then, only voluntary forgiveness by creditors would let debtors off the hook; otherwise, bankruptcy laws are an unjust invasion of the property rights of creditors.

One myth about "debtors'" relief is that debtors are habitually poor and creditors rich, so that intervening to save debtors is merely a requirement of egalitarian "fairness." But this assumption was never true: in business, the wealthier the businessman the more likely he is to be a large debtor. It is the Donald Trumps and Robert Maxwells of this world whose debts spectacularly exceed their assets. Intervention on behalf of debtors has generally been lobbied for by large businesses with large debts. In modern corporations, the effect of ever-tightening bankruptcy laws has been to hobble the creditor-bondholders for the benefit of the stockholders and the existing managers, who are usually installed by, and allied with, a few dominant large stockholders. The very fact that a corporation is insolvent demonstrates that its managers have been inefficient, and they should be removed promptly from the scene. Bankruptcy laws that keep prolonging the rule of existing managers, then, not only invade the property rights of the creditors; they also injure the consumers and the entire economic system by preventing the market from purging the inefficient and improvident managers and stockholders and from shifting the ownership of industrial assets to the more efficient creditors. Not only that; in a recent law review article, Bradley and Rosenzweig have shown that the stockholders, too, as well as the creditors, have lost a significant amount of assets due to the installation of Chapter 11 in 1978. As they write, "if bondholders and stockholders are both losers under Chapter 11, then who are the winners?" The winners, remarkably but unsurprisingly, turn out to be the existing, inefficient corporate managers, as well as the assorted lawyers, accountants, and financial advisers who earn huge fees from bankruptcy reorganizations.

In a free-market economy that respects property rights, the volume of private debt is self-policed by the necessity to repay the creditor, since no Papa Government is letting you off the hook. In addition, the interest rate a debtor must pay depends not only on the general rate of time preference but on the degree of risk he as a debtor poses to the creditor. A good credit risk will be a "prime borrower," who will pay relatively low interest; on the other hand, an improvident person or a transient who has been bankrupt before, will have to pay a much higher interest rate, commensurate with the degree of risk on the loan.

Most people, unfortunately, apply the same analysis to public debt as they do to private. If sanctity of contracts should rule in the world of private debt, shouldn't they be equally as sacrosanct in public debt? Shouldn't public debt be governed by the same principles as private? The answer is no, even though such an answer may shock the sensibilities of most people. The reason is that the two forms of debt-transaction are totally different. If I borrow money from a mortgage bank, I have made a contract to transfer my money to a creditor at a future date; in a deep sense, he is the true owner of the money at that point, and if I don't pay I am robbing him of his just property. But when government borrows money, it does not pledge its own money; its own resources are not liable. Government commits not its own life, fortune, and sacred honor to repay the debt, but ours. This is a horse, and a transaction, of a very different color.

For unlike the rest of us, government sells no productive good or service and therefore earns nothing. It can only get money by looting our resources through taxes, or through the hidden tax of legalized counterfeiting known as "inflation." There are some exceptions, of course, such as when the government sells stamps to collectors or carries our mail with gross inefficiency, but the overwhelming bulk of government revenues is acquired through taxation or its monetary equivalent. Actually, in the days of monarchy, and especially in the medieval period before the rise of the modern state, kings got the bulk of their income from their private estates—such as forests and agricultural lands. Their debt, in other words, was more private than public, and as a result, their debt amounted to next to nothing compared to the public debt that began with a flourish in the late 17th century.

The public debt transaction, then, is very different from private debt. Instead of a low-time preference creditor exchanging money for an IOU from a high-time preference debtor, the government now receives money from creditors, both parties realizing that the money will be paid back not out of the pockets or the hides of the politicians and bureaucrats, but out of the looted wallets and purses of the hapless taxpayers, the subjects of the state. The government gets the money by tax-coercion; and the public creditors, far from being innocents, know full well that their proceeds will come out of that selfsame coercion. In short, public creditors are willing to hand over money to the government now in order to receive a share of tax loot in the future. This is the opposite of a free market, or a genuinely voluntary transaction. Both parties are immorally contracting to participate in the violation of the property rights of citizens in the future. Both parties, therefore, are making agreements about other people's property, and both deserve the back of our hand. The public credit transaction is not a genuine contract that need be considered sacrosanct, any more than robbers parceling out their shares of loot in advance should be treated as some sort of sanctified contract.

Any melding of public debt into a private transaction must rest on the common but absurd notion that taxation is really "voluntary," and that whenever the government does anything, "we" are willingly doing it. This convenient myth was wittily and trenchantly disposed of by the great economist Joseph Schumpeter: "The theory which construes taxes on the analogy of club dues or of the purchases of, say, a doctor only proves how far removed this part of the social sciences is from scientific habits of mind." Morality and economic utility generally go hand in hand. Contrary to Alexander Hamilton, who spoke for a small but powerful clique of New York and Philadelphia public creditors, the national debt is not a "national blessing." The annual government deficit, plus the annual interest payment that keeps rising as the total debt accumulates, increasingly channels scarce and precious private savings into wasteful government boondoggles, which "crowd out" productive investments. Establishment economists, including Reaganomists, cleverly fudge the issue by arbitrarily labeling virtually all government spending as "investments," making it sound as if everything is fine and dandy because savings are being productively "invested." In reality, however, government spending only qualifies as "investment" in an Orwellian sense; government actually spends on behalf of the "consumer goods" and desires of bureaucrats, politicians, and their dependent client groups. Government spending, therefore, rather than being "investment," is consumer spending of a peculiarly wasteful and unproductive sort, since it is indulged not by producers but by a parasitic class that is living off, and increasingly weakening, the productive private sector. Thus, we see that statistics are not in the least "scientific" or "valuefree"; how data are classified—whether, for example, government spending is "consumption" or "investment"—depends upon the political philosophy and insights of the classifier.

Deficits and a mounting debt, therefore, 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 boombust "business cycles."

It is for all these reasons that the Jeffersonians and Jacksonians (who, contrary to the myths of historians, were extraordinarily knowledgeable in economic and monetary theory) hated and reviled the public debt. Indeed, the national debt was paid off twice in American history, the first time by Thomas Jefferson and the second, and undoubtedly the last time, by Andrew Jackson.

Unfortunately, paying off a national debt that will soon reach $4 trillion would quickly bankrupt the entire country. Think about the consequences of imposing new taxes of $4 trillion in the United States next year! Another way, and almost as devastating, a way to pay off the public debt would be to print $4 trillion of new money—either in paper dollars or by creating new bank credit. This method would be extraordinarily inflationary, and prices would quickly skyrocket, ruining all groups whose earnings did not increase to the same extent, and destroying the value of the dollar. But in essence this is what happens in countries that hyper-inflate, as Germany did in 1923, and in countless countries since, particularly the Third World. If a country inflates the currency to pay off its debt, prices will rise so that the dollars or marks or pesos the creditor receives are worth a lot less than the dollars or pesos they originally lent out. When an American purchased a 10,000 mark German bond in 1914, it was worth several thousand dollars; those 10,000 marks by late 1923 would not have been worth more than a stick of bubble gum. Inflation, then, is an underhanded and terribly destructive way of indirectly repudiating the "public debt"; destructive because it ruins the currency unit, which individuals and businesses depend upon for calculating all their economic decisions.

I propose, then, a seemingly drastic but actually far less destructive way of paying off the public debt at a single blow: out-right debt repudiation. Consider this question: why should the poor, battered citizens of Russia or Poland or the other ex-Communist countries be bound by the debts contracted by their former Communist masters? In the Communist situation, the injustice is clear: that citizens struggling for freedom and for a free-market economy should be taxed to pay for debts contracted by the monstrous former ruling class. But this injustice only differs by degree from "normal" public debt. For, conversely, why should the Communist government of the Soviet Union have been bound by debts contracted by the Czarist government they hated and overthrew? And why should we, struggling American citizens of today, be bound by debts created by a past ruling elite who contracted these debts at our expense? One of the cogent arguments against paying blacks "reparations" for past slavery is that we, the living, were not slaveholders. Similarly, we the living did not contract for either the past or the present debts incurred by the politicians and bureaucrats in Washington.

Although largely forgotten by historians and by the public, repudiation of public debt is a solid part of the American tradition. The first wave of repudiation of state debt came during the 1840's, after the panics of 1837 and 1839. Those panics were the consequence of a massive inflationary boom fueled by the Whig-run Second Bank of the United States. Riding the wave of inflationary credit, numerous state governments, largely those run by the Whigs, floated an enormous amount of debt, most of which went into wasteful public works (euphemistically called "internal improvements"), and into the creation of inflationary banks. Outstanding public debt by state governments rose from $26 million to $170 million during the decade of the 1830's. Most of these securities were financed by British and Dutch investors.

During the deflationary 1840's succeeding the panics, state governments faced repayment of their debt in dollars that were now more valuable than the ones they had borrowed. Many states, now largely in Democratic hands, met the crisis by repudiating these debts, either totally or partially by scaling down the amount in "readjustments." Specifically, of the 28 American states in the 1840's, nine were in the glorious position of having no public debt, and one (Missouri's) was negligible; of the 18 remaining, nine paid the interest on their public debt without interruption, while another nine (Maryland, Pennsylvania, Indiana, Illinois, Michigan, Arkansas, Louisiana, Mississippi, and Florida) repudiated part or all of their liabilities. Of these states, four defaulted for several years in their interest payments, whereas the other five (Michigan, Mississippi, Arkansas, Louisiana, and Florida) totally and permanently repudiated their entire outstanding public debt. As in every debt repudiation, the result was to lift a great burden from the backs of the taxpayers in the defaulting and repudiating states.

Apart from the moral, or sanctity-of-contract argument against repudiation that we have already discussed, the standard economic argument is that such repudiation is disastrous, because who, in his right mind, would lend again to a repudiating government? But the effective counterargument has rarely been considered: why should more private capital be poured down government rat holes? It is precisely the drying up of future public credit that constitutes one of the main arguments for repudiation, for it means beneficially drying up a major channel for the wasteful destruction of the savings of the public. What we want is abundant savings and investment in private enterprises, and a lean, austere, low-budget, minimal government. The people and the economy can only wax fat and prosperous when their government is starved and puny.

The next great wave of state debt repudiation came in the South after the blight of Northern occupation and Reconstruction had been lifted from them. Eight Southern states (Alabama, Arkansas, Florida, Louisiana, North Carolina, South Carolina, Tennessee, and Virginia) proceeded, during the late 1870's and early 1880's under Democratic regimes, to repudiate the debt foisted upon their taxpayers by the corrupt and wasteful carpetbag Radical Republican governments under Reconstruction.

So what can be done now? The current federal debt is $3.5 trillion. Approximately $1.4 trillion, or 40 percent, is owned by one or another agency of the federal government. It is ridiculous for a citizen to be taxed by one arm of the federal government (the IRS), to pay interest and principal on debt owned by another agency of the federal government. It would save the taxpayer a great deal of money, and spare savings from further waste, to simply cancel that debt outright. The alleged debt is simply an accounting fiction that provides a mask over reality and furnishes a convenient means for mulcting the taxpayer. Thus, most people think that the Social Security Administration takes their premiums and accumulates it, perhaps by sound investment, and then "pays back" the "insured" citizen when he turns 65. Nothing could be further from the truth. There is no insurance and there is no "fund," as there indeed must be in any system of private insurance. The federal government simply takes the Social Security "premiums" (taxes) of the young person, spends them in the general expenditures of the Treasury, and then, when the person turns 65, taxes someone else to pay the "insurance benefit." Social Security, perhaps the most revered institution in the American polity, is also the greatest single racket. It's simply a giant Ponzi scheme controlled by the federal government. But this reality is masked by the Social Security Administration's purchase of government bonds, the Treasury then spending these funds on whatever it wishes. But the fact that the SSA has government bonds in its portfolio, and collects interest and payment from the American taxpayer, allows it to masquerade as a legitimate insurance business.

Canceling federal agency-held bonds, then, reduces the federal debt by 40 percent. I would advocate going on to repudiate the entire debt outright, and let the chips fall where they may. The glorious result would be an immediate drop of $200 billion in federal expenditures, with at least the fighting chance of an equivalent cut in taxes.

But if this scheme is considered too Draconian, why not treat the federal government as any private bankrupt is treated (forgetting about Chapter 11)? The government is an organization, so why not liquidate the assets of that organization and pay the creditors (the government bondholders) a pro-rata share of those assets? This solution would cost the taxpayer nothing, and, once again, relieve him of $200 billion in annual interest payments. The United States government should be forced to disgorge its assets, sell them at auction, and then pay off the creditors accordingly. What government assets? There are a great deal of assets, from TVA to the national lands to various structures such as the Post Office. The massive CIA headquarters at Langley, Virginia, should raise a pretty penny for enough condominium housing for the entire work force inside the Beltway. Perhaps we could eject the United Nations from the United States, reclaim the land and buildings, and sell them for luxury housing for the East Side gliterati. Another serendipity out of this process would be a massive privatization of the socialized land of the Western United States and of the rest of America as well. This combination of repudiation and privatization would go a long way to reducing the tax burden, establishing fiscal soundness, and desocializing the United States.

In order to go this route, however, we first have to rid ourselves of the fallacious mindset that conflates public and private, and that treats government debt as if it were a productive contract between two legitimate property owners.