Debt and Sovereignty: The Lost Lessons

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In an earlier article entitled "The Moral Hazard of Modern Banking," I, in effect, warned: Beware of bankers. Bankers think they're smarter than other people and often use their smarts to get the better of others in less than honest ways. While some readers thought I was too hard on bankers, I did not deliver a blanket condemnation of usury. In fact, I noted that a blanket condemnation of usury in the Christian West was misguided, that debt is not always bad, and that we owe most of our modern material blessings to the system of debt we call capitalism. The problem is that, in the pursuit of happiness and the fight against communism, we lost sight of capitalism's dark side, the inherent danger of debt.[1]

Excessive debt an individual and collective danger.

That danger is only now dawning on us once again. It is a danger to each of us individually inasmuch as we all labor under the burden of mortgages and consumer debt. It is also a danger to us collectively as a nation and even as a civilization. Every week we hear new warnings about the threat to the nation's credit ratings. The national debt is roughly 100 percent of our gross national product, and the people who lend to the

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[1] Brian Patrick Mitchell, "The Moral Hazard of Modern Banking," *Humanitas* 22:1-2 (2009), 33-39.

federal government are beginning to worry that they will not get their money back. Yet without continuous borrowing, the nation cannot possibly sustain its accustomed lifestyle. Something has got to give.

Greater ability to borrow gave republics a decisive edge over monarchies.

In this article I want to offer a brief history of public borrowing as the basis of the way to think about the impact of debt on national sovereignty. My principal source is *A Free Nation Deep in Debt: The Financial Roots of Democracy*, a book by James Macdonald, an erstwhile investment banker from Oxford, England.[2] Macdonald took his title from an anonymous pamphleteer writing in 1719 in praise of "publick credit" as the key to British independence. The complete sentence was, "Let us be, say I, a free Nation deep in Debt, rather than a Nation of Slaves owing Nothing."[3] Macdonald argues that a greater ability to borrow gave republics a decisive edge over monarchies, thus accounting for the steady decline in monarchies around the world. I shall focus mostly on the British experience because I think it best illustrates the lessons learned by European republics that were later forgotten by our modern mass democracies. But I am going to start a little further back in history so as to get the fundamentals of public finance right.

When all the world was ruled by kings, every king kept a "war chest," a hoard of precious gems and metals that could be easily traded for arms or food. When the hoard ran out, there was little that a king could do. He could not borrow money because, for a very long time, there was no one from whom a king could borrow. Most of the world's wealth was under the control of rival kings. The little that was not under their control was in the hands of persons who could not trust a king with a loan. After all, who could force a king to pay?

Absent a force to compel repayment, few loans will be made.

This is an important point to remember in thinking about debt and sovereignty. The wise man knows that borrowing makes the borrower servant to the lender, but also that the power of the lender over the borrower is dependent upon a sovereign power sufficient to make the borrower pay up. That

[2] James Macdonald, *A Free Nation Deep in Debt: The Financial Roots of Democracy* (Princeton: Princeton University Press, 2003).

[3] Anon., *The Chimera: Or, the French Way of Paying National Debts, Laid Open*, London, 1720, 7–9. Cited by Macdonald.

sovereign power may be merely moral, when shame is enough to compel repayment, but it is usually also legal, being backed by the force of law. When shame and force are not sufficient to compel repayment, the lender is really just gambling with his money and sometimes simply giving it away.

For a very long time, kings, as sovereign powers, were only able to lend money, never to borrow it. Only in the Christian era did this change, for three main reasons. The first was a new understanding of international law, based upon a moral sovereignty to which kings themselves were subject. The second was the limited sovereignty of kings inherent in both feudalism and Christianity, with its distinction of church and state. The third was the resulting appearance in Europe of large accumulations of wealth outside the control of kings, in the hands of the Church and in the hands of the merchants and moneylenders of the Italian republics and German free cities. For the first time in history, there were banks big enough and secure enough to lend to kings with a reasonable expectation of repayment.

Monarchs as sovereigns were poor credit risks.

Even then, because a lender's power over a royal borrower was strictly moral, kings remained a poor credit risk, able to borrow only small amounts, for short terms, at high interest rates. Consequently, cash-strapped kings often practiced "debt management by default"—every once in a while refusing to pay according to agreed-upon terms, forcing creditors to convert short-term debt into long-term debt, and also sometimes prosecuting creditors for usury or treason.

The credit of kings deteriorated as kings grew in power, consolidating control over the great nations of Europe and assuming absolute sovereignty over everything within their realms, including the Church. Paradoxically, their absolutist pretensions put them at a decisive disadvantage in competition with the mercantile republics of Europe, once those republics figured out how to marshal the wealth of investors at home and abroad through markets in public bonds.

The Italian republics led the way, experimenting with various ways of repaying citizens for contributions to the public treasury. Some of their experiments solved the problem of sovereignty by effectively making citizen-creditors sovereign. Genoa for a long time was governed by a corporation called

Republics solved problem of sovereignty by making citizen-creditors sovereign.

the Casa di San Giorgio, whose 11,000 shareholders represented most of the city's households.

The Dutch went even further, raising public money by the sale of annuities that could be resold at a public market. The freedom to resell the annuities and the certainty that the annuities would be paid on time enabled the Dutch republic to borrow more than 200 percent of its gross national product (GNP) to fund its war of independence from Spain. This was an unprecedented level of public borrowing, and it was possible only because of the symbiosis of public debtor and citizen-creditor: They were the same people. The annuities would be paid because the people paying them were also the people receiving them.

Unfortunately for both the Italian republics and the Dutch republic, the costs of war still overwhelmed their economies, forcing them into retreat. It remained for the British to perfect the system and make the most of it.

For centuries, the English had starved their kings of funds, expecting them to live off their own lands. When the Stuarts tried to take control of the kingdom's finances, to keep up with monarchs on the continent, the English threw the Stuarts out and hired a Dutchman to be king, with the understanding that Parliament would control the finances, managed in the Dutch way by members of Parliament who were themselves heavily invested in government bonds.

With Parliament, led by wealthy bondholders, in charge of Britain's finances, public credit soared.

With Parliament in control of finances, and with a handful of the wealthiest lords in control of Parliament, Britain was less inclined to wage war for religious or dynastic objectives but more inclined to wage war for economic advantage. In fact, public credit made wars easier by reducing their immediate cost. Parliament didn't have to raise taxes much to pay for a war; it could borrow most of what it needed. This effect was not missed by Adam Smith, who wrote:

> In great empires, the people who live in the capital, and in the provinces remote from the scene of action, feel, many of them, scarce any inconveniency from the war, but enjoy, at their ease, the amusement of reading in the newspapers the exploits of their own fleets and armies. To them this amusement compensates the small difference between the taxes which they pay on account of the war, and those which they

pay in time of peace.[4]

For the next hundred years, Parliament borrowed huge sums of money for various wars and paid much of it back in the peace afterwards. France, Britain's chief rival in the eighteenth century, could not keep up. Britain was just a third the size of France in population, but it outspent France handily in both the Seven Years War (£73 million to £53 million) and the American Revolution (£112 million to £40 million). France could not spend more because it could not borrow more. Investors did not trust the French king to pay his bills. On the eve of the French Revolution, France was bankrupt with public debt at 65 percent of GNP, while Britain was carrying on business as usual with debt at 182 percent of GNP—down, in fact, from over 200 percent at the end of the American Revolution.

Superior credit enabled Britain to outspend France militarily.

A generation later, in 1814, Britain's debt reached almost 300 percent of GNP, but confidence in the British government and economy stood so high after Waterloo that Parliament departed from its pattern of paying down debt in peacetime and instead allowed its booming imperial economy to simply dwarf its debt. By 1860, the debt was down to 100 percent of GNP, and by 1913 it was down to just 25 percent. Britain entered World War I as the second least indebted major combatant, after the United States.[5]

Through the three centuries of British history just summarized, from roughly 1600 to 1900, the British pound remained remarkably stable. Wages and prices rose predictably during wartime in response to increased demand and fell predictably upon the return of peace. Macdonald names monetary stability as one of the twin pillars of British credit in that time, the other being fiscal discipline—keeping peacetime expenses down and using budget surpluses to pay down debt. He writes:

Monetary stability and fiscal discipline result when public finances are "absolutely governed by those who furnish them."

> In the eighteenth century it did not occur to the public creditors of Britain and the Dutch Republic that their governments might simply inflate away their problems. Such things did not happen in states "where the finances are absolutely governed

[4] *The Wealth of Nations* (London, 1776), 8. Cited in Macdonald, 237-238.

[5] The U.S. entered World War I with just $1 billion in federal debt; two years later it was $24 billion, 30 percent of GNP. The British economy grew almost sevenfold between 1814 and 1913; in the same years, the U.S. economy, starting at a much lower baseline, grew forty-six-fold.

by those who furnish them."[6]

That last phrase about finances being "absolutely governed by those who furnish them" is actually a slight paraphrase of an envious Frenchman, Duc de Saint-Simon, commenting on the British system.[7]

Sovereign credit weakened by expansion of the franchise.

But the twin pillars of Britain's credit both fell in the twentieth century, as a result of changes in the British electorate. In 1814 the vast majority of British voters were also creditors; by the end of the century, the vast majority were not. With the expansion of the franchise to include all adult males and then all adults, Parliament ceased to represent the interest of creditors and began representing the demands of potential beneficiaries of peacetime social spending.[8] When wages and prices fell as usual after World War I, John Maynard Keynes was there to tell Parliament that its main economic objective should not be paying off creditors, but maintaining full employment with more public spending, made possible by high peacetime taxes and government manipulation of the money supply.

What came next were decades of deficit spending, routine borrowing, wartime rationing, and peacetime inflation. By the mid-twentieth century, the leading nations of the world—"all Keynesians now"—had undergone a fiscal revolution so complete that only the fossils among us could recognize how much things had changed. In 1974, Sydney Homer, head of research for Salomon Brothers, told an audience in Cleveland:

> When I was a student in college, we were all taught that peacetime inflation was unthinkable in our great United States, or for that matter in any other first-class enlightened industrial state except perhaps France. Peacetime inflation was then to be found chiefly in banana republics with their pesos, escudos, and other queer-sounding currencies, and all they needed to save them from the disgrace of inflation was to obtain the monetary advice of any one of our distinguished economists and follow it. … Our [current] inflation is unprecedented in our economic history for times of peace. … What has happened to our stockpile of astute economists that used to lecture small South American countries

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6 Macdonald, 237.

7 Macdonald, 193.

8 Macdonald does not distinguish between republics and democracies in his book, but the shift he notes from an electorate composed primarily of citizen-creditors and an electorate composed primarily of citizen-beneficiaries provides a useful basis for such a distinction.

on how to behave themselves fiscally? Indeed, a few of them are now telling us to emulate South American methods even though these often require a military dictatorship.[9]

Well, we're not quite there yet, but we do seem to be getting there. For the past half century, the United States has been urging debt upon developing nations in the naive expectation that prosperity would automatically follow—and that the governments taking our money would do our bidding, in the United Nations, in the drug war, in the War on Terror, in the campaign against climate change, and in the advancement of human rights. It doesn't quite work that way in reality. After all, we are still dealing with sovereign nations beyond our control. All too often, the rulers of those nations take our money, spend it on themselves, pay us lip service, and use our loans as excuses to squeeze more money out of their people, ostensibly to repay the loans. The predictable results are popular unrest and populist revolt against corrupt regimes seen as serving gringo interests.

Now our own profligate spending is catching up with us. The Fed itself has said it will stop buying U.S. Treasury bonds. Our foreign creditors—which include many of our supposed rivals like China, Russia, Venezuela, and even Iran—have already starting cutting back on U.S. Treasuries. They didn't buy them to leverage our sovereignty; they bought them because they thought they were good investments. Now they are worried that we will not pay up—that we cannott afford all the spending that we have promised ourselves and will continue to devalue the dollar to cover our expenses. That would be the Keynesian thing to do. Keynes, in fact, praised Weimar Germany's devaluation of the mark to avoid really paying reparations, while characterizing Britain's commitment to creditors as "enslaving the taxpayer to the bondholder."

Devaluing the dollar to cover runaway expenses will destroy America's credit, bringing bankruptcy.

Our present administration seems intent on doing just what Keynes would do. It cannot raise taxes and get reelected, but it can take a share of the value of every dollar in existence and reallocate it to new dollars, to be spent on healthcare and warfare etc. That is what inflation does in Keynesian theory: It is a surreptitious taxing alternative to levies that are straightforward but politically difficult.

9 Macdonald, 468.

The trick, of course, is keeping inflation under control, so that it does not scare away creditors. If it gets away from us, our creditors will run for cover, and we will be truly bankrupt. When that occurs, our only hope, and greatest fear, will be real regime change—a new sovereign to take responsibility for the mess that is left.