THE HIDDEN FLAW

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America and much of the world suffers from the impediments of aberrant subpar economic growth and notable income disparity. Monetary and fiscal expansions along with extraordinary debt growth have failed to ameliorate these conditions and no one seems to have any real answers to the world's declining economic growth rates.

Many believe that excess debt is the cause of our weak economy but perhaps debt is just a symptom. To define the real problem might we have to look to our political structure for a clear explanation of our predicament?

When Winston Churchill noted that **"Democracy is the worst form of government, except all those others that have been tried"** he outlined his general frustrations but failed to point out the specifics. Today we see that America, Europe, Japan and others suffer from what is most certainly the tragic flaw of modern democracy and one that conflicts directly with free enterprise and its natural product of prosperity. This is the construct of modern democratic politicians in their ubiquitous declarations; "**Give us your votes and we will give you free stuff."**….free stuff paid for with ever-increasing amounts of debt.

John Adams and Alexis deTocqueville described this flaw as a "tyranny of the majority' but could it be better described as a"tyranny of the minority", epitomized each day in the proclamations of those aspirational politicians before each election?

When Barney Frank wanted to offer up free stuff to unqualified homebuyers in 2003, he said, **"I want to roll the dice a little bit more in this situation toward subsidized housing."** However, in pressuring Fannie Mae and Freddie Mac to change their policies to give cheap mortgages to the constituency he probably did not realize the events he would set in motion or that the eventual outcome would be a debt crisis of epic proportions.

Churchill was right. Democracy is the best form of government. However, it is this gaping hole in our democracy's design and structure that has inflicted us with a progressively worsening worldwide debt crisis and the greatest threat to our prosperity since the Industrial Revolution. If it is not permanently addressed soon, it will surely escalate toward another breaking point in the future.

According to the Mckinsey Global Institute's Report **"Debt and Deleveraging -Not Much,"** global debt loads have increased by $57 trillion to $199 trillion in just the last seven years. To keep this in perspective, the aggregate stock market capitalization of the entire S&P 500 is approximately $21 trillion; so every 30 months the world's economies are adding additional debt greater in sum and proportion than that manifested before the Great Depression and in an amount equal to the capitalization of all the companies in the S&P 500.

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The Europeans, for their part have discovered that promising "stuff" to get elected is the easy part; not bankrupting the economy in the process is a bit more difficult. As people get more accustomed to free stuff or living off government handouts, their moral construct debilitates. Each day we move closer to an eventual outcry of "If I can get free welfare, why not free everything?"

The inherent attractiveness of free stuff and the benefits to the politicians that hand it out are destructively penetrating to free enterprise and prosperity. While any compassionate society should provide well for the 5-8% of the population that suffer from real genetic or physical disabilities, the demands of those who simply don't want to work are now inhibiting the ability of society to provide for those that actually have genuine physical disadvantages. In recent years when 90% of Long Island Railroad workers retired with a "disability" or when 82% of senior California State Troopers claimed they were "disabled" in their last year before retirement, the effect on the genuine needs of society and the truly deserving was radically compromised as a result. This fraudulent mis-allocation of resources does not even address the astonishing limitations such debt places on other scarce resources like education and infrastructure that are needed to promulgate a vibrant functioning system. However, we can be sure of is that those Long Island Railroad workers and California State Troopers promptly voted for whichever politician endorsed their benefits.

As New Jersey Governor Chris Cristie pointed out in his April 14th New Hampshire speech;

"In 1960, when John F. Kennedy was elected President, 26% of the federal budget was spent on payments to individuals. Today, that number is 71%. In the last 25 years, while

our economy has grown by over 200%, Medicare has grown by 539%. Medicaid and related programs have grown by well over 800%. They are 9 times as big as they were 25 years ago and the U.S. economy is only 3 times as big. The share of working age Americans collecting disability has doubled in the last twenty years – from 2.3% to 4.6%. The disability rolls have increased by over 1.5 million just since January 2009, to more than 11 million people. This is up from just 2.7 million in 1986. This is not sustainable."

The bigger problem is that most government transfers to individuals fail to produce a productive long-term return to the economy and other critical needs go unmet. All of this short circuits the natural free enterprise system resulting in increasing income disparity. In essence, capital is consumed to give people fish and as a result there are no returns available for capital investment or to expand private sector employment as they might be if the funds were invested in the growth of, say, the fishing industry. The result is that the economy staggers along like a marathon runner with a backpack of rocks with no way to disperse the burden by lowering interest rates as it has in past years.

Presently, our accumulated debt and regulatory burdens like Dodd Frank leave little room for increasing credit growth, the lifeblood of a money-multiplied economy. Furthermore, when debt is increasing faster than the GDP, net productive economic returns are not available to service the larger debt load. This means that the burden of excess debt eventually becomes so precarious that policy makers are ultimately faced with a choice between deflationary defaults or a significant rise in inflation through direct monetizations.

Compounding the issue given the interrelated nature of the world economy is that the debts of one country affect all countries. Without increasing credit growth on the part of their debt laden western customers, China, Korea, Vietnam and many other producers are forced to add more debt to assist their own slowing economies. Eventually, even non-democratic, more centrally planned economies are drawn into the same debt quandary.

So, how has the United States afforded the parabolic rise in entitlements and the resulting debt growth over the last 20-30 years without collapsing its economy? The answer lies in declining interest rates and their high inverse correlation coefficient with aggregate debt growth.

To better understand this concept compare the expansion of debt in U.S. economy overall to the expansion of debt for an investment in a house or real property. Holding other factors constant, such as the down payment and property taxes, a home buyer can generally get twice the mortgage or buy twice the house relative to his income at interest rates that are one half of their previous levels. Similarly, the U.S. economy currently supports public and private debt of 353% of GDP compared to only 170% of GDP in 1980. This has occurred, in part, because of declining interest rates that over the last 30 years has resulted in the real debt service burden relative to GDP declining while at the same time the actual aggregate gross debt itself has grown dramatically. In short, as debt to GDP has risen, interest rates have declined, thereby lightening the load. Lower rates have therefore performed the same function as they would for a homebuyer and it seems clear that declining interest rates have in part, enabled a large part of our massive debt growth.

However, there is a rub for the future. The closer you get to zero rates, the harder it becomes to push rates below the zero bound to keep the debt service burden on the growing gross debt at a mitigated level. For example, when you have to pay your bank to hold your money, instead of the other way around, it creates a propensity to seek cash withdrawals that in turn inhibits rates dropping far enough below the zero mark to reduce the larger effective debt service burden on a larger gross debt. Therefore, future additional debt burdens that result from entitlements and other non-productive investments will go unmitigated by lower rates. At that point, accretions to debt begin to inhibit growth to an even greater degree, which might also begin to explain the weaker economy we see today.

What are the answers for us?

One thing is clear, additional fiscal stimulation through even more debt is not the answer. Japan spent 20 years patiently waiting for growth to re-emerge, all the while adding debt to their national accounts. Some believe that by waiting to monetize their debt and make structural changes, the Japanese only ended up with a bigger problem and eventually had to debase their currency anyway. In addition, many economists believe that the American public will soon tire of below trend growth and will demand quicker action to reduce the debt burden through a combination of inflation and higher GDP growth. However, the other problem is that increasing fiscal stimulation past a certain point inevitably results in a rapidly declining return of GDP growth for each fiscal dollar borrowed and spent by government.

But there are no perfect choices for treating excessive debt expansion and it often comes down to a choice between a 1930's type deflationary default with its associated obsolescence and decay on the one hand, or a 1980's monetary induced inflation on the other. Inflation at moderate levels does tend to do less physical economic harm than default because on a comparative basis the use of inflation will better maintain the manufacturing infrastructure for the bulk of the industrial base. However, the problem in selecting inflation as a solution is that one can never be sure it will be controlled once gets a little bit out of the box. On the other hand, without inflation, excessive or unserviceable debts frequently culminate in default alongside deflation and this usually produces a worse manufacturing and economic abyss similar to the 1930's, which turned out to be a deflation that was extremely difficult, if not impossible to climb out of until World War II came along.

While a combined growth and inflation rate of 6.8% would reduce real debt/GDP back to 1980 levels in roughly 10 years, it would not solve democracy's long-term problem of vote buying financed by debt. Moreover, it may be true that a gold standard might stop money printing by the central banks but it would not completely stop politicians from expanding nominal debt to buy votes. Certainly, the implied currency restraints of the Euro did little to stop excess borrowing and spending by countries such as Greece, Spain, Italy, France and many others.

In considering other answers, a restraint like sequestration has brought down the U.S. budget deficit over the last few years, but in the long term, it will likely only prove to be a short-term solution, one that is washed away at a moments notice on the whim of the legislature. Consequently, in the end, the only real answer is to take the capacity for excessive deficit spending out of the hands of the politicians. In the U.S. the best way to do that is with a constitutional amendment that limits excess debt growth and confines any debt/GDP expansion to periods of real emergency with strict instrumentalities to eliminate those exceptions once the emergency has passed.

Just because the next crisis has not yet arrived does not mean that we can continue to build a debt structure to the sky with no long-term control mechanisms in place. As Rudiger Dornbusch commented; "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."

America needs to make a real concerted effort to live within its means and to eliminate the proclivity to hand out debt-financed goodies before each election. America needs to permanently fix this flaw of vote buying. It needs to reduce the size of government and end the government's blatant waste of the taxpayer's dollars. With a 20% flat personal income tax rate and the saving of much of its future debt service costs, America's economic potential could reawaken with a vengeance.

By contrast, in failing to control our debt growth, we are not just mortgaging our children's future; we are running the real risks of another crisis, likely to be greater than the last and possibly sooner rather than later. Only by acting now to mandate predictable and prudent spending with limited debt, can free enterprise fulfill the promise of its potential and enable greater prosperity at all levels of society.

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