FINANCE

A Private Affair

by Ed Dodson

WHETHER GOVERNMENT is in the hands of a monarchy, an oligarchy, a representative body or a bureaucratic state, one consistent behaviour is the propensity to spend more than is received in revenue. Governments have always willingly spent to build monuments to themselves with public money. And, all too often, the public is required to pay for adventuristic wars or colonialism, which enrich the few at the expense of the many.

A considerable part of the problem in the United States can be traced to legislative and administrative laws that went far beyond the powers granted to the federal government under the Constitution. Although the Constitution permits the government to borrow money, the original definition of money as gold and silver coinage has been subverted by the issuance of Federal Reserve notes as legal tender for all government debts.

Not since the early years of the Bank of Amsterdam in the sixteenth century has any society experienced the benefits of sound money and honest banking. Within a few decades after its creation, the Bank's directors discovered the short-run profit maximisation system of fractional reserves. Every banking system subsequently established has followed the Bank down this disastrous course.

Today, when the United States government wants to borrow legal tender from private investors, the Treasury Department offers government securities for sale which, in effect, are claims against future tax revenue (and, more frequently, against the revenue raised by the issuance of more securities). The Federal Reserve Banks have no reserve requirements in terms of gold or silver or any other commodities to which the redemption of their Notes is tied. So, based on some monetaristic model of the nation's aggregate need for legal tender and credit, they raise or lower the rate of interest charged to member commercial banks for whatever borrowing these commercial banks require to meet demands for credit beyond the deposits of legal tender .

If the Federal government's need for revenue is sufficiently high, the funds borrowed by commercial banks from the Federal Reserve might very well be reinvested in the securities issued by the Treasury Department.

The stability of the financial system has often been described as dependent on confidence. By permitting government to deficit spend as normal practice, the USA is facing a $4 trillion national debt, or about $40,000 for every household. Assuming an 8% average annual cost of funds, the tax revenue required to service this debt comes to $320 billion. Before the governmentcan spend one dollar on programs that maintain or improve our physical or intellectual infrastructure, each household must be taxed some $3,200 on average. As almost 16% of all households receive incomes insufficient to pay Federal income taxes, the average tax payment required of the remaining 79 million households is over $4,000.

In no country today is serious consideration given to retirement of national debt. Economists generally seem to be either silent on the seriousness of this problem or argue that the debt is not a real drain on economies so long as the debt is not increasing as a percentage of gross domestic product. Perhaps. We will, of course, discover in due course whether this economic principle holds true over the short run, the medium run or the long run (the long run taking us out to the time when most current taxpayers have died and the problem is handed to the next generation).

We must introduce measures to rein in the ability of government to spend without direct permission from the electorate. The first step is to prohibit by constitutional amendment the self-creation of credit. The revenue of all current expenditures must come from taxation. Physical infrastructure - highways, mass transit, bridges, public facilities - ought to be financed by fully amortizing gold and silver securities issued for periods tied to the anticipated life of the improvements constructed. The annual budget would then include taxes sufficient to cover all interest and principle payments.

Getting the Federal Reserve Banks out of the business of issuing legal tender can be accomplished by the creation of a competitive system based on the chartering of banks of deposit. These banks would have no lending powers; rather, they would take in legal tender and purchase a basket of precious metals, establishing for members a credit line against which electronic purchases could be made from other members. Over time, a network of these banks would link producers and consumers together in a system that automatically debits and credits member accounts when transactions between members occur. Losses for bad debts become a thing of the past.

Eventually, vendors could condition contracts with government agencies on their membership in the system. The banks of deposit would earn fees charged to each member. Many existing commercial banks would become members as well, out of self-interest, with the result that their ability to create credit on the basis of fractional reserves would be checked.

With a global system established, Gresham's Law is made to work in reverse: good money drives out bad. Over time, legal tender will circulate at increasingly deep discounts. A wise decision on the part of the citizenry would be to press for legislation (or a constitutional amendment) prohibiting the Federal government from creating its own bank of deposit, although there is no reason why the Federal Reserve Banks should not be permitted to do so as a means of systematically retiring outstanding Federal Reserve notes. As for transactions of nominal amounts, the U.S. Mint could be contracted by the Banks to produce gold and silver coins of a standard metallic content.