Debt and Democracy: Has the Link been Broken?

By Prof Michael Hudson

Theme: Global Economy

Global Research, December 06, 2011
Frankfurter Algemeine Zeitung 6 December 2011

**This article was first published in German in the Frankfurter Algemeine Zeitung, December 2, 2011.*

Book V of Aristotle's Politics describes the eternal transition of oligarchies making themselves into hereditary aristocracies – which end up being overthrown by tyrants or develop internal rivalries as some families decide to "take the multitude into their camp" and usher in democracy, within which an oligarchy emerges once again, followed by aristocracy, democracy, and so on throughout history.

Debt has been the main dynamic driving these shifts – always with new twists and turns. It polarizes wealth to create a creditor class, whose oligarchic rule is ended as new leaders ("tyrants" to Aristotle) win popular support by cancelling the debts and redistributing property or taking its usufruct for the state.

Since the Renaissance, however, bankers have shifted their political support to democracies. This did not reflect egalitarian or liberal political convictions as such, but rather a desire for better security for their loans. As James Steuart explained in 1767, royal borrowings remained private affairs rather than truly public debts.[1] For a sovereign's debts to become binding upon the entire nation, elected representatives had to enact the taxes to pay their interest charges.

By giving taxpayers this voice in government, the Dutch and British democracies provided creditors with much safer claims for payment than did kings and princes whose debts died with them. But the recent debt protests from Iceland to Greece and Spain suggest that creditors are shifting their support away from democracies. They are demanding fiscal austerity and even privatization sell-offs.

This is turning international finance into a new mode of warfare. Its objective is the same as military conquest in times past: to appropriate land and mineral resources, communal infrastructure and extract tribute. In response, democracies are demanding referendums over whether to pay creditors by selling off the public domain and raising taxes to impose unemployment, falling wages and economic depression. The alternative is to write down debts or even annul them, and to re-assert regulatory control over the financial sector.

Near Eastern rulers proclaimed Clean Slates to preserve economic balance

Charging interest on advances of goods or money was not originally intended to polarize economies. First administered early in the third millennium BC as a contractual arrangement by Sumer's temples and palaces with merchants and entrepreneurs who typically worked in the royal bureaucracy, interest at 20% (doubling the principal in five years) was supposed to approximate a fair share of the returns from long-distance trade or leasing land and other public assets such as workshops, boats and ale houses.

As the practice was privatized by royal collectors of user fees and rents, “divine kingship” protected agrarian debtors. Hammurabi’s laws (c. 1750 BC) cancelled their debts in times of flood or drought. All the rulers of his Babylonian dynasty began their first full year on the throne by cancelling agrarian debts so as to clear out payment arrears by proclaiming a clean slate. Bondservants, land or crop rights and other pledges were returned to the debtors to “restore order” in an idealized “original” condition of balance. This practice survived in the Jubilee Year of Mosaic Law in Leviticus 25.

The logic was clear enough. Ancient societies needed to field armies to defend their land, and this required liberating indebted citizens from bondage. Hammurabi’s laws protected charioteers and other fighters from being reduced to debt bondage, and blocked creditors from taking the crops of tenants on royal and other public lands and on communal land that owed manpower and military service to the palace.

In Egypt, the pharaoh Bakenranef (c. 720-715 BC, “Bocchoris” in Greek) proclaimed a debt amnesty and abolished debt-servitude when faced with a military threat from Ethiopia. According to Diodorus of Sicily (I, 79, writing in 40-30 BC), he ruled that if a debtor contested the claim, the debt was nullified if the creditor could not back up his claim by producing a written contract. (It seems that creditors always have been prone to exaggerate the balances due.) The pharaoh reasoned that “the bodies of citizens should belong to the state, to the end that it might avail itself of the services which its citizens owed it, in times of both war and peace. For he felt that it would be absurd for a soldier … to be haled to prison by his creditor for an unpaid loan, and that the greed of private citizens should in this way endanger the safety of all.”

The fact that the main Near Eastern creditors were the palace, temples and their collectors made it politically easy to cancel the debts. It always is easy to annul debts owed to oneself. Even Roman emperors burned the tax records to prevent a crisis. But it was much harder to cancel debts owed to private creditors as the practice of charging interest spread westward to Mediterranean chiefdoms after about 750 BC. Instead of enabling families to bridge gaps between income and outgo, debt became the major lever of land expropriation, polarizing communities between creditor oligarchies and indebted clients. In Judah, the prophet Isaiah (5:8-9) decried foreclosing creditors who “add house to house and join field to field till no space is left and you live alone in the land.”

Creditor power and stable growth rarely have gone together. Most personal debts in this classical period were the product of small amounts of money lent to individuals living on the edge of subsistence and who could not make ends meet. Forfeiture of land and assets – and personal liberty – forced debtors into bondage that became irreversible. By the 7th century BC, “tyrants” (popular leaders) emerged to overthrow the aristocracies in Corinth and other wealthy Greek cities, gaining support by cancelling the debts. In a less tyrannical manner, Solon founded the Athenian democracy in 594 BC by banning debt bondage.

But oligarchies re-emerged and called in Rome when Sparta’s kings Agis, Cleomenes and their successor Nabis sought to cancel debts late in the third century BC. They were killed and their supporters driven out. It has been a political constant of history since antiquity that creditor interests opposed both popular democracy and royal power able to limit the financial conquest of society – a conquest aimed at attaching interest-bearing debt claims for payment on as much of the economic surplus as possible.

When the Gracchi brothers and their followers tried to reform the credit laws in 133 BC, the dominant Senatorial class acted with violence, killing them and inaugurating a century of Social War, resolved by the ascension of Augustus as emperor in 29 BC.

Rome's creditor oligarchy wins the Social War, enserfs the population and brings on a Dark Age

Matters were more bloody abroad. Aristotle did not mention empire building as part of his political schema, but foreign conquest always has been a major factor in imposing debts, and war debts have been the major cause of public debt in modern times. Antiquity's harshest debt levy was by Rome, whose creditors spread out to plague Asia Minor, its most prosperous province. The rule of law all but disappeared when the publican creditor "knights" arrived. Mithridates of Pontus led three popular revolts, and local populations in Ephesus and other cities rose up and killed a reported 80,000 Romans in 88 BC. The Roman army retaliated, and Sulla imposed war tribute of 20,000 talents in 84 BC. Charges for back interest multiplied this sum six-fold by 70 BC.

Among Rome's leading historians, Livy, Plutarch and Diodorus blamed the fall of the Republic on creditor intransigence in waging the century-long Social War marked by political murder from 133 to 29 BC. Populist leaders sought to gain a following by advocating debt cancellations (e.g., the Catiline conspiracy in 63-62 BC). They were killed. By the second century AD about a quarter of the population was reduced to bondage. By the fifth century Rome's economy collapsed, stripped of money. Subsistence life reverted to the countryside as a Dark Age descended.

Creditors find a legalistic reason to support parliamentary democracy

When banking recovered after the Crusades looted Byzantium and infused silver and gold to review Western European commerce, Christian opposition to charging interest was overcome by the combination of prestigious lenders (the Knights Templars and Hospitallers providing credit during the Crusades) and their major clients – kings, at first to pay the Church and increasingly to wage war. But royal debts went bad when kings died. The Bardi and Peruzzi went bankrupt in 1345 when Edward III repudiated his war debts. Banking families lost more on loans to the Habsburg and Bourbon despots on the thrones of Spain, Austria and France.

Matters changed with the Dutch democracy, seeking to win and secure its liberty from Habsburg Spain. The fact that their parliament was to contract permanent public debts on behalf of the state enabled the Low Countries to raise loans to employ mercenaries in an epoch when money and credit were the sinews of war. Access to credit "was accordingly their most powerful weapon in the struggle for their freedom," notes Ehrenberg: "Anyone who gave credit to a prince knew that the repayment of the debt depended only on his debtor's capacity and will to pay. The case was very different for the cities, which had power as overlords, but were also corporations, associations of individuals held in common bond. According to the generally accepted law each individual burgher was liable for the debts of the city both with his person and his property."[2]

The financial achievement of parliamentary government was thus to establish debts that were not merely the personal obligations of princes, but were truly public and binding regardless of who occupied the throne. This is why the first two democratic nations, the Netherlands and Britain after its 1688 revolution, developed the most active capital markets and proceeded to become leading military powers. What is ironic is that it was the need for war financing that promoted democracy, forming a symbiotic trinity between war making, credit and parliamentary democracy in an epoch when money was still the sinews of war.

At this time "the legal position of the King qua borrower was obscure, and it was still doubtful whether his creditors had any remedy against him in case of default."[3] The more despotic Spain, Austria and France became, the greater the difficulty they found in financing their military adventures. By the end of the eighteenth century Austria was left "without credit, and consequently without much debt" the least credit-worthy and worst armed country in Europe (as Steuart 1767:373 noted), fully dependent on British subsidies and loan guarantees by the time of the Napoleonic Wars.

Finance accommodates itself to democracy, but then pushes for oligarchy

While the nineteenth century's democratic reforms reduced the power of landed aristocracies to control parliaments, bankers moved flexibly to achieve a symbiotic relationship with nearly every form of government. In France, followers of Saint-Simon promoted the idea of banks acting like mutual funds, extending credit against equity shares in profit. The German state made an alliance with large banking and heavy industry. Marx wrote optimistically about how socialism would make finance productive rather than parasitic. In the United States, regulation of public utilities went hand in hand with guaranteed returns. In China, Sun-Yat-Sen wrote in 1922: "I intend to make all the national industries of China into a Great Trust owned by the Chinese people, and financed with international capital for mutual benefit."[4]

World War I saw the United States replace Britain as the major creditor nation, and by the end of World War II it had cornered some 80 percent of the world's monetary gold. Its diplomats shaped the IMF and World Bank along creditor-oriented lines that financed trade dependency, mainly on the United States. Loans to finance trade and payments deficits were subject to "conditionalities" that shifted economic planning to client oligarchies and military dictatorships. The democratic response to resulting austerity plans squeezing out debt service was unable to go much beyond "IMF riots," until Argentina rejected its foreign debt.

A similar creditor-oriented austerity is now being imposed on Europe by the European Central Bank (ECB) and EU bureaucracy. Ostensibly social democratic governments have been directed to save the banks rather than reviving economic growth and employment. Losses on bad bank loans and speculations are taken onto the public balance sheet while scaling back public spending and even selling off infrastructure. The response of taxpayers stuck with the resulting debt has been to mount popular protests starting in Iceland and Latvia in January 2009, and more widespread demonstrations in Greece and Spain this autumn to protest their governments' refusal to hold referendums on these fateful bailouts of foreign bondholders.

Shifting planning away from elected public representatives to bankers

Every economy is planned. This traditionally has been the function of government. Relinquishing this role under the slogan of "free markets" leaves it in the hands of banks. Yet the planning privilege of credit creation and allocation turns out to be even more centralized than that of elected public officials. And to make matters worse, the financial time frame is short-term hit-and-run, ending up as asset stripping. By seeking their own gains, the banks tend to destroy the economy. The surplus ends up being consumed by interest and other financial charges, leaving no revenue for new capital investment or basic social spending.

This is why relinquishing policy control to a creditor class rarely has gone together with economic growth and rising living standards. The tendency for debts to grow faster than the population's ability to pay has been a basic constant throughout all recorded history. Debts mount up exponentially, absorbing the surplus and reducing much of the population to the equivalent of debt peonage. To restore economic balance, antiquity's cry for debt cancellation sought what the Bronze Age Near East achieved by royal fiat: to cancel the overgrowth of debts.

In more modern times, democracies have urged a strong state to tax rentier income and wealth, and when called for, to write down debts. This is done most readily when the state itself creates money and credit. It is done least easily when banks translate their gains into political power. When banks are permitted to be self-regulating and given veto power over government regulators, the economy is distorted to permit creditors to indulge in the speculative gambles and outright fraud that have marked the past decade. The fall of the Roman Empire demonstrates what happens when creditor demands are unchecked. Under these conditions the alternative to government planning and regulation of the financial sector becomes a road to debt peonage.

Finance vs. government; oligarchy vs. democracy

Democracy involves subordinating financial dynamics to serve economic balance and growth – and taxing rentier income or keeping basic monopolies in the public domain. Untaxing or privatizing property income "frees" it to be pledged to the banks, to be capitalized into larger loans. Financed by debt leveraging, asset-price inflation increases rentier wealth while indebting the economy at large. The economy shrinks, falling into negative equity.

The financial sector has gained sufficient influence to use such emergencies as an opportunity to convince governments that that the economy will collapse they it do not "save the banks." In practice this means consolidating their control over policy, which they use in ways that further polarize economies. The basic model is what occurred in ancient Rome, moving from democracy to oligarchy. In fact, giving priority to bankers and leaving economic planning to be dictated by the EU, ECB and IMF threatens to strip the nation-state of the power to coin or print money and levy taxes.

The resulting conflict is pitting financial interests against national self-determination. The idea of an independent central bank being "the hallmark of democracy" is a euphemism for relinquishing the most important policy decision – the ability to create money and credit – to the financial sector. Rather than leaving the policy choice to popular referendums, the rescue of banks organized by the EU and ECB now represents the largest category of rising national debt. The private bank debts taken onto government balance sheets in Ireland and Greece have been turned into taxpayer obligations. The same is true for America's $13 trillion added since September 2008 (including $5.3 trillion in Fannie Mae and Freddie Mac bad mortgages taken onto the government's balance sheet, and $2 trillion of Federal Reserve "cash-for-trash" swaps).

This is being dictated by financial proxies euphemized as technocrats. Designated by creditor lobbyists, their role is to calculate just how much unemployment and depression is needed to squeeze out a surplus to pay creditors for debts now on the books. What makes this calculation self-defeating is the fact that economic shrinkage – debt deflation – makes the debt burden even more unpayable.

Neither banks nor public authorities (or mainstream academics, for that matter) calculated the economy's realistic ability to pay – that is, to pay without shrinking the economy. Through their media and think tanks, they have convinced populations that the way to get rich most rapidly is to borrow money to buy real estate, stocks and bonds rising in price – being inflated by bank credit – and to reverse the past century's progressive taxation of wealth.

To put matters bluntly, the result has been junk economics. Its aim is to disable public checks and balances, shifting planning power into the hands of high finance on the claim that this is more efficient than public regulation. Government planning and taxation is accused of being "the road to serfdom," as if "free markets" controlled by bankers given leeway to act recklessly is not planned by special interests in ways that are oligarchic, not democratic. Governments are told to pay bailout debts taken on not to defend countries in military warfare as in times past, but to benefit the wealthiest layer of the population by shifting its losses onto taxpayers.

The failure to take the wishes of voters into consideration leaves the resulting national debts on shaky ground politically and even legally. Debts imposed by fiat, by governments or foreign financial agencies in the face of strong popular opposition may be as tenuous as those of the Habsburgs and other despots in past epochs. Lacking popular validation, they may die with the regime that contracted them. New governments may act democratically to subordinate the banking and financial sector to serve the economy, not the other way around.

At the very least, they may seek to pay by re-introducing progressive taxation of wealth and income, shifting the fiscal burden onto rentier wealth and property. Re-regulation of banking and providing a public option for credit and banking services would renew the social democratic program that seemed well underway a century ago.

Iceland and Argentina are most recent examples, but one may look back to the moratorium on Inter-Ally arms debts and German reparations in 1931.A basic mathematical as well as political principle is at work: Debts that can't be paid, won't be.

Notes

[1] James Steuart, *Principles of Political Oeconomy* (1767), p. 353.

[2] Richard Ehrenberg, *Capital and Finance in the Age of the Renaissance* (1928):44f., 33.

[3] Charles Wilson, *England's Apprenticeship: 1603-1763* (London: 1965):89.

[4] Sun Yat-Sen, *The International Development of China* (1922):231ff.