



# S&P's US Downgrade and the Death of American Exceptionalism

JEFF HARDING APR 29, 2011 2:30 PM



*Unless we deal with the fundamental problems, today's jury-rigged fixes will not stop the continued downward spiral in the US.*



America, the world's greatest country, whose financial strength and currency were supreme for the past 100 years, has been put on notice by **Standard & Poor's** that it is on the road to second rate status. It was disconcerting to read the [ho-hum reactions](#) of economists to S&P's shift to a negative outlook for US sovereign debt. As one who sees darker implications of a downgrade in Treasuries, it gave me pause to wonder if I am overreacting to the event. Perhaps they are correct in that it will probably not happen, and that if it does, it's no big deal because the dollar is still the world's reserve currency. Japan and Great Britain did it and they are fine. And where else would investors go?

My conclusion is that the other 99 guys are out of step. My fellow analysts are mired so deep in the trees that they overlook the forest of reasons why we got into this mess in the first place. The problem with economic analysis and analysts is that there is a tendency of disassembly. By breaking down the problem into its parts one can miss how they all connect. Perhaps if they stepped back and considered where this country is heading they would be less sanguine.

After all, we are not looking at a single event but a series of political decisions made over the past 15 years or so that have created today's budget crisis. And stepping back even farther, we are experiencing fundamental changes in American culture. The well-worn cliché of the large ocean tanker taking miles to change course is an accurate depiction of our situation. There is so much built-in momentum based on entitlements and defense spending it is unlikely that a crisis can be avoided.

Our economic and policy experts need to focus on this long-term problem rather than just its short-term effects. Unless we deal with the fundamental problems, today's jury-rigged fixes will not stop our continued downward spiral.

The long-term problem is that American culture has changed and we are losing what has been known as American "exceptionalism" as [described by de Toqueville](#) in *Democracy in America*:

Toqueville tried to understand why America was so different from Europe in the last throes of aristocracy. America, in contrast to the aristocratic ethic, was a society where hard work and money-making was the

dominant ethic, where the common man enjoyed a level of dignity which was unprecedented, where commoners never deferred to elites, and where what he described as crass individualism and market capitalism had taken root to an extraordinary degree.

These values, behaviors, and ideas made America great.

But, things have changed. Today it is acceptable to rely on government to solve our problems instead of taking responsibility for solving them ourselves. We borrow more, spend more, save less, and rely on government to bail us out in old age. We want government to “take care of us” when it comes to medical care. We have become a culture of entitlement. And our rhetoric is more about victimhood and entitlement than initiative and self-reliance. Unlike our grandparents, we have no shame from accepting handouts.

We now accept Social Security and Medicare as normal. Many want Obamacare and are willing to give up some sovereignty and self-reliance to get it. Our younger generations believe they have a right to higher education and that they (or their parents) should not have to pay for it. Government always has a solution for you.

This is a massive cultural shift and it represents a struggle between two opposing forces: our exceptionalism versus the entitlement culture. Both operate in our society side-by-side, but the trend clearly favors the culture of entitlement.

Our exceptionalism has declined inversely to the rise of the welfare state. It started with the Progressive movement in the early 20th Century and the rise of a powerful federal government. The greatest change came during the Franklin Roosevelt years when government was seen to be a solution rather than the problem that our Founders witnessed. The New Deal changed the social landscape because its [many programs](#) pervaded almost every aspect of society. Many of these programs survive today.

The significance of the Progressive movement is that the now common belief that government “works” has become fixed in the popular psyche. That is far from de Toqueville’s image of self-reliant individualistic Americans. The belief that we can rely on government to solve problems means that we don’t have to solve them ourselves. It means subordinating our individualism to the technocrat class.

What are the consequences of this cultural shift? Higher taxes and a less dynamic economy. Ultimately it means the disintegration of our economy. Let me explain why.

We are becoming “European” in the sense that most of our fellow Americans accept the idea that the welfare state has primacy over the individual in pursuing social goals. As a result we are becoming less dynamic as a society. We are becoming more complacent, culturally acceding to the mediocrity of security at the expense of personal freedom. It means that taxpayers are willing to accept higher taxes to pay for the Nanny State.

The question is: which taxpayers?

It is an axiom of politics that the recipient class will vote to preserve their benefits. If they become the majority you will never get rid of their benefits. The recipient class is already in the majority. The 77 million long-lived Baby Boomers will be the dominant economic force for the next 40 years. And they vote.



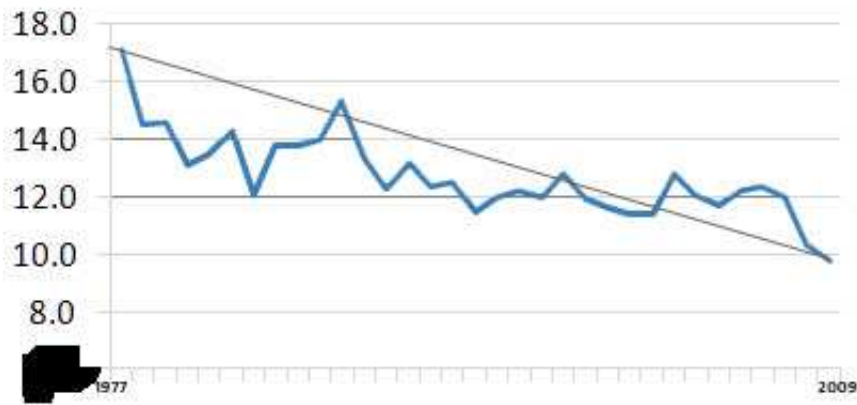
Boomers will retire and apply for their Social Security and Medicare benefits. That is, they will cease being producers and become recipients. They will draw on those benefits for many, many years. It's pretty obvious they won't pay for it.

It doesn't take a statistician to see that our declining birthrate means there will be fewer producers to support a growing class of recipient. The [Social Security Administration](#) estimates that by 2035 only 2.1 workers will support one recipient (down from about 5.1 workers in 1960 to about 3.0 today). Therein lies the problem: our system of benefits is unworkable. When the working taxpayers realize how much they must pay in taxes to support an unworkable system, change will come, just not soon enough to satisfy S&P.

Add to that the [following statistic](#):

A record 18.3% of the nation's total personal income was a payment from the government for Social Security, Medicare, food stamps, unemployment benefits, and other programs in 2010. Wages accounted for the lowest share of income -- 51.0% -- since the government began keeping track in 1929.

You may believe that the cultural values de Tocqueville identified haven't diminished in the US, but they have. Almost every index measuring startups and job creation has declined. Here is some [longitudinal data](#) from the Census Department showing this trend:

**Business Establishment Rate 1977 to 2009**

Source Census Department: Business Dynamics Statistics

It would be foolish of me to ignore the unparalleled entrepreneurial infrastructure we Americans have. It is still strong and serves us well. This infrastructure includes a vast economic system that provides capital and support for entrepreneurs and rewards success well. It is a strong social force that is the exact opposite of the cultural attitudes toward entitlement that I discussed above. We still believe in the ability to make it big.

But that is changing. The decline in new business formation is still a [telling statistic](#). Since most (55%) new business formations have 1 to 4 employees (if 1 to 10, then 76% in 2009), it demonstrates a shift in popular attitudes about starting your own business.

Good things don't last forever when their cultural and moral foundations are being destroyed.

I don't believe we will have budget reform that will be sufficient to turn supertanker America around. We will have budget reform but it won't put a significant dent in our social welfare programs, at least in time to avoid S&P's threatened downgrade of US Treasuries. I would hope that Republicans and Democrats can come together to deal with the *underlying substantive issues*. Maybe the Republicans will be able to force through some major changes in Social Security, Medicare, and (eliminate) Obamacare. If they win the Presidency in 2012 and are able to take Congress as well, it could be a political sea change.

Don't misunderstand what I am saying: I strongly support any attempts at reform, but I don't believe in political miracles. When polls of Tea Partiers show they don't want their retirement benefits touched, their new brand of conservatism illustrates the breadth of our cultural change and the new political reality.

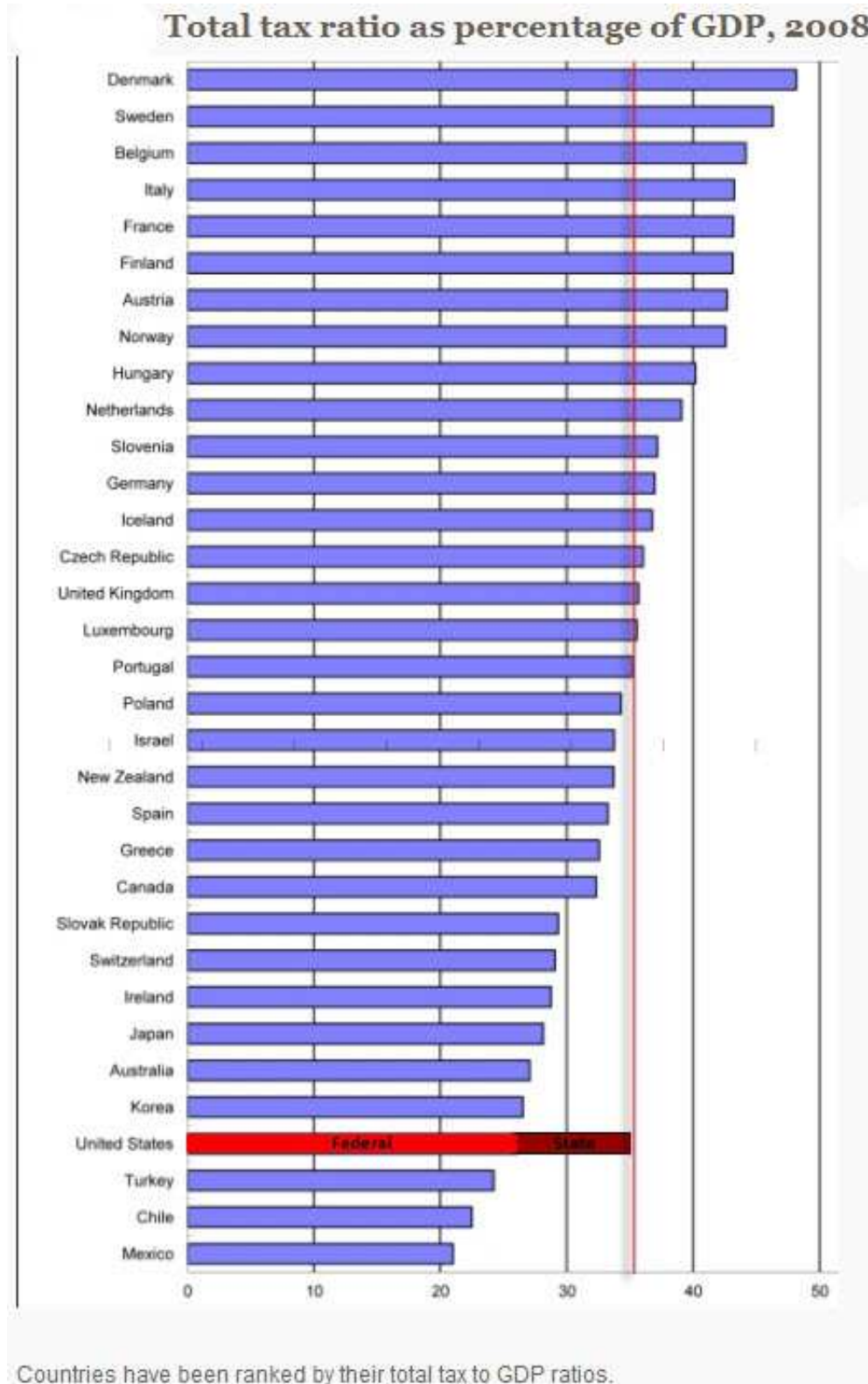
Ask yourself this question: if the welfare system is not quickly reformed, what solutions will our politicians turn to?

The answer is symbolic of the two clashing societal forces in America: the producers versus the recipients. We know that the recipients have more votes.

I believe increased taxes are inevitable and, with Republicans' opposition to increased income taxes, raising them is questionable. That leaves politicians with a very European solution: a national sales tax. With exemptions for politically favored classes ("poor" people, however defined) it will be hailed as a fair tax that will fall primarily on the "rich."

“Everybody who understands our long-term budget problems understands we’re going to [need a new source of revenue](#), and a VAT [value-added tax] is an obvious candidate,” said Leonard Burman, co-director of the Tax Policy Center, a joint project of the Urban Institute and the Brookings Institution, who testified on Capitol Hill [May, 2009] about his own VAT plan. “It’s common to the rest of the world, and we don’t have it.”

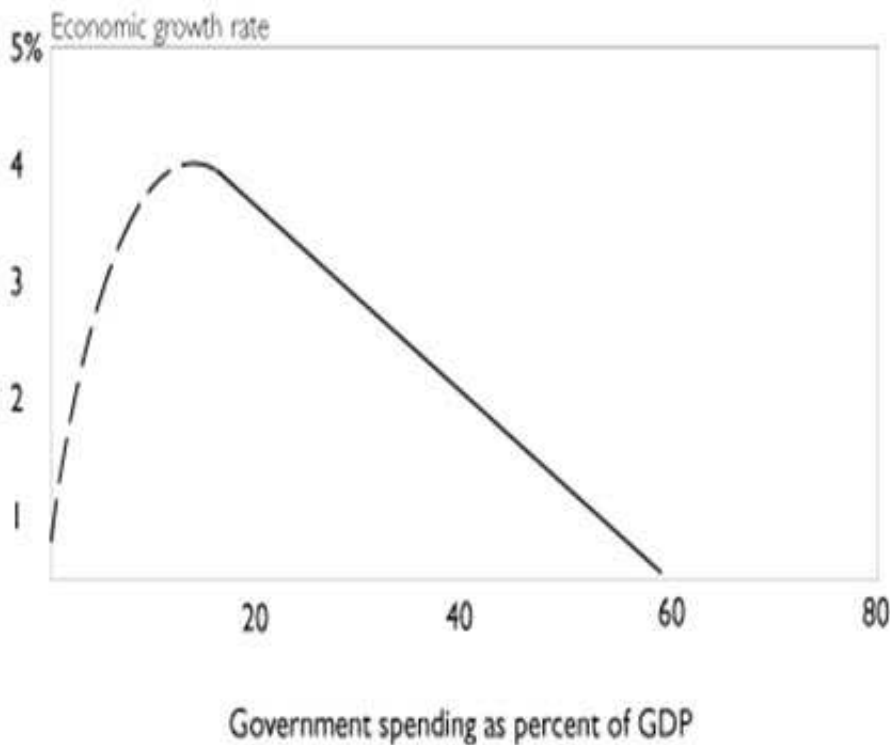
And my point is that Americans will accept high taxes to get their benefits and that makes us similar to Europeans who are used to them:



If we cannot achieve fundamental reform of our welfare system, then high taxes will become a fixture of our society and that has negative economic consequences.

There is an economic concept known as the Rahn Curve, devised by [Professor Richard Rahn](#), now a Senior Fellow at the Cato Institute. It states that as government spending exceeds a certain percentage of GDP, the economy will decline as a result. That number is subject to fierce debate among economists, but it ranges from 15% to 25% of GDP.

## The Rahn Curve: Economy Shrinks When Government Grows Too Large



There are sound reasons for this idea, mainly that since government produces nothing, the more it spends the less the private economy has to invest and spend. This means less productivity. European countries are saddled with low productivity, high taxes, and permanently high unemployment. Further, they are facing the same demographic issues that we find in the US: a graying (and declining) population. Their welfare systems are in trouble now, and as Margaret Thatcher famously warned about socialism, they are finding that eventually you really do run out of other people's money.

What does this mean for America and S&P? It means we are likely to experience a downgrade in our sovereign debt at some point in the future. Don't ask me to predict when this will happen. There are too many "what ifs." A downgrade means that there will be less money available to the government for its programs. It means that debt service costs will rise. It means the Treasury will find it more difficult to place US debt. It means that many holder of our debt will try to unload their positions (it won't be easy for them). It means the Fed will likely acquire more Treasuries, effectively monetizing the debt and this monetary inflation will lead to price inflation. It means that the dollar will decline further. It means there will be pressure on the government to raise taxes further. It also means that inflation will be employed as an additional tool of fiscal policy as rising prices (actually devalued dollars) will allow the government to repay debt with

cheaper dollars.

It will also mean that we will be closer to the European ideal and farther away from American exceptionalism. The very long-term consequences of this cannot be known, but it won't be good for America. We must do something now.

*Editor's Note: This article was originally published at [The Daily Capitalist](#).*

No positions in stocks mentioned.

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