Real World Graduation: Question 53: Rising Debt

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Question 53

A certain man has a steady job and earns a good income. However, he likes to spend more than he makes. In fact, he has no savings or assets, and he spends about 10% more than he earns every year. At first he financed his excesses by running up large balances on his credit cards. Then, when they were at their maximum, he opened up new accounts, paid off the old accounts, and continued to run up debt on the new accounts. He eventually had to stop paying on the principal he owes, and is now only paying the current monthly interest due (although the principal keeps rising due to his continued spending). Over time, he earns more income, but continues to spend about 10% more than he earns, year in and year out. What is his long-term financial outlook?

a) Gradually, the effect of inflation, in which each new dollar has less buying power, will serve to reduce the true debt and he will then be able to pay it off.
b) In the long run, his real income after inflation will continue to rise, and he will be able to grow his way out of debt.
c) He has purchased a number of things with the debt, and can sell them when he needs to in order to pay off the debt.
d) He will be able to borrow indefinitely, since the creditors realize that they may lose what he already owes them if they force him into bankruptcy.
e) Some combination of two or more of the above.

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Answer to Question 53

This is a trick question. In the long run, this man will be bankrupt because he is unable to control his rising debt. He can only avoid bankruptcy by eliminating the overspending, living below his actual means, and paying off what he owes.

Answer (a) is incorrect because it confuses the reduced buying power of an inflated dollar with a reduction of debt. It is true that inflation will serve to reduce the buying power of each new dollar, or, said another way, it will take more dollars to buy the same product. But this man continues to spend 10% more than he earns, so he will spend and go into debt by a larger number of dollars, but that larger number of dollars will still represent 10% of what he earns. A better way to think of it is that if he works 2000 hours per year, his additional debt grows by 200 hours of his labor every year. So, he owes someone the equivalent of 200 hours of additional work each year (that he is not performing), and it does not matter if those hours are denominated in starting dollars or in inflated dollars. The inflation of the currency only makes the numbers larger, but does not affect the actual debt, so long as he continues to overspend.

Answer (b) is incorrect because although his real income will rise over and above inflation, his real debt increases at the same rate because he continues to overspend at the same 10% rate. Over time, he will become a high wage earner with correspondingly large debt.

Answer (c) is incorrect because all the things he possesses from his overspending are used, and they do not have the value they had when he bought them. There will be an occasional exception in which an object increases in value, but generally, the extra things he buys will decrease in value.

Answer (d) will work for a while, but in the long run, the creditors have to resolve their debts and expenses. Ultimately they will have no choice but to conclude they will never be paid, and cut their losses by refusing to lend this man any more money. When that happens, the man will default (stop paying the interest) on his debts, and he will be bankrupt.

This man can declare bankruptcy and start over with a clean slate. He will be out of debt, but he will not be able to get credit, and if he does, will find it much more difficult to declare bankruptcy again. If he subsequently runs up a debt again, and cannot discharge it, he will be required to work but most of his paycheck will be seized to pay off his creditors. He will in effect become a slave.

Many of the false concepts of the "benefits" of debt are applied at the national level. By doing so, the officers of the government are pretending that these basic economic rules do not apply to nations. Unfortunately, nations are not immune to them, and they will either go bankrupt or will confiscate everything of value to pay off the debt (both of which will impoverish most of the people).

Most government officials at the federal level believe that either answer a) or b) is correct. Democrats seem to believe answer a) will work; Republicans seem to believe that answer b) will work. Note that both parties seem to agree that monetary inflation cures debt, which is why both parties are content with inflation as engineered by the Federal Reserve. When both a) or b) prove to be wrong, politicians will then favor option d). They fail to realize or accept that nations do not actually escape by bankruptcy: every national debt must be paid, and it is possible for a nation to become the servant of another over indebtedness.

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