The Great Federal Centralisation

This post is a little deviation from my usual updates on the US economy and inflation as it is a look into an interesting trend that is occurring that is going largely unnoticed. It came to our attention as we find ourselves at a crossroad, the great reset or the great awakening, the continued trends towards globalisation and centralisation or a new decentralisation movement. These are large societal issues which we do not try to address in this post, but only shine a light into an aspect of these trends and speculate of possible paths for the future.

Part 1: The Increase in Government Debt

I believe that the average reader of my posts is fully aware of the secular trends in the rise in government debt (and private too) which seemed to go out of control from 2008 onwards, as shown in Figure 1.

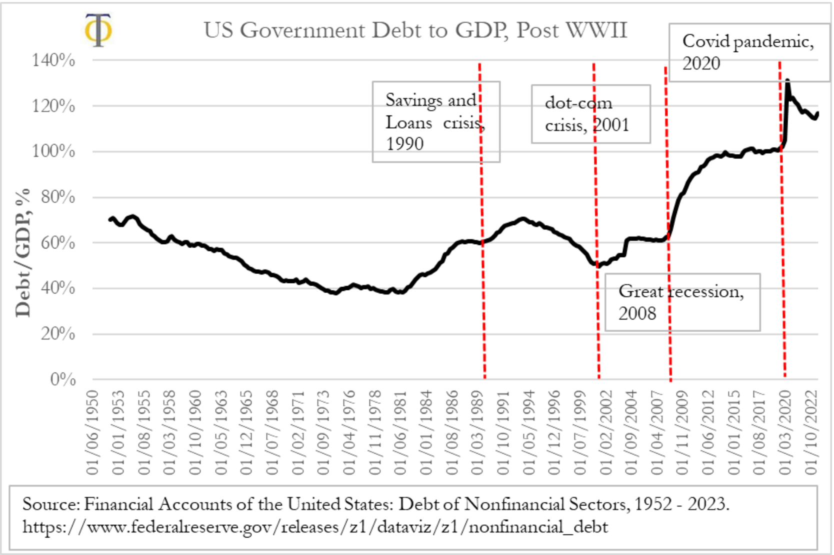

Figure 1 - US Government Debt/GDP from 1952 onwards.

The rise in government debt after the great financial crisis was a consequence of the government intervention to soften the blows of the bursting of the private debt bubble (housing bubble) from 2001 to 2006.

Typically, after each crisis, government debt increases as a percentage of the economy, as Keynesian policies were enacted. These are cyclical forces towards increasing debt levels. Adding to this, we have the secular trend in ageing populations, which seems to be accompanied by a tendency towards the reduction of risk, increased regulations, and centralisation and increased government debt. These trends are common to most developed economies and even some emerging economies, such as China. These trends as well as the comparison in debt levels for different countries is discussed in my book "Economic Cycles, Debt and Demographics"[1].

Ageing populations are also more prone to accept open trade as it reduces inflation for the products they consume. It comes at the detriment of younger workers who have to compete fiercely to produce higher

[1] https://www.amazon.com/Economic-Cycles-Debt-Demographics-macroeconomic/dp/B09FSCGWRP

skilled services and import cheap labour for the manual labour. The globalisation trends of the last 20 years are therefore related to ageing populations in Western countries.

Older populations in developed countries tend to have a majority political impact (the grey vote) who tend to support deflationary policies, which lead to low interest rates and low cost of borrowing by governments, from 2008 lead to higher debt levels.

Part 2: The Great Federal Power Grab

Government debt levels at around 60% of GDP are reasonable and manageable with modest levels of productivity and population growth. Until the 2008 crisis, the US government debt was at 60% of GDP and thereafter rose to about 120% of GDP, as shown in Figure 1.

However, the trend in general US government debt hides an unnoticed trend of the relative decline in state and local government relative to the federal government, as shown in Figure 2. State and local government debt declined from about 35% of total public debt in 1974 to about only 10% in 2023. This trend was only interrupted during the "liberalization period" of 1996 to 2003, where the importance of state and local governments rebounded.

From 2008, state and local government debt has been steadily declining (debt deleveraging) while the federal government debt exploded. As debt is a means for financing different projects, state governors and local politicians are "hostage" to centralised policies, which we refer to as the "great federal power grab" from 2008 onwards.

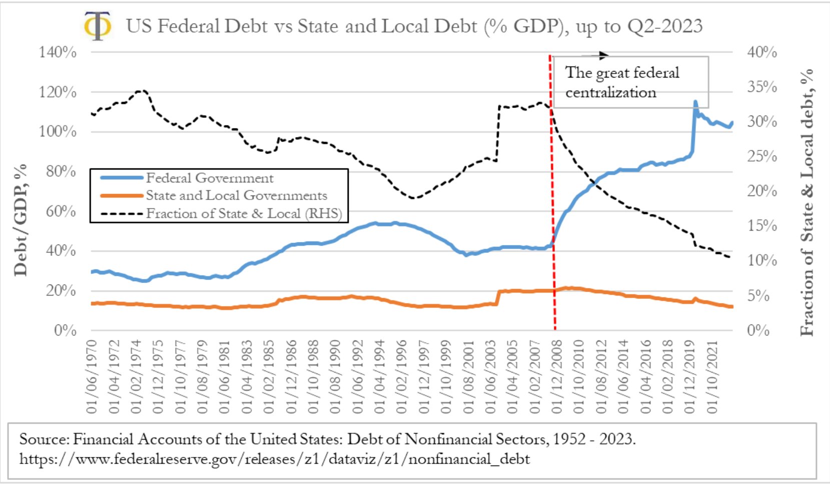

Figure 2 - US Federal versus State and local Debt/GDP from 1970 onwards.

This relatively unnoticed trend begs the question: Are these trends deliberate and what are their consequences? On the one hand, the centralisation of funding to the federal government has clear benefits as the states will rely on the federal government "balance sheet" and it's liquid US government debt market, as well as the FED as ultimate buyer of the US Treasuries. This reduces competition between states for private capital invested towards local bonds.

However, the flipside is that the reduced competition for private funds is replaced by an increased competition for federal funding, which means more aggressive "political lobbying" in DC, and more opportunity for corruption. Another pitfall is that the federal government can easily finance larger deficits leading to lower fiscal discipline and again, the opportunity for corruption at the federal level through bigger ticket items. Finally, through larger dependence and incentives toward federal grants, states dilute their economic and political sovereignty over the federal government dictates.

The graph on Figure 2 shows the trend in increased centralisation of government financing, but to have a better idea of the scale of the effect, we need to look at the absolute numbers, which we'll do next.

Part 3: Changes in Debt for Selected Periods

Figure 3 shows the trend in state and federal US debt in absolute terms (in dollars $). We can observe that from 2009, states and local government debt remained almost constant in absolute dollar amounts. At the same time, federal debt exploded. The first explosion in federal debt, following the great recession of 2008-2009, coincided with the introduction of unconventional monetary policy by the Fed where, through different quantitative easing programs, it bought private (MBSs) and public assets (US Treasuries). The different quantitative easing programs were active from 2009 to 2015. From 2015 to 2019, federal debt increased in line with GDP (see Figure 2). In 2020 alone, as a response to the Covid-19 crisis, debt increased by $4.6 Tn with the Fed monetising a large portion of that debt by expanding its balance sheet by about $1.9 Tn[2].

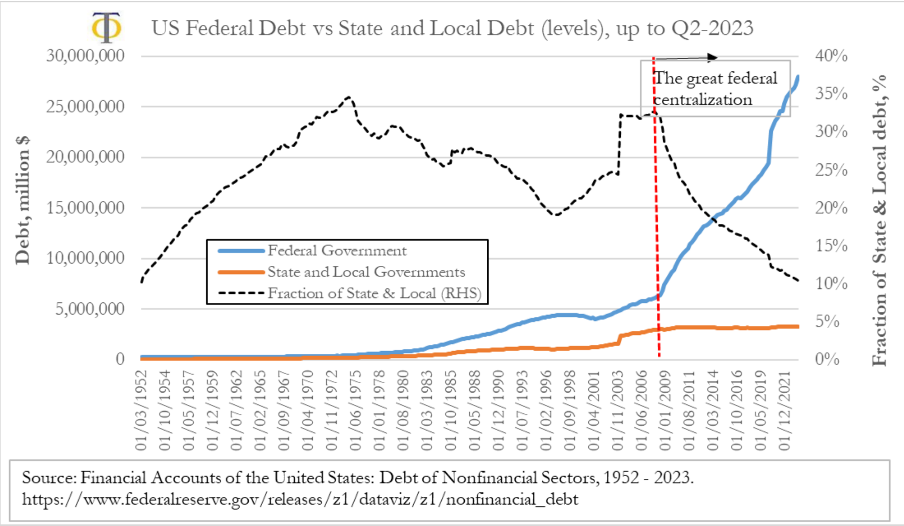

Figure 3 - US Federal versus State and local Debt level from 1952 onwards.

From 2009 to 2019, federal debt rose by $11.25 Tn while state and local debt only rose by $101 Bn, as shown in Table 1. Federal debt grew at an average rate of about $1.1Tn per year during the period. From 2020 do Q2-2023, federal debt grew by $8.5 Tn, a rate of about $2.4 Tn per year.

US Government: Change in Debt for selected periods.

Period	Measure	State and Local	Federal Government
2009Q1 to 2019Q4	Debt, $Bn	101.02	11252.40
	Debt/GDP	-6.50%	33.70%
2020Q1 to 2023Q2	Debt, $Bn	133.61	8529.71
	Debt/GDP	-2.30%	14.10%

Table 1 - Changes in US government debt for selected periods.

The individual states are then financed through both state-level taxes and federal grants. A quick analysis of the ACFR[3] of the four largest US states (California, Texas, New York State and Florida), shows that the

[2] For a detailed analysis, please refer to my book "Economic Cycles, Debt and Demographics, 2nd Ed": https://www.amazon.com/Economic-Cycles-Debt-Demographics-macroeconomic/dp/B09FSCGWRP
[3] Annual Comprehensive Financial Report (ACFR).

size of federal grants to the individual states is of similar magnitude to the taxes raised, corresponding to about 40% of total revenue.

One of the obvious consequences of the centralisation of debt is that the individual states will have to compete with each other for the federal grants, by lobbying in Washington DC. This increases the leverage of the federal government over the individual states, leading to a loss in sovereignty and political independence from the central diktats.

A second consequence is the enhanced possibility for corruption as the decision-making and financing for local projects moves away from the people to the politicians and lobbyists in Washington DC. With bigger, centralised budgets, bigger projects are possible, with bigger prizes for corrupt politicians who are intermediaries in the process.

Finally, an interesting observation is that the individual states have a sound balance sheet, while the federal government is highly indebted. This begs the question if the process continues, will there be a point where individual states could decide to secede and not take responsibility for the federal debt? From the analysis of the individual ACFRs, the four largest states appear to have a strong balance sheet, but this is particularly true for Texas and Florida, when compared to California and New York. If there was more independence of the individual states, competition between states could lead to the breaking of the polarisation in US politics, as they could compete politically and economically which would, over time, bring up the most realistic policies.

Part 4: Time to Go Back to Local?

A final thought is that the centralisation of debt and political power in the US since 2009 seems to be a similar process to that occurring in other countries such as the European Union (for example).

Current trends seem to be towards further centralisation towards a world government where supranational organisations (UN, BIS, IMF, WTO, WHO) gain more power. After our previous discussion, we can clearly see the dangers to local sovereignty of the continued trend towards centralisation on a global level. Additionally, the opportunities for corruption also increase, which would lead to centralisation of corruption (local corruption → corruption at the federal level → global corruption) and consequently, even greater asymmetries in the distribution of wealth and economic opportunities.

However, perhaps we have reached the limits to globalisation. Once we understand the dangers of the centralisation of financing and political decision-making, we will start pushing back, revert these trends and bring power to a more local level. However, to accomplish this, the forces that led to and mechanisms that allowed greater centralisation of power need to be replaced by mechanisms for financing local projects. We should also be warned that the introduction and adoption of CBDC[4]s will provide the ultimate mechanisms that enhance central control over local sovereignty.

[4] Central Bank Digital Currencies