A Closer Look at the Debt and Deficit

by Robert Higgs

The federal government's budget deficits and the mounting public debt to which they give rise are not, in themselves, the greatest problems facing the American people today. Relative to the size of the U.S. economy, the government debt was much greater in the past, during the immediate post-World War II period, than it is now. Yet those years are viewed by many as an economic golden age. Still, to admit that the government's conduct of its fiscal affairs is not the most pressing problem is not to say that it is no problem at all. It is serious, but we need to keep it in perspective.

The government debt is widely misunderstood, even by some professional economists who ought to know better and whose pronouncements contribute to the confusion. The misunderstandings arise sometimes because people think the public debt is like a private debt, at other times because they think the public debt is not like a private debt. In truth, there are similarities and differences, and one must sort them out to get at the truth.

Similarities exist because a legal debt is a legal debt: all borrowers, whether public or private, must either pay the contracted interest and principal when they come due, or default. Servicing a debt is costly for anybody, but if the borrower opts for the alternative and defaults, some unpleasant consequences will ensue, including a diminished ability to borrow again.

The main difference between public and private debt is that the government has some options not available to private borrowers for effecting what amounts to default. Since the government can inflate the money stock, causing prices to tend to rise and thereby reducing the real value of all assets denominated in units of money, it can effectively default on its promises to repay lenders, to the extent that the lenders did not correctly anticipate the inflation when they made the loans. Notice, however, that the government can always defeat the anticipations of lenders. All it has to do is cause an unexpectedly rapid inflation. Because it has unlimited capacity to increase the money stock, it always holds the power to bring about this kind of surprise.

The government could simply repudiate its obligations outright, as it did in the 1930s when it refused to pay the gold it had promised to purchasers of gold-denominated government bonds, but default by means of inflation is more likely. To some extent the government has been doing this for decades. In the present fiat money regime, it can increase the rate of its default whenever the political and monetary authorities decide to do so.

Early in 1990 the official government debt reached $3 trillion, but—strange to say—the true debt can be viewed as either bigger or smaller.

One can say that the true debt is bigger because the government has entered into extremely large guarantees of private loans and of deposits in banks and other financial institutions, such as the savings and loan industry. In the event that the loans or deposits go bad, the government is committed to making up the shortfalls. In a proper set of accounts, the present value of the government's future obligations in the event of such disasters

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would be added to its other liabilities. The current government accounts make no such addition. Indeed, it would be extremely controversial to decide how much to add. But the fact that some addition needs to be made is beyond dispute.

Internal Debt

On other grounds, the official debt can be viewed as overstated. A large part of it, about 25 percent, is held within the government. That is, the Treasury owes money to other Federal agencies, especially the Social Security Administration. The internal debt is more or less "funny money." It is also a misleading way to keep the government's accounts.

There is, for example, no real Social Security Trust Fund—that's just a scam to reassure a skeptical public. In fact, the Social Security Administration collects Social Security taxes and hands the money over to the Treasury, which spends it. In return, the Social Security Administration receives government bonds, which are simply promises that the Treasury will pay fixed sums of money at specified dates in the future. But because the Treasury itself has no big hoard of funds, when future Social Security benefits come due, they will be payable only if the government collects enough taxes at that time (or borrows once again) to make the payments. The same thing can be said about the other bond holdings within the government. If the government repudiated all its internally held debt, nothing real would be affected, so this part of the debt differs fundamentally from the part held by the public.

Another portion of the debt, about 9 percent, is held by the Federal Reserve System, the nation's central bank, which is nominally private but actually a creature of the government. Because, by law, the Federal Reserve cannot earn more than a limited amount, much of the interest it receives on its holdings of government bonds is immediately returned to the Treasury, revealing once again that intramural holdings of government debt are essentially different.

Subtracting the roughly one-third of the total debt held either in government accounts or by the Federal Reserve, we arrive at a figure of about \$2 trillion for the debt held by others in 1990. The holders include commercial banks, insurance companies, corporations, state and local governments, and individuals, among others. Foreigners hold about \$400 billion, that is, about 20 percent of the amount held outside the government and the Federal Reserve.

The amount of the national debt is one of those numbers so huge that the ordinary mind can't grasp it. One must view it relative to some standard. The most common benchmark is the Gross National Product (GNP), the value of all newly produced goods and services the whole economy turns out in a year. Currently the debt is equal to about 57 percent of the GNP. The proportion has been rising for 15 years, and rose especially rapidly during the 1980s. Still, it stands considerably below the ratio that existed in the 1950s. Keeping the relative magnitude of the debt in perspective is a good idea, lest we panic or allow ourselves to be panicked by politicians who seek only to raise taxes.

Historically the government ran persistent deficits only during wars or business slumps. Beginning in the 1960s, however, deficits became chronic. They now occur in good times and bad. Only once since 1960 did the federal government not run a deficit. (Fiscal year 1969 was the single exception.) In the 1980s the size of the deficits shattered all records for peacetime, rising as high as \$220 billion in a single year.

Pernicious Deficits

The deficits of the past three decades can be viewed as pernicious for many reasons. Consider just three of the more important ones.

First, the economic case against deficits. When the government borrows money, it diverts private savings to uses that have a smaller component of investment and a larger component of consumption. By bidding up interest rates, government borrowing "crowds out" borrowers who would have made investments in the private economy, while the funds the government borrows are used overwhelmingly for consumption. The result is that the nation's capital stock, the aggregate of all durable resources that enhance the economy's productive capacity, grows less rapidly. As a consequence, future standards of living will be lower than they otherwise would have been. Our children and grandchildren will reap smaller harvests because our own generation is feasting on some of the seed corn.

Second, the moral case against deficits. When

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the service charges on the debt come due in the future, the obligation to make these payments, by suffering some form of taxation, will fall on persons who will have had absolutely no choice about entering into the debt contract and will have received no benefit from it. Unless the government defaults, which would be morally reprehensible and economically harmful in itself, individuals in the future will be stuck with higher taxes, either directly or via inflation, than they otherwise would have had to bear.

The fact that in the future some individuals will receive the interest and principal on bonds they inherited in no way diminishes the force of the argument. The good fortune of the legatees does not cancel the injustice done to others. And justice has to do with individuals, not classes or generations. The soothing apology for the debt, that "we owe it to ourselves," is a fallacy. The persons who will owe it are not identical to the persons to whom it will be owed.

To gratuitously impose financial obligations on our children and grandchildren for the sake of our own present enjoyment is moral arrogance at best. It bespeaks a contempt for others well captured by the famous remark attributed to Madame de Pompadour, mistress of Louis XV: *après nous le déluge* (after us, the flood), or in today's terms, the future be damned.

Third—and perhaps worst of all—deficits are deplorable because they are symptomatic of a political system gone corrupt to the core. Notwithstanding all the political rhetoric to the contrary, the government runs chronic deficits because the members of Congress want to run them. They make this choice because they value their re-election more than they value the interests of the general public. Even a cursory examination of the evidence shows unmistakably that the emergence of chronic deficits since 1960 has resulted from Federal spending growth, not from decreased government revenues.

Politicians are afraid to rein in the runaway spending so that it will match revenues, because they don't want to offend those who receive the benefits financed by the government—goodies paid for sooner or later by taxpayers. Much of the government's spending is channeled to well-organized political pressure groups whose support is viewed as essential by incumbents seeking re-election. Just think of all those PACs whose contributions loom so large in Congressional campaigns. Members of Congress are unwilling to take fiscal actions that might jeopardize the electoral support of the special interest groups. The deficits reflect a political system responsive to special interests at the expense of the general interest of the public now, as well as the general interest of future generations.

Notice, however, that the system works nearly to perfection for the politicians. In the elections of 1986 and 1988, when public concern about the deficit ran very high, more than 98 percent of all House incumbents seeking re-election were returned to office. So citizens are saddled not only with large, persistent deficits but with a cynical, self-perpetuating ruling elite.

Unfortunately, given the American political system as presently constituted, individual citizens acting on their own can do virtually nothing to remedy these ills. Because people rarely organize for political action except on behalf of some narrow interest, no one is likely to create an effective political movement in opposition to continuing massive deficits. So far as the government's fiscal irresponsibility is concerned, the immediate future probably will be no different from the immediate past. The deficit will continue to be like bad weather: everybody will complain about it, but nobody will do anything about it. □

Politics, Economics, and the Destructiveness of Deficits

by Dwight R. Lee and Cynthia D. Lee

Are chronic budget deficits a threat to the economy? The general public believes that budget deficits are something to fear, but economists are not so sure, and Congress doesn't seem to care.

It is difficult to argue that either Congress or economists are wrong, given their respective concerns, even though the public is justified in its worry over the economic consequences of persistent Federal deficits. The public's concern is real, but it's an unfocused background concern that fails to translate into significant political pressure. So why should the concern over deficits by members of Congress go beyond rhetoric when they can spend the Federal budget into one large deficit after another and still look forward to re-election rates in excess of 98 percent?

Economists don't have to worry about being re-elected, but they are worried about making obviously foolish predictions, and they have noticed that the huge budget deficits of the 1980s have precipitated none of the adverse consequences predicted by deficit doomsdayers. Economists are concerned with explaining the effect of budget deficits on such economic variables as interest rates, inflation, and the savings rate. These variables have not responded to large deficits as predicted by standard macro-economic models, and economists have been busy developing alternative models explaining why they haven't. A major conclusion of these models is that budget deficits are almost completely neutral in their effect on the economy. An increasing number of economists have concluded that deficits have little effect, either positive or negative, on the economy, and see public concern over deficit spending as unfounded.

While economic analysis can provide useful insights, it is always risky to dismiss the concerns of the public. The public may not have a sophisticated understanding of economic analysis, but this is not necessarily a liability. Sophistication in the analysis of narrow economic relationships can divert attention from broader features of the political economy that are more relevant to our economic prospects. In particular, budget deficits may reflect flaws in the political decision-making process that are a threat to economic performance quite apart from any direct economic impact of the deficits themselves.

In this essay we discuss briefly the argument that budget deficits are unlikely to have the adverse economic effects commonly attributed to them. It is pointed out, however, that the theoretical basis for the view that deficits are benign is hard to reconcile with the undeniable fiscal impulses of politicians. And given these impulses, the greater the political latitude to rely on deficit

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