An Ignoble Prize in Economics

"No sovereign government can be bankrupt as a result of debt in its own currency."
—Robert Eisner, *New York Times*, March 19, 1994

Let me be the first to nominate Robert Eisner, economics professor at Northwestern University and former president of the American Economic Association, for this year's Ignoble Prize in Economics. Eisner's article in the *Times*, aptly entitled "Off Balance," achieves a unique status in economic history. It contains more errors per column than any editorial ever published! I counted 15 mistakes, miscalculations, and misconceptions in the article, amounting to one error per column inch.

The subject is the federal deficit, Eisner's pet peeve. In his mind, and in the eyes of most of his colleagues, there is no deficit crisis. Never mind that the national debt has reached an astronomical $4.4 trillion, increasing at an average compounded growth rate of 7 percent over the past forty years. Don't worry that the federal government has irresponsibly failed to balance its books since 1969. Don't concern yourself with the fact that interest payments account for nearly 20 percent of federal revenues, a percentage that will invariably increase as interest rates rise. According to Eisner & Co., the deficit is no economic time bomb, it's a false alarm.

The Federal Debt: Asset or Liability?

Some of Eisner's statements are fantastically naive. For example: "The greater a person's debt, given his assets, the less his net worth; the greater the Government's debt, the greater the people's net worth."

Say again? Eisner ought to get out of his ivory tower and go down to the Chicago Board of Trade, where T-bonds trade. He would learn that his assertion is only true if the price of government securities stays constant or increases. Yet, as bondholders painfully discovered in the first half of 1994, prices of Treasury securities can fall sharply in the face of rising inflationary expectations. Indeed, excessive deficit spending can drive up interest rates and accelerate the collapse in bonds, as the inflationary 1970s demonstrated.

The Potential for National Bankruptcy

No sovereign government can be bankrupt as a result of debt in its own currency? Perhaps Eisner should stop by the history department at Northwestern and obtain a list of governments whose debt markets have collapsed over the centuries due to

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runaway inflation: Germany, Austria, France, Hungary, China, Brazil, and Peru, just to name a few.

Eisner will undoubtedly be surprised to learn that there is no bond market in *cruzeiros* in hyperinflating Brazil. Like many Latin American countries, Brazil can only finance its borrowing in U.S. dollars or other foreign currencies. Even then, many Third World governments defaulted on their dollar debts in the 1980s. Refinancing and moratoriums are technical terms for bankruptcy. Textbook writers Edwin G. Dolan and David E. Lindsey soberly declare the reality of the matter: "Creating new money to cover the government deficit is the source of runaway inflation, at rates of hundreds or even thousands of percent per year, that devastated such countries as Bolivia, Argentina, Brazil, and Israel in the early 1980s."[1]

Eisner's statement, "Government's debt is the liquid assets of the American people," is true today but may not be true tomorrow. Those "assets" can quickly lose value and become illiquid in a collapsing bond market. In fact, in the 1970s, Treasuries lost half their real value and occasionally faced "no bid" days. There are many scenarios which could bring about another round of "no bids" on T-bonds and even T-bills. A devastating recession, a collapsing dollar overseas, resurging inflation, a debilitating war, loss of tax base, etc. Washington has done a good marketing job in encouraging millions of Americans—including conservatives who normally oppose deficit spending—to buy "savings" bonds and Treasury securities, but the Treasury market could face a treacherous future if U.S. finances get out of hand or the economy crumbles. Given the high level and short-term maturity of federal debt, trouble could arise unexpectedly.

I would agree with Eisner on one point. National bankruptcy is not imminent. As Adam Smith once said, "There is much ruin in a nation." We have a long way to go before the government runs out of its ability to dupe the American public into funding the deficit. The timetable in Harry Figgie's bestselling book, *Bankruptcy 1995* (Little, Brown, 1993), has been proven way off the mark. The federal deficit declined last year and is nowhere near the $730 billion level Figgie predicted for fiscal year 1994. Nor are the country's finances in such dire shape that a fiscal crisis can't be averted. A healthy tax cut, privatization, and a couple of years of budget surpluses would do wonders to the economy. Mexico was in far worse shape than the U.S. was in the 1980s, and it turned itself around. Today it is running a budget surplus.

Crowding Out and Economic Malaise

Right now the more serious effect of deficit spending is on economic growth. When billions of dollars in private savings are funneled each year into government coffers via the purchase of Treasury securities and U.S. savings bonds, economic growth suffers. Even Paul Samuelson, a fellow Keynesian, acknowledges this fact: "Perhaps the most serious consequence of a large public debt is that it displaces capital from the nation's stock of wealth. As a result, the pace of economic growth slows and future living standards will decline."[2]

Fiscal mismanagement is one major reason U.S. economic growth has been near the bottom of industrial nations since World War II. Inflation and high taxes discourage saving, investment, and capital formation. By law, Social Security and other federal trust funds must invest solely in government securities. Imagine the favorable impact on Wall Street if $1 trillion in Social Security and other trust funds could be invested in U.S. stocks and bonds!

Crowding out is real. The Treasury market has grown so rapidly that it is now the world's largest financial market and as such systematically undermines the ability of private corporations to raise the capital necessary to produce new goods and services, adopt new technology and production processes, and create jobs. Today federal, state, and local governments consume 85 percent of all new debt issues, forcing major private corporations to issue so-called "junk" bonds and pay 300 to 400 basis points above Treasury rates to raise much needed capital. "Junk" bonds are an unfortunate label imposed on a form of financing that has been responsible for much job creation and economic growth.[3] The real junk bonds are the Treasury securities, which transfer massive amounts of capital from the productive profit centers of free enterprise to the unproductive, unprofitable centers of government waste.

Crowding Out or Crowding In?

Of course, Eisner, the last of the Old Keynesians, rejects the notion of crowding out. He believes in "crowding in," that "greater spending means increases in sales, profits, orders for production and hiring of workers." Those are the *visible* signs of government spending, but what are the *invisible* effects? As Frederic Bastiat once said, "There is only one difference between a bad economist and a good one: the bad economist confines himself to the *visible* effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen." If the federal government is doing the spending, that means there are fewer funds available for free enterprise to buy, produce, and hire. And if the spending is monetized by the central bank, the result is inflation. There is no free lunch, Professor Eisner.

The Growing Threat

Hans Sennholz best sums up the ill-effects of deficit financing and the potential for serious harm: "At first, [federal debt] may consume only a small share of the individual savings coming to market, causing a slowdown in capital formation and economic development. In time, the share consumed by its apparatus of politics tends to grow until it depletes all savings and causes economic progress to grind to a halt. In a final frenzy of spending, it may actually consume capital accumulated by previous generations, and thus cause economic conditions to deteriorate."[4]

Let's hope we never reach the final stage Professor Sennholz describes. But if too many political leaders buy the arguments of Robert Eisner and become complacent about fiscal irresponsibility, it could become a reality. □

1. Edwin G. Dolan and David E. Lindsey, *Economics*, 5th ed. (Hinsdale, Ill.: Dryden Press, 1988), p. 280. Dolan and Lindsey's textbook is one of the few textbooks which acknowledge the possibility of national bankruptcy.
2. Paul A. Samuelson and William D. Nordhaus, *Economics*, 14th ed. (McGraw Hill, 1992), p. 633.
3. An dispassionate assessment of the high-yielding corporate bond market can be found in Glenn Yago, *Junk Bonds* (Oxford University Press, 1991).
4. Hans F. Sennholz, *Debts and Deficits* (Spring Mills, Pa.: Libertarian Press, 1987), p. 76.

"Correction, Please!" Column Is Vindicated

In my May column, "The Mother of All Myths," I focused on a common error in the financial press that consumer spending represents two-thirds of all economic activity. In reality, consumer spending equals only about one third of total economic activity when spending at all stages of production are measured. I also pointed out that gross business investment is by far the largest sector of the economy, not retail sales as previous believed.

Good news! *The New York Times* has now vindicated my point. In a recent business page article, the *Times* changed their statistics. A reporter wrote that retail sales "tracks one-third of all spending in the economy," not the two-thirds they and other mainstream media had previously reported. However, the *Times* continued to interpret the data as if consumer spending were the largest sector. The article stated, "retail sales figures are volatile." (They aren't.) Consumer spending "can be a good indicator of how fast the economy is growing." (It isn't.) Better indicators of future economic activity are industrial production, fixed business equipment, construction, commodity prices, and other early-stage indicators. But the change is heartening and a good beginning.

—*M.S.*

BOOKS

Phantom Risk: Scientific Inference and the Law

edited by Kenneth Foster, David Bernstein, and Peter Huber

MIT Press, 1993 • 457 pages • $39.95

Reviewed by Doug Bandow

Socialism has been defeated almost everywhere in the world—except in the United States. And nowhere is the collectivist impulse stronger than in the environmental movement.

The intellectual case against the apocalyptics has long been overwhelming and is finally receiving serious media attention in the establishment press. Among the more recent books detailing the environmental lobby's fraudulent claims are Ron Bailey's *Eco-Scam: The False Prophets of Ecological Doom*, Michael Fumento's *Science Under Siege: Balancing Technology and the Environment*, and Dixy Lee Ray's and Lou Guzzo's *Environmental Overkill: Whatever Happened to Common Sense?*

Unfortunately, ecological alarmists like Vice President Al Gore continue to dominate the political process. They also enjoy ready access to the courts. The result is "two intersecting problems," write engineer Kenneth Foster and attorneys David Bernstein and Peter Huber. "The first is the great disparity between the ease with which a controversy about a suspected hazard can begin and the difficulty in resolving the nature of the connection, if any, between the suspected hazard and a health effect. The second is the havoc the resulting confusion wreaks in the courts."

Phantom Risk goes on to address these two issues in detail, utilizing contributions from biochemists, toxicologists, physicists, doctors, and other experts. Although the book is not directed at a popular audience, its objective analysis and measured tone should make it a powerful entrant in the ongoing environmental debate.

The first set of issues addressed by Foster and his colleagues are the most dubious—"hazards whose very existence is somehow in doubt." Despite the modestness of the risks, however, the public concerns have been enormous.

For example, many household appliances, such as hair dryers, give off electromagnetic fields and have been blamed for causing cancer. Given the pervasiveness of such gadgets, many Americans have become quite frightened by everything from utility powerlines to electric blankets. Kenneth Foster of the University of Pennsylvania surveys roughly four dozen studies, finding ambiguous evidence "of a slight increase in cancer risk that is somehow associated with electromagnetic fields," but worries "that 'something is there' might be just the accumulated effect of scientific noise." In fact, scientists have yet to identify any specific hazards. Moreover, even the worst case risks pale compared to those people regularly undertake voluntarily: smoking, for instance, or failing to wear automobile seat belts.

Of particular concern to the contributors to *Phantom Risk* is the distorting impact of such issues on the court system. Writes Foster: "In science one can draw no conclusions from unexplained phenomena or inconclusive studies. But in the courtroom it is sometimes enough just to raise questions. And these studies have done that very well."

Similar is the controversy over video display terminals, which also put off electromagnetic fields and have been blamed for causing miscarriages. The reports, writes Foster, "have been overwhelmingly—but not totally—negative, finding no links between use of VDTs and spontaneous abortion or birth defects." This doesn't mean that VDTs don't cause problems; rather, the difficulties are much more mundane, what Foster calls "ergonomic and psychosocial," particularly the fact that "many clerical workers using VDTs simply have lousy