

Chronically large
federal budget deficits

The American experience

Roger W Garrison

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Foreword

The purpose of FMF *Monographs* is to use the analytic method of political economy to shed light on how best the promotion of free markets will improve the workings of the South African economy. In particular, authors are urged to apply the microeconomic approach of studying how individuals, firms and households behave in response to either naturally occurring or regulatory induced incentives. This requires that they display a sound institutional knowledge and understanding of their theme. Where macroeconomic aggregates are introduced into the discussion, FMF authors analyse them from the market perspective, namely from the foundation stones of economics itself, supply and demand, the interactions of countless individuals with differing preferences and intentions. This approach also requires that authors pursue their analysis in a logical fashion to policy proposals unencumbered by preoccupations as to what is or is not politically practicable at any given time. They should not be tailored to gain the approval of pre-existing (but from a historical perspective transient and ephemeral) vested interests or political groupings.

The author of this *Monograph*, Professor Roger Garrison, writes within this framework. His subject is the macroeconomic issue of government or public sector deficits. But he correctly addresses the topic from the viewpoint of the microeconomy, where most consumption and investment decisions are taken, namely at the level of households or firms. When the problem of government deficits is interpreted from that perspective, their consequences Garrison indicates, are not only potentially inflationary and distortive. Indeed, because the consequences of deficits reduce the relative credibility of the private sector as an investment destination for loanable funds, they increase the ease with which governments can borrow further to expand their expenditures!

The importance of Garrison's arguments for South Africa is high. The Minister of Finance, Mr Trevor Manuel, is publicly committed to a policy of "fiscal responsibility". The policy statement *Growth, Employment and Redistribution*¹ (commonly known as GEAR) has a target government deficit equal to 3% of GDP by the year 2000, down from a figure of 5.1% in 1996. It is highly unlikely that that target will be met. If Garrison's arguments hold across economies then the implications for the other GEAR targets, in particular private investment and private sector employment growth are also at risk, while the perverse counter pressures to increase less productive public expenditures will be reinforced.

Garrison's *Monograph* rises above three debates. He does not spend much time examining how deficits are measured – absolutely, or as a ratio to some factor such as GDP. Since he believes deficits to be of crucial importance, however, he issues a strong warning against using techniques for measurement designed deliberately to deflate their real magnitudes².

Second, he clearly does not adopt the classical (or neo-classical) view that deficits are irrelevant; nor the ingenuous macro approach that they harm not today's lucky borrowers, but rather the future generations who have to redeem today's debts. (Some individual citizens tomorrow, after all, will be the inheritors of government bonds which have to be redeemed.)

Nor does Garrison enter the Keynesian : monetarist debate. In the Keynesian world more is required from government than merely providing a framework of laws and institutions in which markets can operate smoothly. In such a state an equilibrium would be reached where not all resources were employed and government would have to undertake fiscal action – not only to run its own activities (such as policing and the military) at break-even point but also to maintain the system in full employment by offsetting any cyclical fluctuations in demand by budgetary expansion or contraction of money and credit. The monetarist interpretation of that model of course is that the direction of causality is reversed.

Professor Garrison probes beneath the macro world of government deficits. Who provides government with funds? Domestic source, directly or through the institutions, if attracted by high interest rates on government securities, no longer provide these funds for private sector investment, or consumption. Business firms and workers suffer from this crowding-out. Or the central bank can

“lend new money into existence” to government (p.12). Inflation and its perversities inevitably follow. Money loses its value and the government is among the least badly hit of the losers. It spends the newly printed money ahead of the inflationary price increases, and its own debts are progressively lessened as the Rand is diminished in worth.

Third, government can fund its deficit by borrowing abroad. But the downside to that is that our grandchildren will indeed have a debt to pay off to others outside of South Africa. Or, finally, government can finance its deficit by taxation, and, most probably, by some better or worse mix of the four. Garrison argues that the mix chosen historically in the United States has been neither predictable nor optimal.

Indeed, Professor Garrison continues, there is inevitably an environment of “deficit induced uncertainty” (p. 20) due to the unpredictability of policy choice for deficit financing. Businessmen become unwilling to commit themselves to capital-intensive or job-creating ventures. And this unwillingness suggests that “*private sector activity can be crowded-out by the uncertainty-creating effects of the deficit rather than by the interest rate itself*” (p. 21).

Garrison provides many thought-provoking alternative routes out of the morass for governments seemingly encumbered with the costs of deficit financing for the foreseeable future. Some are already under debate in South Africa; others, under discussion in the USA, might well be worth examining further here; still others are either radical or reactionary, and neither should be discarded simply because they bear these labels. Thus preserving and enhancing the independent status of the Reserve Bank is recommended, provided the Bank’s goal is exclusively that of monetary stability. This is essential if other government agencies or para-statal can continue to issue apparently risk-free paper. To encourage credibility in the US setting Garrison hints at approval for remonetising gold, so that both foreigners and US citizens can redeem Reserve Bank paper for gold on demand. These constraints, Professor Garrison argues (p. 36) might have a more sobering effect on the spending desires of politicians than the more formal approach of building a “balanced budget” requirement into the country’s constitution. The possibilities for judicial laxness in interpretation of such a constitutional clause, together with the existence of already established “creative accounting” techniques in the calculation of today’s deficits lends credence to Professor Garrison’s reservations.

Other ways of improving fiscal responsibility on government could involve decentralising (privatising) the Reserve Bank’s activities. Government paper would no longer be risk-free but would carry a default risk. The government’s legal monopoly in currency provision would be removed. The most commonly accepted tender would be the most reliable. Gresham’s Law that “bad money drives out good” holds only when the “bad money” has legal tender protection. Otherwise the reverse holds.

Whatever the appropriate solution, Professor Garrison is to be applauded for presenting a wide variety for debate and consideration. The main problem he identified, the deficit, is too important not to be examined as comprehensively as possible. The most appropriate cure will be linked in some way with the proximate cause. That cause of course, is expenditure exceeding income.

The problem is not novel. The classic work by Bagehot on the British constitution pointed out:

‘The House of Commons – now that it is the true sovereign, and appoints the executive – has long ceased to be the checking, sparing body it once was. It is now more apt to spend money than the Minister of the day ... The process is simple. Every expenditure of public money has some apparent public object; those who wish to spend the money expatiate on the object: they say, “What is £50,000 to this great country? Is this a time for cheeseparing objections? Our industry was never so productive; our resources never so immense. What is £50,000 in comparison with this great national interest?”

The members who are for the expenditure always come down; perhaps a constituent or a friend who will profit by the outlay, or is keen on the object, has asked them to attend; and, at

any rate, there is always a popular vote to be given, on which the newspapers – always philanthropic, and sometimes talked over – will be sure to make encomiums.

The members against the expenditure rarely come down of themselves; why should they become unpopular without reason? The object seems decent; many of its advocates are certainly sincere; a hostile vote will make enemies, and be censured by the journals. *If there were not some check, the “people’s house” would soon outrun the people’s money.*³

But if Bagehot was correct, what held government to the fiscal responsibility line? Bagehot continued:

‘That check [on the ‘people’s house’ outrunning the people’s money] is the responsibility of the Cabinet for the national finance. If anyone could propose a tax, they might let the House spend as it would ... but now ... the Ministry must find the money. Accordingly, they have *the strongest motive to oppose extra outlay*. They will have to pay the bill for it; *They will have to impose taxation*, which is always disagreeable, or suggest loans, which, under ordinary circumstances, are shameful.’³

This, of course, begs the question what has altered? The answer lies in the Keynesian debate mentioned earlier, and which Professor Garrison chose to remain above. That is not to say that Keynes was right or wrong in his diagnosis of the instability of the market economy (that is a separate subject) but whether the instrument he devised, budget deficits, could be used in a democracy for the purpose he intended. Even if the technique is appropriate, its use, as Garrison points out, may impose more costs than benefits. In practice once deficit financing is intellectually legitimised it will be grasped by sectional vested interests and politicians who now have a rationale to overspend, over-borrow and run amok. As Nobel prize winner James Buchanan⁴ put it: “the ill-effects of Keynes’s ideas (and) ... Keynesian economics (have) turned the politicians loose”.

Professor Garrison’s aim is to remove “the adverse effects of public-sector deficits on private-sector performance” (p. 44). To accomplish that the powers of politicians, he argues, must be curbed in the market for credit. Not all readers of this *Monograph* will agree with everything he says. His views are not those of the FMF (which has no corporate view), nor of its Council Members or Directors. But Garrison’s understanding of macroeconomic issues from a micro perspective is deep. Given the importance of the public sector deficit, and the unanimous wish of all South Africans for more private sector investment and job creation, the FMF believes this is an important contribution to the debate on how to unshackle the wealth creating energies of that sector.

W. Duncan Reekie

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The author

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Professor Garrison co-authored, with Israel M. Kirzner, the entry on F.A. Hayek for the *New Palgrave Dictionary of Economics*. He delivered the Ludwig Lachmann Memorial Lecture at the University of the Witwatersrand, Johannesburg, South Africa, in 1997.

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Roger W. Garrison

Introduction

The year 1969 was the last year the federal budget of the United States was in surplus; 1971 was the last year the U.S. dollar was officially linked to gold. Admittedly, the surplus was a small one and the link to gold a loose one, but the behaviour of the Congress and the Federal Reserve over the years since gives increasing significance to those last vestiges of fiscal and monetary responsibility. The red ink flowing out of the Treasury and the green ink out of the Federal Reserve have combined to finance an escalating level of government spending for more than a quarter of a century.

The story of the American experience with monetary and fiscal policy involves some interdependencies among institutions and some macroeconomics that give full play to the underlying tradeoffs in financial markets, including the ever-present tradeoff between risk and expected return. The modern dynamics of borrowing, printing, and spending money are complex but not beyond the ability of an interested citizenry to understand. And, as with most issues in political economy, an economically literate citizenry is a prerequisite to a lasting solution to our current monetary and fiscal problems.

Chapter 2 sorts out the various perspectives on public-sector deficits. Chapter 3 identifies the different means of accommodating the deficit, focusing both on the institutional possibilities and the historical chronology. Chapter 4 makes the case that uncertainties about the particulars of deficit accommodation can themselves be a serious source of disruption in the economy's private sector. Chapter 5 deals with the question, "What can be done?" – in the sense of working collectively to solve the problem of the deficit and in the sense of working individually to protect ourselves financially in the face of the festering problem. And finally, Chapter 6 points to some fundamental reforms of our monetary and fiscal institutions that would change the incentives in the right direction. These alternative institutional arrangements (decentralised banking and hence a fiscal authority subject to some market discipline) establish a helpful basis for evaluating less radical reform proposals.

Fiscal excesses in perspective

Hardships and inequities in the 1970s that stemmed from double-digit inflation have given way to concerns in the 1980s and 1990s about dozen-digit deficits. Our federal government now has an outstanding debt in excess of five trillion dollars – with two recent Presidents (Reagan and Bush) virtually quadrupling the net accumulation of more than 200 years. At its worst, the government has plummeted ever deeper into debt at a rate approaching a billion dollars per day.¹

Deficits do matter

The academic journals of the economics profession provide little or no hint of the extent and dangers of these fiscal excesses. Academic debate has centered on the preliminary and tangential issues of how, precisely, to define the deficit and whether it is large or small relative to the gross national product, to private-sector borrowing, or to the public-sector deficits of other western countries. Professional opinion ranges from the Keynesian view that the deficit stimulates the economy to the classical (Ricardian) view that the deficit is irrelevant.² In some quarters, the deficit is thought to be self-financing; in others, an Orwellian redefining of the deficit (making adjustments for inflation and interest-rate changes) transforms a conventionally defined deficit into a surplus.³

The popular press and electronic media have on occasion provided a healthy gauge of the budgetary imbalance. During the Reagan-Bush years, our TV screen was frequently graced by a thirteen-digit debt meter resembling the odometer of an automobile. Although this hard-hitting visual has now been dropped from the networks' repertoire, it can still live on in our imagination. Registering the ongoing accumulation of debt, the trillion-dollar wheel near the left of our screen stands ominously at 5, while the first several wheels at the right spin so fast as to create a disorienting blur. If our automobiles' odometers chalked up mileage that fast, we would find ourselves trading in our old cars (at 100,000 miles) for new ones about every nine seconds. The actual current-dollar federal budget deficits from 1960 through 1997 are presented in Figure 1. The chronically large deficits of the last two decades stand in contrast with the minor fiscal imbalances of the earlier part of this period. What accounts for this modern-day addiction to debt? While the networks' vivid metering of the government's fiscal excesses and even our simple bar chart help to remind us that there is a serious problem in Washington, it does little to explain the source or nature of the problem or to suggest a workable solution. For understanding, we must look elsewhere.

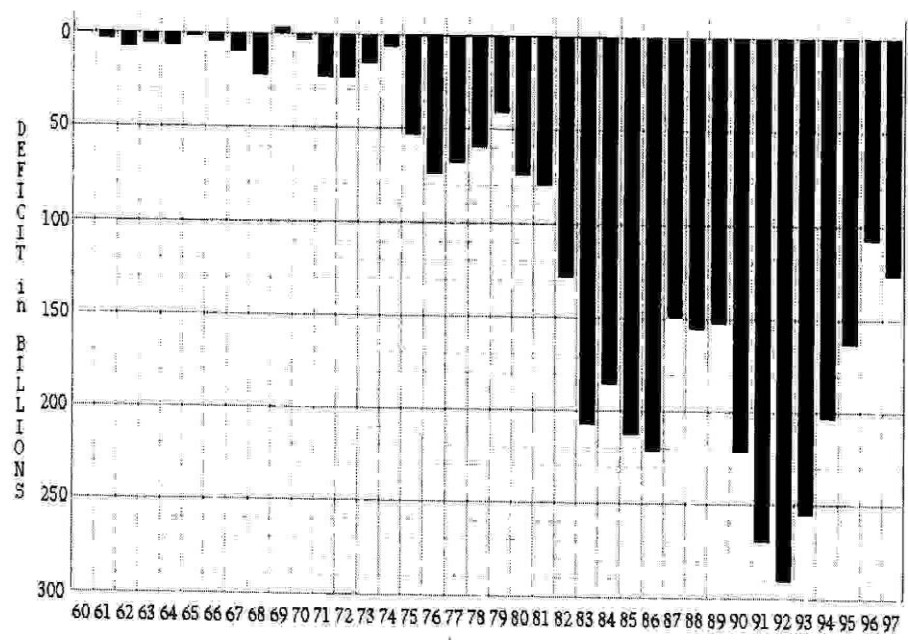


Figure 1: U.S. Federal Budget Deficits (1960-1997)

The unified budget

One issue relevant for gauging the current fiscal excesses – but also of a more general relevance in understanding the nature of government debt – is the issue of what debt counts in assessing fiscal responsibility. There is a popular argument currently coming from both sides of the political spectrum according to which only a particular portion of the deficit is a legitimate cause for concern. The government's budget, in this view, should be divided into a capital budget and an operating budget. Debt associated with the capital budget, which finances real assets whose value wholly offsets this part of the debt, is nothing to worry about. Just like a homeowner who finances his home with a mortgage or a businessperson who borrows to establish or expand his business, the government borrows to finance projects, such as highways, waterways, and parks, that will benefit taxpayers for years to come. Here, government debt – so the argument goes – is simply a means of creating a pay-as-you-go basis for using the government-provided facilities. It serves to avoid burdening the current taxpayers at the outset for the entire cost of long-lived public assets. The other component of the budget, the operating budget, is a different matter. Expenditures associated with entitlements programs and for other current benefits should be funded by-and-large with current tax revenues. Spreading the costs of these publically provided benefits over a prolonged financing period has no economic justification.

However, the technical, political, and even theoretical difficulties in separating the government's capital budget from its operating budget suggests the inadvisability of even attempting to do so. The government's use of a unified budget (with the capital component and the operating component simply added together) reflects a fundamental difference between the public sector and the private sector. Assets in the private sector that justify a separate capital budget can be valued on the basis of market prices. There is a market for the homeowner's home and for the capital assets of a business firm. The housing market and the stock market provide timely and independent verification of the values that borrowing helped to bring forth. But there is no market for the highways and other capital projects of government. Significant in this respect is the government's convention for attributing value to publically provided assets: The actual expenditures made are taken to be a proxy for value created. The millions of dollars borrowed and spent on a waterway project, for example, show up on both sides of the government's capital budget. This supposed value which exactly offsets the debt, though, is more accurately described as sunk costs. There is no independent means of establishing that the actual value is anywhere close to the costs – or even that it is greater than zero. The taxpayers may have to service this part of the debt while receiving little or nothing in the way of benefits. Further, with no market for the shares of Government and Co., Ltd., there would be no check on the government's decision to include all manner of spending programs (medical, educational, environmental) in the capital budget in order to minimise the imbalance in the reported operating budget.

The deficit in the unified budget, together with the accumulating debt does provide some indication of the fiscal excesses of government even if it provides no actual incentives for the government to do something about it. Separating out the capital budget from the operating budget would only create the illusion of a difference and would suggest that government is somehow being run on business principles, when in fact it is not and cannot be so run. In the absence of effective constraints on its authority to tax and to print money, the government is simply not subject to the market's discipline of profit and loss and cannot conduct its affairs as if it were.

Closing the loopholes

Any deviation from measuring the debt and deficit in terms of the unified budget should be in the direction of incorporating the many off-budget items, which currently provide the government an escape valve from accountability, and banning all further use of off-budget budgeting. Although the distinction between on- and off-budget spending has become much more a matter of politics than of economics, some government operations that actually collect fees for services rendered, such as the Tennessee Valley Authority and the United States Postal System, have their own separate budgets. Also, the "special" bond issues of the early 1990s used to finance the governmental bailout of the

Savings and Loan industry were “special” in their being off-budget. (The revenues from the increased deposit insurance premiums were not similarly “special,” which meant that the reported unified deficit was actually reduced as a result of the debt-financed bailout.) The deficits in these off-budget operations do not show up in the government’s unified budget. Incentives for the government to balance its budget, then, can easily get perverted into renewed efforts to de-budget the budget, that is, to finance government spending on an off-budget basis to avoid increasing the deficit in the unified budget. Clearly, this loophole, which now allows the government to hide part of the deficit, should be closed as an essential prerequisite to reform in the direction of fiscal responsibility.⁴

Concerns about our grandchildren

Finally, we can note that the chronic fiscal irresponsibility provides no basis for a sermon about imposing a burden on our grandchildren. We have all heard that lop-sided argument too many times before. The long-established practice of double-entry bookkeeping suggests that there are strict limits to pushing the net burden of borrowing into the future. At death, we tend to leave behind our assets as well as our liabilities. Some grandchildren will inherit interest-bearing government securities – if not directly, then indirectly through banks or other financial intermediaries. Others will inherit the tax liabilities for paying that interest. What we are leaving to our grandchildren, then, is a fiscally unbalanced playing field – one that pre-ordains that some will pay and some will receive.

3

A short list of bad options

While we may feel better now about our grandchildren – or at least about some of them – we must realise that the problem of the debt and deficit is not one that will have to be faced only by future generations. It is one that we face right now. What, then, is the problem? To begin to answer this question, we have to ask: From whom is the government borrowing and how does the government's heavy involvement in credit markets affect the performance of the rest of the economy? To pose the question in this way suggests that the relevant measure of the deficit is one that relates the government's demand for loanable funds to the economy's supply of loanable funds, that is, the deficit-to-saving ratio. Figure 2 presents the deficits from 1960 through 1997 as a percentage of total (private and corporate) domestic saving. This recasting of the deficit problem, which by virtue of being a pure ratio automatically adjusts for the changing value of the dollar, shows the contrast between the last two decades and the preceding decades in real terms. Unlike the more conventional deficit-to-GNP ratio, which seems to trivialise the deficit, the deficit-to-saving ratio provides a sound basis for the claim that the deficits in recent years have been "chronically large." The government is a big player in credit markets. Also, the deficit-to-saving ratio preserves the contrast with earlier years since saving has not kept pace with GNP. That is, the deficit problem reflects both an increasing deficit-to-GNP ratio and a decreasing saving-to-GNP ratio.

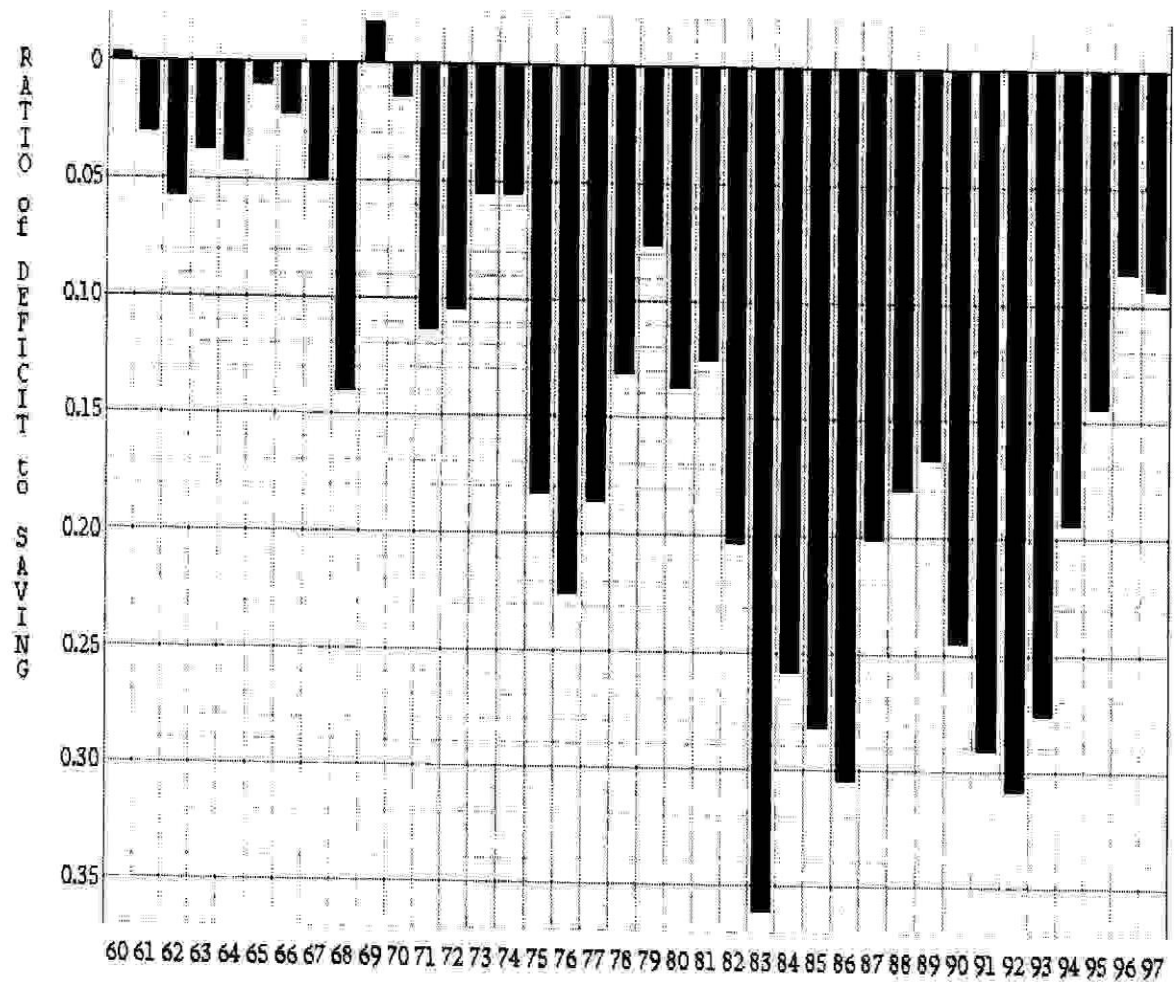


Figure 2: Ratio of Deficit to Total (Private and Corporate) Saving

The suppliers of loanable funds

Thinking in macroeconomic terms, we can identify a short list of potential lenders and spell out the consequences of a heavy reliance on any one of these lenders or of switching from one category of lender to another.

Domestic Savers. First and most straightforwardly, the government can borrow domestically. That is, it can borrow from U.S. citizens. Most of the population own Treasury bills and other government securities – again, if not directly, then through banks, pension funds and other savings institutions. But if individuals or their savings institutions have lent money to the federal government, then that money is not available for private enterprise. Business firms, which are subject to the discipline of the market, tend to lose out when competing with the government for loanable funds. High interest rates attributable to the government's excessive demand for funds crowd out private investors as well as consumers. And reduced consumer demands together with the high cost of borrowing force a business contraction and the consequent loss of jobs in the private sector.

In recent years, the Treasury's high demand for credit has not resulted in a high rate of interest largely because the Treasury is not relying heavily on domestic savers as a primary source of funds. The experience of the mid-to-late 1960s better illustrates the problem of crowding out. During the Vietnam conflict, the economy experienced high interest rates and tight credit markets as the government drew increasingly on domestic savings to finance its military operations. This period of occasional "credit crunches," as they were called, came to an end only with the implementation of the Johnson administration's surtax, which created the modest budgetary surplus in 1969. The credit crunches also provided an impetus for breaking the link between dollars and gold and hence creating another source of funds for the Treasury, namely, the Federal Reserve.

The Federal Reserve. Second, the government can borrow from its own bank – the Federal Reserve. When the Federal Reserve buys Treasury bills, it effectively lends new money into existence. This magic of money creation, sometimes called debt monetisation, keeps the pressure off credit markets. With the printing press running, there is plenty of money to be borrowed by government, business, and consumers. But the monetary magic, not surprisingly, is no permanent solution to the government's fiscal difficulties, it is only a temporary illusion. Initially, interest rates remain low, but soon enough the increased borrowing and spending put upward pressure on prices and wages. The inflation that unavoidably follows money creation is accompanied by rising prices and high nominal interest rates. The economy's long and painful adjustment to inflation creates inequities, perversities, and inefficiencies. Retired workers and others on fixed incomes suffer, wages lag behind prices for workers locked into multiyear labour contracts, and the price system in general functions poorly.

It is true, of course, that inflation also reduces the real value of the government's outstanding debt. If we measure the deficit as the change in the real value of outstanding debt, then debt monetisation can turn a conventionally measured deficit into a surplus. We should note, however, that the ability of the Federal Reserve actually to reverse the direction of fiscal imbalance depends critically on two circumstances. First, a large portion of the debt must be long-term. Short-term debt would simply be rolled over at inflated interest rates. The increased costs of servicing the debt would offset the government's gain from debt erosion. Second, the inflation must be largely unanticipated. Anticipated inflation would be already reflected in interest rates, again offsetting the government's gain. With the maturity structure of government debt becoming increasingly short-term and with the financial sector's increasing sensitivity to future inflation, neither of these two critical circumstances are likely to be all that favorable to the government in the foreseeable future. And more fundamentally, this default-as-you-go aspect of debt monetisation provides no solution to the deficit problem. It is, rather, a manifestation of the problem. That is, chronically large deficits are a problem in part because the government may resort to debt monetisation.

The late 1970s best exemplifies this form of deficit accommodation. The Carter administration was largely successful in shifting the blame for the double-digit inflation to the middle east and to the efforts of OPEC to exploit its relative monopoly on the world supply of crude

oil. But despite its superficial plausibility, the oil-based account of inflation did not stack up well against the money-based account. Why did other economies that were even more dependent on middle-eastern oil, particularly Japan's, not experience high rates of inflation during this period? And why were the increased expenditures on oil and oil-intensive products in the U.S. not accompanied by decreased expenditures in other markets? In the absence of money creation, the economy's adjustment to reduced oil supplies would have been largely an adjustment of relative prices and not a dramatically upward adjustment in the price level. By the end of the Carter administration, the economy's "misery index" (the inflation rate plus the unemployment rate) was approaching 0.20. The double-digit inflation and resulting poor performance of the economy, which were, almost by themselves, responsible for the election of Ronald Reagan, are to be attributed not to OPEC but to the federal government's irresponsible fiscal and monetary policies.

Foreign Savers. Third, the government can borrow in world capital markets – from foreign savers and foreign central banks. If our trading partners – primarily Germany and Japan – are willing to lend funds to our government, then both interest rates and inflation can be kept down in the U.S. But there is a downside to exporting government debt. Ordinarily, citizens in these foreign countries trade with citizens in the U.S. on a more conventional basis. They trade goods for goods: cars, cameras, and electronics for heavy machinery, raw lumber, and agriculture products. During the Reagan revolution of the 1980s, however, they began trading goods for Treasury bills and for other earning assets whose yield was propped up by the government's high demand for credit. Ocean-going freighters, in effect, arrived at our shores with real goods in their cargo compartments and departed for home with government securities in their glove compartments. Many U.S. industries suffered from weak export markets, reflected dramatically during the Reagan-Bush presidencies by the so-called twin deficits – in the federal budget and in international trade. Also, the yield on earning assets – on private-sector securities as well as on Treasury bills – accrued increasingly to our foreign trading partners. (If we don't want our grandchildren to be disproportionately disadvantaged by the debt accumulated during the Reagan-Bush-Clinton years, we better hope that their in-laws are from Munich or Tokyo.)

The dynamics of deficit accommodation

We have now exhausted our short list of options. The government can sell its debt domestically and suffer high interest rates, monetise its debt and suffer inflation, or export its debt and suffer an international trade imbalance.⁵ It can opt for a combination of these alternatives, but typically – as illustrated above by the Nixon, Carter, and Reagan-Bush administrations, the fiscal strategy that characterises any particular period involves an emphasis on one alternative – an emphasis that, because of cumulative effects, cannot last indefinitely. Considering for a moment the dynamics of deficit accommodation, especially over the past two-and-a-half decades, sheds further light on the nature of the deficit problem.

The straightforward application of economic principles suggests that given three alternative strategies for raising more funds – four, if we include tax increases – the government would not lean too heavily on any one but, instead, would pursue all avenues simultaneously. It would borrow domestically, monetise, and sell debt abroad – and levy taxes – until the last dollar raised by each alternative method is equally burdensome to the voting public. The strategy of equalising across the alternatives follows straightforwardly from the principle of marginalism, which has served as bedrock for economic science for well over a hundred years. This basic reckoning of the problem suggests that a balanced budget – like a zero rate of inflation or the elimination of taxes – is not likely to be achieved and maintained over any substantial period of time. We would be surprised if the government were to forswear completely and permanently the use of any one of its financing alternatives.

Binge and crisis

What needs further explanation, however, is the fact that, to a significant extent, the government pursues its alternatives sequentially rather than simultaneously. It binges first on one method of

finance, then on another and deals, however inadequately, with the crises (high interest rates, inflation, trade deficits, etc.) that provoke or accompany the shift from one deficit-accommodation strategy to the next. And during each shift, there is a net increase in taxes brought about through tax reform – the raising of tax rates, the expansion of the tax base, and the imposition of new taxes. The Nixon administration borrowed domestically in the early years before turning to the Federal Reserve for help. The Carter administration, following the lead of Nixon and Ford, monetised debt; the Reagan and Bush administrations sold debt abroad. The Clinton administration, which in its early years flirted with the idea of hidden taxes, such as the VAT (value-added tax), has resorted to a mix of debt export and debt monetisation to help accommodate a somewhat smaller federal budget deficit. (As will be argued later, the slowing of debt accumulation into the \$100 billion range just before the re-election of President Clinton does not presage an actual solution to the deficit problem.)

Understanding the sequential binge-and-crisis aspect of deficit finance characteristic of the last two decades requires a little institutional history. Except for wartime emergencies, the U.S. dollar has been tied to a monetary metal (silver and/or gold) from its introduction during the final decade of the eighteenth century through the first seven decades of the twentieth century. The last effective institutional constraint in the form of the dollar's official link to gold was severed by Nixon in 1971, thus marking a critical turning point in matters of money creation and debt issue.⁶ (Re-establishing this or some effectively similar institutional constraint, it turns out, is the key to restoring monetary and fiscal responsibility.) Since 1971, the much looser constraint – sometimes binding, sometimes not – is the one imposed by public opinion, which by its nature, forms and changes slowly as the otherwise unconstrained Federal Reserve and Treasury attempt to finance increasing levels of government spending.

The “closing of the gold window” in 1971 is the metaphorical expression for the government's reneging on its commitment to foreign central banks to convert dollars presented by them into gold. This momentous event marked the beginning of our experiment with a pure paper money.⁷ The government continued to print money and to accumulate debt on the basis of the relative costs of these alternative methods of fund raising. But now the politically relevant costs of raising funds are not the cost as measured by international gold flows but rather the costs as perceived by the citizenry and registered in the voting booth. Unlike the textbook applications of marginalism, where the costs are clear and the market equilibrium is a stable one, the application of marginalism to deficit finance involves changing perceptions of the costs and hence a sequence of unstable solutions to the government's fiscal problems. The ability of the citizenry to perceive the costs of some particular method of finance is not constant over time but varies with experience. When accumulated experience allows the costs of domestic borrowing – or of debt monetisation or of exporting debt – to become more fully understood, elected officials tend to opt for some other method: one for which there is little recent experience and hence no widespread understanding or concern – or organised opposition.

Even the particular sequence of financing alternatives takes on a certain significance. We can rank the different alternatives in terms of the difficulty of perceiving the true costs. Plausible arguments could be offered that the ranking – from most easily perceived costs to most difficult-to-perceive costs – would dovetail with the actual chronology, starting in the 1950s when the deficit was nil. The government has gone from taxing directly to borrowing domestically to monetising debt to exporting debt to.... The obvious question, of course, is What next? What future method of finance could address the concerns of the voting public about the deficit without simply shifting those concerns undiminished to the new method?

With trade imbalances, inflation, and credit crunches all still within our collective political memories, the method of finance likely to dominate in the future may involve some unconventional tax levies. Taxes, though – or, at least, direct taxes – impose costs on the citizenry that are most easily perceived. There were tax increases and selective (not to say net) spending cuts incorporated in the 1994 budget, the first budget of the Clinton administration. These changes in the tax take and in the flow of public funds were at the same time so large as to cut quickly and deeply into the new

administration's approval ratings and so small as to be almost trivial in comparison to the projected gap between total revenues and total expenditures. The posturing in the direction of fiscal responsibility was widely heralded as the largest deficit reduction plan in the republic's history. The actual reduction in the deficit at mid-decade, however, is attributable to a decrease in the unemployment rate rather than to the Omnibus Budget Reconciliation Act of 1993 or to any changes in the fiscal constitution proposed by the President or enacted by Congress.

Further attempts at deficit reduction are likely to involve heavy doses of indirect taxes. The Clinton administration's still-born energy tax is a good hint at the kind of tax that may become politically viable when the unemployment rate rebounds to a more sustainable level (to be discussed in Chapter 4) and the public concern about the deficit is rekindled. And the value-added tax is still waiting in the wings. These kinds of indirect taxes are favored by elected officials precisely because their true costs to the public are difficult to perceive. Their political viability depends critically on each voter believing that the tax is paid by someone else. Taxing ergs or value added is suggested here not as a preferable or lasting solution to the government's fiscal problems but rather as a likely next round in its efforts to finance the high and rising levels of government spending.

In early-1998, the budget that President Clinton submitted to Congress was advertised as the first balanced budget in nearly thirty years. The balance, however, was achieved by transferring funds from Social Security (and from other sources within the federal government) and counting the transferred funds as revenues. Tellingly, the 1997 Economic Report of the President projects that the nation's debt will rise by \$170 billion while the change in its indebtedness, that is, the (official) deficit, is only \$5 billion! Difficulties in perceiving the true costs of large deficits are being compounded by difficulties in perceiving just how large the deficits are.

Coping without a crystal ball

According to some, the point of no return, when the compounding of interest alone dominates the debt's growth path, is not far in our future. Drawing on his experience as a member of the Grace Commission in the mid 1980s, Harry Figgie created a graphical projection of debt accumulation through the year 2000. He designated his depiction of past and projected indebtedness as "the hockey stick curve" because of its general shape – a relative flatness through most of the republic's history punctuated with a tall spike at the end of the twentieth century.⁸ Our shift of focus from the accumulation of debt to the dynamics of deficit accommodation suggests a different analogy. We might say that if debt accumulation resembles a hockey stick, the fate of the market participants in a Treasury-dominated credit market resembles that of a hockey puck.

New and higher indirect taxes may become an important part of the fiscal history of the next century. But there is significance to the fact that we do not know with confidence that fiscal strategy will shift in this direction and certainly do not know about the timing of the shift or the particulars of the indirect taxes. We need to step back for a moment from the details of the particular methods of deficit finance to assess the broader significance of the deficit, given that we as business people, income earners, savers and investors have no crystal ball that can tell us what, precisely, to expect next. We simply don't know in which direction and how hard the stick will hit the puck.

Let us take a hypothetical year during which the government is collecting in taxes about one-and-a-quarter trillion dollars and spending about one-and-a-half trillion. In effect, the government is putting the private sector on notice: "We're taking \$1.25 trillion in accordance with the established tax codes. And we're taking another \$250 billion as well, but we're not saying just how, just when, or just whose. Taxes, complex and distasteful as they are to both the business community and the consuming public, are a known quantity. We make our plans around them, we pay our accountants to minimise them, and we brace ourselves for them. But the deficit is a different story. There is no deficit code to parallel the tax code. No matter how certain a large deficit may be, there is no effective way for either business people or the rest of us to minimise it, plan around it, or hedge against it."⁹ It could hit us with high interest rates, with inflation, with weak export markets, with increased taxes, or with some combination of these eventualities. But until the government's fiscal strategy takes some definite form, the \$250 billion of intent to appropriate funds in some yet-to-be-specified way looms large as a cloud of uncertainty over the economy.

Uncertainty-based crowding out

The economy's poor performance in the early 1990s can be attributed in part to the deficit-induced uncertainties that pervaded the private sector.¹⁰ The recession at the end of the Bush administration and the slow recovery that characterised the beginning of the Clinton administration reflected an unwillingness on the part of business people to commit themselves to capital-intensive or job-creating business ventures. The uncertainty about market conditions over the near and intermediate future cast too much doubt on the ability of the would-be venturers to meet payrolls and maintain lines of credit. Ironically, the deficit-related waning of the private sector's demand for credit allowed the government to increase its own borrowings without putting much upward pressure on interest rates.

The low interest rates of that period (and to some extent of the current period), then, suggest that private-sector activity can be crowded out by the uncertainty-creating effects of the deficit rather than by the interest rate itself. This uncertainty-based crowding out can account for the co-existence for large public-sector demands for credit and low market rates of interest. If correct, this

explanation implies that during a deficit-ridden recession, a renewed prosperity stemming from some spontaneous revival of business confidence is unlikely. Given the plateau of government borrowing, any significant resurgence of credit demand in the business community would send interest rates up sharply and put strict limits on private-sector expansion. Restoring fiscal integrity in the public sector and thus eliminating the uncertainties created by a large and chronic deficit, then, should be seen as prerequisite to a lasting revival of business activity and hence to sustainable prosperity in the economy.

But restoring fiscal integrity is not the story of the 1990s. Instead, the black cloud of debt was countered by monetary ease. The performance of the economy in the mid-to-late decade is best understood in terms of a chronically large budget deficit compounded by the political business cycle.

Deficits and the political business cycle

The bar charts of Figures 1 and 2, by themselves, suggest that there has been some success in recent years in dealing with the deficit problem. They show declines in the nominal deficit and in the deficit-to-saving ratio beginning in 1992 and especially in the last four years (1994 through 1997). Is this a sign of a regained fiscal responsibility on the part of government? And can the trend towards a balanced budget be expected to continue into the next century? Answers to these questions require that the trends in Figures 1 and 2 be interpreted in the light of the temporal pattern of the unemployment rate, which is shown in Figure 3. This graph tracks the seasonally adjusted monthly unemployment rate for the last four years.¹¹ Clearly, there is a correlation between the deficit and the unemployment rate. But what is causing what? Is increased fiscal responsibility on the part of government creating a healthier climate in the private sector, allowing the economy to function at (and even above) its full-employment potential? Or is the decreased unemployment impinging on both tax revenues and government expenditures, causing the deficit to shrink. There is scope, of course, for cause and effect to run in both directions – and scope for some third factor, such as the monetary policy of the Federal Reserve, to be the cause of a lower unemployment rate and hence a reduced deficit.

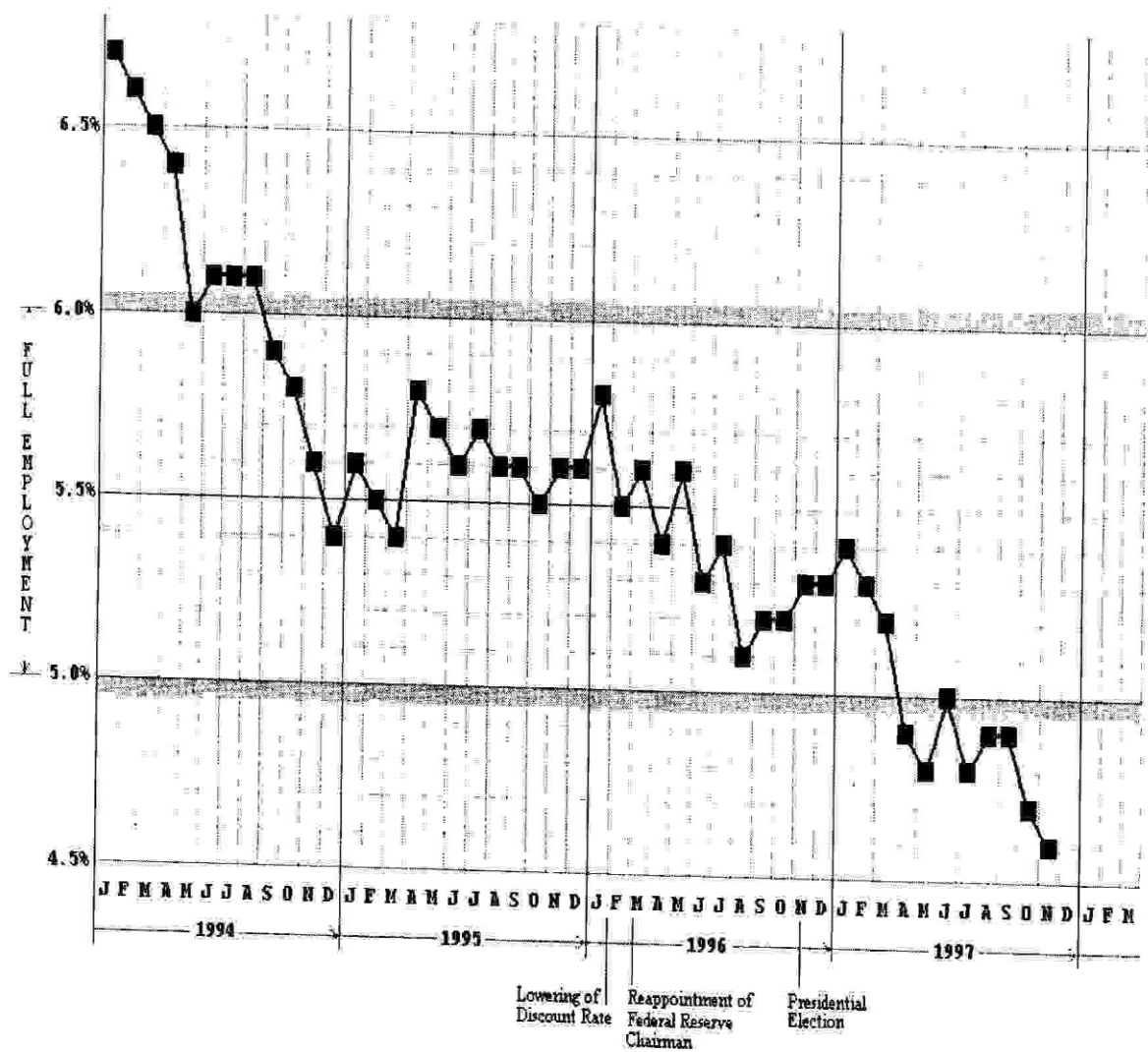


Figure 3: U.S. Unemployment Rate

Full employment is conventionally taken to mean unemployment in the range of five or six percent. That is, even in the best of times, five or six percent of the work force are between jobs or are entering the job market for the first time. Some may have lost their jobs in contracting industries and have not yet been hired in expanding industries. (Also included in this group of unemployed workers are those who are having difficulty securing jobs because of legislated restrictions, such as minimum-wage legislation.) Full employment simply means that the economy is not in recession. It is possible for the unemployment rate to drop below the five-to-six percent range, but as a matter of both theory and history, an unemployment rate this low is considered to be unsustainable. Figure 3 shows that over a period of about three years the unemployment rate has dropped out of the recession range, through the full-employment-range and into the unsustainable range. This pattern of movement, together with an assessment of the actions of the Federal Reserve over the period, suggests that cause-and-effect runs from Federal Reserve policy to the unemployment rate to the deficit. It suggests further that current and recent rates of unemployment are not sustainable and hence that the trend toward a balanced budget is not a lasting one.

The role of the Federal Reserve in recent years was vividly foretold in early 1993, just after the inauguration of Bill Clinton. His televised State of the Union Address included conflicting messages about the future course of fiscal policy. The new president identified two action items as essential to the future health of the economy: (1) a stimulant package, which would involve billions of dollars of new public-sector spending projects as well as tax breaks to encourage private-sector spending and (2) fiscal responsibility, which would require decreases in government expenditures and increases in tax revenues. Members of Congress and other invited guests were undoubtedly as confused as was the television audience. How could fiscal stimulation and fiscal responsibility be achieved at the same time? Uncertainty about the actual course of fiscal affairs could hardly have been diminished by Clinton's posturing in both directions simultaneously. (This is not to suggest that odds-makers would have to assign 50-50 odds to each of the two divergent directions. Subsequent developments revealed that – not all that surprisingly – the politically beneficial stimulant package took priority over the economically sound budget balancing.)

As usual, the audience included the Chairman of the Board of Governors of the Federal Reserve System. Highly unusual was the fact that the Chairman was seated, very strategically, between Hillary Clinton and Tipper Gore. The next morning's newspapers contained all the predictable bar charts and pie charts to aid us in understanding just where the economy is and just where it may be headed. But the most telling chart the news media could have presented was the seating chart. By allowing himself to be flanked on this formal occasion by the First and Second Ladies, Alan Greenspan, initially appointed of Ronald Reagan and reappointed by George Bush, gave us the best clue about the future of the economy: He had signed on as a team player in the Clinton administration.

The Federal Reserve as a team player

The job of Federal Reserve Chairman is inherently a politically sensitive one, but by his public showing of allegiance, Greenspan made the job explicitly and dramatically so. During the first year of the new administration, however, there was no clear conflict between economically sound policy and politically expedient monetary policy. The economy was still recovering from the Bush recession, which had contributed importantly to Bush's defeat. Both the conventional wisdom of mainstream macroeconomists and the political interests of the White House dictated that the Federal Reserve pursue a course of monetary ease while the unemployment rate was above the range of full employment and then tighten the monetary constraint as the unemployment rate fell below six percent. Monetary stimulation followed by a "soft landing" in the five-to-six percent range of unemployment required the solid technical skills that Greenspan had clearly developed, but did not require that technical considerations be played off against political considerations.

Even at full employment, monetary policy can stimulate the economy, but the effect of the stimulation is only temporary. Long-run considerations – of inflation and economic discoordination—warn against monetary ease in a fully employed economy. The duration of the

seemingly positive but temporary effects of a cheap-credit policy is believed to be about 18 months or possibly longer. The critical period to examine, then, is the 18 months prior to a national election, a period that is likely to be punctuated by the upturn of a political business cycle. The last half of 1995 and early 1996, a period during which the unemployment rate was near the middle of the full-employment range, was within the critical 18-month period preceding the presidential election of November 1996. With a fully employed economy and an election approaching, the actions of the Federal Reserve early in the election year provided an important test of the Chairman – and helps put current economic conditions, including the federal budget deficit, into perspective.

The Federal Reserve cut the discount rate on the last day of January 1996, just before the release of new data on unemployment, which indicated a rise in the unemployment rate from 5.6 percent to 5.8 percent. The mainstream financial press, both then and later, referred to this move in the direction of monetary ease as “questionable” and as “probably unwarranted” – and for good reasons. First, the economy was still well within the range of full employment; second, a single month’s increase in the unemployment rate does not justify a response by the Federal Reserve; and third, the increase of 0.2 percent in unemployment was easily accounted for by an unusually harsh winter month.¹² While the increase in the unemployment rate may have provided some “cover” for the Federal Reserve, there was widespread belief that its monetary tools were being wielded against the Republican party and not against the winter storms – that the reduction of the discount rate marked the upturn of a political business cycle. (The fact that the expiration of Greenspan’s second four-year term – and possible reappointment to a third term – fell in March 1996 added an extra element of politics to a politically sensitive situation.)

The conflict between economic soundness and political expediency was evident the very next month when the unemployment rate fell by 0.3 percent – to the very middle of the full-employment range. If the January figure had provided Greenspan a cover for monetary ease, the February figure had blown his cover. How would the Federal Reserve respond? Would it maintain its monetary ease in light of the upcoming presidential election, or would it tighten to avoid overshooting its target of full-employment? Uncertainty about the Federal Reserve’s response was registered on the day the new unemployment rate was announced by a drop in the Dow Jones of 171 points. Good news on main street (unemployment down) got translated into bad news on Wall Street (demands for liquidity up). This market reaction to a lower unemployment is strong evidence that political considerations – and hence uncertainties – were dominating the decisions of buyers and sellers in securities markets.

The Federal Reserve kept the discount rate down, and the episode was replayed just four months later when the unemployment figures for May were announced. Again, the unemployment rate fell by 0.3 percent, this time from 5.6 to 5.3. On the day of the announcement the Dow Jones fell by 115 points. As before, many investors preferred to get out of the market rather than try to guess what the Federal Reserve would do and expose themselves to the risk of big losses in the event that their guess was wrong. And as before, the Federal Reserve kept the discount rate down.

An unsustainable prosperity

The market does not always react negatively to a seemingly positive development in the economy. The perversity (of Dow Jones dropping on the announcement of a lower unemployment rate) is a symptom of the politicisation of the Federal Reserve. A genuinely strong economy tends to get reflected in high prices on Wall Street. But an economy being spurred on with undue monetary ease is characterised by uncertainty and by volatility in the demands for liquidity.¹³ The particular uncertainty about Greenspan’s allegiance to the Clinton administration had dissipated by September, when still a third drop of 0.3 in the unemployment rate was announced. With the presidential election only a few weeks away and the Federal Reserve committed to monetary ease, the market did not react as it had in the earlier episodes. The Dow Jones actually rose by 53 points. (At the time, however, there was some reading of the tea leaves according to which the market had plummeted the day before the announcement in anticipation of a lower unemployment rate and then rebounded when the news was not as good as feared!)

It should be noted that a 0.3 percent change in the unemployment rate is a large change only in comparison with the average month-to-month change. A change of 0.3 is small in comparison to the width of the full-employment range. Even the cumulative net change (from 5.8 to 5.1) took place wholly within the context of a fully employed economy. And ironically, none of the 0.3 changed survived the revisions that the unemployment statistics – like other macroeconomic statistics – routinely undergo. The currently reported time series for the unemployment rate shows no change greater than 0.2 for the entire 18 months preceding the presidential election. The market's reaction to the monthly changes, then, must be understood in terms of its having to second-guess the actions of the Federal Reserve in a politically charged environment.

Now, more than a year after the election and with the discount rate still at the level set in early 1995, the unemployment rate has fallen to a twenty-five year low. It has hovered below the full-employment range during most of 1997, dipping to 4.6 percent in November. The market continues to be buffeted by growing concern that the Federal Reserve will tighten. Greenspan continues to voice concerns about a future inflation, but actual inflation is still not high enough to provide a politically acceptable justification for raising the discount rate. Though temporary, increased output corresponding to the decreased unemployment rate has countered the upward pressure on prices. Students of the political business cycle can justifiably suspect that Greenspan's fear of inflation is based not so much on any of the leading indicators of future movements in prices or wages but rather on his lingering worries about the ultimate consequences of the unwarranted monetary ease during the reelection campaign.

Market uncertainties associated with the political business cycle are a problem in their own right. The discussions in the financial press of "interest-rate jitters" are well grounded in our understanding of the conflict between economically sound policy and politically expedient policy. Traders in securities markets have to keep one eye on the Federal Reserve and try to anticipate when policy will turn political and when it will turn back.

The political business cycle also has clear implications about the federal budget deficits and about the possibility of lasting deficit reduction. In summary terms, we can say that although the deficits in recent years are considerably smaller than the Reagan-Bush deficits, they appear alarmingly large when assessed in the context of the unemployment rate. Even in the view of those macroeconomists who recommend deficits as an important part of the government's stabilisation policy, the budget should be in balance when the economy is performing at its full employment level. That is, the *structural* deficit should be nil. And at full employment, the *cyclical* deficit would also be nil. With no structural deficit, movements of the unemployment rate in the direction of recession would induce a cyclical deficit, and movements in the unemployment rate in the other direction would induce a cyclical surplus. The budget, then, would be in balance over the cycle.

Taking this perspective, we realise that with the unemployment rate (4.6 percent) decidedly below the level associated with full employment (5.0 - 6.0 percent), the federal budget should be in surplus. Instead, we have a structural deficit that is swamping a cyclical surplus, giving us a net deficit in the \$100 billion range. A crude estimate of the structural deficit is the average of the deficits that correspond to the middle of the full-employment range, or about \$150 billion. On this basis, we can estimate that the budget should be currently showing a surplus of about \$50 billion. Further, when the unemployment rate returns to the (sustainable) full-employment range, the deficit will return to the \$150 billion range; and, if the economy goes into recession, the deficit will go even higher.

This reckoning does not offer much hope for a continuing trend towards a balanced budget or even for lasting relief from the fiscal excesses of the Reagan-Bush administrations. The Clinton administration's projection of budgetary balance or near-balance through 2003 is based on the rosy forecast that the unemployment rate will rise only slightly, levelling out at 5.4 percent – still below the midpoint of the full-employment range. Interest rate projections are similarly rosy. The only alternative reckoning is one that relies on a downward adjustment of the full-employment range of unemployment. Has this range dropped from its long-standing five-to-six percent level to a level that centers on some rate below five percent? There are arguments that the range has actually fallen

– as a result, for instance, of changes in the structure of labour markets and changes in labour productivity. The wage demands of labour unions, according to one argument, are now more in line with economic realities. According to another argument, the economy is just now feeling the positive effects of the computer revolution. The computer-enhanced productivity of labour has increased labour demand; the corresponding increase in the economy's output has held both wages and prices down and has allowed us to achieve a new plateau of lower unemployment without inflation. These arguments are not wholly without merit. They serve as reminders that the estimates that we made of the structural deficit are crude ones. But the evidence would have to be exceedingly strong for us to reject the idea that the unemployment rate has dropped below the full-employment range and adopt the view that the full-employment range has kept itself centered on these recent, historic lows in the unemployment rate.

5

What can be done?

The prescription of policy and reform is implicit in our understanding of the nature of the problem of the deficit. What can be done about the fiscal irresponsibility? Several different answers can be offered – each based upon a different interpretation of the question. (1) What institutional reform is needed to restore fiscal responsibility? (2) What can we do as citizen/voters? And finally, (3) what can we do as managers of our own personal finances?

Institutional reform

The answer to the first question is the easiest to articulate and the most difficult to implement. Re-establishing an effective institutional constraint on the Federal Reserve's powers of money creation would have a profound and lasting effect on both monetary and fiscal affairs. It is well understood that limiting the growth rate of the money supply is the only way to avoid the problem of excessive debt monetisation and, more generally, of inflation. But as it turns out, tightening the reins on the Federal Reserve also tightens the reins on the Treasury. The *actual* debt monetisation during the 1970s gave us inflation; the *potential* for debt monetisation during the 1980s and 1990s has allowed the Treasury to issue debt in unprecedented volume without any risk of default attaching itself to the Treasury securities.¹⁴ Individuals and financial institutions accumulate assets in the form of risk-free Treasury bills, while the very existence of so much government debt imposes heavy doses of uncertainty on the private sector. Undoing the damage done by Nixon's closing of the gold window in 1971 – and allowing U.S. citizens as well as foreign central banks to convert their Federal Reserve paper to gold – would be a strong move in the direction of monetary and fiscal integrity. In the absence of gold convertibility, the Federal Reserve must develop a reputation for managing the money supply with the exclusive goal of monetary stability. Its developing a reputation for not accommodating the Treasury and not being a team player for the incumbent administration is essential to the separation of monetary and fiscal affairs and hence essential to imposing some market discipline on the fiscal authority. In turn, the stricter limits on the government's ability to raise funds would help to curb the rate of growth of government spending. Effectively constraining the Federal Reserve may have a more sobering effect on Congress and the Treasury than could be achieved by the more direct approach of mandating a balanced budget by so amending the constitution. (A critical assessment of the often-proposal balanced-budget amendment as well as further considerations of the relationship between the monetary authority and the fiscal authority are discussed in separate sections below.)

Evaluating public policy

As individual citizen/voters, we have some difficulty mandating gold convertibility or other such a fundamental institutional reform. But it helps to know what an effective solution would look like when we turn to evaluate the actual policy proposals offered by elected officials. We can spell out several considerations that will help us avoid false solutions to the deficit problem. First, in the post-1971 era, both the level of government spending and the level of taxation have drifted above their historical trend lines – spending more so than taxing. Nonetheless, many advocates of fiscal responsibility want a so-called balanced approach to deficit reduction, by which they mean that we should reduce the deficit by equal doses of spending decreases and tax increases. Left-of-center Democrats tend to favour relatively heavier tax increases; right-of-center Republicans tend to favour relatively heavier spending decreases. But the lack of an effective constraint on the Federal Reserve and the Treasury has put an upward bias on both spending and taxing. Spending is

increased during the period in which the public has not yet perceived its true costs; taxing is increased as part of the crisis management once perceptions have caught up with realities.¹⁵ Undoing the fiscal irresponsibility, then, must involve decreases in both the level of government spending and the level of taxation – in spending more so than in taxing. Considerations of political strategy reinforce this conclusion and warn against tax increases as any part of deficit reduction: increased government revenues are more likely to result in increased government spending than in reduced Treasury borrowing.

Second, the constraint on the Federal Reserve must be direct and self-imposing. Reestablishing a link between the dollar and gold, for example, is one possible solution; freezing the monetary base at its current level is another. A more radical solution would be to eliminate the Federal Reserve as we know it, allowing for a thoroughly decentralised banking system. By comparison, debt limitation legislation and deficit reduction legislation are notoriously ineffective and understandably so. The legislative body responsible for eliminating or reducing fiscal excesses cannot be the same body that generates those excesses.

Third, the successive rounds of binge-and-crisis should be recognised for what they are. Neither hiding debt at the Federal Reserve – or overseas – nor substituting hidden taxes for worrisome debt are workable or lasting solutions to our deficit problem. They are, in fact, specific manifestations of the problem.

Managing our own finances

Finally, a few thoughts can be offered about managing personal finances during this period of increasing debt and chronically large deficits. The purpose here is not to offer special advice of how to profit from the coming macroeconomic instabilities, but rather to suggest that the most sensible decisions in the area of personal finance are ones that reinforce our understanding of the nature of the deficit problem. Giving advice in any more specific sense on how to cope with a debt-ridden economy would require that we be able to predict the unpredictable. For this reason, the last two decades have been a particularly bad time for even the most seasoned investment advisors. Throughout the bull market of the 1980s, when the conventional wisdom was that both inflation and interest rates would remain low as the Reagan administration went the distance on funds borrowed abroad, it appeared to some that the market would never stop rising. These were the Gaga years.¹⁶ But dating from the stock market crash of October 1987 through the recession and into the slow and uncertain recovery, there was no conventional wisdom about the nature of the investment climate. Investors, advisors, and the market itself were all trying to find their financial feet. The mid-to-late 1990s have seen a stock market rising to heights that are out of proportion to realised economic growth and continuing concern that current “over-exuberance” – to use Greenspan’s term – is a bad omen for the future.

Prescribing investment strategies post-Gaga, then, is a risky business, but sensible management of investment portfolios can take economic and political realities into account: In general, don’t make long-term investments whose payoffs depend critically on the continuation of present trends in interest rates, inflation, or other market variables. This is reasonable advice for most any investment climate, but it is especially good advice during the era of high deficits when government is pursuing its binge-and-crisis strategy. If you invest in some particular enterprise on the basis of your own expectations of changes in market conditions that are likely to affect the market value of its shares, pay due attention to the effects of possible changes in the government strategy for accommodating its deficit – or at least factor in the risks to you of possible changes.

We learned in the 1970s that we had to watch inflation as closely as we watched our own specific investments. Some made money in real estate, for instance, not because of what they knew about the particular properties they bought but because of what they knew about the Federal Reserve. Similarly, in the 1990s, we may trade on our guesses about deficit accommodation as much as on our knowledge of particular markets. For instance, the capital value of a firm that sells its output in other countries may be more sensitive to changes in the government’s ability to attract funds from foreign sources than to changes in market conditions unique to the firm’s own specific

output. As the national debt grows, playing the market transforms itself increasingly to playing the deficit.

A final piece of advice can directly reinforce our understanding of the basic problem. If you are a conservative investor, having neither the time nor the stomach for second guessing the U.S. Treasury and the Federal Reserve, then stay out of the market. Refinance your home at seven percent and put the monthly savings into Treasury bills. The low thirty-year fixed-rate mortgages now available will virtually insure another savings-and-loan crisis down the road, when interest rates rise in the face of monetary and fiscal realities. And the Treasury bills that will protect you from default risks will allow the government to postpone a little longer its own day of reckoning. Your personal peace of mind may be tainted with the realisation that financial conservatism practiced by individuals may lead to fiscal crisis experienced by the economy. But you can take comfort in your understanding that such a dramatic clash between private and public interests stands as testimony to the seriousness of the problem of our federal debt and deficits.

The futility and perversity of a constitutional amendment

The occasional flirtation by opinion makers and political leaders with a balanced-budget amendment – and the near passage of such an amendment in the Senate in 1994 – justifies a critical look at this proposed solution to the problem of the government's chronic fiscal irresponsibility. Amending the constitution would be a dramatic move and would serve to recognise the seriousness of the problem. But drama and due recognition aside, it would probably be no more effective than amending the Lord's Prayer so as to make specific mention of Treasury borrowing when asking to be saved from temptation.

The federal budget, after all, is a forecast. A budget in balance is one that reflects the legislature's forecast that the Treasury's outlays over an upcoming twelve-month period will not exceed its receipts. But both the expected outlays and the expected receipts depend critically on the underlying assumptions about the economy – about its growth rate, unemployment rate, interest rates, exchange rates, and dozens of other market parameters. Even without a constitutional amendment, the executive branch has adopted the strategy – pioneered by the Reagan administration – of “working backwards” to create documentation in support of the proposed budget it submits to Congress. That is, a judgment is made about how large the deficit can be without becoming too much of a political liability. This judgment then dictates what assumptions have to be made about economic growth and all the other parameters.

But whatever the basis for political judgments and economic forecasts, every move in the unemployment rate during the budget period sends Treasury receipts in one direction and Treasury outlays in the other. A balanced budget based upon overly optimistic forecasts of a continued low unemployment rate can easily give way to a ballooning deficit if economic growth is interrupted by recession. Any submitted budget can be made to show a balance between revenues and outlays and undoubtedly would be made to show one if the constitution so mandated. We should realise, however, that a constitutional amendment outlawing an actual *ex post* imbalance may as well be accompanied by a second amendment outlawing recessions. While proposing this second amendment may be more obviously absurd, it is, in reality, no more absurd than proposing the first one. To see both as futile is simply to recognise that the laws of macroeconomics cannot be legislated.

Along with second marriages, the well established tendency for actual deficits to exceed initial forecasts stands as testimony of the victory of hopes over experience. Amending the constitution to require a balanced budget would make the forecasts—and hopes—even more politically charged than they currently are. And whether enforced by the Supreme Court or by Congress itself, there would be great difficulty in making a judicial distinction between “guilty” and “too optimistic.” Further, even a finding of “guilty beyond a reasonable doubt” would leave unanswered – and possibly unanswerable – the question of just who is to be held culpable and just what form the penal action would take. And finally, the very circumstances in which the Treasury incurs an unanticipated deficit are circumstances in which the amendment would allow even further

deficit spending. That is, finger-crossing provisions included in almost all proposed balanced-budget amendments, allow the government to counter a recession, which is marked by a cyclical deficit, by deliberately increasing the structural deficit.

Members of Congress could claim the mantle of fiscal responsibility by virtue of having voted for the amendment, while continuing to support the spending programs and middle-class tax cuts so essential for re-election. Worse, the inevitable flouting of the balanced-budget amendment would erode the integrity of the Constitution. But more to the point, a series of episodes in which *ex ante* balance turns to *ex post* imbalance would bring neither economic stability nor political accountability.

6

Changing the incentives

Writing fiscal responsibility into the constitution would be ineffective at best and perverse at worst. This is not to suggest, however, that a fiscally responsible government is an unattainable end – only that a balanced-budget amendment is not the means to achieve this end. Private enterprise does not achieve fiscal responsibility by writing it into corporate charters and bylaws. Rather, fiscal responsibility is imposed upon overextended business firms by a credit market that lends, if at all, at an interest rate which reflects the risk of default. Each extra dollar's worth of borrowing reduces the firm's creditworthiness in the eyes of potential lenders. For a firm that relies excessively on short-term credit, the default-risk premium is particularly effective. At some point the increased cost of servicing the outstanding debt will wholly absorb the new borrowing. For most firms even the prospects of paying a substantial default-risk premium is enough to ensure fiscal responsibility.

Congress cannot resist dipping ever deeper into a seemingly bottomless pool of credit. The bottomlessness is attributable precisely to the fact that the Treasury encounters no default-risk premium no matter how much red ink it spills. Treasury bills are safe; they are free of default risk. Investors routinely put their funds in Treasury bills when they are uncertain about market conditions in the private sector. And the uncertain market conditions in recent years are to a substantial degree attributable to the black cloud of government debt that chronically overhangs the private sector. It is both ironic and perverse that investors buy Treasury bills to avoid the risks caused by the Treasury's issuing of so many of them! Still, given the current powers of the federal government, the Treasury bills are default-risk free. More pointedly, the government's power to create money – unconstrained by gold reserves or by any other non-political considerations – ensures against outright default.

Default, in short, is institutionally and definitionally precluded: A borrower with ready access to a printing press can never declare itself "unable to pay." It is true, of course, that actual money creation for the purpose of making interest payments on Treasury bills – or for any other purpose, for that matter – would cause inflation. If the inflation rate is higher than generally expected, then lenders would receive a lower real rate of return than they otherwise would have. But this "inflation tax," as it is sometimes called, is imposed broadly across credit markets and does not distinguish between buyers of Treasury bills and other lenders. Neither inflation nor the anticipation of it functions as a default-risk premium.

The government is further set apart from private business firms by its power to tax. Firms have to earn their revenues from willing buyers of their products. By contrast, the government's tax revenue are extracted rather than earned. But the power to tax is not, by itself, enough to keep a default-risk premium off of government-issued securities – as evidenced by New York City and a few other large municipalities in the mid 1970s. When New York municipal bonds began trading at increasingly heavy discounts in response to the accumulating municipal debt, the city was forced to deal with its fiscal crisis – forced, because it had no printing press of its own with which to monetise its debt and because its appeals to the federal government for help in this direction were ignored. Then Vice President Nelson Rockefeller candidly acknowledged that while New York was not as overextended as was the federal government, its excessive borrowing had precipitated a crisis precisely because the city, unlike the federal government, had no power to create money.

This understanding of the relationship between the power to create money and the ability to push into the indefinite future all serious effort to deal with the chronic fiscal irresponsibility draws our attention away from the constitution and focuses it squarely on the central bank. It is the very potential for debt monetisation – or, more generally, for Treasury accommodation – that keeps Treasury bills default-risk free, making the government's IOUs so attractive to borrower and lender alike. Removing this potential, then, is the key to successful monetary and fiscal reform. The most

telling question about any proposed reform aimed at curbing government indebtedness is: “Does it put a default-risk premium on government securities?” If it does, the reform will cause the federal government to be at least as fiscally responsible as state and municipal governments. If it does not, the reform probably shares most if not all of the flaws of a constitutional amendment.

Towards the decentralisation of banking

It is worthwhile to consider the consequences of thoroughly privatising and decentralising the banking system if only to establish a crucial test for more politically viable reform proposals. There is a strong case to be made for free banking, and there is a large and growing literature to support monetary reform in this direction.¹⁷ Advocacy of competition in the provision of money, which has a long and honorable history, has gotten a second wind in the last decade or so. New theoretical inquiry as well as historical investigations have helped to bolster the case that market mechanisms can outperform central authority in providing a stable medium of exchange. The case has been made largely if not wholly independent of the connection between money issue and deficit finance. We can note, however, that no individual competing bank in a decentralised system would be obligated to accommodate the Treasury. The decentralisation of banking, then, means that the risks of over-extension on the part of the Treasury would be born in some measure by those who actually buy Treasury bills. That is, there would be a default-risk premium on government IOUs. Advocating the abolition of the Federal Reserve in order to force Congress to reduce the deficit may be seen as an overkill. But advocating competition in the provision of money as a worthwhile reform in its own right finds justification in both theory and history. Imposing fiscal responsibility on the Treasury and hence on Congress is simply an added benefit of a decentralised monetary system.

With or without the Federal Reserve, Congress would behave responsibly if, at some level of indebtedness, the Treasury faced a default-risk premium on its IOUs. It is no coincidence that the elimination of the dollar’s last link to gold in 1971 – the last effective check against debt monetisation – was followed in just a few years by a sharply escalating debt. Until some effectively similar check is re-instituted, the problem of chronically large federal budget deficits is likely to continue.

A helpful metaphor

The reckoning of deficit problem offered here stands apart from the reckonings of the more familiar schools of thought. Charles Schultze¹⁸ has offered an imaginative and memorable taxonomy of the most popular views – and has provided a basis for contrasting them with our not-so-popular view. Schultze identified the character of deficits as seen by three loosely defined schools of thought as that of wolves, termites, and pussycats. Wolves threaten imminent disaster; termites eat away at the economy’s capital base; pussycats do nothing – and pose no threats. The uncertainty associated with deficits together with the political aspects of taxing and spending allows for an addition to the Schultze menagerie. The imagery below is intended to relate borrowing to its alternative of taxing as evaluated by entrepreneurs – or more broadly, by tax-paying market participants.

We can conceive of the government’s fiscal strategy as a cat-and-mouse game in which the cats are federal fiscal agents, who are looking to fund their spending programs, and the mice are entrepreneurs and other market participants, who are looking out for cats. To hunt for the needed funding, the cats are organised into two groups. Cats in the first group, which is charged with collecting taxes, wear bells around their necks; cats in the second group, which is charged with accommodating the deficit, wear no bells. The mice are fond of neither group, but at least they know where members of the first group are, and they make their own plans accordingly. And even though the second group is smaller than the first, the threat of harm as well as actual harm done by the unbellied cats is relatively large.

The pussycat view of the deficit, identified by Schultze, is that deficits are harmless, or at least no more harmful than taxes: Cats are cats, bells or no bells. The alternative imagery offered here suggests otherwise. Cats are a threat, all the more so if they are not wearing bells. And if the

unbelled cats are more successful at catching mice, then promises by the federal fiscal agents to deploy fewer of them are not likely to be kept. Some mice might well conceive of schemes to bell the unbelled cats. One such scheme is to reduce deficit spending by allowing taxes to be raised. But belling cats in this way is ultimately a counterproductive one if with each newly belled cat another unbelled cat is recruited to look for still more funds. That is, tax hikes intended to achieve deficit reduction may result instead in increased government spending and undiminished borrowing. The uncertainties and worries about this second group of cats will persist until they can be marked by their own special bell – in the form of a default-risk premium. Only with this market-imposed discipline on the fiscal agent can we expect the total amount of funds collected – and spent – to be effectively constrained.

The cat-and-mouse analogy offered in the spirit of Schultze, like the more serious arguments in earlier sections, suggests that meaningful reform does not consist of finding new ways of financing the expanding public sector. To the contrary, we should realise that the public sector has been allowed to expand at the expense of the private sector in large part because of a fiscal system in need of reform. Nor should we be deluded to think that chronically large deficits are beneficial or irrelevant – or that seemingly large deficits are actually small in comparison to some all-inclusive macroeconomic aggregate such as gross national product. Instead, our assessment of the significance of the deficit as well as our efforts to restore fiscal responsibility in the public sector should be based on the fullest understanding of the fiscal and monetary institutions, of the economics and politics that drive the dynamics of deficit accommodation, and of the continuing adverse effects of public-sector deficits on private-sector performance.

Footnotes

- 1 The federal budget deficit has been in the dozen-digit range (i.e., over \$100 billion) continuously since 1982; during the Reagan-Bush administrations (1981-1993), the cumulative debt rose from \$0.995 trillion to \$4.351 trillion; the 1992 deficit of \$290.2 amounted to more than three quarters of a billion dollars of new debt daily. (Figures are from the *Budget of the United States Government, Fiscal Year 1998*, pp. 23-24 and 103-104.)
- 2 A good survey of professional opinion is provided in James M. Rock, ed., *Debt and the Twin Deficits Debate*. Mountain View, CA: Mayfield Publishing Company, 1991.
- 3 Harvard's Robert J. Barro believes that increased government borrowing leads to increased private saving, as taxpayers prepare themselves to pay higher taxes in the future. Northwestern's Robert Eisner argues that the Carter Administration's \$60 billion deficit in 1979 was actually a \$10 billion surplus, once the debt-eroding effects of inflation are factored in. See Barro, "The Ricardian Model of Budget Deficits," and Eisner, "Deficits and Us and Our Grandchildren," both in Rock, ed., *Debt*.
- 4 See James T. Bennett and Thomas J. DiLorenzo, *Underground Government: The Off-Budget Public Sector*. Washington, D.C.: Cato Institute, 1983.
- 5 There is no implication here that current-account trade deficits are *fully* attributable to the export of government debt. Real factors, such as a difference in saving preferences between trading partners, can account for an ongoing trade imbalance. But the policy-induced component of the trade imbalance, largely because of the possibility of substantial and unpredictable variation, is of special significance, as the discussion in this and the following section indicates.
- 6 Nearly a century earlier the link to silver was severed, leaving only gold as a monetary anchor. The demonitization of silver is recorded in the history books as the "Crime of '73." See Milton Friedman, "The Crime of 1873," in his *Money Mischief: Episodes in Monetary History*. Harcourt Brace Jovanovich, Publishers, 1992. If reducing the number of hard-money anchors from two to one was a criminal act, then reducing the number from one to zero was even more so. Historians who see the link between our current fiscal malaise and the actions of President Nixon on August 15, 1971 can legitimately write about the "Crime of '71."
- 7 U.S. citizens had lost the right to convert their dollars into gold – and even to own monetary gold – in 1933 at the hands of Franklin D. Roosevelt. Private ownership of gold regained its legal standing in 1973, but domestically held gold remained demonetized.
- 8 Harry E. Figgie, Jr., *Bankruptcy 1995: The Coming Collapse of America and How to Stop It*. Boston: Little, Brown and Company, 1992. The "hockey stick curve" appears on p. 65. Figgie's tone is shrill, his techniques crude, but even though his specific predictions were off, his facts and figures carry the argument. Books with similar themes include David P. Calleo, *The Bankrupting of America: How the Federal Budget is Impoverishing the Nation*. New York: William Marrow and Company, Inc., 1992 and Stephen Delos Wilson, *The Bankruptcy of America: How the Boom of the 80's Became the Bust of the 90's*. Germantown, TN: Ridge Mills Press, 1992.
- 9 The uncertainty-based distinction between taxing and borrowing is blurred when the government imposes indirect taxes or when direct taxes can be imposed retroactively, as have been proposed in recent years. Because there is no effective hedge against such fund-raising tactics, these approaches to deficit reduction serve only to compound the problem.
- 10 I have developed the theme of deficit-induced uncertainties as the basis for the economy's poor performance in my "Public-Sector Deficits and Private-Sector Performance," in Lawrence H. White, ed., *Crisis in American Banking*. New York: New York University Press, 1993.
- 11 These unemployment data, which are supplied by the St. Louis Federal Reserve Bank, are revised data. For the critical 18-month period preceding the 1992 presidential election, the percentages actually announced by the Bureau of Labor Statistics have been substituted for the revised figures to preserve the relationship between BLS announcements and Wall Street reactions to be discussed below. (The announced and revised figures do not differ by more than 0.1 percent.)
- 12 The unemployment figures released in early February of 1996 and presented in Figure 3 are, as indicated earlier, seasonally adjusted figures. This simply means that only a harsher-than-average winter month will affect the adjusted unemployment rate. January 1996 was just such a harsh month.
- 13 The distinction between genuine and policy-induced growth underlies Mark Skousen's resolution of the otherwise puzzling "Perversity of Wall Street." See Mark Skousen and Kenna C. Taylor, *Puzzles and Paradoxes in Economics*, Brookfield, VT: Edward Elgar, 1997, pp. 206-8.

- 14 The significance of potential debt monetization for the Treasury's ability to sell excessive amounts of debt is spelled out in Roger W. Garrison, "The Roaring Twenties and the Bullish Eighties: The Role of Government in Boom and Bust," *Critical Review*, vol 7, no. 2-3, 1994, pp. 259-276.
- 15 According to a popular view, "Taxes and spending are the real culprits, not deficits and debt." See Milton and Rose Friedman, "The Facts: Government Spending, Taxes, and Deficits," in their *Tyranny of the Status Quo*. New York: Harcourt Brace Jovanovich, 1984. The growing debt, in their view, is a red herring. Accordingly, we should aim directly at reducing taxes and expenditures and not worry about how the government bridges the gap between these two growing magnitudes. My own perspective reverses both the analytical and the strategic significance of the government's borrowing and spending. The government has been spending more precisely because the (political) costs of raising funds has been reduced.
- 16 See Brett Duval Fromson, ed., *The Gaga Years: The Rise and Fall of the Money Game, 1981-1991*. New York: Citadel Press, 1992. The term Gaga years is attributed to Joseph Nocera.
- 17 See, for instance, George A. Selgin and Lawrence H. White, "How Would the Invisible Hand Handle Money?" *Journal of Economic Literature*, vol 32, no. 4 (December), 1994, pp. 1718-1749; and Kevin Dowd, ed., *The Experience of Free Banking*, London: Routledge, 1992.
- 18 Charles L. Schultze, "Of Wolves, Termites, and Pussycats," *Brookings Review* (Summer 1989), pp. 26-33.