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Deficits Do Matter

by Hans F. Sennholz

Editor's Note: With the federal deficit expected to reach $500 billion or more this fiscal year, Congress on a spending binge unequalled in recent times, and the President without a veto pen, it's a good time to revisit this FEE Timely Classic *on budget deficits.*

Politicians and officials in high places are telling us that government debt does not matter; after all, we owe it to ourselves. As long as government borrows funds internally and expenditures are financed from internal sources, so the notion goes, no real cost is incurred. Interest payment on debt merely represents transfers from taxpayers to bondholders. Debt to foreigners, by contrast, is seen as a wholly different matter because it necessitates interest payments to outsiders. It is analogous to private debt.

The recurrent notion that "we owe it to ourselves" springs from the doctrines of mercantilism. It was very popular with European monarchs during the sixteenth, seventeenth, and eighteenth centuries because it placed them in the center of economic life and made them the promoters and guardians of national prosperity. Kings and princes who looked upon the economic lives of their subjects as mere extensions of their own economic activities viewed their debts as both accounts payable and accounts receivable. After all, if the subjects belong to his lordship, also their property is his. The debt he may owe them he owes to himself.

The so-called Keynesian revolution during the 1930s revived the doctrine and promoted it to a great principle of economic knowledge. Economists throughout the Western world accepted it almost universally. And yet, it is as fallacious today as it was when the kings and their ministers proclaimed it. It is the rationale of spendthrift governments ever eager to run into debt.

The federal government debt now exceeds $2 trillion and is expected to reach the $3 trillion mark by the end of the decade. We do not owe these sums to ourselves, the U.S. government owes them to individual savers and investors. Surely, in a command system such as communism or fascism, government owns and controls everything and everyone and, therefore, may be said to owe it and simultaneously own it all. But in our free order, individuals do have rights and may own property. They may own treasury bills, notes, and bonds and expect to be paid; the fact that they, too, may be taxpayers is irrelevant for the claim. They expect to be reimbursed by the debtor, the government, which in turn depends on taxpayers for payment. It does matter to every individual whether he

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owns such obligations or merely owes taxes that service the debt.

The core of the fallacy lies in the holistic way of equating individual action with community action as a whole. If individuals were part and parcel of the collective whole and personal property an integral part of government property, it would not matter how the credits and debits are listed; they all would balance out. But in our free order, private property is not government property and government property is not private property. This is true no matter whether the individual owner is a native or foreigner. The law protects both from government infringement and transgression.

Deficits Curtail Investments and Are Tax Liens

Government debt usually signals the consumption of individual savings and economic resources. It is a rare exception for government to invest its funds productively, applying property for future income or benefits. Politics tends to favor present use and enjoyment at the expense of the future. A huge debt signals huge consumption of economic resources for political ends, incurred in the past at the expense of the future. It speaks of factories not built, stores not opened, businesses not started, and jobs not created.

Deficits consume funds that otherwise would be available for private investment; they represent a direct transfer from investment to consumption. The deficits of the U.S. government curtail the rate of economic expansion, keep productivity and labor income lower than they otherwise would be, impede international competitiveness, and cause American levels of living to fall relative to those in other countries where people save and invest more.

It may be argued that other governments throughout the world incur similar deficits and, therefore, exert similarly restrictive effects on their countries. But such an argument is badly misleading because the savings rate is much higher in many other countries. Where the investment rate exceeds 20 to 30 percent of income, the impact of a 5 percent deficit is less adverse on investment than in the U.S. where the savings rate barely reaches 5 percent. Americans cannot afford any further reduction in investment through government deficits.

Deficits and debts also signal future tax exactions. Having incurred the debt in the past, government, in order to repay the funds or just pay the interest, must levy taxes in the future. In essence, therefore, a government debt is a government claim against private property—an unpaid tax bill so to speak—that will fall due in the future. Like all other business taxes, it is bound to depress labor productivity and the value of productive property.

To most people government spending is a panacea for all economic evils and difficulties, a cure-all for human woes. Where economic stagnation impedes progress and prosperity, government is expected to stimulate through deficit spending. Where there is unemployment, government is expected to supplement private demand and thus create jobs. Where there is poverty it is expected to provide affluence through more spending and debt. But nature forgives no debt and grants no benefit without cost.

There can be no beneficiary of government largess without a victim of exaction. Government cannot pile up debt without ever paying it off; all government expenditures must ultimately be paid out of tax revenues or be repudiated through inflation, which is merely another form of taxation. Either immediately or ultimately every dollar of government spending is taken out of the pockets of taxpayers. When seen in this light, the supposed benefits of government spending are rather questionable. To build a pyramid of Federal debt is to delay the inevitable and pay interest thereon.

Inflation Reduces Debt

Politicians point out that over the decades the Federal debt has actually declined in terms of purchasing power as well as relative value. If growing budgetary deficits are accompanied by shrinking real debt and rising ability to pay the debt, the happy spenders may indeed be right that Federal debt no longer matters.

True, the Federal debt has actually declined both in purchasing power and relative value. But this decline in itself is a great evil that is spawning many other evils. Most of it is the handiwork of inflation, the willful policy of currency debauchery, which enriches one class of people at the expense of another. It deprives creditors of their rightful claims and enriches the debtors, primarily politicians and government officials who incur the debt and place it on the people. It breeds economic and political conflict as it pits the economic interest of one social class against another, jeopardizing peaceful social cooperation and endangering the democratic process. Surely, debt and depreciation do matter.

Depreciation of debt by inflation is repudiation pure and simple. It is deceit, wicked and desperate; its consequences can never be foreseen. When deceit has been practiced in matters where all should be fair, confidence cannot be easily restored. In financial terms, interest rates signal the dangers of repudiation; they cannot be expected to return to normal as long as deceit can be expected. In this sense, the deceiver is bound to pay a price for his evil ways.

The rising burden of interest on the Federal debt illustrates the point. In fiscal year 1986 the U.S. government is estimated to pay $196.095 billion in interest on its debt; in 1987 it is scheduled to pay $206.855 billion. In terms of Federal revenue the interest is expected to consume some 25 percent of estimated receipts, in terms of gross national product some 4.5 percent, which is the highest in U.S. history. Even in 1945 when the Federal debt amounted to 133 percent of GNP, the burden of interest consumed less than 10 percent of net receipts and barely 2 percent of GNP. If government expenditures on goods and services were deleted from GNP figures because government revenue merely consists of exactions from private production, the interest burden on every American would be seen to be even greater. Surely, debt and interest do matter.

Deficits Disrupt Foreign Trade

Federal budget deficits cause interest rates to be higher than they otherwise would be, which may induce the American people to save more and foreigners to move funds into the United States. The foreign investments alleviate the savings shortage, permitting the federal government to continue the deficit spending and the American people to maintain their levels of living. But the foreign investments also serve to drive up the value of the dollar, which causes American goods prices to rise in international markets and American firms to become noncompetitive. In other words, the inflow of foreign capital leads to an overvalued dollar, which leads to more imports of foreign goods and to what is commonly called balance-of-trade deficits. The imports, in turn, keep the price inflation low but also hamper American competitiveness, depressing competing industries and causing the loss of jobs in those industries.

If the budget deficits continue, American competitiveness may be damaged permanently. The consumption of capital in the United States and the formation of capital abroad may necessitate permanent adjustments in patterns of production and international trade. Capital-intensive industries may contract in the United States but expand wherever capital continues to be formed. American wage rates may fall while some foreign rates continue to rise.

As budget deficits continue, the U.S. dollar must ultimately fall not only in purchasing power but also in the money markets of the world. When foreign investors finally conclude that they have enough dollar liquidity and enough investments in the United States, the dollar must fall. In fact, it may plummet when foreigners lose confidence in U.S. economic and monetary policy, when willful dollar depreciation inflicts painful losses on their dollar investments, and causes them to liquidate rather than invest. When foreigners become dollar sellers rather than dollar buyers the international situation is bound to change. The American dollar will fall, American competitiveness will improve, the flood of imports will cease, competing American industries may relax, but goods prices will soar. After all, if the rising dollar stimulates foreign imports and investments, a falling dollar tends to bring forth the opposite. Smaller supplies signal higher prices. Moreover, as foreign imports decline the American firms that compete with imports can now, in turn, raise their prices. In the end, large Federal deficits are bound to generate serious inflationary pressures.

Even Keynesians Object

Large budget deficits usually induce monetary authorities to engage in massive credit expansion in order to finance the deficits. They conduct what Keynesian economists call "an infusion of aggregate demand" which in time is said to add to inflationary pressures. The inflation effects are said to be rather slow, though, given idle plant and equipment and a high unemployment rate. Nevertheless, Keynesian economists recommend that budget deficits should be avoided as the economy approaches full employment. Federal deficits, Keynesians reassure us, are the appropriate remedy for recessions; they are inflationary at other times. If they are already very large at the beginning of a recession, public policymakers may be reluctant to pursue yet larger deficits during the recession. They may be reluctant to prescribe Keynesian remedies so that, according to Keynesians, recessions will be deeper and larger than they otherwise would be.

One may disagree completely with the Keynesian rationale, and yet agree with the conclusion that government budgets should be balanced. In fact, they should be balanced all the time, not just during periods of "full employment," which may be slow in coming. Government deficits consume economic substance and wealth; by their very nature they depress economic activity. The stimulation that may be observed in the wake of deficit spending is the result of willful currency and credit creation; it is the effect of the injection of monetary funds that lower interest rates and misguide businessmen in their investment decisions. When interest rates are lower than market rates and goods prices are made to rise faster than wage rates and fringe costs, the demand for labor tends to rise and unemployment may fall. This morsel of economic knowledge constitutes the secret ingredient of the Keynesian recipe.

Keynesian deficit spending during recessions is destined to fail whenever goods prices don't rise faster than labor costs. Workers and their trade unions may see through the inflation machination and readjust their demands to the willful depreciation, demanding cost-of-living clauses and other compensation adjustments to offset the inflation losses. When the workers no longer can be made to suffer reductions in real income the Keynesian recipe loses its power. Moreover, when deficit spending is given in large doses in recessions after large deficits were suffered in a boom period, deficits may turn into a prescription for deep depression and mass unemployment. A 20 percent inflation rate may cause a 20 percent unemployment rate because productive capital may no longer function; it may join other assets in the flight into inflation hedges.

Deficit spending is the mother of debt, which is the prolific mother of folly and despair. A small debt may be cleared off in a little time, whereas a large debt may never be repaid. A debtor who owes a great deal may despair of ever being able to pay and, therefore, may be tempted to default. As the U.S. government debt soars past the $2 trillion mark, the possibility of default looms ever larger. □