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Do Deficits Necessarily Depict or Predict Deficiencies? (Part I)

Intuition tells us that deficits are bad. Two types of deficits, the federal budget deficit and the trade deficit, draw scorn from many Americans and provide us with ripe topics for Discourse discussions. We will discuss both deficit types, asking whether and why either or both deficit types are necessarily bad, and what the federal government's role might be, or should be, when facing one or both types. Our November 2017 discussions will concentrate on the federal budget deficit. In January 2018, we will discuss the trade deficit, and as we look into the causes for the trade deficit, we will discuss the link between the trade deficit and the budget deficit.

The Federal Budget Deficit (and the National Debt)

A federal budget deficit occurs when the federal government's expenditures exceed federal tax revenues. This condition, known as "deficit spending," is unacceptable to many. Responsible public servants ought to balance the federal budget; failure to do so, the thinking goes, is tantamount to dereliction of duty. The importance and urgency of avoiding deficits appears all the more critical when Americans speak emotionally about the expanding national debt, which is the aggregation of government deficits. To many, the debt betrays national weakness and a promise for a troubled future. The sky is falling; America is failing.

This essay and the discussions it precedes acknowledge that budget deficits add to the national debt which, in turn, imposes an expanding interest payment burden on future generations, but we refuse to presuppose that budget deficits, even continuous ones, necessarily mean that America is failing. We explore several ideas.

- Might deficit spending cultivate benefits for future generations that outweigh costs?
- Does a budget deficit point to a lack of discipline or unrealistic expectations?
- What problems do continuous budget deficits expose, and what problems accrue as a result of continuous budget deficits?
- What economic indicators might tell us that deficit spending and the national debt is problematic?

Our nation's financial history provides context as we consider these questions.

The Advantages of Deficit Spending and National Debt from the Get-Go…

Federal government deficits, and their accumulation, the national debt, have been with the United States before the states were united, even before the colonies became states. If deficit spending and increased national debt were necessarily a harbinger of failure, then the United States would have failed in its earliest days and several times since.

Alexander Hamilton, student of economics, and finance, daring revolutionary, founder of the Bank of New York, and the first Treasury Secretary, reckoned that national debt represented a useful instrument of national power. He facilitated federal deficit spending after the Revolutionary War so that the newly formed United States could leverage the advantage of debt financing.

Hamilton's inspiration was informed in part from his observations of England's successes in prosecuting wars against France during the 18th Century. Bond issuances of debt executed through the Bank of England advantaged the island nation by funding wartime mobilization and execution with shorter lead times and at a much lower (interest) cost than France. Hamilton was so enthusiastic about the benefits of debt financing, that he called it a "national blessing."

Hamilton's Treasury Department blessed the country with a national debt of $71,060,508.50 in 1790, the first year of the U.S. National Government. Thus, the U.S. federal government experienced national debt since its inception – for reasons that Hamilton believed were necessary for the state to survive and flourish.

The Treasury Secretary believed it advantageous for the federal government to subsume the debt that individual states had incurred during the Revolutionary War. Shifting responsibility for those debts to the national (i.e. federal) government, Hamilton reasoned, would cultivate indebted states to appreciate their stake in the success of the national government and thus, in his words, "cement more closely the Union of the States."

Utilizing a national entity to satisfy debt would also, Hamilton thought, "promote the increasing respectability of the American name." Hamilton supposed that a young country displaying financial sophistication and modernity that few European countries could match would indeed earn respectability, a necessary, if abstract enabler for a nation state to take its rightful place among world powers.

Hamilton utilized the English model to leverage debt to fund federal responses to national emergencies, something the United States has been doing since. To bolster its "security against foreign attack," the United States took on more debt to prosecute the Quasi War with France, the War of 1812, the Civil War, and other wars. Deficit spending and more debt has also become de rigueur on occasions when the federal government needed "to establish public order" in response to unrest. And, of course, the nation took on debt to recover from economic recessions throughout U.S. history where the federal government was the only available entity to, using Hamilton's words, "restore landed property to its due value," or "to furnish new resources, both to agriculture and commerce."

The Dangers of Deficit Spending and National Debt

The historical snapshot above suggests that deficit spending and the associated national debt are not inherently bad things. A more detailed look at the nation's financial history might indicate the same. Deficit spending and the resultant increase in national debt have indeed helped the country when its well being or existence was threatened.

So why then, in the face of overwhelming evidence pointing to the role that deficit spending and debt played in helping the nation, would several Republican politicians have chosen to sign Clause 3 of the *Contract from America* (2010) which demands a balanced budget (No democrat signed.)? Why would presidential aspirant Senator Ted Cruz, during the run up to the 2016 presidential election, call national debt an impingement on individual liberty when history seems to suggest, as Hamilton did, that United States debt "was the price of liberty?"

An answer could be that while deficit spending and national debt are not inherently bad things, practice shows that deficits can be difficult to justify, and theory tells us that national debt *can be* bad. We look first at four attributes of deficit spending that in practice cast doubt upon the wisdom of any particular public investment that might underscore deficit spending. We then consider two reasons why, in theory, the accrual of national debt could be problematic for the nation.

<u>A Practical Matter</u>

Deficit spending is justified only when the benefits that accrue as a result of the expenditure outweigh the costs. The problem is that benefits that result from public expenditures are hard to account for while the costs are painfully evident.

First, it is difficult to know whether conditions observed after an investment are attributable to the investment itself. Let's assume, for example, the nation deficit spends to bolster the capabilities of the U.S. military. Now let's assume that after the expenditures, military readiness does indeed increase. It is unlikely that any analyst or military expert can certify that the improvement in readiness is attributable specifically to the expenditures. Too many other variables affect military readiness to be absolutely certain.

Second, even if the improved military readiness were known to be attributable to the investments, it is highly unlikely that we could measure the magnitude of the improvements. And then, even if we were somehow to measure the magnitude, understanding the monetary (dollar) value of those improvements to allow for comparing them with costs as a part of a robust benefits-costs analysis is fraught.

Third, many of the benefits from government investments accrue over long periods of time – well into the future. And since people tend to ignore or under appreciate the future, there is an inclination to either undercount or ignore future benefits, and thus, bias the benefits-costs analysis of the proposed investment against making the expenditure(s).

Fourth, while uncertainty surrounds the calculus of the benefits of expenditures, the financial burden – the pain – that the expenditure imposes is altogether easy for taxpayers to feel. The relative tangibility of the costs and the intangibility of the benefits of any given expenditure biases decision-makers against government expenditures.

Theoretical Matters

Theory might also – perhaps should also – give pause to any decision-maker considering legislation that leads to deficit spending and the resultant increase in national debt. Two matters come to the fore: the "crowding out" effect and what I refer to as the "foreign creditor leverage" phenomenon.

Deficit spending increases national debt and necessitates that the federal government borrow monies from the financial markets (i.e. capital markets), increasing demand for available monies. Increased demand for money bids up the price of borrowing money, known as interest rates. The increased interest rates, in turn, are more likely to prove too expensive for private sector entities to finance their investments. In other words, a daisy chain of events resulting from deficit spending can "crowd out" other investments – some of which might well have been more beneficial to society than the government investments that drove deficit spending and the higher interest rates.

"Foreign creditor leverage" refers to the fact that foreign entities lend almost 40% of the monies that the federal government borrows to support deficit spending and the national debt. As deficit spending continues; as the national debt grows; and as foreign entities fund an ever larger part of the debt; the United States grows more dependent upon the willingness of those foreign entities to continue to enable our deficit spending. Two worries arise. First, those foreign entities, including those whose own national interests might be contrary to those of the United States, might be able to leverage American financial dependency to influence American policy that served their interests rather than the United States' interests. Second, if those foreign entities were to end their willingness to loan monies to the United States suddenly, they would precipitate a sudden and significant shock to United States financial markets and thus, damage or destabilize the American economy.

Questions regarding dangers of deficit spending include…

- What role do or what role should political figures fulfill to ensure that difficult-to-appreciate benefits from public expenditures are well understood?

- Is there any evidence of "crowding out" – in any period of American history?
- Are any nations which lend large amounts of monies to the United States able to disrupt American financial markets?

Hamilton's Caveats…

Hamilton himself, the enthusiast who recognized that the ability to deficit spend with debt financing was aware of the potential for problems. He insisted on a high bar to justify deficit spending, warning that deficit spending ought be "not excessive." Hamilton also emphasized that, like the Bank of England, the American entity borrowing on behalf of the country must be "a competent debtor," meaning that the bonds it issued must remain liquid and reliable. In other words, Hamilton recognized that the federal government's bonds need to be: tradable, convertible, and guaranteed to be paid upon maturity. At least two important questions arise from Hamilton's caveats.

- What amount of borrowing qualifies as "excessive?"
- What does the federal government do to assure that it remains – and always appears to be, "a competent debtor?"

… and a more Contemporary Warning

Perhaps no President of the United States since World War II was a more effective communicator than Ronald Reagan, the "Great Communicator." And perhaps no president ever was more insistent and articulate in warning against deficit spending. President Reagan referenced deficit spending in his first inaugural address.

> *For decades, we have piled deficit upon deficit, mortgaging our future and our children's future for the temporary convenience of the present.... You and I, as individuals, can, by borrowing, live beyond our means, but for only a limited period of time. Why, then, should we think that collectively, as a nation, we are not bound by that same limitation?*

The address suggested that deficit spending would decrease during his administration. Economic, political and geo-political realities, however, changed the calculus of the Reagan Administration. Indeed, during the eight year Reagan Presidency, deficit spending increased, and national debt exploded. The United States went from being the world's largest creditor nation to the world's largest debtor nation in fewer than eight years. National Debt tripled between 1980 and 1990.

Yet the wisdom of reducing, or better yet eliminating deficit spending (and decreasing national debt) still very much resonates within the Republican Party. Indeed, President Reagan's folksy appeal to commonsense, by equating the nation state's fiscal responsibility to the financial responsibilities of an individual still appeals.

Balanced budget activists, again, largely affiliated with the Republican Party also use states as standard bearers exemplifying of the advantages of maintaining balanced budgets. Many states indeed have adopted balanced budget amendments that outlaw budget deficits, and their supporters believe that the same advantages of good fiscal stewardship would benefit the federal government and thus, all Americans.

The appeal to balance budgets by equating the federal fiscal situation to individual or state government responsibilities presents us with a couple of questions.

- What are the limits of comparing an individual or an individual household's financial responsibilities to the fiscal responsibilities of the federal government?
- What are the limits of comparing an individual state's fiscal responsibilities to that of the federal government?

Conclusion

It seems that we might be able to conclude that there is a time and a place to deficit spend. We might agree, therefore, that deficit spending and the accompanying increase in national debt neither depicts existential problems, nor predicts future troubles for the nation. We might also accept, however, that deficit spending and increased national debt can be dangerous to the well-being of the nation and thus, ought not be habitual. Proposals that result in deficit spending ought to be scrutinized by government officials and the citizens who elect them.