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Deficits, Debt, and Debasement

BY SCOTT A. BEAULIER AND PETER J. BOETTKE

"Those of us who manage the public's dollars will be held to account, to spend wisely, reform bad habits, and do our business in the light of day, because only then can we restore the vital trust between a people and their government."
—BARACK OBAMA
Inaugural Address, January 20, 2009

In recent years policymakers have pushed the economy ever closer to the brink of fiscal catastrophe. Federal spending rose substantially under President George W. Bush, with the deficit reaching $460 billion in his last full year. In President Barack Obama's first two years in office, it soared to $1.4 trillion in 2009 and $1.29 trillion in 2010. Deficits are on track to remain at unprecedented levels in 2011, and President Obama's promise to halve the deficit by 2012 turned out to be the same "politics as usual" that he denounced during his campaign. Even if he made good on that promise, deficits would still be twice as high as ever before.

To be fair, the gloomy budgetary picture is not entirely Obama's fault. His is just the latest administration unwilling to tackle serious fiscal challenges. While bailouts and stimulus programs compounded the problem, its source is the big three transfer programs—Social Security, Medicare, and Medicaid. Together, these programs consume approximately 10 percent of U.S. gross domestic product. By 2052 they will reach 18.2 percent of GDP and, assuming tax collections remain at their long-term levels, will absorb all federal tax revenue collected by the government. In other words, no discretionary spending and no defense spending will be possible by 2052 unless tax revenue increases or the government

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At a Cato Institute Conference in April, SEN. MIKE LEE (R-UT) called for a balanced budget amendment to address the burden of federal spending in Washington. Lee also attended a private breakfast held at Cato in June, where he talked with Cato analysts about several policy issues. **PAGE 14**

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slashes benefits to these three programs.

BREAD AND CIRCUSES

An inevitable crisis seems the almost certain outcome of America's deficits and debts. The massive increases in transfer spending, coupled with steady growth in discretionary and defense spending, mean that large deficits will haunt America for the foreseeable future. Deficits occur when government expenditures exceed tax revenues, leading to higher interest rates and crowding out private investment. They generate unpredictability in policy, as they herald rising taxes. Since deficits cannot be left unpaid, governments normally finance them by issuing bonds that promise to repay the principal (with interest) over a period of time.

Most troubling, deficits add to our already high federal debt. Publicly held debt currently stands near 60 percent of GDP and, according to the Congressional Budget Office, will rise to 90 percent by 2021. As debt rises, interest rates rise, taxes on future generations rise, and politicians inflate the currency to hide their profligate spending. To pay off this debt, the government must run surpluses, which occur when tax revenues exceed spending. If the government is unable to generate surpluses, a third and far more dangerous option can be employed to eliminate long-term debt: debasing the currency.

Debasement is the "pretend payment" of debt that occurs when governments inflate their currency by printing money. It's a problem of nearly every government, from the "bread and circuses" of ancient times through today. In the 18th century, governments debased their currencies by trimming metal coins and recirculating them. By making a coin worth less in real terms, governments throughout Europe were able to spend beyond their means. "The honour of a state is surely very poorly provided for," Adam Smith wrote in 1776, "when in order to cover the disgrace of real bankruptcy, it has recourse to a juggling trick of this kind."

Today, paper money limits governments' ability to physically trim the edges of metal coins. But by printing money to pay off debts, governments debase the currency and ultimately erode its purchasing power. Simply put, they are using a slight variation of the same "juggling trick" to achieve their ends: by pushing the debt problem into the future, they hide the full cost of repayment to the public.

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As a result, the symptoms of debasement are not always easy to recognize. Yet several recent indicators have been revealing. The Federal Reserve's balance sheet, for instance, has expanded from its long-established level of $800 billion to $2.9 trillion. This expansion in the money supply helped fuel a bond market rally that resulted in artificially low Treasury yields. The Fed's direct interventions into the mortgage-backed security market have held mortgage rates at record lows as well. By purchasing toxic assets private investors weren't interested in, the Fed artificially expanded the money supply. As more money entered the system, prices rose and each dollar lost some of its value.

Inflation is always and everywhere the result of monetary expansions, and its pernicious effects are becoming palpable. Commodity prices are all nearly twice as high as they were in 2008. Prices for education and health care continue to rise rapidly. Consumer price increases, when food and energy are included, are well above levels a central bank would normally be comfortable with. And prices for technologies like cell phones, personal computers, and televisions are not falling as rapidly as they should be.

The distortions in these prices indicate that debasement is already taking place—and it stems from problems that economists have been warning about for decades.

Historically, the public accepted deficits and debts only in response to major wars and huge economic crises. During World War II, for example, public debt increased to nearly 109 percent of GDP. Yet after the war, the government made a concerted effort to pay down the debt, reducing it to 50 percent of GDP by 1956 and 24 percent by 1974. The experience of the last 30 years, however, shows that deficit spending is no longer an emergency response to catastrophe. In 1980, America's total national debt stood at $1 trillion. Over the next three decades, it grew 14-fold—without a major depression or world war. Deficit spending has become business as usual, and we're quickly approaching the point where repayment is impossible.

HOLDING A TIGER BY THE TAIL

Politicians are unable to address our current fiscal challenges in part because they rely on flawed Keynesian arguments to justify their spending. Simplistic Keynesianism argues for greater government spending when the economy softens, followed by spending cuts when the economy returns to growth. But this rests on the crucial assumption that politicians act benevolently, in the interest of the overall economy. It assumes politicians will exercise fiscal restraint.

The historical record since Lyndon B. Johnson's "Great Society" suggests otherwise: politicians, regardless of party, do not follow Keynesian assumptions. Instead, they spend during the bad times and during the good times. There are, of course, good public choice reasons why politicians cling to Keynes: he offers an economic justification for promising everyone everything! Politicians therefore achieve success through a simple mantra: "Spend 'em if you got 'em, and spend 'em if you don't."

Government officials don't want to lose popularity by raising taxes and cutting spending. Instead, they employ juggling tricks to give the illusion of paying their bills. The Treasury finances government expenditures by floating bonds to the public, and the Federal Reserve steps in as buyer whenever the Treasury is unhappy with the market interest rate. The process is referred to as monetization, but really it's debasement, and it stems in part from the fact that it is difficult to keep the Fed and the Treasury separate.

In fact, some have said that the idea of a separate Fed and Treasury is utopian, that the two offices within government will remain forever entangled. The 1974 Nobel Prize winner in economics, F. A. Hayek, called the monetary and fiscal policy dance an exercise in "holding a tiger by the tail." In 1969, while discussing the broad, inflation-borne prosperity affecting Venezuela and much of the Western world, Hayek said:

> How long can this inflation continue? If the tiger [of inflation] is freed, he will eat us up; yet if he runs faster and faster while we desperately hold on, we are still finished!

Hayek's message was that inflation leads to a misallocation of resources. During inflationary periods, the structure of production gets distorted and higher-order, capital-intensive goods like housing get overproduced. At some point during the inflationary cycle, central bankers face a choice of either inflating more or contracting the money supply. When the money supply is contracted, the capital-intensive "boom" finally "busts." According to Hayek, any attempt by policymakers to address the misallocation through deficit spending—letting the tiger run faster—creates further distortions and a greater misallocation. By keeping prices and interest rates away from their natural levels, fiscal and monetary interventions simply prolong the inflationary cycle and prevent a return to normal, long-run conditions. Two decades after his death, Hayek's "tiger by the tail" critique of Keynesian policies remains as relevant as ever.

In 1977 James Buchanan and Richard Wagner warned about the political legacy of Keynesian economics. "Sober assessment suggests that, politically, Keynesianism may represent a substantial disease," the two wrote in *Democracy in Deficit*, "one that can, over the long run prove fatal for a functioning democracy." If economic policies are not somehow constrained by rules and supermajorities, deficits are the predictable outcome of democracy. "The bottom line: political capitalism is not laissez faire capitalism," they write. "To continue down our current path is to reinforce the perverse folly of politics that has threatened the viability of the current economic system."

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TYING THE JUGGLER'S HANDS

There are several ways we can constrain the juggler in an attempt to reverse our current course. The first involves tying the juggler's hands. The federal government could adopt a balanced-budget amendment, for instance—one similar to those constraining many states. This would limit the government's fiscal authority through constitutional mechanisms, with the goal of confining levels of taxation and balancing the budget. Such an amendment would be quite popular with voters, though obviously less so with elected officials, and it could choke off the fuel needed for deficits, debts, and debasement.

To provide a further safeguard against this cycle, legislative steps could be taken to separate the Fed from the Treasury. The two currently work as "partners," but by any measure they are dangerous bedfellows. Reform that better defines the roles of the organizations could greatly reduce the threat of debasement. One such step would be to limit the kinds of bonds the Fed can purchase from the Treasury. For example, the second round of quantitative easing (QE2) would not have been possible had there been a rule saying the Fed cannot buy long-term bonds from the Treasury. A vast literature in monetary economics has consistently found that more independent central banks outperform ones where the fiscal and monetary authorities are closely aligned. Other rules—along the lines of antitrust restrictions—that limit Fed and Treasury interaction would also be worth considering.

Because it is difficult to imagine members of Congress taking actions that tie their own hands, these steps would ideally be augmented with more radical fiscal reform. Reverse revenue sharing would get the federal government out of the business of taxation and would instead allow for 50 different experiments in optimal taxation across the different states. Unlike the Articles of Confederation, which encouraged free-riding by states, each state could be required to contribute a certain amount to the federal government. But, rather than be hampered by one-size-fits all federal taxes, individuals could choose from different tax regimes in various states. Reverse revenue sharing reduces many of the problems of our current federal system—special-interest groups become less relevant and centralization declines.

LIMITING THE JUGGLER'S TRICKS

We fully recognize that we're a long way from a world where federal balanced budget amendments and reverse revenue sharing programs are the preferred policy options. But we firmly believe we are a long way down the bankruptcy path, and any kind of turnaround requires far more drastic action than typical policy measures. To ensure the juggler has fewer tricks at his disposal, goods and services provided by government must be shifted to the market and privatization must be embarked on.

Our current entitlement programs, for instance, are unsustainable. The plan to reform Medicare being advanced by Rep. Paul Ryan is an acknowledgement that we are on an unsustainable entitlement path, and his commitment to rein in spending is commendable. But these reforms still fall short because they leave power in the hands of the juggler. What is really needed is reform that fully shifts medical coverage for the elderly and the poor from the public sector to the market. Reforms that fall short of full privatization still leave the juggler with tricks on hand.

Even more fundamental than privatizing

entitlements would be to strip the government of its control of the money supply through a return to the gold standard, a monetary rule, or "free banking." Reforming the Fed and chasing after the "separate Fed and Treasury" ghost has proven futile, and it may be time to acknowledge that our central banking system has failed. While there would certainly be transitional costs to work through and consider in the short-term with a move to free banking, a decentralized monetary regime would help to check and constrain any particular bank aiming to overexpand the money supply.

ENDING THE CYCLE

Many of the policy recommendations we are making ask politicians to fall on their own swords for the sake of financial solvency. While these reforms are admittedly radical, the alternative is undoubtedly more extreme. To see why, it is worth expanding on Adam Smith's juggling metaphor from earlier. In the final chapter of *The Wealth of Nations*, Smith observed:

> When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. . . . Publick bankruptcy has been disguised under the appearance of a pretend payment. . . . When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor and least hurtful to the creditor. The honour of a state is surely very poorly provided for, when in order to cover the disgrace of real bankruptcy, it has recourse to a juggling trick of this kind. . . . Almost all states, however, ancient as well as modern, when reduced to this necessity, have upon some occasions, played this very juggling trick.

"We are currently faced with a problem of unprecedented magnitude, one that should justify giving unconventional reforms a seat at the table."

Federal bankruptcy—whether it occurs through debt repudiation or a more orderly process of restructuring—would serve as a sobering wake-up call. The municipal bankruptcies some cities and counties have faced in recent years, along with the state budget crises afflicting most states, are grim portraits of what bankruptcy at the federal level would look like. People promised benefits would see their expectations dashed. Taxes across the board would rise. Interest rates on future debt issuance would soar. The long-term consequences of reneging on our promises would be difficult to estimate in full. As such, we are currently faced with a problem of unprecedented magnitude, one that should justify giving unconventional reforms a seat at the table.

After vowing "to spend wisely, reform bad habits, and do . . . business in the light of day," President Obama instead accelerated the country down the path of overspending, made unsustainable promises, and used the Fed to conceal the full cost of government profligacy. Perhaps our best hope now is to consider measures that fundamentally challenge the system, and finally break free from the cycle of deficits, debt, and debasement. ■

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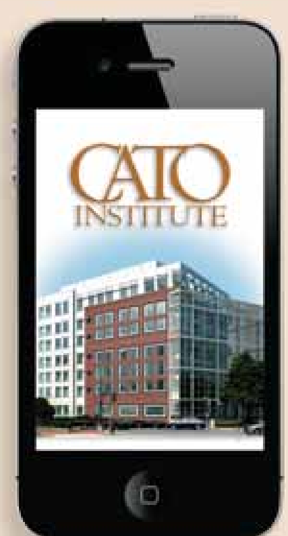

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