

CHAPTER TWO

**FEDERAL DEBT IN HISTORICAL
PERSPECTIVE**

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The federal government will spend \$4.6 trillion and raise \$3.6 trillion in revenues in 2020. The resulting \$1 trillion deficit will be financed by borrowing and add to accumulated federal debt of \$17 trillion, which is more than \$130,000 for every U.S. household.¹

Federal debt has more than doubled over the past decade. When measured against the size of the economy, it is the highest in our nation's peacetime history. Rising debt will impose a huge burden on future taxpayers and could trigger a financial crisis that will further undermine our prosperity.

Historically, federal government debt spiked during wars but was always paid down when crises subsided. Today, lawmakers are running massive deficits even though the nation is not at war and is enjoying strong economic growth. Official projections show a nonstop gusher of red ink in coming years as federal entitlement programs balloon in cost.

This essay looks at the history of federal debt and describes five types of harm that it causes. It concludes that policymakers should cut spending to balance the budget and reduce debt. Spending cuts would spur growth by reducing the economic distortions caused by many programs. Cuts would also reduce the risk of a financial crisis and avert pressure to impose harmful tax increases down the road.

JEFFERSONIAN FISCAL PRUDENCE, 1790–1930

America was born with a hefty load of government debt, which had been issued to finance the Revolutionary War. Following Alexander Hamilton's plan, Congress transferred state government debts to the federal government in 1790, creating a total federal debt of \$75 million. Hamilton and the Federalists were in no rush to pay off the debt, and by the end of John Adams's administration in 1800 debt had edged up to \$83 million.

Thomas Jefferson assumed the presidency in 1801, promising to end internal taxes, restrain spending, and pay down the debt.² In a 1799 letter to Elbridge Gerry, Jefferson said, "I am for a government rigorously frugal & simple, applying all the possible savings of the public revenue to the discharge of the national debt."³ Jefferson followed through on his promises with the help of his outstanding Secretary of the Treasury Albert Gallatin.⁴ They kept total spending roughly flat over eight years and were able to pay down a substantial part of the federal debt, even with added borrowing to pay for the Louisiana Purchase.

Figure 2.1 shows federal debt as a percent of gross domestic product (GDP) back to 1790.⁵ Debt fell from 30 percent of GDP in 1790 to 6 percent by 1811. But then the nation entered the War of 1812, and the government again began borrowing heavily. Debt increased to 10 percent of GDP by 1815.

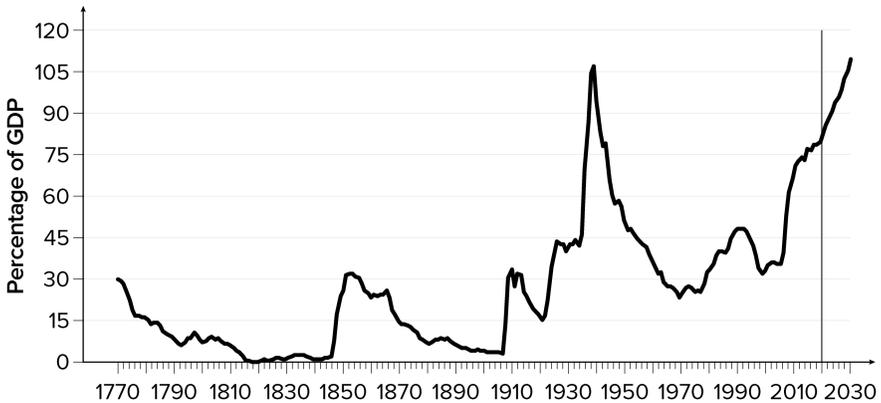
After the war, policymakers were able to cut spending, and they began to focus on the goal of becoming "wholly free" of federal debt.⁶ By the 1820s, policymakers were running surpluses in most years, and in his 1824 State of the Union message, President James Monroe said that federal debt could be fully paid off by 1835.

That prospect caught the imagination of many political leaders who believed in both the moral and the practical benefits of debt freedom. They associated government debt with corruption and the erosion of liberty. Debt freedom was also favored by the public, which strongly supported frugality in the federal government.⁷

With policymakers focused on debt elimination, numerous efforts to expand spending during the 1820s and 1830s were foiled. Some members of Congress—such as Henry Clay of Kentucky—wanted the government

FIGURE 2.1

Federal government debt held by the public, percentage of GDP



Sources: Congressional Budget Office (CBO), “Historical Data on Federal Debt Held by the Public,” August 5, 2010; Amber Marcellino, “Updated Historical Budget Data Following BEA’s Recent Update of the National Income and Product Accounts,” CBO blog, August 12, 2013; CBO, “The 2013 Long-Term Budget Outlook,” September 17, 2013.

Note: GDP = gross domestic product.

to fund “internal improvements.” And President John Quincy Adams had grand plans to fund roads, canals, a national university, and many other items. However, such spending plans conflicted with the popular goal of debt freedom, and they were blocked in Congress. Opposition to spending came from members such as Martin Van Buren of New York and John Randolph of Virginia.

President Adams was replaced in 1829 by Andrew Jackson, who was a firm believer in debt freedom. In his first inaugural address, he promised “extinguishment of the national debt, the unnecessary duration of which is incompatible with real independence.”⁸ Jackson succeeded in his goal, making the period from 1835 to 1837 the only time in our history that the federal government has been debt-free.⁹ Unfortunately, borrowing resumed when the economy plunged into recession after the Panic of 1837.

During the 1850s, the government ran surpluses nearly every year, and the federal debt plunged to just 1 percent of GDP. Massive spending

during the Civil War caused debt to spike to 31 percent of GDP during the 1860s. But then the Jeffersonian tradition reasserted itself, and lawmakers reduced the debt in subsequent years to just 3 percent of GDP by the beginning of World War I. The government balanced its budget every single year from 1866 to 1893.

Debt peaked at 33 percent of GDP in 1919 as a result of the war, but it was then reduced under Presidents Warren Harding and Calvin Coolidge. The 1920s were the last hurrah for the Jeffersonian anti-debt tradition, which had been part of our unwritten “fiscal constitution,” as numerous scholars have called it.¹⁰

KEYNESIAN PROFLIGACY, 1930–2020

In his 2014 book, *America’s Fiscal Constitution*, Bill White argued that the anti-deficit stance of federal policymakers lasted from 1790 through Bill Clinton’s presidency but then “collapsed” under President George W. Bush.¹¹ It is true that Bush presided over deficits and increased spending, but so have many presidents since Herbert Hoover. White’s timing is off: the real dividing line in America’s fiscal history was the 1930s.

Before the 1930s, policymakers kept federal spending very low. From 1790 to 1929, federal spending averaged just 2.7 percent of GDP, even including the war years during that period.¹² As late as the 1920s, spending was less than 4 percent of GDP. Yet starting in the 1930s, spending began a precipitous climb, reaching the current level of about 20 percent of GDP by the late 1970s.

Before the 1930s, policymakers not only kept spending in check, but also believed strongly that running deficits and racking up debt was immoral and bad for the economy. Those beliefs restrained the basic incentive politicians face to spend more on their constituents than the available tax revenue.

Two developments during the 1930s undermined the anti-debt ethos and shifted the federal government toward deficit spending. First, the creation of entitlement programs—such as Social Security—allowed for automatic annual spending increases without policymakers having to vote for them. Autopilot spending induces political irresponsibility.

Today, entitlement programs account for two-thirds of all noninterest federal spending.¹³

Second, the rise of Keynesianism beginning in the 1930s misinformed policymakers that deficit spending was good for the economy. Nobel Prize-winning economist James Buchanan points his finger at Keynesian economics for the decline in beneficial “Victorian fiscal morality,” which had focused on balancing budgets and limiting debt.¹⁴ With the rise in Keynesianism, the “modern era of profligacy” was born, Buchanan said.¹⁵

Figure 2.1 shows a sharp spike in federal debt in the 1930s and 1940s as a result of the Great Depression and World War II.¹⁶ Federal debt peaked at 106 percent of GDP in 1946. But the importance of entitlements and Keynesianism grew over the decades, paving the way for almost continuous deficit spending since the 1970s.

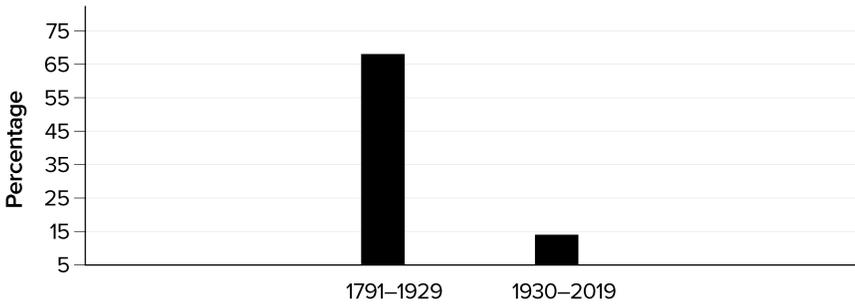
In the figure, it appears that policymakers were fiscally prudent after World War II because the debt-to-GDP ratio falls rapidly. Actually, that fall was not due to policymaker frugality. Indeed, the government ran deficits in 7 out of 10 years in the 1950s.

Then what caused the fall in debt after the war? First, strong GDP growth helped produce a falling ratio of debt-to-GDP. Second, the debt was greatly reduced by inflation. Inflation reduces the real value of outstanding debt, and thus imposes losses on creditors. The ability to reduce the debt by inflation depends upon the debt’s maturity and on whether creditors expect inflation. If the average maturity is long, the government can reduce the real debt load with an unexpected bout of inflation.

That is what happened following World War II. The federal debt-to-GDP ratio was cut almost in half between 1946 and 1955. Economists Joshua Aizenman and Nancy Marion found that nearly all of that drop was due to relatively high inflation during that period combined with a long average federal debt maturity of nine years.¹⁷

By the mid-1970s, the average maturity of federal debt had shrunk to just three years, so the high inflation in that decade resulted in little debt shrinkage.¹⁸ The debt-to-GDP ratio started rising again in the

FIGURE 2.2
Percentage of years with balanced federal budget



Source: Author's calculations.

1980s and peaked at 48 percent by the early 1990s. Debt fell during the late 1990s as a result of budget restraint and an economic boom.

In the new century, all fiscal restraint has been put aside, and debt soared to \$17 trillion by 2019, or 78 percent of GDP.¹⁹ This measure of debt is “debt held by the public,” which captures the effect of federal borrowing on credit markets.

Today’s federal debt ratio is easily the highest in America’s peacetime history, and it will keep on growing unless Congress makes major budget reforms. Figure 2.1 shows that under the Congressional Budget Office (CBO)’s “alternative fiscal scenario” debt is expected to rise to 109 percent of GDP by 2030.²⁰ Thus, The United States could have World War II levels of debt just a decade from now, and even higher levels after that.

The bipartisan belief that balancing the budget is both prudent and morally proper largely disappeared after the 1930s. From 1791 to 1929, the government balanced its budget 68 percent of the years.²¹ But from 1930 to 2019, the government balanced its budget just 14 percent of the years, as shown in Figure 2.2.

In his history of the Jackson-era effort to eliminate the federal debt, Carl Lane concludes, “Debt freedom, Americans in the Jacksonian era believed, would improve the material quality of life in the United States. It would reduce taxes, increase disposable income, reduce the privileges

of the creditor class, and, in general, generate greater equality as well as liberty.”²² That is the type of sound fiscal thinking that we need to revive today.

THE PROBLEMS WITH GOVERNMENT DEBT

Over the years, numerous economists and pundits have argued that federal debt does not matter much because we “owe it to ourselves.”²³ *New York Times* columnist Paul Krugman has disparaged analysts who express concern about deficits, and he has argued that high government debt is not at all like high family debt. He says that government debt does not hurt future generations because it is mainly “money we owe to ourselves.”²⁴

Krugman is wrong, and his view is a minority one among economists. The Congressional Research Service says that “the current consensus among economists is that the burden of the national debt is largely shifted forward to future generations.”²⁵ Rising federal debt will impose real pain in the years ahead. Contrary to Krugman, the dangers of families and governments getting deep into debt are similar. Economist James Buchanan argued, “For citizens, the national debt is fully analogous to a private debt that has been incurred to finance a consumption spree in some past period.”²⁶

To understand the harm of debt, first consider the effects of government spending financed by taxes. Such spending may damage the economy in two ways:

1. *Spending distortions.* Most federal spending goes toward subsidy and benefit programs. Such spending distorts the economy, and thus reduces overall output and incomes.²⁷ For example, Social Security reduces private savings, welfare programs reduce work incentives, and farm subsidies induce overproduction. These distortions cause economic damage, which economists call “deadweight losses.”
2. *Tax distortions.* The taxes to fund federal spending cause additional deadweight losses. That is because higher taxes induce

people to change their working, investing, and consumption activities, which misallocates resources. Economists estimate that the deadweight losses from each one dollar increase in federal income taxes is roughly 50 cents, including about 10 cents for the added compliance or paperwork costs.²⁸

Suppose that the government spends \$10 billion on a new subsidy program financed by income taxes. The program will cost the private economy about \$15 billion when the deadweight losses of the higher taxes are included. If this new program creates distortions, or is poorly executed, it may produce benefits of perhaps just \$5 billion. That would create an overall ratio of costs to benefits of three-to-one.

Economist Edgar Browning examined the effects of federal tax and spending programs in his book *Stealing from Each Other*. As a ballpark estimate for the overall federal government, he concluded that “it costs taxpayers \$3 to provide a benefit worth \$1 to recipients.”²⁹

Now consider the effects of federal spending financed by borrowing:

1. *More spending induced.* The deadweight losses caused by spending on subsidy and benefit programs are the same whether programs are financed by debt or current taxes. However, the availability of debt financing may induce policymakers to increase overall spending, particularly on low-value programs. Since borrowing makes programs appear to be “free” to citizens and policymakers, the government has less incentive to be frugal and prune low-value programs.³⁰
2. *Tax damage moved to the future.* With borrowing, the deadweight losses from taxes are moved to the future when taxes are raised to pay the interest and principal on the debt. The damage from the funding of programs is imposed on people down the road because that is when the government will use coercion to extract the needed money from taxpayers.
3. *Reduction in investment.* Government borrowing may reduce national saving, and thus crowd out private investment, reduce the U.S. capital stock, and reduce future output and incomes.³¹

James Buchanan said, “By financing current public outlay by debt, we are, in effect, chopping up the apple trees for firewood, thereby reducing the yield of the orchard forever.”³² A decline in investment may be partly or fully averted if private saving rises to offset government deficits.³³ But the CBO concludes, “the rise in private saving is generally a good deal smaller than the increase in federal borrowing, so greater federal borrowing leads to less national saving.”³⁴ Government debt may also deter investment as a result of business expectations. Businesses may be reluctant to make long-term investments if high and rising debt creates fears of tax increases down the road.

4. *Borrowing from abroad.* A decline in private investment as a result of government borrowing may be avoided by net inflows of capital from abroad. In recent years, huge federal borrowing has been facilitated by global capital markets. In 2018, 39 percent of federal debt was held by foreigners.³⁵ Borrowing from abroad may prevent a fall in domestic investment, but it does not prevent the shifting of costs to future generations. That is because some share of the future earnings of Americans will be taxed to pay the interest and principal on the debt held by foreign creditors. For this portion of federal debt, Americans certainly do not “owe it to themselves.”
5. *Macroeconomic instability.* The CBO echoes many experts when it warns, “A large and continuously growing federal debt would . . . increase the likelihood of a fiscal crisis in the United States.”³⁶ High levels of government debt tend to result in lower growth and increased financial fragility in nations and the global economy.³⁷ In their study of hundreds of financial crises in history, Harvard professors Carmen Reinhart and Ken Rogoff conclude, “again and again, countries, banks, individuals, and firms take on excessive debt in good times without enough awareness of the risks that will follow when the inevitable recession hits.” Government debt, they find, “is certainly the most problematic, for it can accumulate massively and for long periods without being put in check by markets.”³⁸

James Buchanan uses a simple story to illustrate the error in the “we owe it to ourselves” claim.³⁹ Suppose a lender, L, lends \$100 to a borrower, B, who spends it on consumption. L will have \$100 less in cash but his “notes receivable” will go up \$100. B has a liability of \$100, but he has no asset because he spent the cash. Now let’s say that L and B get married, and they combine their finances. B’s liability and L’s notes receivable cancel out. L and B “owed it to themselves” and the debt disappears.

However, the \$100 that B spent initially is now gone. If that money had instead been put into a productive investment, the married couple would now be wealthier by \$100 or more. Buchanan notes that incurring debt “to finance current consumption will permanently decrease the flow of potentially available income.”⁴⁰

It is true that the future net burden of federal debt would be reduced if government borrowing was used for high-value capital investments. But that is usually not the case: federal investments are often mismanaged and misallocated. Reporting on the government’s \$80 billion annual investment in information technology, the Government Accountability Office found that “investments frequently fail, incur cost overruns and schedule slippages, or contribute little to mission-related outcomes.”⁴¹ Other types of federal investment are similarly wasteful, such as capital spending by the Army Corps of Engineers and Federal Transit Administration.⁴²

More importantly, only a tiny share of federal borrowing and spending is for capital investment purposes. Within the \$4.6 trillion federal budget in 2020, just 3 percent will be spent on nondefense “major physical capital investments.”⁴³ Thus, today’s huge federal deficits are not being caused by investment spending but by consumption spending on benefit and subsidy programs.

CONCLUSIONS

Rising federal debt undermines economic growth and stability, and it imposes an unfair burden on taxpayers in the future. Policymakers used to understand the harms of debt better than they do today. Thomas Jefferson was right that “the multiplication of public offices, increase of

expense beyond income, growth and entailment of a public debt, are indications soliciting the employment of the pruning-knife.”⁴⁴

Congress should take a pruning knife to the budget and identify programs in every department to terminate.⁴⁵ One factor that makes spending cuts a pressing issue is that even CBO’s scary outlook of rising debt shown in Figure 2.1 may be optimistic. America may face unforeseen military challenges or endure another deep recession in coming years, which would make deficits worse than projected. Also, interest rates and other economic variables may not be as favorable as expected. The best way to prepare for the nation’s uncertain future is to cut spending, end deficits, and begin paying down the debt before the next crisis hits.

To that end, we should consider structural changes to encourage policymakers to be more fiscally responsible. One option is adding a balanced budget amendment to the Constitution. In 1798 Thomas Jefferson wrote, “I wish it were possible to obtain a single amendment to our constitution . . . I mean an additional article taking from the federal government the power of borrowing.”⁴⁶

However, there may be better methods of restraining spending than a balanced budget amendment, as other essays in this book consider. One simple alternative would be to cap the annual percentage growth in total federal outlays.⁴⁷ Congress directly controls spending, not deficits, so spending is the best target for a budget limit. Perhaps a combination of structural reforms would be the best solution for the fiscal mess in Washington.

Channeling Thomas Jefferson, Franklin Roosevelt said in a 1932 radio address, “Let us have the courage to stop borrowing to meet continuing deficits. Stop the deficits. . . . Any government, like any family, can for a year spend a little more than it earns. But you and I know that a continuation of that habit means the poorhouse.”⁴⁸ Unfortunately, when he was elected president later that year, Roosevelt put Jefferson aside, and imposed the pro-spending and high-debt policies of Alexander Hamilton, which still bedevil the American economy today.