CHAPTER 11

THE MYTHOLOGY OF DEFICITS

with Lauren J. Feinstone

At the rate of one dollar per second, it would take over one hundred thousand years to pay off the national debt. Such facts titillate, but they do not enlighten. Unfortunately, they have come to pervade public discourse. As a result, the public’s understanding of debt and deficits is almost nonexistent. In its place is a collection of unsubstantiated beliefs—myths, if you will—that are routinely and uncritically repeated in the halls of Congress and on the nightly news. These myths have become almost as widespread as they are indefensible. Yet a few basic principles, easily mastered, suffice to clear the mind.

The myths about the deficit underlie three grand misconceptions. One is that the numbers that are officially reported and widely analyzed are actually reflective of anything approaching economic reality. Another is that government deficits clearly cause high interest rates via simplistic mechanisms that people think they understand. A third is that certain identifiable groups (“future generations,” the private sector generally, the export industry in particular) are clearly and unambiguously hurt by deficits.

Each of these grand misconceptions arises from several subsidiary myths that we shall dissect individually. Before doing so, we want to present a parable that will clarify all of the important issues related to government debt. We will then return to the grand misconceptions and the myths that underlie them.
A PARABLE

Suppose that you engage a purchasing agent to do your clothes shopping for you. This agent is empowered to make certain decisions on your behalf. First, he must decide how much to spend on the various components of your wardrobe. Second, he must decide how to finance those purchases.

In order to focus on the second of these decisions, let us suppose that your agent has already resolved to spend $100 on your clothes. There are three methods of financing available to him. First, he can withdraw $100 from your bank account and use it to pay for his purchases up front. Second, he can charge the purchases to your credit card and settle the debt a year from now. In this case, the credit card bill to be paid off next year will be $110—the $100 principal and $10 interest (assuming an annual interest rate of 10%).

There is also a third option—the agent can charge the $100 to your credit card with no intention of ever paying off the principal. In this case, you will be billed for $10 interest every year, ad infinitum, and your agent will withdraw $10 a year from your bank account to meet these payments.

Now the question is, Which payment scheme do you prefer? To investigate this, let's consider what your financial status will be one year hence under each of the three options.

We have assumed a prevailing interest rate of 10% and will suppose that your $1,000 bank account is earning this prevailing rate. This means that in the absence of any clothes purchases, your balance would rise to $1,100 by this time next year. Any of the three plans that your agent can adopt will partially deplete this $1,100; let's see by how much.

Plan A removes $100 from your bank account today, reducing it from $1,000 to $900. A year from now that $900 will have earned $90 in interest, and your balance will be $990. This is $110 less than the $1,100 that you would expect to have if you hadn't purchased any clothes. Where did the $110 go? Exactly $100 was used to buy your clothes; the other $10 is interest forgone as a result of paying for the clothes at the time of purchase.

Under Plan B, no payments are made until next year. At that time, your bank balance will be $1,100 (just as if no purchases
had been made, because nothing has been withdrawn). From this, your agent will withdraw $110 to pay the credit card bill ($100 principal plus $10 interest), leaving you with a balance of exactly $990.

In other words, Plans A and B ultimately deplete your bank balance by identical amounts. In either case, your clothes have cost you $110 by the end of the first year. Under Plan A you forgo earning $10 in interest, while under Plan B, you earn $10 in interest and then send it along to the credit card company.

There is also Plan C, under which the purchases are charged and never paid off—a policy of “eternal deficit.” How does your bank balance look after a year on this plan? From a balance (one year from now) of $1,100, your agent will deduct $10 for the first annual interest payment. This leaves you with $1,090 in liquid assets—or does it? Knowing that you are committed to making payments of $10 a year forever, you will be forced to set aside a fund from which to make these payments. How large a fund will you need? The answer is exactly $100, because this will earn an interest payment of $10 a year forever, which is what you need to meet your obligations.

In other words, your bank balance is $1,090, but of this there is $100 that you dare not withdraw. This leaves you with usable assets of $990—exactly the same as you would have under Plans A and B.

Questions of finance, then, can safely be left in the hands of your purchasing agent, and you need not concern yourself with what he decides. It is true that if your agent plunges you into debt, you will incur interest obligations. It is also true that through deficit financing, he allows your assets to earn interest that would otherwise be forgone. When you assume a debt, the costs and the benefits cancel each other out exactly. The issues of whether to run a deficit—and if so, for how long—are of no consequence.

Of course, other issues are of consequence. Specifically, the decision to spend $100 on clothes—which we have been taking as given throughout this discussion—does matter to you, even if the method of financing does not. If you consider a $100 clothes budget to be either overly profligate or overly penurious, you may be very unhappy with your agent, and you may wish to fire him.
been withdrawn). From the point of view of the credit card company, you have a balance of $1,090, but of this there would have under Plans A and B.

In the same way, you may be very unhappy with a government that spends either more or less on various programs than you would prefer. But once this level of spending has been chosen, there are only three ways for the keepers of the Treasury to finance it. They can tax you today. They can borrow money and pay it off (with interest) at some fixed time in the future, taxing you enough then to meet their obligations. Or they can borrow money and roll over the debt forever, periodically taxing you enough to meet the interest payments. The analogy of government as purchasing agent suggests that it doesn’t make a bit of difference to you which method is selected.

Now this parable is undoubtedly too simple, for a number of reasons. If you expect to die in six months, and if you don’t care about the size of your bequest, then you can come out ahead by running up huge debts due a year from now. (On the other hand, if you view your heirs’ well-being as an extension of your own, the analogy is restored.) It is also the case that individuals may have preferences between being taxed now and being taxed later if they expect their tax liabilities (e.g., their incomes) to change substantially between the two periods.

But the analogy is still a powerful one, which suggests that if deficits do “matter,” then they do so for rather subtle reasons. It demonstrates that deficits, in and of themselves, are no better or worse than taxation and makes it plausible that our primary concern should be with the level and composition of government spending, rather than with how that spending is financed. These are themes to which we shall return.

**MYTHS ABOUT WHAT THE NUMBERS MEAN**

The official measurements of government spending (and consequently of government deficits) arise from a hodgepodge of numbers that are arbitrarily added together with no theoretical justification. These figures include actual consumption of goods and services by the government, a measure of how much the government pays in salaries, and current interest payments on government debt. But they don’t include capital expenditures on infrastructure and defense, and they don’t include the gains or losses on government investments. In fact, the story becomes more realistic when we replace your clothes buyer with the government. We have been assuming that your bank account earns the same rate of interest at which you borrow from the credit card company. This may seem objectionable. But the interest payments on government debt are at the Treasury bill rate—which you can earn by the simple expedient of buying Treasury bills.
resources by the government (e.g., spending for education or the military), transfer payments (like Social Security), and interest on past debt. The result of adding together these apples, pears, and oranges (and then subtracting tax revenues to compute a deficit) has no economic significance, although it appears to be a powerful totem in our society. Government agencies attempt to estimate it, newspapers solemnly report it, and pundits agonize over it. None of them ever seems to ask what the number signifies. Here are some of the myths underlying the widespread acceptance of this meaningless calculation.

Myth 1: Interest on past debt is a burden. Interest payments on past debt are included in the calculation of the deficit, which implies that these payments add to the taxpayers’ burden. The parable of the purchasing agent reveals this to be false. Interest payments on past debt are precisely offset by the interest we earn when we defer our tax liability. This point is crucial. Government borrowing allows us to defer paying our taxes, just as his credit card allows the clothes buyer to defer paying his clothing bill. This allows taxpayers to earn interest on their own assets for a longer period of time, which exactly cancels the “burden” of eventually paying interest on the government debt.

It follows that interest on past debt should not be included in any meaningful measure of government spending or government deficits. But it always is included, and as a result all reports of the size of the deficit are grossly overestimated."

Myth 2: A dollar spent is a dollar spent. That is, a dollar spent in erecting a government office building (which uses up steel, glass, labor, etc.) is the equivalent of a dollar paid out by Social Security (which makes one person richer and another poorer without actually consuming anything). Clearly this is false, and any number that results from pretending it is true must be highly suspect.

Myth 3: Inflation doesn’t count. In fact, inflation is an enormous boon to any debtor, including the government. If the government owes a trillion dollars and inflation is at a rate of 10% per year, then in the course of a year the real value of government debt is reduced by 10% of $1 trillion (or $100 billion).

*Ironically, politicians often depict interest on past debt as the most burdensome component of the deficit!
That $100 billion is government revenue, just as surely as $100 billion raised in taxes is government revenue, and it ought to be counted as such. It isn't. After correcting for this missing revenue, Prof. Robert Barro of Harvard University found that the federal government ran a surplus as recently as 1979 and annual deficits of under $10 billion in the first two years of the Reagan administration!

Myth 4: Promises don't count. Suppose that a new president promises to increase government spending on highways, education, and other forms of infrastructure. Even before the program gets underway, the president's commitment to future spending is a form of debt (just as it is a form of debt if I promise today that I will deliver a $100 check to you next week) and should probably be counted in calculating the current deficit. It isn't.

The measurement problem becomes subtler when there is legitimate uncertainty about either the president's sincerity or his ability to deliver. If I promise to deliver you a $100 check next Tuesday and neither of us is sure whether you should take me seriously, have I incurred a debt or haven't I?

It is by no means clear how to solve that measurement problem; we raise it to point out that any potential solution is open to legitimate criticism, so that any single measure of the deficit can be legitimately dismissed as wildly incorrect.

The government's biggest outstanding promise is to continue the Social Security program. Whether this promise is counted as a debt makes an enormous difference in calculating the deficit. Laurence Kotlikoff, the recent author of *Generational Accounting*, puts the matter this way: According to the government's accounting, payments from workers and employers to the Social Security system count as taxes, and benefits that the system pays to retirees count as transfer payments. It would be equally legitimate to adopt an alternative accounting system under which payments from workers and employers count as loans to the government and benefits to retirees count as repayments of those loans.*

*Under this system, if benefits exceed what it would take to repay the loans at a market interest rate, only the excess would still count as a transfer payment. If benefits fall short of what it would take to repay the loan, the deficiency would count as a tax.
According to the government’s accounting, the outstanding national debt is now somewhere between $3 and $4 trillion. According to the alternative accounting, the outstanding debt is closer to $10 trillion. The only reason for using one accounting system rather than the other is that somewhere in the mists of history, some accountant performed the equivalent of a coin flip. How much economic significance can underlie a number whose value depends on a perfectly arbitrary choice among equally legitimate accounting methods?

MYTHS ABOUT INTEREST RATES

In the first presidential debate of 1984, Walter Mondale made the statement that “everybody, every economist, every businessman” agrees that deficits affect interest rates. That statement, particularly as it concerns economists, is very far from true.

Do deficits affect interest rates? We don’t know. Did Mr. Mondale have any good reasons for thinking that deficits affect interest rates? Almost surely not. Yet, an unwarranted faith in the power of the deficit would place him squarely in the mainstream of the electorate.

A belief in the power of deficits over interest rates seems to be indelibly ingrained in the American psyche, reinforced by two essentially fallacious arguments. The fact that these arguments break down under careful scrutiny doesn’t prove that deficits don’t affect interest rates, but it does mean that Mr. Mondale (like so many others) failed to prove his case. Indeed, he failed to give us any reason to suspect a connection between deficits and interest rates, other than an unjustified appeal to the authority of “every economist.” Let’s examine the arguments about deficits and interest rates.

Myth 5: The “Goliath” Myth. According to this theory, the country is populated by little “Davids,” competing against the “Goliath” of the federal government, which annually consumes $200 billion that would otherwise be available to Davids seeking to finance their cars and their houses. This competition for a limited supply of money drives up interest rates to the point where David can’t even afford to finance a slingshot.

The analogy is entirely without foundation. Government does not consume money by the act of borrowing it; dollars borrowed
by government are immediately available to be borrowed again by individuals. Suppose that the government decides to bor-
row a dollar in order to purchase a paper clip for use at the
Pentagon. It effects this borrowing by selling a bond to Jack,
who withdraws a dollar from his bank account to make the
purchase. The dollar is immediately used to buy a paper clip
from Jill, who deposits it in her bank. Now it is true that Jack’s
bank has a dollar less in deposits, but Jill’s has a dollar more.
The total number of dollars that the banks have available to lend
to David is exactly the same as it was before the government
started borrowing. Goliath consumes no money; he just moves
it around a little.

The key observation here is that governments don’t just bor-
row without reason; they borrow to spend. The spending re-
estores the money that the borrowing appears to “use up.” The
usual fallacy is to notice the borrowing but not the spending.

Myth 6: The Myth of Dick and Jane. The fallacious argument
here runs like this: “If the government wants to increase its
borrowing, it must induce people to lend to it. This means it
must offer higher interest rates. Then everyone else must offer
higher interest rates in order to remain competitive.”

The mistaken notion underlying this argument is that if Dick
wants Jane to lend him a dollar at the prevailing rate of 10%,
and if she is reluctant to do so, then Dick must offer a higher
interest rate to get Jane to change her mind.

Not so. There is another way to change Jane’s mind. Dick
can offer to lend Jane a dollar at 10% interest, in exchange for
her making an identical loan to him. Indeed, Dick can convince
Jane to lend him any amount at all—as long as he lends her
the same amount, at the same interest rate—without producing
any upward pressure on that rate.

This example is not as fanciful as it sounds. Whenever the
government wants to borrow a dollar, it simultaneously lends
a dollar, just as Dick does. After all, why does the govern-
ment borrow? It does so to avoid raising your taxes for the
time being—in effect, lending you back the taxes that it would
ordinarily assess.

Unlike the borrowing of an individual, government borrow-
ing is always accompanied by an implicit loan to the taxpayers.
The government, like Dick, borrows from the public (or Jane),
while simultaneously lending the same amount at the same rate. Like Dick and Jane, the government and the public can carry this on at any level without having any effect on the rate of interest.

MYTHS ABOUT THE BURDEN OF THE DEBT

The final set of myths concerns who bears the burden of government debt. Because it isn’t clear that government debt is in any sense a burden, it may be unnecessary to examine these too closely. But exposing the flaws in these arguments is an instructive exercise that illustrates a number of important points.

Myth 7: Our grandchildren will inherit our debts. Our grandchildren will inherit not only our debts but also our savings accounts, which include the additional wealth that we save by paying lower taxes in the present. Before that day comes, both the debts and the savings will increase owing to accumulated interest. If we make a one-dollar debt payment today, we can indeed free our grandchildren from a two-dollar debt burden tomorrow, but only at a cost that undoes the favor: By removing that dollar from our savings accounts, we reduce their inheritance by two dollars as well.

Myth 8: The Myth of Crowding Out. It is argued that government borrowing uses resources that would be better employed by the private sector. This is similar in form to the Goliath myth, except that this one concerns physical resources rather than money. It is false because government borrowing does not consume anything. What consumes resources is government spending. If the government purchases a million tons of steel, then a million fewer tons of steel are available to the private sector. This is equally true whether the steel is purchased with tax revenues or with borrowed funds. The burden on the private sector is correctly measured by the resources government consumes, not by the way in which it acquires those resources.

Myth 9: Deficits hurt our trade position. Many incorrect arguments have been advanced to support the contention that deficits are bad for the domestic export industry. All of these arguments proceed in one way or another from the twin assertions that deficits affect interest rates and that these in turn affect the value of the dollar. As we have argued repeatedly,
The link between deficits and interest rates is tenuous at best. It would take us too far afield to explore the relationship between interest rates and exchange rates. We confine ourselves to the observation that a chain of reasoning is only as strong as its weakest link.

Those who would engage the attention of the public find it useful to have an instinct for the sensational. It is therefore not surprising that those myths about the deficit that find their way into public circulation all tend to exaggerate both its size and its importance. It is important to deflate such myths and to defuse the near hysteria they sometimes engender. It is equally important not to be lulled into a false sense of well-being.

Every argument we have made in this article assumes a fixed level of government spending. There is no question that high levels of spending are detrimental, in precisely the ways that large deficits are often claimed to be.

Indeed, it may very well be the case that the most harmful effect of deficits is to distract our attention from our most urgent economic priority, which is to find some mechanism for getting federal spending under control. If we fail to meet this challenge, our obsession with balanced budgets will not save us from the consequences.

*We cannot resist pointing out one common and obvious error. High interest rates on U.S. bonds increase the demand for U.S. bonds. It is not at all clear that they should make U.S. currency any more attractive relative to other currencies.