

## Government Budget and the National Debt

There are three general paradigms concerning government deficits and the national debt: Deficit Hawk, Deficit Dove, and Functional Finance. First, let's keep in mind some basic definitions.

**The government budget** is the relation between government spending,  $G$ , and tax revenues,  $T$ , in one year.

If  $G = T$  then this is a balanced budget.

If  $G > T$ , there is a budget deficit.

If  $G < T$ , there is a budget surplus.

**The National Debt** is the accumulation of all past deficits (and surpluses).

**Deficit Hawks** take the view that budget deficits and the national debt are almost always and everywhere negative. The deficit hawk argument usually includes some combination of the following five points:

1. **Deficits cause inflation** – Because most Hawks accept the basic neoclassical theory, they view the economy as tending to full employment. Since budget deficits increase aggregate demand, they will tend to set off inflationary pressures in a full employment—or near full employment—economy.
2. **Deficits cause high interest rates** – Accepting the neoclassical view of savings and investment and interest rate determination, Hawks view government spending that is financed by borrowing (i.e., deficits), to be coming out of a fixed ‘pool’ of savings. Government is thus competing with the private sector for savings, bidding up interest rates.
3. **Deficits ‘crowd out’ private spending** – Related to the previous point, if government and the private sector are competing for a fixed pool of savings to finance their spending, government spending financed by borrowing decreases the resources leftover for financing private expenditure. Thus any increase in deficit spending “crowds out” (is exactly offset by) decreases in private spending.
4. **The national debt is a burden on future generations.** They have to pay the debt.
5. **Government deficits and debt are generally immoral.** Hawks often make an analogy between government deficits and debt and household or business debt.

**Deficit doves** take the view that deficits can be okay under certain circumstances—it depends on the economic context. But Doves also devote a lot of attention to issues of defining and measuring deficits and the debt, often arguing that they are not as big as they might appear.

1. **Are deficits being measured in constant or current dollars?** Doves argue that it is wrong to compare deficits between years in current dollars, because the value of the dollar has changed. One way of correcting for this is to look at deficit/GDP ratios (and debt/GDP ratios). These ratios are also important for Doves, because they argue that a larger GDP means we can afford a bigger deficit or debt.
2. **The Federal Government doesn't keep a capital account.** So when there is a large capital expenditure it looks like a lot has been paid out in this period and the budget doesn't reflect the services that will last for years.
3. **The Government owns assets.** The Government may have a debt, but it also owns asset land, buildings, stocks, gold, water sewage treatment plants, hospitals, schools, etc.
4. **State and Local Budgets often not considered.** Often the Federal budget is discussed, even though historically Federal deficits have been offset by surpluses at the State and local levels.
5. **Government agencies own government debt.** It is argued that in this case, we really do “owe it to ourselves.”
6. **We should examine the “full employment deficit”** Doves argue that much of the deficit is due to unemployment. When there is unemployment, income is lower, so tax revenues are lower, and government spending on various assistance for the unemployed is higher.
7. **Balance budget over the business cycle, rather than in one year.** Doves argue that one year is an arbitrary amount of time. Instead, it makes more sense to run deficits during recessions and surpluses during booms, so that the budget is balanced over the cycle and debt is not growing.
8. **Debt is not a burden on future because we are also creating assets for the future.** Doves also argue that the debt will be paid to those in the future as well.
9. **Doves argue that if deficits and high interest rates are correlated, the causality goes the opposite way—from high interest rates to big deficits.** When interest rates are high, interest payments are high, pushing deficits higher.
10. **To the extent the analogy with households and firms is applicable, Doves think it support their view.** Well-managed, responsible debt is not a bad thing for households and firms—same with government.

**The Functional Finance view** says both Hawks and the Doves are wrong.

- 1. In a Modern Money system, the purpose of taxation is to create a demand for—and give a value to—unbacked currency.**
- 2. The Federal Government is the monopoly issuer of the currency.** The government doesn't need the public's money; the government needs the public to need its money to give it value.
- 3. The purpose of bond sales is not to finance spending, but to drain excess reserves created by deficit spending.** This is necessary to maintain positive short term interest rates.
- 4. In the functional finance view, the relation of G and T doesn't matter – all that matters are the *effects* of any policy.**
- 5. “Printing money” can have no effect on the economy independently of the six different fiscal operations (taxing, spending, giving, taking, lending, and borrowing).** To consider the effects of printing money and these six would be to double count.
- 6. The sound money, sound finance view of the Hawks treats the modern money system as if it were a gold standard.**
- 7. Doves are wrong because by saying that the deficit is not really as big as it seems, or that we can balance the budget over the cycle, they are giving in to the Hawk view that it matters whether we deficit spend, how big the deficit or debt is, and whether we balance or not!**
- 8. The deficit is just accounting information – it tells us how much the public wants to ‘net save’.** In a closed economy,  $(G - T) = (S - I)$ , that is, the public deficit equals the private surplus.
- 9. The national debt is just accounting info.** It is the record of government's draining of excess reserves to maintain short term interest rates. It might be better called the “IRMA” (interest rate maintenance account) than the national debt.
- 10. The national debt is not a burden on the future, because there can be no financial burden on a money monopolist.**