The Rise and Rise of Deficit Government

Christopher DeMuth; *Law & Liberty*; May 5, 2021

The U.S. federal government followed a balanced-budget policy for 181 years, from its first year of operations in 1789 through 1969. That policy had three components: (1) regular operations were paid for with current revenues from taxes and tariffs; (2) borrowing was reserved for wars, other emergencies such as economic depressions, and investments in national development (territory, harbors, transportation); and (3) debts accumulated for those purposes were paid down by subsequent budget surpluses and economic growth. The policy was followed imperfectly but with impressive consistency. It was supported by a broad political consensus spanning Alexander Hamilton and Thomas Jefferson, Andrew Jackson and Woodrow Wilson, Herbert Hoover and FDR.

Beginning in 1970, the federal government shifted to a budget-deficit policy. A significant and growing share of regular operations was paid for with borrowed funds during good times and bad, in years of peace and prosperity as well as war and emergency. In the 1950s and 1960s, annual budgets had continued to vary between small deficits and small surpluses most of the time—borrowing funded more than 10 percent of spending only in the war years of 1951 and 1968 and the recession year of 1959, and averaged 3 percent of spending over the entire period. Since then, we have run deficits in 48 of 52 years, starting small and going big. Borrowing was 10 percent of spending in the 1970s, 18 percent in the 1980s, 18 percent in the early 2000s. In 2019, the last year of a long economic expansion where a budget surplus would have been in order under the earlier policy, borrowing was 22 percent of spending. It ballooned to nearly half of spending in the pandemic year of 2020 and will continue in that range in 2021 if Congress enacts the Biden administration's spending proposals.

A half-century of routine deficit spending has left the government deeper in debt than ever in its history. By official measures, the debt is now $28 trillion, much more than a year of current GDP. This is said to be comparable to the peak debt of the mid-1940s, years of all-out national mobilization in World War II hard on the Great Depression. But today's debt is much higher than it was then, because of contingencies embedded in the post-war welfare state—$1.6 trillion in student loans, guarantees behind $9 trillion in home mortgages, and a shortfall of future revenues to outlays in the big entitlement programs of well over $100 trillion.

And little things keep cropping up. The recently enacted, debt-financed American Rescue Plan Act contributed $86 billion to the Pension Benefit Guarantee Corporation's liabilities for underfunded private pension plans. That may be a precedent for converting to federal debt some of the states' $4–5 trillion in unfunded pension liabilities through a Washington bailout.

The change from a balanced-budget policy to a budget-deficit policy was a profound, quasi-constitutional transformation of American government. Herbert Stein, who witnessed only the initial stages but grasped where they were heading, called it a revolution. Yet it was never debated in those terms by political leaders. In contrast to similarly momentous transformations, such as the adoption of a federal income tax and the Supreme Court's acquiescence in the New Deal, the fiscal transformation was slow and insensible, without a defining moment, and can be seen for what it was only in hindsight. The transitional presidents, Richard Nixon through Bill Clinton, still struggled with budget deficits and regarded them as temporary expedients (and Clinton boasted about the budget surpluses at the end of his second term). Our most recent presidents, George W. Bush through Joe Biden, have regarded much larger deficits with manifest indifference; on their watches, fretting over deficits and debt has receded to formulaic talking points of the party in opposition.

How did this come about, and what does it portend?

From Balanced Budgets to Borrowed Benefits

The old balanced-budget policy embraced the elementary rules of sustainable finance. The nation-state, no less than the family, business firm, and charitable organization, must practice fiscal restraint if it is to continue to perform the functions it has set for itself. Income (in real resources, including income from owned assets) must at least equal outlays (in real resources) over time, and borrowing must be limited to navigating temporal space between current outlays and future income. The canonical function of borrowing is investment—to support current expenditures that are expected to generate future income sufficient to service the loans. Borrowing may also support current consumption—but then future income, apart from returns on debt-financed investments, must be sufficient to service the borrowing. That is the primary function of the home mortgage in personal finance and, in public finance, of deficit spending during episodes of war, depression, and other emergencies. Deficit spending, unless it finances successful investments or is followed by periods of sufficiently higher income, is

unsustainable: eventually, outlays will contract, promises will be broken and expectations defeated, and resources will be captured and repurposed by creditors or competitors.

By this reckoning, the turn toward budget deficits was an ominous development. It is not just that deficits were routine and growing and that debt was growing faster than output, but that the composition of spending shifted dramatically toward current consumption. In 1970, about 36 percent of federal spending (net of interest payments) was in the form of benefits to individuals—Social Security, the recently created Medicare and Medicaid, unemployment compensation, and means-tested welfare benefits. Benefits spending then began to grow mightily—it is now about 76 percent of federal outlays, heading briskly toward 80 percent by official estimates.

And the concurrent growth of deficits and benefits was clearly more than coincidence. The shriveling share of federal spending on traditional government (defense and diplomacy, courts and justice, parks and infrastructure, basic research) has remained subject to annual appropriations, while most benefits spending is treated as an automatic entitlement. Entitlements have been mostly exempted from occasional spending-reduction initiatives and government closures. The politically salient parts of the Trump and Biden pandemic-relief programs have been cash payments and other personal benefits, some of them likely to continue. To some substantial degree, the old balanced-budget policy has been replaced by a borrowed-benefits policy.

That is not the end of the matter, however. The government of a nation as rich and powerful as the United States, and one that is deeply entangled in the financial and commercial sectors, has unusual flexibility in following the rules of fiscal sustainability. Its monopoly of the supply of the world's reserve currency puts it in a strong position in credit markets, produces huge seigniorage earnings independent of taxing and borrowing, and enables it to manipulate interest rates (for example by purchasing its own bonds) for significant (although never certain) periods of time. Its trillions of dollars of annual transactions with the private sector, not only in bond sales and interest payments but in currency management, taxation and regulation, sales and purchases, and grantmaking and law enforcement, present manifold opportunities for sustaining itself at private expense in ways that are difficult or impossible to monitor.

Moreover, the social and political repercussions of government spending muddle distinctions between investment and consumption, distinctions that are sufficiently clear in the budgets of households and businesses. When politicians and economists say that spending on food stamps and health care are investments in America's future, I think they are mostly wrong. But when I recycle my Social Security benefits into education savings accounts for my grandchildren, I think I am mostly investing. The economic returns on many capital investments, such as the Reagan defense build-up intended to rattle the Soviet leadership, cannot be specified. At the same time, many federal investments, such as the California bullet train, are obvious boondoggles better understood as current consumption for the politically well-connected.

These qualifications complicate portraying the fiscal transformation as a fall from financial grace. Sure enough, the balanced-budget policy sustained the government of a striving, risk-taking nation for 181 years, including several wars and civil crises that might have been ruinous. But the budget-deficit policy has sustained us for another 52 years that included the Cold War endgame, several hot wars, a financial collapse, and a major pandemic.

The post-1970 budget-deficit period has also featured a marked decline in the strong economic and productivity growth of most of the balanced-budget period. Many observers (including me) believe the declines were in part the result of large-scale public borrowing and benefit payments. But these are complicated matters, with much room for abstract theorizing and disagreement over causation. Borrowed-benefits might have been a *response* to the economic slowdown—a political effort to sustain accustomed levels of income growth in the face of headwinds in technology, demographics, and family structure. What we know for sure is that interest rates and debt-service burdens have remained unusually low, and inflation relatively low, for several decades of large public deficits and mounting debt—confounding repeated warnings that the day of reckoning was close at hand. As of mid-April 2021, the budget-deficit policy has proven remarkably sustainable.

Theory or Practice?

Arguments about deficit spending often ascribe conscious purpose to policies that were primarily adaptations to changing circumstances. This is to some degree a rhetorical shortcut, like saying that a biological feature has a purpose, just to avoid reiterating the intricacies of natural selection. But in policy debate it is also a

style of advocacy—attributing intelligent design to political decisions—that can confuse understanding of how we got where we are and what might happen next.

On one side of the deficit debates, advocates of balanced-budget policy often describe it as generational husbandry in action: Each generation should avoid burdening future generations and should instead pay its own way and build capital for the future. In this view, our forbearers were morally upright, far-sighted builders, while we have become a nation of self-absorbed, live-for-the-moment consumers.

I very much like the husbandry principle and wish it were a central tenet of modern government. And I can think of several reasons why today's citizens might be less future-oriented than in those of earlier times, such as the decline of the family and religious conviction. But the shift from balanced-budget to budget-deficit policy cannot be satisfactorily explained in these terms. Although the balanced-budget policy was sometimes justified as protecting posterity, it was primarily a device for policing government corruption and extravagance in the here-and-now. Most citizens in olden days had little ability or inclination to follow Washington politics, but knew for certain that they and their neighbors heartily disliked paying taxes. Limiting spending to revenues (except for conspicuous opportunities like the Louisiana Purchase or emergencies like the Civil War and Great Depression) was therefore a palpable discipline, and officeholders swore by it to demonstrate their devotion to honesty and thrift. The ethos of balanced budgets was not handed down from on high—it was handed up from the populace.

And contemporary politics remains awash in appeals to sacrifice for future generations, as in the global-warming debates, and, as we have noted, in imaginative efforts to justify all manner of spending as investments in posterity. These, too, may be lofty rationalizations for immediate interests—but it is notable that politicians, who are experts in gauging popular sentiments, still believe they have loft.

These considerations suggest that we look beyond moral turpitude to explain the emergence of borrowed benefits. It may be that the policing function of balanced budgets has become obsolete. We are pummeled with news of Washington political machinations hour by hour, and are abundantly equipped to communicate our preferences to officeholders, directly and with particularity. That the government has become a cash-flow machine for the citizenry is a new form of precommitment: Our legions of benefit recipients are akin to creditors, with contracts for regular payments that transcend the cant and corruption of politics,

and the politicians know it. (And anyone who thinks beneficiaries are more short-sighted than bond holders does not understand credit markets.)

On the other side of the debates are the fiscal progressives. Proponents of the budget-deficit regime present it as the application of newfound sophistication in understanding and manipulating financial markets for the common good. In this view, we have learned that the balanced-budget policy, and the rules of sustainable finance I have summarized, are incomplete and short-sighted. Deficit spending is sound policy not only to sustain income and production during serious economic contractions, such as the Great Depression and the 2020 pandemic, but whenever output is below its potential—which is almost always, and can be adduced by applying econometric models to aggregate data on economic performance. This kind of fine-tuning is said to be sustainable, and borrowing from future generations ethical, because we can be confident that future generations will be wealthier than ours, and that economic growth will often be greater than the government's interest rate on borrowed resources. In the more radical formulation of Modern Monetary Theory, large-scale deficit spending is not borrowing from the future at all, but rather investing in the future, because it uncorks large reserves of inchoate supply and thereby generates higher economic growth.

There are several easy retorts to the financial enlightenment explanation. It is manifestly the case that modern financial markets are larger and more efficient and calibrated than in earlier times, and that this makes credit more readily available to and manageable by government, just as for corporations and consumers. But it is much less obvious that government financial management has become sophisticated and far-sighted during the budget-deficit era. Witness the stagflation of the 1970s and unheralded financial collapse of 2008, both built on confident economic modeling. That the new learning provides reliable policy guidance is belied by the disagreements among leading fiscal progressives at every turn in the economic road; today this includes sharp differences among Lawrence Summers, Paul Krugman, J.W. Mason, and Stephanie Kelton over the Biden administration's policies and plans for massive deficit spending.

This is not to belittle the intellectual achievements and public spiritedness of policy economists from John Maynard Keynes to Oliver Blanchard. But their work did not motivate or shape deficit spending, which was dominated by practical politics throughout and embraced with particular vigor by nonprogressive Republicans such as Ronald Reagan and Donald Trump. (George W. Bush's administration was more wracked by crises, but he did contribute the Medicare

prescription drug benefit, the first major benefit program to be largely deficit-financed in conception, and a great political success.) Instead, the teachings of progressive economists played a supporting role, as a sort of elite permission slip for thoroughly populist deficit policies.

Keynes himself was a budget balancer, but over the course of the business cycle rather than the fiscal year—government should run deficits to get through downturns, offset by surpluses when things turned up. That policy was never implemented beyond step one—economic revivals were taken as proof that deficit stimulus worked and so ought to be continued. What stuck was the idea that spending budgets should be determined not by real current revenues but instead by imagined conceptions of future states of the world. The change in perspective was consolidated by Keynes's disciples, with their emphasis on continuously refining demand to fill output gaps, and by the modern monetarists, with their emphasis on costlessly liberating supply. The new approach was warmly embraced, and interpreted pragmatically, in the world of politics—where the present is always cluttered with problems and conflicts and special pleading, and where our best days always lie bright ahead, especially if we can just work our way through today's upheavals. (When British Prime Minister Harold Macmillan was asked to describe the greatest challenge of his tenure, he replied, "events.") Whatever else the new conception of budgeting may have liberated, it certainly liberated political calculation.

Before long (I think as early as the mid-1970s, when benefits payments became more than half of federal spending), a powerful new principle of political economy took hold: The government would provide large numbers of voters, including middle-class voters, with personal benefits that exceeded what it charged them in taxes, kiting the difference to nonvoting future generations. This was largely an American innovation, because of the federal government's lack of broad-based consumption taxes as in Europe and Scandinavia, and reliance on highly progressive and wasteful income taxes that produce relatively meagre revenue. Indeed, the U.S. tax system has increasingly become an adjunct of borrowed-benefits policy—a means of distributing benefits rather than a means of paying for them.

Modernity, Regression, and Risk

My explanation of the transit from balanced-budget to budget-deficit policy is material rather than cultural or intellectual. It was, in my view, primarily the result of

high affluence and high technology. By the late 1960s, the growth in incomes, education, and leisure time had generated much more widespread political attentiveness, facility, and participation than ever before. Concurrently, advances in transportation and, especially, in communications and information technologies produced breathtaking reductions in the costs of political action, a trend that accelerated in the 2000s. These developments made it radically easier to organize effective, increasingly discrete interest groups and ideological groups on the demand side of "policy markets." On the supply side, they made it radically easier for legislators and other political aspirants to pursue careers in partnership with activist groups, independently of parties, congressional hierarchies, and civic establishments. The traditional institutions, which had mediated politics and constrained policy agendas, survived by adopting a new business model of branding political entrepreneurs who had their own power bases.

In effect, politics was disintermediated by market developments that were doing the same thing to finance. And the two worked together, combining the economic power of private profit-seeking with the political power of government coercion. The financial collapse of 2008, an artifact of easy mortgages for homeownership as an off-budget government benefit, revealed the dangers of this partnership. And there is ample evidence that political disintermediation has propelled the broader program of borrowed benefits. It was in the early 1970s that Congress, overwhelmed by surging demand for new spending and regulating, dismantled its structure of powerful committees and annual budgeting—a structure that had, as John Cogan and others have shown, been key to holding spending and borrowing in check. Today, most members of Congress find the very idea of budgeting strange and horrifying. The financial progressives' sloshing economic aggregates conceal thousands of well-armed spending fortresses—grants for university STEM initiatives, SNAP eligibility requirements, Medicare reimbursements for cataract surgery, and on and on. Each one is indifferent to the sources of its funding and angered by think-tank notions of resource constraints and trade-offs among worthy causes that no longer have powerful institutional champions; the fortresses are not easily fine-tuned.

If I am right about the forces behind the fiscal transformation, it has set the stage for a long period of economic decline and zero-sum political rancor. We may hit a wall as abrupt and unheralded as the 2008 collapse. A revival of 1970s levels of currency inflation, which may be underway today, may produce marginal corrections but at serious cost. A significant increase in interest rates—prompted

by the loss of the dollar's reserve status, the accumulation of debts so large they finally rattle credit markets, or the arrival of a major war or other crisis—could lead to precipitate benefit reductions and widespread personal hardship. Gloomiest of all is the prospect that our indebted circumstances will tempt our enemies and make war more likely.

I may be wrong of course. My understanding of the requirements of sustainability may be mistaken. We may find ourselves in a period of prolonged, unprecedented growth in productivity and economic output, brought about by a monetary modernist spending gusher or by surprising developments in technology and society. But what seems beyond argument is that our situation is one of extraordinary risk to the nation and its citizens. It is remarkable that the academic advocates of continuous deficit spending, and its political practitioners now embodied in extreme form in the Biden administration, are so unconcerned about the risks of their being wrong. This, too, may be a consequence of the atomized free-for-all that modern government has become.