The Politics *of* Debt

Not facing a debt crisis is not the same as superbly managing public debt.

BY DOUGLAS HOLTZ-EAKIN

Why all the fuss about federal government deficits and federal debt? After all, the really important decision is to undertake federal spending in the first place. Is that spending a genuine investment or simply government-provided consumption? Does it correct a private market failure or simply crowd out equivalent private activity? These are important and difficult questions that might engender a heated debate.

Similarly, the level, composition, and design of federal taxes have important impacts on economic efficiency and the distribution of well-being. Should taxes be earmarked to pay for specific spending programs or simply constitute general revenue? Are all forms of income created economically equal, or should there be preferential rates on the return to saving and investment? Again, these are important and difficult questions that might engender a heated debate.

But having had those two debates, why is the decision to replace federal tax levies with the issuance of Treasury securities such a lightning rod? With spending, current voters can commit to programs that future voters are free to eliminate. Similarly, with taxes current voters can impose a level and structure that future voters can completely restructure. But when current voters (or their representatives) choose to issue debt, there is no way for future voters to "undo" that decision. They will simply inherit this financial legacy without any choice.

This excessive power raises the concern that once one leaves the realm of blackboard exercises, federal debt will enable current politicians to spend

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excessively and tax minimally in the present, and at the expense of future voters. In practice, this temptation has transformed into a reality in which federal debt has risen dramatically and is projected to continue to rise in an unsustainable fashion.

THE ECONOMICS OF THE FEDERAL DEBT

One cares about debt-financed federal activity because it impacts the performance of the overall economy. Here are some of the key channels by which debt affects the economy.

The starting point for understanding the impact of debt on economic performance is to think of a situation when it has no impact. Suppose that the spending programs are politically supported now and in the future. Instead of raising taxes by $100, however, the government borrows the $100. If households recognize that taxes will have to be $100 higher in the future, they will put aside $100 to cover the tax bill. Of course, the $100 in debt will also accrue interest, but so will the private saving.

Overall, it will be a wash. The government will borrow more, but the private sector will exactly offset that by saving more (or borrowing less). Total saving in the economy will be unchanged, the total investment funded by the saving will be unchanged, and the economic outlook will be unchanged.

There are more elaborate versions of this logic that recognize that the future taxes might fall on the children of the current taxpayers. But if those taxpayers care enough about their children, they will still put aside the extra $100 to make sure their ability to live is unimpaired by the higher taxes.

Federal debt will enable current politicians to spend excessively and tax minimally in the present, and at the expense of future voters.

There is no evidence, however, to support the idea that households do the elaborate fiscal arithmetic just outlined. Instead, when the government chooses debt instead of taxes, households (and firms) do not change their saving. Instead, the savings remain the same, but the pool of borrowers competing for it grows by the addition of the federal borrowing. Since the federal government is a very low-risk borrower, it will get its money.

By definition, that means capital markets will allocate less toward the demand for funds by firms for their investments in training, technologies, and physical capital.

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This "crowding out" of productivity-enhancing investments will slow the growth of productivity and real wages. Accordingly, the decision to debt-finance will lower the standard of living (compared to what it would have been) in the future. This is the economic cost of the debt.

There is a footnote to this scenario in which the federal spending financed by borrowing is just as productive as that crowded out by the borrowing. If so, aggregate investment is effectively unchanged and there is no impact from the debt. This is an essentially theoretical possibility because, rhetoric from lawmakers notwithstanding, federal spending averages a substantially lower rate of return than government investment.

Finally, it can be argued that "debt is good" only because there are two circumstances in which it provides great utility. In the first, imagine that the private sector is obsessed with capital and accumulates way more than needed. Indeed, the costs of maintaining the capital are so great that they wipe out the ability to simply consume more. Suppose the government issues a pile of debt and simply hands out the proceeds. Current voters could have a massive party and be better off. At the same time, government debt would crowd out the replacement investment, reduce the capital stock, reduce the maintenance and replacement bill, and allow people in the future to consume more. It's a pure win-win, as everybody has a higher standard of living. The ability to rob the future to raise the standard of living in the present turns out to be a blessing.

The other key circumstance when debt is valuable is fighting recessions. The basic logic is that debt can be

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used to finance lower taxes or greater spending that stimulates overall demand and reduces the depth and duration of recessions. This improves well-being in the present. When the government runs surpluses during the good time, it offsets the burden passed to the future, leaving the future unchanged and the present improved.

What's not to like? Evidently nothing, as this was the powerful intellectual argument that legitimized deficits (the excess of federal spending over tax revenue in any fiscal year that necessitates debt issuance to cover its cost) and debt in the twentieth century. Unfortunately, as it turns out, the federal government never ran the surpluses that would make debt neutral across the business cycle. This observation is the beginning of the divergence between the pure economics of the federal debt and the political economy of the debt, to which I now turn.

THE POLITICAL ECONOMY OF THE FEDERAL DEBT

The gap between the pure economics of the public debt and the political economy of the debt is driven by the desire of politicians to enhance consumption—the standard of living—in the present. Federal entitlement programs—programs on autopilot and not annually approved by Congress—are feel-good cash, food subsidies, health benefits, and other consumption benefits. These programs were 26 percent of federal spending in 1962 but have ballooned to 70 percent at present. This growth was fed by debt finance—on the eve of the pandemic Medicare alone was responsible for one-third of federal debt outstanding. The upshot is that consumption-oriented spending gets funded at the expense of annual decisions to fund national security, infrastructure, basic research, education, and the other investments in the nation's future.

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From the pure economic perspective, this is a toxic combination: crowding out productive private investment to fund consumption; replacing positive-return activities with zero return, at a tremendous cost to the future.

CLOSING THOUGHTS

These political economy dynamics have been going on for decades in the United States, subtly undercutting its productivity and competitiveness. To its eternal discredit, the Biden administration proposes to double down on this strategy by having a massive expansion of the social safety net that is not truly paid for. It is, however, proof of the power of the incentives.

The fashionable defense of this assault on the next generation is to emphasize that, despite the dire warnings of fiscal conservatives, the ever-increasing federal debt has not produced a problem. Presumably what is meant by this is that the United States has not had a sovereign debt crisis. Often at this juncture, Japan is raised as proof that having a lot of debt is not a problem.

But this thinking is as muddled as telling a D student they are doing fine. Not failing is not the same as excelling, and not facing a debt crisis is not the same thing as superb management of the public debt.

Federal debt does not have to be a bad thing. Unfortunately, on average, it is. ◆