



# The National Debt: It Shrinks While It Swells

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There is a story economists like to tell of the former student who came back to visit his old economics teacher a few years after graduation and found him preparing an exam. The alumnus looked at the text and remarked that this was practically the same one he had taken 15 years ago. "Yes," the professor replied, "in economics the questions are always the same."

"Aren't you worried that the students will pass the questions on to next year's class?" asked the old student.

"No," said the professor. "In economics the questions are always the same; it's the answers that change."

## CHANGE IN ECONOMIC VIEWS

It seems that no topic in economics fits the story better than the significance of the national debt. Most of those who studied economics before the 1930's were taught that the budget should be balanced every year and the national debt kept as low as possible.

In 1932, when the national debt has risen some \$5 billion over its \$16 billion level of 1929, there was widespread expression of concern lest the government bankrupt itself and the rest of the economy. When the national debt reached some \$48 billion in 1939, many people, including a number of Congressmen, were prophesying economic collapse. We can imagine what the reaction then would have been to a prediction of a national debt in 1972 in excess of \$450 billion! A prediction of this sort would have been tantamount to one of national disaster.

Yet we see economists today teaching that there is nothing wrong with a national debt of over \$450 billion, and that there are many times when a budgetary deficit is the most appropriate fiscal policy.

This change in economic thinking has still not been accepted by a large number of government officials and businessmen. Yet it can be easily explained and defended. It should be emphasized, however, that the change in approach to the national debt was not conceived or conspired by the economists. It was probably made necessary by the unfortunate events of the 1930's, which changed the role of economics in our society.

The main reason why the balanced budget was considered so important before the 1930's was that the Government's role in economics was the passive one of maintaining business confidence. It was felt that as long as business had confidence in the economy, business spending would continue at a reasonable level and this spending in turn would sustain economic activity. As to the Government's help in maintaining this confidence, what could be more reassuring than to see the national debt as low as possible and the Federal Government striving to have its revenues match its expenses year after year?

Why the government changed its economic role is simple: it did not work. In the early 1930's, while the Government tried to balance the budget, our economy experienced the greatest depression in its history. It was soon realized that the Government's role would have to be active if total spending were to be strong enough to keep the economy stimulated.

## CHANGING ROLE OF THE FISCAL POLICY

Fiscal policy was changed from a passive to an active force helping the economy to recover in depressions and recessions and helping to contain inflationary pressures during prosperity. In the same way, monetary policy ceased to be a neutral force maintaining the flexibility of the money and credit supply. Both monetary and fiscal policy became, instead, active forces helping to stabilize the economy.

With fiscal policy and the national debt acting as stabilizers, the direction in which the debt is moving at any given time became more significant than the absolute size of the debt itself.

## USES OF DEFICITS

In recession years, when private spending is not adequate to keep the economy operating at a satisfactory level, deficits are welcome because government spending is helping to keep the economy vibrating. The common worry that government deficits bring inflation does not make sense in such a circumstance. For with excess productive capacity and unemployment both high, stimulation by deficit spending would not push prices higher. Instead, it would put more of the available men and machines to work. Some of the healthiest periods of expansion and growth in real output have occurred at times when the public debt was increasing most rapidly.

On the other hand, deficit spending in a period of boom, when the economy is operating close to capacity and unemployment is relatively low, would be more likely to help bring inflation. If the stimulation of government deficit spending takes place at a time when private spending is already taxing capacity, this increase in federal spending cannot bring about more production of goods and services. Instead it will bid up the prices of available men and material and lead to inflationary pressures. In short, sound fiscal

policy today involves deficit spending in recessions, when the economy needs a stimulant, and budgetary surpluses during prosperous times when some curtailment on economic activity is needed to avoid price advance.

To be sure, since few people are willing to accept higher taxes and the reduction of government expenditures, even though they may favor a budgetary surplus, our country is much better at generating deficits than it is at building surpluses. But this does not mean that the principle of a counter-cyclical fiscal policy should be abandoned. It does mean, however, that more efforts are necessary to gain understanding that if the federal deficit is to serve as a stabilizing tool, there must be times when this stabilization curtails the economy as well as times when it helps sustain economic activity.

Economists have generally agreed that a counter-cyclical fiscal policy is necessary and that the direction in which the debt is moving is more important than the absolute size of the debt. But are there not valid reasons to worry about the size of the national debt? Isn't the existence of a \$450 billion dollar debt dangerous, and wouldn't we be better off if we liquidated it?

The answer is an absolute "No!" In fact, to pay off the national debt would be very disruptive to our economy.

## PAYING OFF THE NATIONAL DEBT

The first question that comes to mind is how we would pay off the debt. Since it is over \$450 billion and since, in essence, it is simply deferred federal taxation, to pay it off would involve collecting over \$450 billion in new taxes and using this revenue to pay the holders of the debt. Granted, many of those who would pay the additional taxes would also receive money as the debt was paid off. But since many would pay much more than they receive, or vice versa, paying off the debt would involve a giant distortion in the flow of funds through the economy. There would be a tremendous impact even on those few whose additional taxes would just match the amount they would receive as their bonds were paid off. While they would face no loss in cash, instead of holding government securities -- a safe and valuable asset -- they would be holding cancelled checks reflecting increased tax payments.

## ECONOMIC IMPACT OF DEBT REDUCTION

Moreover, approximately 20 percent of the national debt is held by commercial banks. If these securities were to be paid off, it would be accomplished by collecting taxes from the public. This would reduce the public's demand deposits, and the proceeds would be used to retire bank-held securities. The end result would be a decline of \$60 billion in demand deposits and \$60 billion in bank-owned government securities; for retirement of commercial bank-held securities contracts demand deposits in the same way that bank purchases of new Treasury securities increase such deposits. Unless the banks are willing to reinvest their reserves, the nation will face a sharp drop in its money supply and a reduction of economic activity.

The elimination of the national debt would create a serious problem for banks. There would be a drastic shortage of liquid investments available for bank secondary reserves for liquidity.

For the Federal Reserve, the absence of a government debt would mean that open market operations would be virtually impossible, and day-to-day monetary policy would have to be handled in a new manner. Undoubtedly, whatever substitute could be developed for open market operations would be far less satisfactory.

## DEBTS AND ASSETS

It is important to realize that every debt must have its credit counterpart somewhere. For every debt which someone owes, that is, for every liability; there must exist someone else to whom these funds are owed, someone who has a credit counterpart, an asset of equal value. Since funds are transferred from savers to investors primarily through the medium of debt, our willingness to hold debts of others as our assets enables our complex economic system to function. Not only has the national debt grown as a part of our economic process, so have the real productive assets behind the debt. As long as the Federal Government borrows productively, an increasing debt is one of the best measures of the nation's growing wealth. What the balance sheet equation tells us is that the debts are merely claims against the assets. And which of us is for smaller assets?

A nation can have a steadily rising debt without ever being brought any closer to financial ruin as long as the debt does not grow at a faster rate than the national income. The truth of this statement is illustrated by the history of Britain's national debt, as Lord Macaulay pointed out many years ago in his HISTORY OF ENGLAND. With each major war, the British debt mounted. He noted that "At every state in the growth of that debt, the nation