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ABSTRACT

This essay analyzes current fiscal policy in the United States within an historical context. The objective is to clarify why recent developments in the United States are troubling, but also to understand why the United States, in contrast to other countries such as Italy, has so far avoided the path to fiscal disaster. The discussion suggests that perhaps the American public understands, at least implicitly, that unless fiscal policy limits the growth of the public debt, the government's credit is sure to run out at some unpredictable future time, as has happened in Italy, with the consequent need for drastic and painful fiscal adjustments.

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American Fiscal Policy in the 1990's

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Italy is facing a fiscal disaster. It appears that the Italian government has exhausted its credit. The Italian public debt is now so large that lenders fear that further increases in the public debt would cause the Italian government to succumb to the temptation to repudiate its debts. Unable to continue borrowing as in the past, the Italian government is being forced to make drastic fiscal adjustments regardless of the pain that these drastic adjustments inflict.

The contrast between the recent history of the public debt in Italy and in the United States is striking. Although American commentators express concern about the continued growth of the public debt of the United States federal government, fiscal policy in the United States has been a model of prudence compared to Italy. This essay analyzes current fiscal policy in the United States within an historical context. The objective is to clarify why recent developments in the United States are troubling, but also to understand why the United States, in contrast to Italy, has so far avoided the path to fiscal disaster.

The Traditional Theory

The traditional normative theory of public debt offers the following prescription for a prudent fiscal policy: A government should borrow whenever either its spending is temporarily high or its tax revenues are temporarily low.[1] Temporarily high government

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[1]The traditional theory also prescribes that the government should borrow to finance capital expenditures, with the presumption that depreciation of the public capital is fully included in current spending. The difficulty of constructing a capital account for the public sector makes it difficult to make this prescription operational. The present discussion abstracts from this part of the traditional theory.

spending is most often associated with times of war, but also can occur in times of economic depression when the government is called on to relieve hardship. Temporarily low tax revenues can occur in times of either economic depression or war when the government's tax base is temporarily reduced.

The traditional theory also prescribes that in times of peace and prosperity the government should run budget surpluses and reduce the public debt. This prescription is an essential part of a prudent fiscal policy because all borrowers, even governments, face a potential ceiling on the amount of debt that they can incur. Lenders do not allow borrowers to incur unlimited amounts of debt because lenders know that no borrower would be able to resist the temptation to repudiate its debts, were its debt burden to become large enough. Reducing the public debt in times of peace and prosperity maximizes a government's ability to incur new debts during the next war or depression. For a growing economy the traditional theory generalizes to the prescription that the government should allow the public debt to grow relative to national income during wars or depressions, but should reduce the public debt relative to national income in times of peace and prosperity.

In the traditional theory the possibility of incurring public debt is most important in a major war in which the government wants to spend on the war effort an amount that exceeds the maximum current revenue that it can obtain from taxation. In such a case, borrowing enables war spending to avoid the constraint on tax revenue implied by the Laffer curve. In some historical wars, a government's ability to borrow has been critical not only for avoiding defeat, but also for securing the very survival of the state. For example, in his discussion of the Napoleonic Wars, the French historian Braudel concludes, "The national debt was the major reason for the British victory. It had placed huge sums of money at England's disposal at the very moment when she required them." Similarly, Keynes wrote in 1916, "If we go on giving the army what they want longer than the Germans can do this for theirs,

we may *appear* to win by military prowess. But we really shall have won by financial prowess." Or, as Alexander Hamilton wrote in 1795 in his famous "Second Report on Public Credit", "There can be no time, no state of things, in which credit is not essential to a nation, especially as nations in general continue to use it as a resource of war."[2]

The traditional theory also allows a government to incur more public debt than is necessary to finance a gap between its spending and maximum tax revenues or for a government to incur public debt in small wars and depressions in which it could raise sufficient revenue from taxation to pay for its desired spending. In these cases the purpose of borrowing is to mitigate the need to increase taxes to pay for a temporary increase in spending. (The traditional theory would even permit a reduction in tax rates during a depression.) The rationale for minimizing increases in taxes during wars and perhaps even reducing taxes in depressions is that such a policy would help to smooth the disposable incomes of taxpayers over time. Smoothing of disposable income is desirable because taxpayers typically prefer a constant stream of income and consumption to a fluctuating stream with the same average value. This preference reflects diminishing marginal utility of consumption.[3]

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[2]The sources for the quotations are as follows: Fernand Braudel, *The Perspective of the World,* volume 3, Librairie Armand Colin, 1979; English translation, Harper & Row, 1984, page 384. Elizabeth Johnson, editor, *The Collected Writings of John Maynard Keynes, Activities 1914-1919,* volume 16, Macmillan, 1971, page 187. Harold C. Syrett, editor, *The Papers of Alexander Hamilton,* volume 18, Columbia University Press, 1961.

[3] Some theories of consumption behavior assume that, regardless of the time path of taxation, each taxpaying household can use private saving and borrowing to smooth its own consumption. If this assumption were true, then the government would have no reason to be concerned about smoothing disposable income. Theorists who take this assumption seriously have invented another reason for avoiding tax increases during wars and depressions. This reason is the desirability of smoothing the distortions to the economy, such as disincentives to work, that result from taxation. These theorists

Under the traditional theory, paying off debts that were incurred during a war or depression requires a government to keep taxes higher than would otherwise be necessary when peace and prosperity return. The traditional theory prescribes that taxes should be kept permanently high enough to pay for the government's spending over the cycle of war and peace and over the cycle of depression and prosperity.

The History of the American Public Debt

The traditional theory not only provides a prescription for fiscal policy, but it also describes the fiscal policy that government of the United States actually has followed for most of its history. Until the last few years the United States federal government borrowed large amounts only during major wars and during the Great Depression. During all other times the American public debt decreased, at least relative to national income.[4]

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assume that a constant tax rate causes less distortion than a fluctuating tax rate with the same average level. [See, for example, Robert Barro, "On the Determination of the Public Debt," *Journal of Political Economy,* 87, October 1979, 940-971.]

Although this argument for avoiding tax increases is clever, the need to invoke it is questionable, because the assumption that taxpaying households can smooth their own consumption does not seem to be true for many, or even most, households. In practice people can borrow only limited amounts against the security of future income. In practice the traditional concern with smoothing disposable income seems to provide a sufficient rationale for a fiscal policy that avoids tax increases during wars and depressions.

[4] The total American public debt, which includes debts incurred by state and local governments, has a similar historical pattern. The present discussion focusses on the public debt incurred by the federal government.

The traditional theory also seems to describe actual British fiscal policy from the beginning of the eighteenth century up until the present. The United States and Great Britain are the only major sovereign states whose accumulated public debts were not wiped out either by explicit repudiation or by inflation at some point in the twentieth century. For an analysis and interpretation of the history of the American and British public debts, see Herschel Grossman, "The Political Economy of War Debt and Inflation", in *Monetary Policy for a Changing Financial Environment,* W. S. Haraf and P. Cagan, editors, American Enterprise Institute, 1990. Even in

At first glance it might appear that American fiscal policy began to violate the prescriptions of the traditional theory when the United States federal government continued to allow the public debt to increase relative to national income after the major recession of 1981-82 had ended. But, this impression may be superficial. Most of the decade of the 1980's, although a time of prosperity, also was a period of intense cold war, with higher military spending than in the years either immediately before or after. Thus, one can argue that in large part the increases in the public debt during the 1980's were consistent with the traditional prescription for borrowing to finance war spending, albeit in this case spending to fight a cold war rather than a hot war.

The experience of the last few years, however, is more difficult to reconcile with the traditional theory. The United States federal government has continued to run large budget deficits into the decade of the 1990's, a period of unambiguous prosperity and peace. An increasing public debt relative to national income during a time in which national income has been growing and military spending has been decreasing is surely inconsistent with the prescriptions of the traditional theory. Moreover, existing government spending plans and obligations together with existing tax rates imply that the United States public debt is unlikely to decrease, even relative to national

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the American and British cases inflation was responsible for much of the decrease in the real value of the public debt during the second half of the twentieth century.

It is also noteworthy that, despite the importance of Keynesian ideas in academic and political discussions of fiscal policy from the 1930's until the 1970's, the history of the public debt in the United States and Great Britain during this period is explicable without any reference to Keynesian ideas. In his classic study, *The Fiscal Revolution in America,* University of Chicago Press, 1969, Herbert Stein claims that "by the time that tax cut of 1964 was enacted, budget balancing had ceased to have an important influence on fiscal decisions and compensatory finance had taken its place as standard doctrine and major, though by no means exclusive, determinant of action" (page 454). But, the Keynesian "fiscal revolution" to which Stein refers is not apparent in the historical data.

income, in the foreseeable future.[5]

From the perspective of the traditional normative theory of public debt, current American fiscal policy seems imprudent. By not reducing the public debt and the cost of debt servicing relative to national income in the present period of peace and prosperity, the federal government seems to be acting as if it is unconcerned about its ability to borrow during the next war or depression.

To rationalize this behavior, one might plausibly argue that the prescriptions of the traditional theory are no longer relevant. Given the current economic and political situation, what is the probability that the United States will experience a major war or depression anytime in the future? Although historical experience warns against the view that we need no longer worry about major wars or depressions, it is arguable that advances in knowledge and technology have brought us to an unprecedented age of permanent peace and prosperity. If a future major war or a future depression is indeed highly unlikely, then it may be appropriate for current fiscal policy to pay little attention to the prescriptions of the traditional theory.[6]

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[5] See, for example, Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1996-2000,* U.S. Government Printing Office, January 1995. It is also worth noting that, although the ratio of the federal government's public debt to annual national income is still less than 50%, and is much below its peak in 1945 of about 100%, interest payments on the federal government debt are now about 3% of national income, as compared to less than 2% of national income in 1945, when interest rates were much lower. But, the same projections also suggest that relative to national income both the public debt and interest payments on the public debt will increase little, if at all, in the foreseeable future.

[6] In an recent paper, Laurence Ball, Douglas Elmendorf, and Gregory Mankiw ["The Deficit Gamble", National Bureau of Economic Research Working Paper No. 5015, February 1995] consider the viability of a hypothetical fiscal policy in which beginning now tax revenues will be just sufficient to pay for all future government spending except interest payments on the public debt. They abstract from the possibility of a future major war or depression. Under their hypothetical policy not only is the current public debt never paid off, but the government also incurs

The Public Debt and Economic Growth

In fact, in the currently ongoing debate about fiscal policy in the United States the prescriptions of the traditional normative theory of public debt are rarely, if ever, mentioned. Instead, "responsible" commentators, especially economists, have been focusing on a different concern about current American fiscal policy, which is that the government's chronic budget deficits are gobbling up national saving and crowding out investment, and, as a result, are stunting productivity and depressing economic growth.

From an individualistic perspective this concern with national savings and investment seems unwarranted. Regardless of current fiscal policy, any individual taxpaying household who thinks that its current consumption is too high relative to its expected future consumption opportunites can increase its own private saving and investing. More generally, by adjusting its own current saving any individual taxpaying household can prevent government borrowing from affecting its time path of consumption.

For example, suppose that the government were to reduce current taxes and increase its current borrowing, and that this policy implies higher taxes in the future. Any taxpaying household who objects to this policy and who would prefer not to consume more now and not to consume less in the future can completely offset the effects of this policy simply by increasing its current saving by the amount by which its current taxes are reduced. In the simplest case, it can use this increase in saving to buy public debt and then it can use the interest that it receives to pay the higher

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additional debt in the future to pay for servicing the existing public debt. Ball, Elmendorf, and Mankiw point out that for this policy to be viable the rate of economic growth must be sufficiently high relative to the interest rate on public debt. Without a sufficiently high rate of economic growth, the public debt would grow relative to national income and eventually the government would be forced to increase taxes in order to pay off the public debt. But, Ball, Elmendorf, and Mankiw find that, given the current American public debt and historical patterns of economic growth and interest rates, their hypothetical fiscal policy is likely to be viable.

future taxes.

For many participants in the current debate about fiscal policy in the United States these observations about individual options are not decisive. They argue, either explicitly or implicitly, that economic growth generates positive externalities and, consequently, that savings, investment, and economic growth should not be left to the outcome of individual choices. As examples of such positive externalities one might plausibly cite national strength and influence as well as social harmony.[7]

But, even if we accept this externalities argument, it alone does not seem to provide an operational criterion for fiscal policy. If economic growth is good, then how far should the fiscal policy go in promoting economic growth? Should the government attempt not only to reduce its current budget deficit, but even to achieve large budget surpluses that it could use to finance increases in investment? If so, how large should these surpluses be?

Tax Increases

Given the difficulty of reducing government spending, a reduction of the government's ongoing budget deficits in practice will require an increase in current taxes. Equally clearly, there is little political support for higher current taxes, and it is easy to understand why. Higher taxation would reduce the options available to taxpaying households who have either temporarily low incomes or temporarily high expenses and who are credit constrained -- that is, who cannot borrow against the security of their future incomes. For such households low taxes now are desirable, even though government borrowing implies higher taxes in the future,

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[7] Professor Benjamin Friedman has been one of the more articulate proponents of the argument that the United States government should borrow less in order to leave a larger part of national savings available to finance private investment. See, for example, Benjamin M. Friedman, *Day of Reckoning: The Consequences of American Economic Policy under Reagan and After,* Random House, 1988. Also, Benjamin M. Friedman, "The Clinton Budget: Will It Do?" *The New York Review,* July 15, 1993.

because low current taxes enable them, if they so choose, to increase current consumption at the expense of future consumption. Moreover, as we have already seen, any taxpaying household who does not prefer higher consumption now and lower consumption in the future can get exactly the time path of consumption that they want by increasing their own current savings.

In short, taxpayers on balance want the government to borrow, rather than to collect enough taxes to pay for current spending, because this policy postpones taxation and allows those who desire it the option of high current consumption. But, like concern about economic growth, popular preference for postponing taxation also does not provide a sensible operational criterion for fiscal policy. If government borrowing, which allows people to put off paying taxes, is good, then why collect taxes at all as long as the government can borrow to finance its spending? Why should not the government just borrow as much as it can until its credit runs out?

In recent decades some governments actually seem to have followed this strategy. Italy is an example, and the Italian experience reveals the negative consequences of such a fiscal policy. Once a government's credit is exhausted, the government is forced to make whatever drastic fiscal adjustments are necessary to balance its budget regardless of the pain that these drastic adjustments inflict. In addition, it is difficult to predict and, hence, to plan for the time at which the government's credit will be exhausted. In practice, lenders will cut off the government's credit whenever they sense that further increases in the public debt might cause the government to succumb to the temptation to repudiate its debts. The strategy of borrowing until the government's credit runs out leaves national welfare at the mercy of the capriciousness of lender attitudes.

Current Fiscal Policy

The current debate about fiscal policy in the United States has not provided a clear substitute for the traditional normative theory of public debt as a prescription for fiscal policy. How then can we explain current fiscal policy in the United States? The

preceding discussion suggests, as a plausible hypothesis, that American fiscal policy in the 1990's reflects a balancing in the popular consciousness of several considerations.

Although the public debt of the United States federal government has not been decreasing relative to national income in the present period of peace and prosperity, neither is the American public debt presently growing faster than national income. Moreover, as noted above, existing government spending plans and obligations together with existing tax rates imply that the public debt is likely to increase little, if at all, relative to national income in the foreseeable future. Thus, despite understandable popular preference for postponing taxation, it appears that the American public supports a fiscal policy that limits the growth of the public debt, probably for a combination of several reasons.

What are these reasons? First, the concerns implicit in the traditional theory probably still carry weight. In its current incarnation the traditional theory prescribes that the government should limit the growth of the public debt in the present time of peace and prosperity so that it will be able to increase its borrowing in the event, however unlikely, of a future war or depression. Second, the preaching of economists that the social benefits of investment exceed the private benefits and that government borrowing crowds out investment possibly has had some influence. Third, and probably most importantly, perhaps the American public understands, at least implicitly, that unless fiscal policy limits the growth of the public debt the government's credit is sure to run out at some unpredictable future time, with the consequent need for drastic and painful fiscal adjustments. An unanswered question is why these concerns, which so far seem to have saved the United States from the path of fiscal disaster, failed to do so in Italy.