The Frank E. Seidman Distinguished Award In Political Economy

Acceptance Paper By

JAMES M. BUCHANAN

The Deficit and American Democracy

Award Bestowed September 20, 1984

Rhodes College
Host College of the Award

THE FRANK E. SEIDMAN DISTINGUISHED AWARD IN POLITICAL ECONOMY

The Frank E. Seidman Distinguished Award in Political Economy was established in memory of Frank E. Seidman by Mr. and Mrs. P.K. Seidman. The host college for the Award is Rhodes College (formerly Southwestern at Memphis), a liberal arts college established in 1848. An honorarium of ten thousand dollars will be given to an economist who has distinguished himself or herself internationally by contributing, in the judgment of his or her peers, to the advancement of economic thought along interdisciplinary lines and to its implementation through public policy.

The purpose of the Award is to recognize and encourage economists who are attempting to extend their work into the interdependent areas of the other social sciences. The Award is established with the expectation that social welfare will be advanced when proper cognizance is given to environmental and institutional influences upon the economic behavior of individuals and groups. The basis for evaluation will encompass both the synthesis of existing thought in political economy and the pathbreaking development of new concepts.

The recipient of the Award is chosen by the Board of Trustees upon the recommendation of a rotating Selection Committee composed of eminent economists.

The Award is presented annually at a formal banquet in Memphis, Tennessee.

Mel G. Grinspan
Director

JAMES M. BUCHANAN
Recipient of Eleventh Annual Frank E. Seidman Distinguished Award in Political Economy

Memphis, Tennessee, September 20, 1984

Dr. James M. Buchanan, known particularly for his pioneering work in the area of public choice, is the recipient of the eleventh annual Frank E. Seidman Distinguished Award in Political Economy from Rhodes College, formerly Southwestern At Memphis.

Dr. Buchanan presently heads the Center for Study of Public Choice at George Mason University (Fairfax, Virginia) where he is also a professor of economics. The current president (1983-84) of the Western Economic Association, Dr. Buchanan is often cited for his work in applying economic analysis to political science decisions.

More than 30 years ago he was writing of the impact of large federal deficits, emphasizing that borrowing imposed a great debt on future generations. More recently, his work on public budgetary policies has focused on the dangers of unlimited government expansion.

Dr. Buchanan's career in economics spans more than thirty years, a period during which he has authored 20 books and

contributed to countless others, written scores of journal articles, filled top offices in professional organizations and on advisory boards around the country and taught at leading universities. Selected by the American Economic Association as its Distinguished Fellow for 1983, Dr. Buchanan joined George Mason University in 1983 after 24 years as a distinguished university professor at Virginia Polytechnic Institute and State University.

Born in Murfreesboro, Tennessee, Buchanan earned his B.S. degree from Middle Tennessee State College in 1940, his M.A. from University of Tennessee in 1941 and his Ph.D. from University of Chicago in 1948. He has held professorships in economics at University of California, Los Angeles (1968-69), University of Virginia (1956-68), Florida State University (1951-56) and University of Tennessee (1948-50) and additionally chaired the economic departments at University of Virginia and Florida State. While at VPI he was general director of its Center for Study of Public Choice; at Virginia, director of the Thomas Jefferson Center for Political Economy.

Along with visiting professorships at Miami Law School, University of California, Santa Barbara, Brigham Young University, London School of Economics and Cambridge University, Dr. Buchanan was a Ford Faculty Fellow in 1959-60 and a Fulbright Research Scholar in Italy in 1955-56. Since 1976 he has been an adjunct scholar with the American Enterprise Institute and a Fellow with the American Academy of Arts and Sciences. In 1971 he served as vice president of the American Economic Association; and 1963, as president of the Southern Economic Association. Dr. Buchanan has been awarded honorary doctorates by the University of Giessen, Germany, and the University of Zurich, Switzerland.

THE DEFICIT AND AMERICAN DEMOCRACY

by

James M. Buchanan

I. Introduction

In our own 1984, by comparison and contrast with George Orwell's visionary nightmare, the major issue of political economy is the apparent inability of our established procedures of democratic governance to eliminate or even substantially to reduce the budgetary deficit of the United States government. We are not alone in this plight; in more or less acute forms, the problem plagues all Western democracies as well as many of the developing nations.

I shall, however, remain provincial here, and I shall discuss the issue in terms of three related questions:

1. Why is the American democracy apparently unable to behave in accord with the precepts of fiscal responsibility?
2. Why is this failure apparently unique to the historical experience since World War II, and, notably, to the period since the 1960's?
3. Why can economists contribute so little to the discussion?[1]

My first question is answered by a simple and self-evident proposition from elementary public choice theory, namely, politicians like to spend and do not like to tax. My answer to the second question concerning the onset of the regime of deficits only in the postwar years is more controversial. I shall argue that the moral constraints that inhibited massive resort to debt financing for ordinary governmental outlays were effectively undermined by

---

[1] In trying to sketch out provisional answers to these questions, I shall summarize material that will be familiar to those who have read some of my previously published books and papers. I hope that the reiteration here will not be overly tedious, and I can assure you that something new will indeed be added.

For earlier works that are relevant, see my Public Principles of Public Debt (Homewood: Irwin, 1958); Democracy in Deficit (with R. Wagner) (New York: Academic Press, 1977); Fiscal Responsibility in American Democracy, edited by James M. Buchanan and Richard Wagner (Hague, The Netherlands: Martinus Nijhoff, 1979).

the policy advocacy of Keynes and the Keynesians. My answer to the third question concerning the inability of modern economists to contribute to the policy discussion is even more likely to be challenged. I shall argue that many economists are stiffled in argument because they have got their analysis of public debt wrong.

After elaborating the argument in response to the three questions, I shall then discuss the genuine difficulties involved in securing an effective escape from what we may call "the deficit dilemma." I shall outline the institutional-constitutional reforms in our politics that are required to secure such an escape.

Almost all of my remarks here will seem totally straightforward to those of you who are unsophisticated in the intricacies of modern macroeconomic theory. My views on the matters to be discussed are much closer to those held by the general public than they are to the views held among my economist peers. In this case, however, it is my peers who have been and remain confused, not the general public. As you must realize, I have faced a sometimes lonely and mostly losing battle of ideas for some thirty years now in efforts to bring academic economists' opinions into line with those of the man on the street. My educational task has been the reverse of that which we normally face in economics and political economy. My task has been to "uneducate" the economists rather than to "educate the public," and economists are an intellectually stubborn lot.

II. The Elementary Principles of Democratic Fiscal Politics

As I suggested, the answer to my first question is easy, once we begin to look at democratic politics without blinders. Each and every one of us, in one capacity or another, receives some benefits from some federal spending program, or programs, and we tend to support that congressional representative who promises to expand such programs and to push for new ones. Those who seek elected office are no different from the rest of us; they respond to constituency demands. And, given any opportunity, they will support expansions in outlays on programs or projects that offer specific benefits to voters in their own states and/or districts. (We must indeed search hard to find a congressman who is hard right enough to reject spending programs that seem to offer differential

benefits to his own constituents. Do any such congressmen exist? I doubt it.)

Spending programs must be financed, however, and elected politicians are constrained in their proclivities to expand outlays by the necessities of raising revenues, one way or another. Traditionally, of course, funds for ordinary governmental programs were supposed to be raised from taxes, and the raising of taxes provided the flip side of the coin that describes democratic fiscal politics. None of us enjoys paying taxes, even if and when we accept the benefits of spending programs. And we surely do not accept increases in tax rates without complaints. Those who seek elected office respond to these pressures against tax increases just as they respond to pressures for spending increases. If revenues were raised exclusively from taxation, we would find some sort of political equilibrium established when these two forces come into rough balance with each other. Even within a budget that describes such a balance of pressures on politicians, we might argue that non-symmetrical distribution of the benefits from spending and the burdens of taxation might generate levels of spending that are excessive, given the United States legal and budgetary structure and history.[2] Such a possible distortion of budgetary level from that which might, in some sense, be defined to be "efficient," is not my primary concern in this paper. From where we are, in 1984, it would indeed represent major improvement if our politicians were merely required to finance all ordinary spending from tax revenues.

Unfortunately, however, there are two ways of financing spending programs apart from taxation. National or central governments possess power to create money, and, throughout the ages, governments have used inflation as a means of finance when they have had access to the printing press, or its varying equivalents. In the 1970's, in particular, the Federal Reserve Board did finance, directly and/or indirectly, a sizable share of government's deficits. In the 1980's, however, the monetary authority has

---

[2] For a discussion, see James M. Buchanan and Gordon Tullock, The Calculus of Consent (Ann Arbor: University of Michigan Press, 1962). We argued that because benefits of spending programs are more highly concentrated than taxes, political pressures for expansions in spending are not appropriately matched by pressures for reductions in taxes.

taken its monetary stabilization responsibility more seriously. If access to money creation as a means of financing is not available or is denied to government, there is only one way of finance other than taxation. Quite apart from the question as to whether or not the money creation means has been effectively denied to the United States government in the 1980's, I want to concentrate on the remaining means of non-tax financing.

My emphasis is on the third means or way that governments and the politicians who act for governments have of raising revenues with which governmental programs may be financed. This third way is governmental borrowing or, put conversely, governmental issue and sale of public debt instruments. This means of finance involves neither taxation nor money issue. The government goes into the financial market as a seller of securities, of bonds, notes, and bills, and then uses the funds it thereby secures to meet its monthly bills. As you know, at the present time, the federal government finances almost $200 billion of its annual outlays by debt, more than one-fifth of its total spending.

The attractiveness of financing spending by debt issue, and hence to engage in deficit financing, to the elected politicians should be obvious enough. The constituency support for expansions in programs is guaranteed, and there is no offsetting needs to increase taxes to get the required revenues. Borrowing allows spending to be made that will yield immediate political payoffs without the incurring of any immediate political costs. When we so much as begin to look at fiscal politics in this way, the difficult question is not why deficits, but, rather, why any revenues are raised from taxes. Why do politicians refrain from borrowing all of the funds required to meet spending demands?

The answer is, of course, that government debts, like private debts, must be paid, or, at the least, that those persons and institutions, domestic or foreign, who lend to government voluntarily (that is, who purchase the bonds) think that debts will be paid when due. That is to say, government borrowing creates a future-period tax liability, and taxpayers (and their elected political representatives) will recognize this future obligation that debt embodies. There are, therefore, also political thresholds or limits that constrain resort to government borrowing. The demands for spending programs can never be fully satiated, and the debt-

induced expansion will be limited. With the availability of the borrowing or debt-issue option, we can expect that (1) governmental spending will be larger than if all revenues are raised from taxation, (2) rates of taxation will be lower than they would be in the absence of the borrowing option. The political equilibrium that determines (1) the size of the budget, (2) the rate of taxation and hence the share of the budget that is tax-financed, and, (3) the size of the debt-financed deficit will, however, be stable only in a current-period sense. This equilibrium will necessarily shift over time, because of the interest charges on the debt. The simple logic of compound interest insures that a progressively larger share of the deficit will be required to meet the interest charges on previously-issued debt. Hence, again within the threshold limits, a progressively smaller share of program benefits can be financed directly by debt. Eventually, interest charges will exceed the size of the deficit itself, and political pressures for default become almost insurmountable.

So much for a summary account of the principles of fiscal politics, a tale that I have told in many guises. These principles allow us to answer my first question straightforwardly. We observe the regime of continuing and accelerating budget deficits because this is the regime that emerges naturally from the workings of democratic politics, within the rules that constrain this politics in the 1980's.

III. The Modern Emergence of the Deficit Regime

My second question is not so easy to answer as the first. Why do we now apparently live in what seems to be an historically new regime of deficit financing? Why did the change in the practice of fiscal politics occur only from the 1960's onwards?

There was no sudden invention of public debt, an institution that has been at the hands of governments for centuries. There was no major shift in financial technology. Traditionally, before the 1960's, governments had resorted to debt as a means of financing only extraordinary expenditures, for the most part expenditures that were necessary to finance wars and other short-lived emergencies. Public debt, so created, was always substantially reduced, or paid off, after most wars for most countries. Apart from war-related

spending, public debt was also often justified in the classical discussion as a means of financing genuine capital investments on the part of governments. If, for example, a special investment in the construction of some income-yielding, tax base expanding infrastructure (say, a national road or highway network) is undertaken, it was deemed legitimate to finance the temporally bunched outlays by debt because the project that is financed is expected to yield benefits over the period during which the loan might be amortized.

What has made the experience in the postmiddle decades of this century so different is the apparent willingness of governments to finance ordinary public consumption outlay needs by debt rather than by taxation. This fiscal practice is without historical precedent and without classical justification. We must ask why the dramatic shift has taken place.

As I suggested in my introduction, there was a change in the moral constraints produced by the Keynesian theory of economic-budgetary policy. Prior to the Keynesian influence, the resort to public borrowing as a means of financing public consumption was considered sinful or grossly immoral, both by the citizenry and by the elected political agents. This moral constraint no longer exists. That which was wrong to do earlier is now no longer wrong to do. I have, in another paper written for a conference earlier this year,[3] tried to show why the constraint against the consumption of capital value by way of debt-financed public consumption was so vulnerable to the Keynesian persuasion, and I shall not repeat the argument in detail here. Let me say only that the Keynesian rationalization of deficit-financing gave politicians the opportunity to revert to their natural proclivities, and that there existed no institutional rules to inhibit such reversion.

If my general argument here is broadly correct, however, why do I date the modern regime of continuous and increasing deficits from the 1960's, rather than from the 1930's when the Keynesian revolution in economic, and specifically, fiscal, policy advocacy occurred? In this case, it is necessary to separate the Keynesian revolution in the thinking of professional economists from the

---

[3]See my "Victorian Budgetary Norms, Keynesian Advocacy, and Modern Fiscal Politics," Center for Study of Public Choice, George Mason University, Working Paper No. 4-02 (1984).

lagged impact on the thinking of political decision makers and, indirectly, on general public attitudes. Economists, at least many of them, changed their ideas and attitudes on deficit financing at least by the 1940's, but the old-fashioned rules for fiscal and budgetary prudence were not abandoned in general political attitudes until well after the conversion of the economists. Indeed we might say, with some accuracy, that economists, at least many of them, had really become non-Keynesian by the time that political leaders began to realize the impact of the Keynesian policy message.

To be historically more specific, there was only one "shining hour" when economists' and public attitudes seemed largely in sync, the fine tuning episode of the early 1960's, when Keynesian economists with political influence persuaded the practicing politicians to depart quite explicitly from the classical precepts for fiscal prudence. Alas and alack, once the genie was let out of the bottle, there was no going back, and even the Keynesian economists found it impossible to convince the unfettered politicians that policy advocacy must be two-sided if it is to work at all. By the late 1960's, Keynesian fiscal policy was in shambles, as indeed might have been easily predicted from the elementary principles sketched out earlier. We have reaped the fiscal whirlwind.

IV. The Economics of the Deficit and the Inability of Economists to Contribute to Modern Budgetary Dialogue

We come now to the third question that I posed, the question concerning the minimal contribution that modern economists seem to be making in the ongoing dialogue on the deficit, surely the single most pressing current domestic issue in political economy. Economists, who seem always so eager to advance opinions on almost anything, seem tongue-tied when they are asked about the deficit. They seem unable to agree as to its effects, and they seem unsure about how the deficit might be reduced or eliminated.

There are two separate parts of my explanation of the economists' difficulties here. There is, first, what we may call the simple welfare economics of the deficit, and there is, secondly, the economics of public debt, more generally considered. Let me treat

each of these two parts separately.

<u>The simple welfare economics of the deficit.</u>—In its basics, the financing of a large share of current governmental outlay (including transfers) from debt amounts to a straightforward transfer from taxpayers in future periods of time to beneficiaries who live currently. And in its fundamental aspects, this intertemporal transfer is no different from any other transfer. To reduce or to eliminate it would require that beneficiaries give up or lose benefits which they value, something that they will never willingly do, or that, current taxpayers pay more, again something not likely to be achieved by voluntary agreement. The deficit-induced transfer is different, however, and hence more difficult to eliminate than ordinary in-period transfers since the taxpayers who are asked to pay for the programs are not now with us. Only the beneficiaries exist in the constituencies of the political agents who make our fiscal decisions. Those who would benefit from deficit reduction, future taxpayers, cannot now vote or otherwise bring pressures to bear on politicians, other than through the interests of those current voters who might have some concern about their children and their children's children.

A more sophisticated way of stating these propositions is to say that there is no Pareto-superior means of reducing or eliminating the deficit that describes the budgetary <u>status quo</u> in 1984. As with other pure transfers, there is no readily available way to work out sets of bribes, compensations, side payments, or pork-barrel packages from which the potential losers from a change in policy might be brought around to agree. One of the difficulties in the economists' position on the deficit is, then, the absence of an <u>economic</u> argument for its elimination, at least an argument that can be brought within the economists' familiar efficiency framework. That is to say, economists can argue for deregulation (of airlines, taxicabs, trucking), or for elimination of the minimum wage, on efficiency grounds; they can advance no comparable argument against continued debt-financing of public consumption. At best, they must introduce arguments based on the relation between interest rates, capital investment, and economic growth.

The argument for fiscal responsibility must be, at base, a moral argument, and economists find themselves at a loss for words when they confront moral issues.

The simple economics of public debt.—Even when we recognize the reluctance of economists to enter directly into moral argument, however, there is an intellectual-analytical barrier that prevents many modern economists from meeting the deficit issue squarely in these terms. They cannot condemn the deficit-financing regime as immoral because they do not interpret or understand deficit financing in terms of the simple intertemporal transfer model that I have sketched out above. To put it quite bluntly here, many modern economists do not know what they are confronting when they look at the deficit. They are placed in an intellectual-analytical straitjacket by their own methodology in macroeconomics.

Obviously I cannot, in these remarks, survey the whole of an intellectual tradition. I have, for almost three decades, attempted to clarify some of the issues involved in the theory of public debt, but, as mentioned earlier, I have not had notable success. To the noneconomist, the effects of public debt are easy to understand. If government borrows in this period, the costs of that which it finances with the borrowed money are transferred forward or put off in time. This understanding is correct, but economists get themselves all confused because they do not think in terms of the opportunity costs that individuals confront. To modern economists, or at least to many of them, there can be no shift of cost or burden forward in time because the resources used by government must be given up by someone in the here and now, regardless how the revenues are secured. And, or so the economists' argument goes, the opportunity costs of debt-financed outlay are also located in the here and now. But this argument totally neglects or overlooks the other side of the financing transaction. Those persons who give up command over resources now so that government may spend, do so in a wholly voluntary transaction through the market for debt instruments, for bonds, notes, and bills. These persons suffer no cost in exchange for "public goods"; they are "paying for" the return promised them on the government bonds, notes and bills, along with the principal when due. In no sense, are these persons, these bond buyers "paying for" the benefits of the programs that are debt-financed. And, indeed, if this were the only cost of such programs, we should have invented the fiscal equivalent of the perpetual motion machine.

Correct opportunity cost reckoning suggests that the costs of the

spending program that is debt-financed must be borne by those persons who will be taxed in future periods, and by no one else, at least in a primary sense. To an extent, of course, these future-period tax liabilities may be recognized when debt is issued, and these future liabilities may be capitalized into reduced current capital values of assets. But this possible capitalization, which presumably would only be partial at best, modifies in no way the straightforward effect; debt allows the cost of spending now to be transferred forward in time.

A first and necessary step that economists must take, therefore, before they can even begin to make a substantive contribution to the discussion of the deficit is to accept the elementary principles of debt issue. In order to examine the deficit as a moral issue, the intertemporal transfer that it represents must be recognized for what is is. Until and unless economists take this first step, they must continue to discuss the deficit in terms of its secondary and tertiary consequences such as the effects on rates of interest, on capital formation, on prospects for potential monetization, etc.[4]

V. The Prospects for Reform

There are two stages in any movement toward fiscal reform. The first involves positive analysis, and this analysis must be got right before the normative stage is reached. There are two related elements of positive analysis that must be accepted. The simple economics of public debt must be understood along with the simple principles of fiscal politics. These combined are sufficient to suggest that the natural proclivities of modern politicians tend to guarantee the intertemporal transfer of costs that the deficits embody.

As I noted, there is no direct efficiency-based argument against continuation of the intertemporal transfer from future taxpayers to current beneficiaries, at least within wide limits. The argument against the deficit regime must be a moral one; we must recognize that it is grossly unjust to impose the costs of the benefits we currently enjoy on future taxpayers, on our own grandchildren if you will, who cannot now have a direct voice in fiscal politics.

---

[4]For an example, see the papers by economists in the book, Economic Consequences of the Deficit, ed. by L. Meyer (Boston: Kluwer-Nijhoff, 1983).

But we must also recognize that moral constraints that evolved over long periods of cultural evolution cannot be restored readily, once these have been practically destroyed in the modern consciousness. It is as if we have, as a result of the Keynesian advocacy, destroyed a moral norm that had major capital value for the working of democratic politics. At best, we can try to replace the pre-Keynesian moral constraint by explicit constitutional restrictions on political agents. The only effective avenue for reform lies in closing off access to the government borrowing option. We need to add to our constitution the amendment that Thomas Jefferson, in 1798, indicated that he regretted, had not been included at the outset. We need to have a budget-balance requirement as a basic element in our constitutional law.

It may serve relatively little purpose to take political action to reduce the deficit in, say, 1985, or 1986, without the introduction of the constitutional amendment. There is no assurance whatever that differing political coalitions in, say, 1987 or 1988, might not revert to deficit financing on a scale as large or even larger than that which we currently observe.

I am not overly optimistic that we can reform our fiscal politics. But it is too easy to ignore the progress that has been made. I can now talk about a constitutional amendment to balance the budget to an audience of economists. I could not have done so without derision in, say, 1964. I should have then been hooted down with the message that is at least listened to if not accepted now. Our thinking has moved forward. Ideas do indeed have consequences, and the ideas of the political economists in this century have wrought harms as well as benefits. The more sophisticated understanding of politics that modern scholarship in public choice has produced allows us to flesh out the "political" half of the term "political economist" and to coordinate political and economic understanding. If we, as political economists, can get our own ideas straight, we can be sure that, ultimately, those who determine political results will be influenced.

The dialogue on the "constitutional economics" of the deficit has just commenced.

1984 Board of Trustees
The Frank E. Seidman Distinguished Award in Political Science

Lawrence J. Seidman
Chairman of the Board of Trustees
Retired Chairman,
Seidman & Seidman
Chicago, Illinois

James H. Daughdrill, Jr.
President,
Rhodes College
Memphis, Tennessee

Robert P. Bryant
President,
Economic Club of Memphis;
Vice-Chairman, Carson, Pirie, Scott & Co.;
President, Dobbs Houses, Inc.
Memphis, Tennessee

Gardner Ackley
President,
American Economic Association;
University Professor of Political Economy
University of Michigan
Ann Arbor, Michigan

Gary L. Seevers
Former Member,
President's Council of
Economic Advisers;
Vice-President,
Goldman, Sachs & Co.
New York, New York

Marshall E. McMahon
Chairman,
Department of Economics
and Business Administration
Rhodes College
Memphis, Tennessee

Richard M. Gillett
Chairman of the Board,
Old Kent Bank and Trust Company
Grand Rapids, Michigan

P. K. Seidman
Chairman Emeritus
Attorney,
Memphis, Tennessee

Kurt F. Flexner
Consultant to the Board of Trustees
Economist
Memphis, Tennessee

Mel G. Grinspan
Director of the Award
Distinguished Service Professor,
Department of Economics
and Business Administration,
Rhodes College
Memphis, Tennessee

1984 Selection Committee

Arthur Bayer	Dean, Undergraduate Studies, Babson College Wellesley, Massachusetts
David A. Martin	International President, Omicron Delta Epsilon; Head, John Wiley Jones School of Business, College of Arts and Sciences, State University of New York Geneseo, New York
Zvi Griliches	Chairman, Department of Economics Harvard University Cambridge, Massachusetts
Richard A. Musgrave	1981 Award Recipient Adjunct Professor of Economics University of California at Santa Cruz
Herbert Stein	A. Willis Robertson Professor of Economics University of Virginia; Senior Fellow, American Enterprise Institute Washington, D.C.