



“CAN YOU FALL OFF A CLIFF AND HIT A CEILING?": ON SHOOTING YOURSELF IN YOUR OWN ANALOGY

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‘Sequester’; ‘fiscal cliff’; ‘debt ceiling’ – economists, politicians and journalists in the United States are on a constant quest to find new terms to describe old ideas. Whether under the guise of the Washington Consensus, structural adjustment, or austerity, the goals are the same: smaller government, tax cuts, fewer social programs, privatization. A haircut is one thing; the United States seems intent on playing the role of neoliberal skinhead. In such crisis-ridden times, it is necessary to reconsider our most fundamental, closely-held views, and to assess the impact on ongoing socioeconomic well-being. In this case, there are perhaps no perceptions with greater implications than those regarding federal government budgets and the public debt.

There are three paradigms for understanding government budgets and the national debt: Hawk, Dove, and Owl (functional finance). We will now review each of these in turn, beginning with the deficit hawks. Hawks view government budget deficits and the national debt as almost always and everywhere a negative for the economy and society. Often associated with a ‘sound money’ position, some hawks support a balanced budget amendment to the US Constitution requiring the federal government to run a balanced budget except in times of national emergency.

There are five basic hawk arguments as to the negative impacts of deficits and the debt. Not all hawks subscribe to all five, but virtually all hawks take one or more of these positions. Many of the hawk argu-

ments follow from the basic neoclassical economic vision explicit or implicit in the hawk conception of how the macroeconomy operates. This vision can be described by two main features. First, the market economy has a built-in tendency toward full employment of resources, including labor. Second, savings determines investment through variations in the rate of interest, as in a loanable funds model.

1. *Deficits cause inflation.* The economy tends to full employment, so excess aggregate demand caused by deficit spending is inflationary. Actually, the idea that deficits can be too large if they increase aggregate demand beyond the full employment level of output is shared by many hawks, doves and adherents of functional finance. The differences then regard whether involuntary unemployment is viewed as a short-term, disequilibrium macro-phenomenon or a normal, permanent feature of the system, consistent with macro equilibrium. But if the economy is at or near full employment, deficit expansion can result in what Keynes called ‘true inflation’ (some cost-push or supply-side instances of rising prices may be more about relative price changes). Interestingly, some hawks would require the money supply to increase for there to be inflation (if they take a traditional monetarist view).
2. *Deficits cause high interest rates.* There are several versions of this argument, some concerning only long-term interest rates (more later on the empirical evidence). But basically, for the hawks, government spending financed by borrowing increases competition in the loanable funds market, bidding up interest rates.
3. *Deficits crowd out private spending.* This also has several versions, partial versus full crowding out, for example. There are also those who view crowding out as resulting only from government borrowing *versus* those who hold the position that even government spending financed by tax revenues crowds out private expenditure. In any case, if all resources are fully employed, government can employ a resource only if it takes

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it away from the private sector. Viewed slightly differently, government borrowing to finance deficit spending reduces the loanable funds available to finance private spending, whether investment or consumer durables.

4. *The national debt is a burden on future generations.* Because they have to pay it.
5. *Deficits and the national debt are generally immoral.* The analogy is often made here between government deficits and debt and firm or household deficits and debt. “If I ran my company with spending in excess of revenue year after year, I’d be out of business!” “I can’t continually spend in excess of my income and expect to stay afloat, why should the government?”

The point has been made that some of the hawk positions are applicable to an economy on a gold standard or other fixed exchange rate regime, such as a currency board, monetary union, or peg to another nation’s currency (or a weighted basket of currencies). This will be discussed in more detail below.

Deficit doves view deficits (and an increased national debt) as reasonable, under certain circumstances, depending on the economic context. Doves have concentrated much attention on issues of defining and measuring deficits and the national debt. The following ten points summarize various dove arguments, including dove responses to and criticisms of the hawks. Just as most of the hawk positions follow from the fundamental neoclassical vision characterizing their analytical framework, dove arguments tend to follow from a basic Keynesian view of how the macroeconomy operates. Specifically, doves view unemployment and excess capacity as normal features of a modern capitalist economy, and they tend to reject a loanable funds view of savings and investment, instead seeing investment as determining savings through changes in income.

1. *Are deficits being measured in constant or current dollars?* Doves argue that it is wrong to compare deficits between years in current dollars, because the value of the dollar has changed. One way of correcting for this is to look at deficit/GDP ratios (and debt/GDP ratios). These ratios are also important for doves because they argue that a larger GDP means we can afford a bigger deficit or debt. A related issue is the changing *real* value of the national debt due to inflation or

deflation. When Reagan claimed that a pile of dollar bills of an amount equal to the size of the federal deficit or the national debt would reach almost to the moon (later repeated by Clinton), I proposed making dollar bills thinner. A similar, often repeated hawk image is that the same number of bills laid end to end would go around the earth three times, prompting my proposal that we make dollar bills shorter so they would only circle the globe twice.

2. *The federal government does not keep a capital account.* So when there is a large capital expenditure it looks like much has been paid out in the current period and the budget does not reflect the services that will last for multiple years into the future. Firms and state and local governments keep a capital account, but all federal expenditures go on the current account.
3. *The government owns assets. The Government may have a debt, but it also owns assets* such as land, buildings, stocks, gold, water sewage treatment plants, hospitals, and schools. Next to the pile of dollars representing the deficit or debt we could make a pile representing government assets that might go past the moon. Hypothetically, these assets could be sold, but what economic reasoning would justify such an action?
4. *State and local budgets often not considered.* The media and politicians often do not make clear whether they are talking about the consolidated (federal, state and local) government budget balance or only the federal deficit. Historically, federal deficits have sometimes been offset by surpluses at the state and local levels, although in recent years that has not been the case. Federal transfers to state and local governments are also common. Doves take this confusion between the consolidated and federal budget as yet another example of the imprecision in defining and measuring deficits and the debt.
5. *Government agencies own government debt.* For example, state and local governments may invest in government bonds, as do some federal government agencies, in which case it is argued that we really do ‘owe it to ourselves’. At the start of 2010, over 40 percent of the US national debt was held by government agencies. Interest payments, therefore, constitute inter-governmental transfers. And, of course, all US citizens are citizens of the nation, a state, and a locality.

6. *We should examine the 'full employment deficit'.* Doves argue that much of the deficit is due to unemployment. When there is unemployment, income is lower, so tax revenues are lower, and government spending on various forms of assistance for the unemployed is higher, so unemployment increases the size of the deficit. Job creation causes incomes and therefore tax revenues to rise, and lowers government spending to support the unemployed, resulting in a decline in the size of the deficit. The 'true' deficit would be the real value of the full employment deficit on the current account, net of government debt purchases and state and local transfers. Estimates of its size have often virtually wiped the deficit clean.
 7. *Balance the budget over the business cycle, rather than in one year.* Doves argue that one calendar year is an economically arbitrary amount of time. Instead, it makes more sense to run deficits during recessions and surpluses during booms, so that the budget is balanced over the cycle and debt is not growing. It is true that in recent years the nation has run deficits during both phases of the cycle, but that does not alter the fact that there is little economic meaning to a twelve month period and a constitutional amendment to balance the federal budget in each calendar year would make sensible fiscal policy impossible, except in a national emergency. A double-digit unemployment rate, by the way, constitutes a real national emergency.
 8. *Debt is not a burden on future because we are also creating assets for the future.* Doves encourage consideration of two scenarios: one in which our children inherit a strong economy with high employment, an up-to-date infrastructure, good schools and hospitals, as well as a larger national debt; and another in which the debt is smaller, but the economy is weak, unemployment is high, and the infrastructure is crumbling. Which would our children and grandchildren prefer? Doves also argue that the debt will be paid to those in the future as well, so the whole idea of the national debt as a burden on the future is the result of more misunderstanding and confusion.
 9. *Doves argue that if deficits and high interest rates are correlated, the causality goes the opposite way – from high interest rates to big deficits.* When interest rates are high, interest payments are high, pushing deficits higher. In any case, doves point out that short-term rates such as the federal funds rate and the discount rate are directly controlled by the central bank, and these rates serve as benchmark rates for other important rates such as the prime rate. The argument that deficits cause high interest rates is also not supported by the empirical record.
 10. *To the extent that the analogy with households and firms is applicable, doves think it supports their view.* Well-managed, responsible debt is not a bad thing for households and firms – same with government. Why do households go into debt? Think of the homes we would live in and the cars we would drive if we had to pay cash, or how old we would be before we could purchase a home or a car. For firms, debt is often a sign of strength; firms borrow to invest in producing goods and services for sale to earn revenue and profits. But doves generally do not think the analogy is a good one, as it is rooted in a failure to understand the logical fallacy of composition.
- The owls argue that both the hawks and the doves are wrong, but in different ways and for different reasons. Managing the government budget according to the principles of functional finance requires a 'modern' (chartalist or state) money system, i.e. a non-convertible, floating currency. Functional finance therefore does not apply to a monetary system with any type of fixed exchange rate – no gold standard, pegged currencies, currency boards, or currency unions, to give a few examples. Economies operating with a fiat currency system, however, can and should manage their budget according to the principles of functional finance. The owl perspective can be summarized by the following 10 points.
1. *The federal government is the monopoly issuer of the currency.* Since the US dollar is a sovereign, non-convertible, floating currency, why would the federal government need to tax or borrow from the public in order to spend? The federal government, as the money monopolist and issuer of the (intrinsically valueless) currency, doesn't need the public's money; what the government needs is for the public to need its monopoly money.
 2. *In a modern money system, the purpose of taxation is to create a demand for – and give a value to – unbacked (i.e. intrinsically valueless) currency.* If the federal government does not need the public's money in order to spend, why does it tax? By imposing a tax obligation and announcing

it will accept only dollars in payment of taxes, the federal government creates a demand for its otherwise intrinsically worthless currency and gives it value. It is obvious that, as monopoly issuer of the currency, the federal government could not collect any dollars from the public in payment of taxes unless it had first spent (or lent or given) dollars in the first place.

3. *The purpose of US government bond sales is not to finance spending, but to drain excess reserves created by deficit spending in order to maintain positive short term (overnight, interbank) interest rates.* Government spending, lending, and giving of money add to the reserves in the aggregate banking system; government taxing, borrowing, and taking of money drain reserves from the system. When the federal government runs a budget deficit, the amount of reserves added by government spending are greater than the amount drained by taxation, and so the net effect of a budget deficit on aggregate bank reserves is positive. These excess reserves will cause the federal funds rate to fall toward zero. If the authorities desire a positive overnight (interbank) lending rate, bonds are sold to drain the excess reserves from the system. Notice that budget deficits put downward pressure on interest rates, the exact reverse of what most hawks claim.
4. *In the functional finance view, the relation of G and T does not matter – all that matters are the effects of any policy.* Policies should be judged on their ability to achieve the goals for which they are designed and not on any notion of whether they are ‘sound’ or otherwise comply with the dogmas of traditional economics. There is nothing inherently ‘good’ or ‘bad’ about any particular relation between government expenditure and tax receipts. It depends on the economic circumstances and on the results a particular budget stance will promote under those circumstances. As Abba Lerner wrote in his 1951 book, *Economics of Employment*, if the amount of taxing or spending required to achieve macroeconomic goals such as full employment “should conflict with the principles of ‘sound finance’ or of balancing the budget or of limiting the national debt, so much the worse for those principles”. Promoting a balanced budget or surplus or a paying down of the national debt regardless of the macroeconomic effects would best be referred to as *dysfunctional finance*.
5. *‘Printing money’ can have no effect on the economy independently of fiscal operations (in this case, the spending, lending and giving of money by the treasury and/or central bank).* If a trillion dollars are printed and left in a closet there will be no impact on the economy. To have any impact, money must be spent, lent, or given away. Therefore, if these fiscal operations are comprehensively accounted for, and ‘printing money’ is also considered, this would constitute double-counting. Therefore, ‘printing money’ can be effectively disregarded.
6. *The ‘sound money’, ‘sound finance’ view of the hawks treats the modern money system as if it were on a gold standard.* Former Federal Reserve Board Chairman Alan Greenspan has said as much: “since the late ‘70s, central bankers generally have behaved as though we were on the gold standard. [W]e’ve behaved as though there are, indeed, real reserves underneath the system”. Fixed exchange rates, such as a gold standard, reduce or even eliminate a nation’s ability to use fiscal and monetary policies to pursue the public purpose. Under a gold standard, government spending is constrained by the accumulation of gold (or by the accumulation of foreign currency under a peg), and the central bank’s ability to set short-term interest rates are sacrificed to the requirements of maintaining the peg. In any case, different systems operate according to different logics, and managing a modern money system according to the logic of a gold standard is like playing chess using the rules of checkers.
7. *Doves are wrong because, by saying that the deficit is not really as big as it seems, or that we can balance the budget over the cycle, they are giving in too much to the hawk view and end up harming the position of supporters of common-sense budgetary policy.* According to what has come to be known as ‘Lerner’s Law’, trying to placate the public and the media for reasons of short-term political expediency will inevitably backfire. Eventually, one will be revealed as a hypocrite, one’s hands will be tied, or both. This seems a likely explanation of what has happened to Democrats who decided to call the Republicans fiscally irresponsible during the 1980s. Currently, Republicans and the Democrats each vie to be more ‘fiscally responsible’ than the other, and they are likely to run the nation’s (and possibly the world’s) economy into the ground in the process. As one student remarked when I explained that virtu-

ally all members of both parties are now hawks: “anything that all Democrats and Republicans agree on [i.e. that deficits and a larger national debt are harmful] must be wrong!”

8. *The deficit is just accounting information – it tells us how much the domestic private and foreign sectors want to ‘net save’ in assets denominated in the domestic currency.* The government budget deficit is the mirror image of the non-government surplus in the basic macroeconomic accounting identity:

government deficit = non-government surplus

where non-government surplus includes both the domestic (or resident) private sector and the foreign (non-resident) sector, which includes foreign firms, households and governments. It is therefore equivalent to the well-known identity:

$$(G - T) = (S - I) + (M - X)$$

Government budget deficit = domestic private sector surplus + foreign sector surplus

where the foreign sector surplus is another way of expressing the trade deficit. The government budget deficit permits both the domestic private sector and the foreign sector to ‘net save’ in the government’s unit of account. Only a domestic government budget deficit permits the domestic private sector and foreign sector to actualize their combined desired net saving. Deficits do not reduce savings, as the hawks argue, but just the opposite: deficits generate savings.

Another way of stating the problem is to focus on the relation between the desired and actual levels of holdings of net financial assets, or net nominal savings. Nobel Prize-winning economist William S. Vickrey argued that if, at the full employment level of output, the supply of assets held by all individuals in the economy falls short of their desired holdings, spending will decline as people try to bring their net worth up to their desired level. Business sales, output, employment, and income will all fall until the demand for assets is reduced to their supply. As Warren Mosler has cogently argued, unemployment may be viewed as the real, material evidence of a discrepancy between desired and actual levels of net nominal savings, for if

the desired level was lower, individuals would be spending more, sales would be higher, and firms would be hiring more workers.

There is only one solution to closing the gap between desired and actual levels of net nominal savings: government deficits. This is because there is no other source of change in the private sector’s total holdings of net financial assets (in dollars). If one individual in the private sector wants to increase their holdings of net financial assets, this can only occur if another individual is willing to decrease their holdings by the corresponding amount. The private sector is incapable of creating net nominal assets. Under such conditions, budget deficits and increasing public debt are the norm.

It must be emphasized that this is not a ‘closed economy’ argument, as the foreign sector – including foreign governments, firms, and households – is included in the private demand for assets. Beggar-thy-neighbor exporting of unemployment through trade surpluses is, of course, not a global solution, even if it were desirable. While Americans could indeed net save dollar assets with a trade surplus, this would only be temporary, as the resulting world-wide dollar squeeze would cause the government deficit to rise.

9. *The national debt is just accounting info.* It is the record of government’s draining of excess reserves through bond sales to maintain short term interest rates. It might therefore be better called the ‘IRMA’ (interest rate maintenance account) than the national debt.
10. *The national debt is not a burden on the future, because there can be no financial burden on a money monopolist in a modern money economy.* The only financial constraints are those that are self-imposed. There may be other constraints, such as political, ideological, or even environmental ones, but the *financial* capacity of a modern money monopolist is infinite. As Alan Blinder, former Vice Chair of the Federal Reserve Board of Governors put it, “as long as our borrowing is denominated in dollars, we never need fear defaulting, for we can always print as many dollars as we need”.

As previously discussed, functional finance is equally valid in an open or closed economy context. It

may be true that, without a full employment policy, a country must suffer over its trade balance. With a full employment policy, however, there is no need to worry about importing ‘too much’ relative to exports.

Fears regarding the current account and flexible exchange rates are generally about a fall in the currency as international investors dump the currency, but three things must be recognized:

- Under flexible exchange rates, this has no effect on the central bank’s ability to set interest rates and thus on the term structure of rates on the government’s debt. Dumping the currency doesn’t mean that the government has more debt service unless it has borrowed in another currency – which a functional finance approach would argue strongly against doing in the first place.
- If the currency drops, the trade balance improves and the government’s deficit can fall. Orthodox economists generally think this is a good thing. But note that is what it means to dump the currency – stop net saving in that currency, and by definition the current account improves, unemployment falls, and so on. Yes, domestic businesses that borrow in other currencies would be in trouble, as in the Asian Crisis of 1997–98, but that suggests that domestic businesses did not hedge against a fall in the domestic currency and that mostly happens under a fixed peg, not a flexible exchange rate (again, Asia during 1997–98). Under a flexible exchange rate, businesses should know that they should hedge.
- The purpose of functional finance is to expand the economy to full employment and no further, so there should be no additional inflationary pressures. A nation with full employment would seem to be an attractive place to invest, so it is not clear why investors would be dumping that nation’s currency.

Understanding modern money and macro balance sheets enables a society to use the government budget for achieving economic and social policy goals. We can afford prosperity under such institutional arrangements, and the good news is that this is exactly the way our current system operates. The question then becomes whether we can find the political will to move forward, or whether we will continue to choose austerity over expansion. In a nation with millions unemployed and living in poverty, and in a

world with billions living under similar and worse conditions, economic prosperity is the only long term solution to the challenges of the twenty-first century. In the United States both political parties must decide to call a halt to the ‘deficit scares’ – with their frightening images. Rather than ‘cliffs’ we must begin to envision ‘vistas of prosperity’ Instead of ‘ceilings’, we need to invoke images of ‘limitless skies’. This is what economic justice must mean today.