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Government Deficit Spending: An Analysis

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GOVERNMENT DEFICIT SPENDING: AN ANALYSIS

By
Gene S. Evenskas

A thesis submitted to the Department of Business Administration Carroll College

In partial fulfillment of the requirements for Academic Honors with the A.B. Degree in Business Administration

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Helena, Montana 1967
<table>
<thead>
<tr>
<th>Divisions</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Introduction</td>
<td>1</td>
</tr>
<tr>
<td>II. Spending - Demand and Income</td>
<td>44</td>
</tr>
<tr>
<td>III. Spending - the Business and Consumer Sectors</td>
<td>7</td>
</tr>
<tr>
<td>IV. Characteristics of the Business and Consumer Sectors' Debt</td>
<td>11</td>
</tr>
<tr>
<td>V. Savings in Our Economy</td>
<td>15</td>
</tr>
<tr>
<td>VI. The Reason for Government Intervention in Our Economy</td>
<td>18</td>
</tr>
<tr>
<td>VII. Proper Government Fiscal Policies</td>
<td>20</td>
</tr>
<tr>
<td>VIII. Characteristics of Government Debt</td>
<td>25</td>
</tr>
<tr>
<td>IX. Influence of the Government Debt on the Economy</td>
<td>31</td>
</tr>
<tr>
<td>X. The Debt's Built-in Stabilizers</td>
<td>32</td>
</tr>
<tr>
<td>XI. What Backs the Bonds of the Debt</td>
<td>33</td>
</tr>
<tr>
<td>XII. Inflation</td>
<td>35</td>
</tr>
<tr>
<td>XIII. Arguments Against Deficit Spending and Refutations of Them</td>
<td>37</td>
</tr>
<tr>
<td>XIV. Conclusion</td>
<td>39</td>
</tr>
<tr>
<td>Tables and Graphs</td>
<td></td>
</tr>
<tr>
<td>Bibliography</td>
<td></td>
</tr>
</tbody>
</table>
In the last ten years the phrase, government deficit spending, has become a common household term and the center of many discussions concerning the economics of government fiscal policy. Webster's Dictionary defines the word deficit as follows, "the amount by which a sum of money is less than what is expected, due, needed, etc.; shortage." Thus, government deficit spending is said to exist when the government spends more money on its various programs than it takes in by way of taxes and their revenue. To finance this difference extra money is obtained by the sale of government bonds, which create a debt and a liability for the government and an asset to the bondholder. However, deficit spending is only one of the alternatives the government can take with its fiscal policy, the others are a balanced budget or a surplus, which happens when tax receipts are greater than expenditures.

The idea of deficit spending is not, however, a new

concept of present economic thought, but rather, it can trace its formulation and creation back two hundred years to the following men: Voltaire, Pinto, Halton, and Alexander Hamilton. It was, however, Parson Thomas Malthus who became the first champion of deficit spending, and its ability to increase production thereby laying the foundation for future examination of the question. Nevertheless, it remained for eclectic English economist, Lord John Maynard Keynes, to synthesize the idea into practical application. Keynes' states his theory and ideas concerning government deficit spending in his book, The General Theory of Employment, Interest, and Money, which provides a sound analytical foundation for the application of the theory of compensatory government spending to the real world. It was during Franklin D. Roosevelt's New Deal programs in the depression of the thirties that Keynes' theory received its first test. During the Kennedy and Johnson administrations there has been a resurgence of Keynesian economics and policies. This theory is in contra-


3Ibid., p. 60.

diction to the earlier Classical theory of Adam Smith and Ricardo which stated that government expenditures were unproductive, and thus funding a debt was a process which reduced private capital. To them the best policy was one in which the government interfered and intervened only when it was absolutely essential in order to insure the welfare of the nation.5

Deficit spending is not an arbitrary course of action taken by the government but is permitted and necessary in order to compensate for certain inefficient developments in the economy. One of the times, when the government must intervene in an attempt to insure and to promote economic growth and development, is when the two other sectors in our economy, consumers and business, fail to consume all of the goods and services that our economy can and does produce. Thus, when one of the sectors fails to consume all that it could the other sectors must compensate for this by increasing their purchases. This process of compensation usually leads the sector to deficit financing, however, this deficit is a consequential by-product or an unsolicited side effect of the government’s attempt to insure full employment by compensating for the inadequacies of others in our economy.

5Harris, OP. Cit., pp. 51-54.
Another case calling for the government running a deficit is when planned savings is greater than planned investment. What happens in this particular case is that money is withdrawn from the income stream and the economy, thus decreasing the amount of spending which should be done and thereby causing a subsequent decrease in demand and production.

This deficit that the government has inherited by compensating for the inconsistency of the other sectors does by its very nature have some favorable and unfavorable characteristics. Some of these favorable characteristics are that the debt has built-in economic stabilizers, that the debt to a large degree is internally held, and that the debt can and does provide a certain amount of income to the households of the economy through interest payments on the bonds. However, its disadvantageous must not be overlooked, because they have a profound influence on our economy. It is felt that the debt does encroach upon the incentives of individuals, that it can lead to inflation within the economy, and that its existence shakes the confidence of business in the stability of our economy.

II

Spending defined as demand which is synonymous to buying is the very backbone of the American economy and is done by
three different groups. These distinct sectors are: consumers for consumer goods and services, investors or business for additions to their capital wealth, and government for goods and services. Therefore, in order for this economy to progress and continue to expand there must be an increase in spending, because the spending by the various sectors is in fact income to the economy. "Just as the income of a particular unit depends on the spending of other units, so the spending of each unit creates income for others." Thus, the income of one sector is the result of spending by another sector, and that total income is identical to total spending. Thus, this income, which is equal to or identical to spending, can be disposed of in different manners as is illustrated by the following:

Money can be spent in only two ways, for consumption C, and for investment I, so that C plus I equals total spending which of course equals total income.

Since spending means the same as demand, and what is spent by one sector is income to another, the amount of

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7 Ibid., p. 65.
8 Ibid., p. 66.
9 Ibid., p. 65.
10 Ibid., p. 69.
spending that is done can have a profound effect upon the level of output and production that takes place in our economy. The following quotations illustrate this:

However, there is no reason why greater or lesser income could not be expected with spending plans modified accordingly.\(^{11}\)

If we want to increase output, we must increase demand. To increase demand means to increase buying. It follows therefore that if Gross National Product is to rise to its full potential one of the great buying sectors must lift its purchases.\(^{12}\)

Therefore, a nation can enrich itself only by spending, and if this total spending increases production will likewise.\(^{13}\)

The reason that spending causes an increase in the economy is because of the fact that no one produces and places his goods on the market without demanding and anticipating due compensation for his efforts. This total spending or income in our society is measured by the Gross National Product\(^{14}\) which is defined as, "the dollar value of the total annual output of final goods in the nation."\(^{15}\)

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\(^{11}\)Ibid., p. 71.


\(^{13}\)Wallace, ibid., pp. 60, 63.

\(^{14}\)Ibid., p. 65.

III

Of all the spending that is done in our economy the largest amount is done by the consumer sector. Consumer buying is thus the biggest single source of demand for the businessman, and thus the biggest single source of production and employment.

The unfortunate thing in our economy, however, is that not all of the goods that are produced are consumed and as a result many are carried over onto next year's inventory. As has already been pointed out our economy and its growth is dependent upon the consumption of goods and spending; however, if not all of the income is spent or all of the products consumed our economy will experience a certain amount of decline. Thus, the following expressly states the problem:

Here is truly the key to understanding the problem of who buys our national output. For the answer is that we can not buy our output unless one sector compensates for another.

This does not mean that people should not save, because it is only through savings that money is available for busi-

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17 Ibid.
18 Ibid., pp. 19-19.
19 Ibid., p. 30.
ness to invest in capital resources, but every amount of savings must find an investor to maintain the equilibrium. A perfect example of this problem is the underdeveloped countries who consume everything produced in order to live, thus, leaving little money to be used in building new factories.\(^{20}\) The point is that a harmonic relationship must exist between the two, savings and investment.

As has been already stated sometimes sectors fail to consume all that is expected of them, and therefore, one of the other sectors must compensate. The first sector that usually fails to fulfill its obligations is the consumer sector.

But what is surprising is the amount by which consumer buying falls short of absorbing the entire final output of the nation. In 1962, out of the total final output of $554 billion, consumers did not buy $197 billion worth.\(^{21}\)

Since the spending of one sector is the income of another sector, it seems strange that the consumer is not able to purchase the entire output of our economy. The reason he cannot do this is that:

Consumers cannot buy the whole output of society because they don't get paid enough wages and salaries and dividends

and profits to do so.\textsuperscript{22}

Another reason that consumers fail to purchase the economy's entire output is that out of their income they are required to pay a certain amount of it to the government in the form of taxes.\textsuperscript{23}

The problem now arises as to who will purchase the remaining output of the economy is seen in the following quotation: "...when consumers save, they fail to buy. Who will make up for the missing demand?"\textsuperscript{24} The ultimate answer to this perplexing problem is that either the government or business (investor) or both must perform this function.\textsuperscript{25}

Since most people and nations adhere to the philosophy in which the government takes a passive role in the nation's economy, the business sector is the principle candidate for the role of compensator.

\textsuperscript{22}\textit{Ibid.}, p. 25.
\textsuperscript{23}\textit{Ibid.}, p. 29.
\textsuperscript{24}\textit{Ibid.}, p. 29.
\textsuperscript{25}\textit{Ibid.}
However, sometimes the investment sector too fails, and so the government is required to take a course of action that will overcome this underspending. This can be understood from the following statement:

Yet if the drop in investment is not to bring about some fall in GNP, it will have to be fully compensated by an equivalent increase in government spending or by a fall in taxes large enough to induce an equivalent amount of private spending.26

Thus, "If we are to buy everything that we are capable of producing, we must be sure that all saving of the community is converted into demand."27

This process of compensating, because of the failure of the other sectors to perform their functions, results in that particular sector running a deficit because it is required to buy more goods than it had anticipated. The reason for this deficit is that the sector's income is not adequate enough to purchase these extra goods. Thus, every sector is a chronic borrower, the government as well as households and business.28 The following point, therefore, must be considered, "When the government borrows and spends we call it 'deficit-financing' but the essential process of spending more that one's regular income is as characteristic

26Heilbroner, op. cit., p. 126.
27Bernstein and Heilbroner, op. cit., p. 33.
28Ibid., p. 30.
of the consumer or the business firm as it is of the government."29 In fact, "we find that consumers spent $21 billions of borrowed money."30 Even more significant is the fact that in the years from 1946 to 1962, a period of great prosperity, the total debt increased from $400 billion to $1,000 billion.31 Graph I indicates this relationship between the total debt and Gross National Product. The primary compensators in our economy should be the businessmen and the consumers, in fact, "If business debts and equities grow fast enough...there is no reason why government debts should grow."32

IV

Since the following statement is true:

It is that the process of borrowing and spending of 'deficit financing' is by no means limited to the government. On the contrary, it is equally or even more conspicuous in the consumer and business sector.33

we should examine the characteristics of consumer and business debt. One question that immediately surfaces in any

29 Ibid., p. 45.
30 Ibid., p. 44.
analysis of individual debt is, does the individual pay back his obligations and debts. The answer is, no. This fact is shown in the following quotation, "The fact that consumer debt as a whole goes steadily upward shows that consumers as a whole do not pay off their debts." In connection with this statement there is one thing that must be considered and that is, "...it is obvious that individually consumers must and do repay their debts. But collectively they need not and do not." This statement sets forth the limits on the size of the individual's debt:

A man or a household can carry as much debt as he can afford to 'service' - that is as much as he can afford to pay in the way of interest and amortization.

A consumer can borrow up to the point at which some lender thinks the risk of not getting paid interest and amortization is too great to warrant making a loan.

"Like consumers, business collectively does not pay back its debt." The things that limits the size of an

34 Bernstein and Heilbroner, op. cit., p. 53.
35 Ibid., p. 52.
36 Ibid., p. 52.
37 Ibid., p. 51.
38 Ibid.
39 Ibid., p. 53.
individual business debt are:

Can an individual business carry its debts forever, never paying them back? If its earning power remains high enough to cover the interest payments and if the bond buying public continues to trust in its future prospects, there is no reason why a corporation debt cannot be carried indefinitely.40

There are some businesses who are able to sustain this large debt indefinitely.41 The way that they accomplish this is by the corporation or firm floating a bond issue to pay off the mature bonds, this procedure is called refunding.42 There is, however, a certain burden that accompanies business debt, and that burden is that in refunding the deficit there is a redistribution of income or the process of paying funds from one sector of the community to another.43 Another trait of the debt that imposes a burden upon business is that it can never be sure of its income which is necessary to meet its obligations, because of the erratic behavior and buying patterns of the consumer.44

Tables I, II, III, show how two large business firms

40Ibid., p. 54.
41Neilbroner, op. cit., p. 125.
42Bernstein and Neilbroner, op. cit., p. 53.
43Neilbroner, op. cit., p. 133.
44Bernstein and Neilbroner, op. cit., p. 54.
have sustained large debts over the years, and also, the
apparent growth in the size of the debt of the different
sectors.

There is, however, a distinct advantage to this steadily
rising consumer and business debt, and that is that as a
result of their spending there is more money in circulation,
thus creating more jobs and more income. 45

Thus, we can draw some final conclusions about the
debts or deficits that have been acquired by the investors
consumers in our economy. It should be noted that spending
which creates income and output cannot be continued unless
there is a subsequent deficit. 46 Also:

With exceptions to be noted in a moment,

once debt has been created it has no
direct bearing whatsoever on the volume
of spending. Its main effect on spending
flows not from its existence but rather
from the process by which it is created. 47

If a nation's deficits are too small and its total debt
is growing at a slow rate, than that nation's income, out-
put, and employment will surely decline. 48 Furthermore, the
fear of creating a large uncontrollable debt can be reduced

46 Wallace, op. cit., p. 65.
47 Ibid., p. 87.
48 Ibid., p. 60.
because, "If additional deficits are incurred only when total spending is inadequate, by definition we can never get too much spending by increasing deficits." 49

As we have stated previously a consumer can do two things with his income, he can spend it, which we have discussed, or he can save a portion of it. The word savings can be defined as follows, "By savings we mean funds withheld from spending for consumption and made available for production of new capital." 50 Thus, money saved represents a withdrawal from the income stream in our economy. 51 Therefore, the only reason that savings presents a problem to our economy is that we are capable of producing more goods and services, but these savings reduce our spendable income which is used to buy these items. 52

How does this saving affect the economy? The following statements illustrate what the results are:

Unless that last sum of saving is somehow spent for goods and services, there will be large losses for many corporations. 53

49 Ibid., p. 90.
50 Ibid., p. 67.
51 Ibid., p. 66.
52 Bernstein and Heilbroner, op. cit., pp. 31-32.
53 Ibid., p. 29.
Other things being equal, it is clear that these savings must cause the spending stream to drop unless there is some way to put them back. 54

The impact of such savings, or 'non-spending' taken by itself is deflationary. The effect is to reduce sales and the demand for goods. 55

Thus, it is evident that the save part of the consumers income must be returned to the income stream or unemployment and recession will result. 56 Total spending which is essential for economic growth will also fall by an amount equal to savings. 57

Hence, it is vital that consumer savings find a spender and are returned to the economy. 58 This is done by the process of investment which is defined as follows, "investment here means actual spending for the construction of a capital asset, or the acquisition of new inventory which also adds to wealth." 59 However, in connection with this idea of the business sector returning the savings of the economy to the

54 Wallace, op. cit., p. 66.
55 Ibid.
56 Ibid., p. 77.
57 Ibid., p. 67.
58 Bernstein and Heilbroner, op. cit., pp. 28-29.
59 Wallace, op. cit., p. 67.
spending stream by borrowing them for investment purposes creates a problem, for in the economy the decisions to save and the decisions to invest are made by two completely separate and distinct groups. Thus we see that the ex ante, planned, plans to save and the ex ante plans to invest are made by very different bodies. Thus, "...It would be the nearest accident if total plans to save were equal to the plans to invest." Therefore, it is evident that the surplus funds, savings, must be returned to the spending income stream by one of the other sectors borrowing this surplus and spending it for the production of new assets. This process of borrowing results in that particular sector deficit-financing itself. All of this applies even to the federal government who must spend or return to the spending stream its tax revenues. The preceding is seen in a statement from John Kenneth Galbraith:

The government taxes more than it spends

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60 Ibid.
61 Ibid., p. 70.
62 Ibid.
63 Ibid., pp. 66-67.
64 Bernstein and Heilbroner, op. cit., p. 28.
This difference is not spent. Hence it is a not reduction in the spending of country as a whole. If this difference, which in the case of the United States government is the surplus in the cash consolidated budget, is sufficiently increased, then total spending in the economy will no longer press on the capacity of the economy.

The following sets forth the limits on the size of the savings that can be allowed in a nation's economy. "Hence the amount of saving a nation can do without impoverishing itself is limited by the total amount of deficits which it finds desirable and profitable to incur."66

VI

Thus we have seen two situations of probable difficulty in our economy, which if not corrected in some manner can lead to a sluggish, unprogressive, and declining economy. The first case is when the consumer sector in our economy fails to consume all of the goods and services that it produces. When this happens, one of the other sectors, business or government, must compensate for this underconsumption, and this invariably leads to deficit spending. The other situation is concerned with the savings in our economy, because this results in a removal of income and spending.


66 Wallace, Am. cit., p. 69.
which are essential to economic growth. Consequently, it is necessary at times for the government to employ a fiscal policy which will attack these problems at their source and provide us with an economy of full employment and price stability. It must be constantly kept in mind that this government debt is not the primary purpose of our fiscal policy, but rather, is an incidental or secondary result of a policy designed to insure full employment and a progressive, growing economy. This very idea is stated in the Employment Act of 1946 which reads:

The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential consideration of national policy with assistance and cooperation of industry, agriculture, labor and state and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining in a manner calculated to foster and promote free competitive enterprises and the general welfare, conditions under which there will be afforded useful employment, for these able, willing, and seeking to work and to promote maximum employment, production, and purchasing power.

Therefore, it is inevitable that the government must

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at times employ a budget deficit in order to insure full employment in our economy. The following statements indicate this:

The government deficit is desirable only when the spending of the consumers and businessmen falls short of what the economy requires for full employment and maximum output.68

But if a falling GNP is caused by an inadequacy in one sector, our analysis suggests an answer. Could not the insufficiency of spending in the business sector be offset by higher spending in another sector, the public sector?69

The use of the government budget as a stabilising device means that the government must be prepared to spend more than its normal tax receipts.70

However, these debts will not be a burden, because they are the results of activity that the economy would not have undertaken or would have failed to undertake.71

VII

Now that we have stated that the government must take steps to insure growth, and that these steps will at certain times result in a deficit, the question to ask is, what is

63 Jerstein and Heilbroner, op. cit., p. 97.
69 Heilbroner, op. cit., p. 117.
70 Ibid., p. 122.
71 Jerstein and Heilbroner, op. cit., p. 89.
the best fiscal policy to follow? The following paragraph states the advantages and disadvantages of the three types that can be employed:

In conclusion we find we really have three choices of fiscal policy. First, we could plan and execute a balanced budget. Second, we could plan and execute the 'right' amount of deficits or surpluses necessary to avoid inflation on the one hand and recession on the other. Third, we could allow budgets to run surpluses and deficits more or less possibly as a result of movements in the business cycle. The first choice would involve no increase or decrease in government debt but would tend to intensify the ups and downs of the spending-income stream, the pattern of the boom and the bust. The second policy would from time to time involve possibly large increase in government debt, and at times decreases as well. It would have maximum smoothing effects on the business cycles and promote economic growth. The third policy, which is a compromise would involve less change in government debt than under policy two, but would have a more limited stabilising effect. It is the third policy which the United States has followed in the postwar period.\(^7\)

Thus, the purpose of the government's fiscal policy in which it runs a deficit is to assure the economy of utilization of all of its resources and that all of the savings of the economy are entered into the spending stream. Therefore, we can make the following statement, "Hence approximately

\(^7\) Wallace, op. cit., pp. 33-34.
'right' total amounts could be assured by central planning of Government deficits or surpluses which would provide the necessary increase or decrease in the spending stream."\(^{73}\)

However, an important item must be kept in mind and that is, "...it must also be clear that the government budget is in essence no different from the 'budget' of the entire business sector or of the consumer sector."\(^{74}\)

From this it is apparent that the government must attempt to increase demand and spending to insure full employment of all of the economy's factors of production, during the periods when the other two sectors have failed to do this. The government in an attempt to accomplish this can follow the course of action of appealing to the consumers to increase their purchases, however, these appeals are often singularly ineffective.\(^{75}\) The government can, nevertheless, increase the demand in the economy by increasing its own demand for goods and services. However according to the following statement this course of action has a certain draw back but it suggests another alternative, "Because

\(^{73}\)Ibid., p. 81.

\(^{74}\)Bernstein and Heilbroner, An. cit., p. 42.

\(^{75}\)Ibid., p. 35.
of this time-lag problem (between the time the government becomes aware of the problem and takes action and the time that its influence is felt upon the economy) interest recently focused on another method of achieving a government deficit a deliberate tax cut. "76 A much more likely way to persuade businessmen to act is to increase their profits. And this is where a tax cut can play a role similar to the one it plays in increasing the spendable income of a consumer." this shows the way that a tax cut is used to induce business spending.77 It is also felt that a tax cut itself might induce business to spend more that the tax cut because of the multiplier effect, and hence, be that much more of a stimulant to the economy.78

When the government implements this tax cut and decreases its expenditures the entire potential effect is destroyed and the economy does not profit from this course of action.79 The following example and figures will illustrate

76 Heilbroner, op. cit., p. 150.
77 Berstein and Heilbroner, op. cit., p. 56.
78 Ibid., p. 37.
79 Ibid., p. 40.
a tax cut accompanied by a decrease in government expenditures:

<table>
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<tr>
<th>Sectors</th>
<th>($ billions)</th>
<th>Change</th>
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<tbody>
<tr>
<td>Consumers</td>
<td>367</td>
<td>362</td>
</tr>
<tr>
<td>Government</td>
<td>115</td>
<td>105</td>
</tr>
<tr>
<td>Business</td>
<td>77</td>
<td>82</td>
</tr>
<tr>
<td>Foreign</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>554</strong></td>
<td><strong>554</strong></td>
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The following example shows the result of a tax cut without a reduction in government expenditures:

<table>
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<td>5</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>554</strong></td>
<td><strong>564</strong></td>
</tr>
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Thus, we can draw certain conclusions about the effects a tax cut can have on the economy. It can be seen that by reducing the amount that the business sector must pay in taxes, there is an increase in the amount of money that they have to place into the economy. So it is possible that more tax revenue will be collected in the long run due to the fact that our economy will have raised to a higher level.

Government viewpoints namely, that all of any new consumer income made available by a tax cut will be spent on con-

\[80\text{Ibid., p. 39.}\]
\[81\text{Ibid., p. 40.}\]
sumption, and that none of it will be added to savings.32

This is the ideal condition, however, this is not practical for the problem with a tax cut is that not all of the excess money is spent, since some of it is saved.33 As we have already pointed out this act of saving is deflationary in that it withdraws valuable money and income from the economy. Some feel that a program of increased government spending is better than a tax cut in that it insures us that the money earmarked for a specific purpose will be entered into the spending stream.34 Professor Galbraith is one of those who favors government spending over a tax cut, because he feels that it more directly attacks the problems and is more likely to combat the ills of our society.

VIII

We have thus far seen that the government follows a fiscal policy in which it attempts to maintain full employment and production in our economy by compensating for the lack of households and businesses to purchase all of the goods produced in our economy. The government, however, is only able to purchase these extra goods and services.

32 Wallace, op. cit., p. 76.
33 Bernstein and Heilbroner, op. cit., p. 37.
34 Wallace, op. cit., p. 77.
when it raises the money through the sale of bonds which results in a government debt. Another debt creating project which the government performs is to return excess consumer savings to the spending stream.

This government debt is characterized by different traits of which some are favorable and some are unfavorable. The most complex characteristic of the debt is the fact that it is internally held.\textsuperscript{35} An internally held debt can then be defined as, "... a debt that members of a community owe to one another."\textsuperscript{36} One of the advantages of an internal debt is, "Internal debts do not drain the resources of one community into another, but merely redistribute the claims among the members of the same community."\textsuperscript{37} What is meant by that statement is that the money needed to finance the government's programs is obtained from the people who buy bonds, than when it is time to pay the interest on the bonds the government simply collects taxes from the public in general and pays it to the bond holding public. It is, therefore, simply a matter of taxing Peter to pay Paul. Because

\textsuperscript{35}\textit{Ibid.}, p. 36.

\textsuperscript{36}\textit{Berstein and Heilbronner, op. cit.}, p. 57.

\textsuperscript{37}Heilbronner, op. cit., p. 129.
our debt is internally held, this same principle can be applied to the process of liquidating the entire debt. In this case the government would levy taxes against the public in an amount equal to the debt and then use these tax revenues to pay the bondholders. As a result of this the following is true: 

"... a government that borrows internally can always meet its obligations." The internal debt and the payment of it present two problems concerning the redistribution of income. The first of these is the redistribution that accompanies the payment of the entire debt. By this we mean that the bonds are bought by those people who enjoy a certain amount of excess wealth, and therefore, when the debt is liquidated only the bondholders will receive the value of the bonds while everyone will be required to pay the tax levied to finance the liquidation of them. The second problem deals with the income received from the bonds. As we have stated those who have an excess of wealth are the ones who buy the bonds and are the ones who receive the added addition to their wealth in the form of the interest payments.

The advantage that the government debt has over the business debt is that it is owed to the people themselves.

83 Berstein and Heilbroner, op. cit., p. 59.
whereas, the business debt is externally held.\textsuperscript{39} This same thing limits the size of the debt the state and local governments can manage, because of the fact that the debt is owned by outside creditors, who possess claims and liabilities against the borrowing government. The factor that limits the size of the federal debt is the amount of the debt which is owned by outsiders such as foreign countries whose claims must be met when they are due. Thus, the payment to the outside creditor is not a redistribution within our economy but a payment to a group outside of our economy, which in essence is a loss of money to our economy. This next statement points out another difference that exists between the business and government debt and the advantages of the government debt:

Thus, for example, Buchanan says that public and private debts are basically alike. Yet our unbridged difference exists in the fact that the national government has the power (a) to issue money... (b) to tax all of its citizens.\textsuperscript{90}

Another characteristic on the debt is the fact that it possesses certain built-in stabilizers.

The Federal budget shows a reverse pattern. It consistently moves towards a

\textsuperscript{39}\textit{Ibid.}, p. 57.

surplus as the economy expands and towards a deficit as it contracts. These movements are mainly a passive result of the operation of the automatic fiscal stabilizers.91

These stabilizers will be discussed and examined more closely in later paragraphs.

Another mark of the debt which should be taken under consideration is the fact that the idea of the debt is not as disturbing when it is thought of as an asset.92 Also, it must be remembered that the federal debt is controllable do to the fact that it is contingent upon the type of fiscal policy the government decides to follow.93 Another point is that a large amount of the mistaken conceptions that surround the debt are because of the accounting procedure that is used. Therefore, the following has be suggested:

Many countries—including Sweden and Great Britain—separate their public wealth-creation from their expenditures on 'current' account—a practice that obviously goes a long way toward quieting fears of growing debt.94

The present debt is also the result of certain trends in the notion of government spending. The following state-

91 Wallace, op. cit., p. 83.
92 Meade and Heilbroner, op. cit., p. 51.
93 Ibid., p. 42.
94 Ibid., p. 50.
ment indicates this trend:

First, government buying as a whole has been moving rapidly upward since 1947. Second, state and local spending for goods and services has risen much faster than federal spending since the middle of the 1950's. And third, just about all of the expansion in federal purchases is due to national defense.95

In fact over half on the government purchases are for national security and interrelated programs.96

There are many things which have initiated this new trend in public spending. One of them is that there is a certain growing social conscience among some of the democracies today that causes them to feel that they should own and operate the public utilities. The fact that there are some large scale projects such as dams and roads that are necessary parts of our society, but which cannot be financed or handled by private concerns has lead to public investment. Another reason for this recent trend is that there has been a gigantic rise in the standard of living which results in a greater demand for public projects to improve society.97

95 Ibid., p. 79.


97 Harris, The New Economics, op. cit., p. 216.
"Growing debt is clearly essential to continued health."93 This states the influence that deficit spending has upon the economy. It is felt that, "rising debts are the counterpart to rising demand and spending, which in turn leads to expanding output and employment."99 Thus, it is evident that increase in demand to consume more goods and services and increase in production and employment are dependent upon borrowing and spending; which is a form of deficit financing.100 The government debt also has the following influence on tax revenues, "But insofar as government wealth (from deficit spending) increase the income of the nation ... it does increase the governments tax revenues and therefore is an earning asset."101 These tax revenues vary inversely to the planned consumption, thus during a recession a Government deficit occurs automatically.102 Investment decisions are also influenced by government activity, for when the government decides to reduce taxes there is a resulting increase in investment.103 "Thus we have come to

93Wallace, op. cit., p. 68.
100 Bernstein and Heilbronner, op. cit., p. 47.
101 Ibid., p. 45.
102 Wallace, op. cit., pp. 76, 82.
103 Ibid., p. 76.
99 Bernstein and Heilbronner, op. cit., p. 47.
see that a government deficit is essentially a way of raising demand.\textsuperscript{104} is the conclusion we can draw from viewing the vital influence deficit spending has upon the economy.\textsuperscript{104}

As was previously mentioned there is one characteristic of the debt that has a profound effect upon the economy, and that is its built-in stabilizers. These built-in stabilizers work in the manner that is outlined in the following statement:

As GDP falls because private spending is insufficient, taxes decline even faster and public expenditures grow thereby automatically causing the government sector to offset the private sector to some degree.\textsuperscript{105}

The advantages of these is that it keeps declines from developing into large recessions and possible depressions.\textsuperscript{106} Not only do the continued expenditures help stabilize, but also, the interest payments from the bonds continue during recession periods, placing more money into the hands of the consumer. In the same connection there is a certain feeling of wealth obtained from holding interest bearing bonds which

\textsuperscript{104}Serateau and Heilbroner, \textit{an. cit.}, p. 45.

\textsuperscript{105}Heilbroner, \textit{an. cit.}, p. 119.

\textsuperscript{106}Ibid.
cause the individual consumer to increase his expenditures.107 The influence that the interest can have on the economy is evident from the facts that show that in 1966 the interest payments on the debt amount to $12,132,000,000,000 or approximately 2% of our GNP.108 Thus the following should be kept in mind:

Offsetting the adverse effect of the added taxes which must be paid to restrain the income-effect of the public is the benefit which all members of the community enjoy from the fact that the debt acts as a built-in stabilizer.109

II

Now that we have seen that the government must take certain steps in order to insure that our economy will operate at full capacity and that this very activity requires that the government borrow money by selling bonds which creates a debt, we ask can we afford it? I believe the answer is, yes. Our national wealth in 1962 was worth approximately $2,000,000,000,000, now this figure does not include money, stocks, bonds, mortgages, deeds, or certificates of ownership. These paper items only indicate claims against wealth or some asset.110 The bonds of the government for

107Hansen, on. cit., p. 217.
109Hansen, on. cit., p. 216.
110Borstein and Heilbroner, on. cit., p. 17.
its debt are backed by 168 billions of United States government buildings. However, the biggest item backing our debt is our country's manpower, which when left idle produces nothing but when united with the other factors of production gives rise to production. Also, substantial amounts of the United States' wealth are not being used to their full capacity because of unemployment and some of our industries standing idle. It must be remembered that when the factors of production are operating they are adding to our national wealth, thus giving the country a broader base to support and increase our debt. The bonds that represent claims against this debt are good on the market only because of the confidence people have in the stability and in the wealth of the nation that backs them. The characteristics of the government bonds are:

For what the bonds really promise us is that we have a claim on the Treasury of the Government of the United States for so-and-so many years for interest, and thereafter for the face value of the bond.

111 Ibid., p. 49.
112 Ibid., 18.
113 Ibid., p. 19.
114 Ibid., p. 56.
115 Ibid., p. 65.
The fear of inflation is one of the greatest obstacles to a rational understanding of the mechanics of government finance.116

It is this fear of inflation that causes distrust and skepticism in deficit spending. It should be stated, however, that, "All of the truly disastrous inflations, in other words, are ascribable to inadequate or damaged productive capacity."117 Usually this damage to productivity and the following sensational inflations is caused by the holocaust of war.118 Thus, it is evident that inflation cannot be entirely related or dependent upon government deficit spending.119

Inflation can be described in many different forms, cost-push, demand-pull, but we shall be concerned with it as a breakdown in the demand-supply relationship. In this case prices rise because the demand for goods is greater than the supply available.120 We can, therefore, see that if this condition persists than an increase in demand from

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116 Ibid.
117 Ibid., pp. 65-66.
118 Ibid., p. 69-66.
119 Ibid., p. 69.
120 Ibid.
any sector can result in inflation. The type of fiscal policy that the government should follow during such a period is one of higher taxes and lower expenditures.

There is some fear that the monetization of the debt, the process whereby the government sell its bonds to commercial banks and obtains new money, places too much money in the economy. It is felt that this practice can and does lead to inflation. The point is that banks make their profits by lending money, and thus, the supply of money will increase regardless of which sector borrows the money. The following statement should be considered:

In other words, what happens to the supply of money or even to the national debt is an inadequate guide to the outlook for inflation. Rather, the focus of attention should be on whether the total rate of spending is running ahead of or behind the rate of production of goods and services.

Nevertheless, there is one part of the debt that can be inflationary and that is the interest payments on the obligation. The interest payments are continuous and during periods of high demand and low supply this added income

121 Ibid., p. 74.
122 Ibid., p. 75.
123 Ibid., p. 76.
and wealth can intensify this demand and thereby encourage the already existing inflation. The real danger of inflation comes during periods of full employment, because at this point the supply can not increase substantially, but yet demand can with no way of satisfying it.

III

The idea of deficit spending is not without its opponents who do have worthwhile suggestions which must be considered for the value that is contained in them. One of them is Professor Meade who says:

Major adverse effects of a large national debt may perhaps for convenience be listed as follows (1) the 'Pigou-effect' on savings; (2) the 'Kaldor-effect' on incentives to work, invest, and accumulate; (3) the adverse incentive effect of the additional taxes needed to finance interest payments...; (4) the adverse effect of the higher interest rates needed to counter the inflationary impact of the 'Pigou-effect'.

A closer examination of Meade's four points shows that by point one he means. Additional taxes reduce the net yield from investment, after taxes, and make socially useful investments unprofitable to the investor. Also:

125 Hansen, op. cit., p. 212.
126 Ibid.
the interest payments on the national debt, by making taxation necessary for the prevention of inflation, interferes with the efficiency of the economy by discouraging useful investments. 127

"An increase in the national debt...can make the owners of the government bonds less willing to work," this is the Kaldor-effect of Buchanan's second point, and this he feels is one of the adverse effects on the existence of a debt. 128

Buchanan's third criticism of a debt is:

Of real importance is the consideration that taxes necessary to offset the inflationary effects of the interest payments may reduce the net reward for work below the value of the marginal net product. 129

We have stated previously that in order to meet the interest payments the government must tax the entire public, and since taxes reduce the individual's income the above is possible. "The growth of national debt is an increase in the holdings of wealth...and so it relieves the pressure to save." is the final criticism. 130

Alvin Hansen, however, answers these charges in the following manner. To the first charge he gives this answer:

127 Ibid., pp. 212-213.
128 Ibid., p. 213.
129 Ibid.
130 Ibid.
A large national debt can have an important effect on the stability of the economy over the cycle. The 'built-in' stabilizer aspect of the wealth-effect.

The characteristics of this built-in stabilizer has already been discussed. Hansen points out that the debt does not seem to have depressed American saving in fact in 1929 they saved 5.0% of their income while in the period from 1950-1957 that percentage has increased to 7.0%. Also, the debt does not seem to have decrease the employment in the United States or in the United Kingdom. Hansen makes the following point, "...there is little if any evidence that the incentive to invest has been blunted by the existence of a large national debt." There is also one other point that should be mentioned in answer to Buchanan's charges, and that is that the interest from the bonds is in effect income to the economy.

What does all of this mean? What conclusions can be drawn? We have seen where consumption of all produced goods

131 Ibid., p. 216.
132 Ibid., p. 217.
133 Ibid., p. 218.
134 Ibid., p. 219.
135 Ibid.
and services, spending, is essential to economic growth. The reason for this is that this spending by one individual is income to another individual which is then used to purchase goods and services. This activity of spending is carried on in our economy by three different sectors: consumers, business, and the government. However, there are times when the different sectors do not consume all of goods that they could and this results in an imbalance and unemployment of all of our resources and a loss of income to the economy. To insure that our economy does not regress and enter into this stage one of the other sectors must consume these excess goods, however, the compensating sector usually lacks the necessary capital to purchase these goods, and therefore, must engage in deficit financing.

Another case that requires the sectors to deficit spend is in their attempt to absorb the savings, which withdraw income and money from the economy, into the income stream. Business accomplishes this by taking the savings in our economy and investing them in capital goods. Thus we see that the ex ante savings and the ex ante investments must be equal in our economy in order to insure its stability and growth. Therefore we can concluded that every sector in our economy is a chronic borrower, even the federal government.
The debt of the federal government is not intended in itself but rather is the result of a fiscal policy designed to insure society and the economy of full employment, price stability, and continued growth. Since this fiscal policy is really a tool that is to be used to insure these things, there are times when it is necessary that the government run a budget giving them a surplus. The times, however, when it is necessary for the government to intervene and finance by means of a deficit are when the demand of one of the sectors decreases and it does not by all that it could; another time is when ex ante savings and investment are not in equilibrium.

The government can combat the first problem in one of two ways. One way is by the use of the tax cut which reduces the government's tax revenues. A tax cut is useful in that it places more money in the hands of individuals, which will probably induce him to spend more. The other way is by the government obtaining more money to use on expenditures through the sale of bonds. The second problem is solved in somewhat the same manner as the first. For when the desire to invest on the part of the business sector is down, it can be encouraged by a tax cut. In the case where savings are greater than investment plans these extra funds can be funneled back into the economy by inducing buyers to purchase...
Graph II shows how an increase in the government's expenditures can add to the total wealth of the country.

This debt which the government has incurred has certain distinguishing characteristics one of which is the fact that the majority of the debt is internally held. In connection with the reality that most of the debt is internally held the obligation of meeting this debt can always be fulfilled by a matter of income redistribution. The debt can also function as a stabilizer during periods of unnatural activity in our economy. It also provides income to our economy through the interest payments that are paid on the outstanding bonds.

We have also noticed the fact that inflation is not a serious threat and inevitable consequence of deficit spending. For inflation is caused by activity in our economy that is quite independent of this. There is also no reason to fear this accumulating debt, for it is a wealth creating asset, and the bonds are backed by our nation's and government's large wealth. As to the problem of paying off this debt we have seen that this presents no problem because of the fact that the debt in internally held. Therefore, most of the fear and criticism of deficit spending is because the public is not fully informed on the issue and it does not know the economic theory that surrounds and underlies the concept.

Therefore, we must conclude that the government should
pursue a course of action that will insure and enable our economy to progress and grow on a healthy and sound foundation. Thus, the government must implement a fiscal policy that will insure full employment, when the economy independently is not able to do so, even though at times this will lead to a deficit. The possibility of a deficit should be of no concern or influence when the type of fiscal policy that is needed under the particular conditions is being decided. We must not say or create the impression that the debt is without its detractors and disadvantages, but I believe that its qualities and advantages far out weigh these.

Throughout this paper we have had under consideration the economic influences and determinants of fiscal policy and deficit spending. These very items we have noticed are capable of being quantitatively measured to some degree, and so the influences and effect that they have can be predicted with a certain amount of accuracy. There is, however, another phase of fiscal policy and deficit financing which we have not considered to any great extent but whose importance should not be taken for granted. This intangible, immeasurable thing is the attitude of the people of the particular society whose economy is under examination. This attitude is concerned with the society's social conscience, the society
belief as to the purpose and function of the government, and the societies feelings as to war. It is this last item which has had probably the most profound effect upon our economy, our fiscal policy, and our debt, but yet this very thing escapes being placed and cannot be placed into some theory or postulate, such as the General Theory, which can predict its ramifications and influences. The existence of this problem has been very evident since 1940, and we can see its influence in our economy, but war is a political entity and the course that it takes is decided by man, thus defying any attempts to measure or predict it.

There is also no doubt about the fact that there has been an evolution in societies attitude toward government and the functions it should assume. It is evident that as our society reaches higher plateaus in its standard-of-living and the people become more highly educated they expect more from the government in helping them conquer their large social problems. Again however this cannot be measured and a formula applied to it that can predict its influence upon the economy or predict its occurrence so that we might act with the proper policy at the proper time to meet the needs and challenges.

Thus the question that I raise is, "Are the economic aspects of fiscal policy and deficit spending which can be measured and predicted the major determinants of the direction
and foundation of our economy or are the major determinants the intangible, immeasurable attitudes that exist in man's intellect and escape quantification, measurement, and prediction? And if this is so, are our economic theories in fiscal policy and deficit spending significant?
TABLES AND GRAPHS
### Table I

**Outstanding Corporate Debt**

<table>
<thead>
<tr>
<th></th>
<th>A.T. &amp; T.</th>
<th>Consolidated Edison</th>
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<tbody>
<tr>
<td>1929</td>
<td>$1,149,000,000</td>
<td>$240,000,000</td>
</tr>
<tr>
<td>1962</td>
<td>$1,382,000,000</td>
<td>$1,439,000,000</td>
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</tbody>
</table>

*Bernstein and Heilbroner
A Primer of Government Spending*

p.53
**TABLE II**

**GROWTH OF DEBT 1950-55**

<table>
<thead>
<tr>
<th></th>
<th>1950 (Billion)</th>
<th>1955</th>
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<tr>
<td><strong>State and Local Debt</strong></td>
<td>21</td>
<td>38</td>
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<tr>
<td><strong>Corporate Debt</strong></td>
<td>251</td>
<td>403</td>
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<tr>
<td><strong>Consumer Debt</strong></td>
<td>97</td>
<td>172</td>
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<tr>
<td><strong>Federal Debt</strong></td>
<td>219</td>
<td>232</td>
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`Bernstein and Heilbroner
A Primer of Government Spending
p 46`
### Table III

<table>
<thead>
<tr>
<th>YEAR</th>
<th>GNP</th>
<th>NET FED Gouv Debt</th>
<th>FED Debt % GNP</th>
<th>GROSS FED Gouv Debt</th>
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<tr>
<td>1946</td>
<td>210.7</td>
<td>229.7</td>
<td>109</td>
<td>259.5</td>
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<tr>
<td>1962</td>
<td>553.9</td>
<td>256.8</td>
<td>46</td>
<td>304.0</td>
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<tr>
<td>% INCREASE</td>
<td>163</td>
<td>12</td>
<td>-</td>
<td>17</td>
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<table>
<thead>
<tr>
<th>YEAR</th>
<th>NET STATE AND LOCAL Gouv Debt</th>
<th>NET PRIVATE DEBT</th>
<th>TOTAL NET DEBT</th>
</tr>
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<tbody>
<tr>
<td>1946</td>
<td>13.6</td>
<td>154.1</td>
<td>397.4</td>
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<tr>
<td>1962</td>
<td>72.0</td>
<td>671.9</td>
<td>1000.7</td>
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<tr>
<td>% INCREASE</td>
<td>429</td>
<td>336</td>
<td>152</td>
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<table>
<thead>
<tr>
<th>YEAR</th>
<th>A.T.YT DEBT</th>
<th>ALL COMMERCIAL BANK DEPOSITS</th>
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<tr>
<td>1946</td>
<td>1.7</td>
<td>139.0</td>
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<tr>
<td>1962</td>
<td>8.2</td>
<td>256.1</td>
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<tr>
<td>% INCREASE</td>
<td>282</td>
<td>84</td>
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The Two Phases of Debt

Graph 1

GDP Growth vs. Total Debt

Gross National Product
BIBLIOGRAPHY


