Tom Nugent

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How to "Solve" the Budget Deficit

It all comes down to which lens you look through.

By Thomas E. Nugent

A recent *Wall Street Journal* article about problem-solving contests contained this interesting little nugget: "The further [a] problem was from a solver's expertise, the more likely he or she was to solve it. It turns out that outsiders look through a completely different lens."

Economists take note. If you are a monetarist or a Keynesian, or maybe even if you are a supply-sider, you might be among those who view the current budget deficit as either a critical problem now or in the near future. Traditional solutions to this perceived dilemma require reduced government spending, increased taxation, or some combination of the two. Unfortunately, by attempting to reduce the budget deficit in such ways, economic activity also will suffer — meaning that by solving one problem, we'd be creating another.

Maybe it's time we look at this situation through the outsider's lens.

A few years back, traditionalists said that paying for the Iraq war would result in bigger budget deficits and rising interest rates, which would crowd out private investment. Yet, here we are — four years later — with low interest rates, rising investment, a booming economy, *and* a shrinking deficit.

Then Hurricane Katrina hit, after which President Bush announced a plan to spend $200 billion to rebuild the ravaged Gulf Coast. The opposition responded that the resulting larger budget deficit would penalize future generations and drive interest rates higher. Some politicians even wanted to cut spending, postpone tax cuts, and raise taxes to pay for the hurricane damage. Yet here we are — one-and-a-half years later — with lower interest rates, a growing economy, rising incomes, and mounting wealth via record highs in the stock market.

These failed forecasts have done nothing to encourage their purveyors to alter their thinking. Even Federal Reserve chair Ben Bernanke suffers from budget-deficit nearsightedness.

Bernanke recently spoke extensively about the risks of a growing budget deficit, and of how it could precipitate federal insolvency and slow economic growth as investment is crowded out. Fortunately, Bernanke's forecasting of Armageddon is based on the same traditional approach to fiscal policy practiced by many of today's deficit hawks; it's an approach that is easily refuted, as problem-solvers viewing the situation through an outsider's lens might attest.

Essentially, there is no relationship between budget deficits and insolvency. In fact, as former Fed chairman Alan Greenspan pointed out, with a floating exchange rate, there is no such thing as federal insolvency. Rather, the problem is the risk of future inflation caused by excessive federal-government demands on the private sector. But somehow Bernanke, our top inflation fighter, overlooks this fact, focusing instead on nonexistent insolvency risks.

This insolvency issue is not unlike the accusation that, unless something is done, the Social Security system will go bankrupt. Again, one must understand how the U.S. government functions in a floating-exchange-rate environment.

In effect, fiscal policies — i.e., spending and taxation — are not constrained by some fixed asset, such as the gold in Fort Knox. This *had been* the case prior to 1971, when the U.S. was constrained by the gold standard. But today the federal government can write as many checks as it desires, with the only limitation being the inflation risk created by excessive demands on the private sector.

As an example, the federal government writes checks to construction companies for aircraft carriers, just as it writes checks to Social Security recipients in retirement. These entities then deposit their checks at local banks. When each check clears, the Federal Reserve credits the local bank's reserve account at the Fed, after which the local bank credits the corporate or individual account with what is known as "good" funds.

Operationally, virtually all of the federal government's "spending" consists of the Fed crediting an account — that's it. So essentially, there is no distinction between printing money and not printing money. Similarly, there is no federal "box of money" which receives tax collections and the proceeds from new Treasury securities, with these proceeds then available for use by the government through spending or lending.

Think about this: If you pay your taxes in actual cash, the government shreds it; if you pay by check, your bank balances are reduced by that amount. Either way, the federal government receives nothing of value!

The critical point here — the outsider-looking-in point — is that the entire government spending process is not constrained by government "revenue." Whether or not the government has collected taxes, or borrowed money from individuals here or abroad, such activities do not factor into the payment process. Any constraints on that process are self-imposed, such as when the government sets a debt ceiling.

Meanwhile, federal government checks will *never* bounce unless Uncle Sam decides to bounce its own checks. This should come as a relief to Social Security recipients: The U.S. government is not going broke and it's not about to stop making Social Security payments.

The idea of "paying for" Social Security or Medicare or Medicaid — the supposed major culprits contributing to future increases in the budget deficit — is *not* the issue. The real concern is the economic consequences of the many proposed solutions to this "looming," though non-existent, crisis. The tax-increase solution will constrain economic growth; so will the spending-reduction approach. In other words, the gloom-and-doom forecasts of Ben Bernanke may indeed come true, but only because the cure is worse than the disease.

Our top inflation fighter should stick to what he is supposed to do best — minimize the risk that inflation becomes a real threat to economic growth. Meanwhile, Congress can do its part by lowering stifling regulations, structuring taxes to encourage increased output, and reducing restrictive tariff barriers to lower the cost of goods and services. These are the essential elements of a plan that will keep the mythical Grim Reaper of insolvency in check.

That's the lens I'm looking through today — one through which the future still looks very bright. Grim Reapers, darkness, doomsdays, and bogeymen — that's what you see when peer through the outdated lenses used by way too many of our current public officials.