

Policy Note 04/07



“AN INTERVIEW WITH THE CHAIRMAN”

**TAXES, SPENDING,
DEFICITS, INFLATION:
THE WORKINGS OF
FEDERAL FINANCE**

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TAXES, SPENDING, DEFICITS, INFLATION: THE WORKINGS OF FEDERAL FINANCE

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What follows is a mock—but no less relevant and revelatory—congressional interview with the chairman of the Federal Reserve System. Just how does the US Treasury accept and make payments? Is its spending revenue-constrained, or is there something else at work? And what are the ramifications: Is the Social Security Trust Fund really broke? Is healthcare funding much simpler than we’ve been led to believe? Find out more below.

Senator X: Isn't it true, Mr. Chairman, that last year's budget deficit of \$298 billion **ADDED** exactly that amount to the financial assets—the savings—of the nongovernment sectors of the economy?

Not \$297 billion or \$299 billion, but exactly \$298 billion, correct? Or these two gentlemen from the Congressional Budget Office sitting here with me will have to work late to find their arithmetic mistake.

Senator Y: Excuse me, Senator X, but—before the chairman answers—let me get this straight. Are you suggesting that government deficits **ADD** to savings? Haven't we been hearing for years that they take away from savings?

Senator X: Yes, Senator, you heard the question correctly. And these gentlemen from the CBO are here to substantiate this testimony as a matter of accounting, not of theory.

Senator Y: And just what do you mean by “nongovernment” savings?

Senator X: Just that, Senator: financial savings by every individual and entity that is not part of the US government. That includes households, businesses, residents and nonresidents, as well as foreign corporations and foreign central banks—all of which are casually called “the private sector.”

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I am asking the Chairman to confirm that last year's \$298-billion federal deficit added a total of \$298 billion in net financial assets—financial savings—to the private sector.

And these are the gentlemen who do the accounting, who make sure that the total savings that the deficit added to the nongovernment sectors equals that \$298 billion in federal deficit spending.

Can the chairman answer the question now?

Senator Y: Certainly, but please repeat it; thank you. [Question repeated.]

Fed Chairman: Yes.

Senator X: Thank you. And, likewise, Mr. Chairman, did not the federal budget surpluses of 1997-2000 **SUBTRACT** exactly that much from what I call (if you'll permit me) the “private savings” of financial assets?

Fed Chairman: Yes, that is correct.

Senator X: Thank you, Mr. Chairman. So we have confirmed—have we not?—that surpluses take away from savings, and deficits add to savings, to the penny?

Fed Chairman: Yes.

Senator X: Now, Mr. Chairman, tell me: Is it not true that, if one were to pay his taxes with actual cash at the Fed, the Fed would give that person a receipt that says the taxes have been paid and then take the cash and toss it into a shredder?

Fed Chairman: Yes, that's our current policy. In the past, cash received that way was incinerated.

Senator X: Most interesting!

Therefore, if we levied additional taxes—perhaps as an attempt to “save Social Security”—and those taxes were paid in cash, the bills would be shredded?

Fed Chairman: Yes, that is operationally correct.

Senator X: Well then . . . clearly, the government isn't collecting taxes in cash in order to actually use that cash to pay for anything, or it wouldn't destroy it?

Fed Chairman: Yes, Senator, that is correct.

Senator X: Now, if taxes are paid by check, does the government actually “get” anything? I assume a gold coin doesn't jump out of the Fed's computer, or anything like that. [Laughter]

In fact, if I pay by check, isn't it true that all the Fed does is reduce the balance of my bank at the Fed, and, in turn, my bank reduces my balance?

Fed Chairman: Yes, that is exactly what happens.

Senator X: Therefore, when I pay my taxes by check, a figure on my bank statement gets changed (i.e., reduced). But, again, it seems that the government isn't actually “getting anything” to spend?

Fed Chairman: That is correct, Senator. However, we “account” for the payment with a credit to the US Treasury's account. And, by law, the Treasury can't spend without having money in its account.

Senator X: Understood. Thank you.

Now, when you specify “by law,” are you saying there's nothing, operationally, to stop the US Treasury from spending? That you could physically “clear” any check the Treasury writes?

In other words, what keeps the Treasury from spending more than the balance in its account at the Fed is not an operational constraint but, rather, what I would call a constraint “self imposed” by government statute.

Fed Chairman: Very true.

Senator X: Is it fair to say, then, that government spending is not inherently revenue-constrained? And that any such constraints on government spending are necessarily self-imposed?

Or, to put it more simply: Treasury checks don't bounce, even with no money in the Treasury's account at the Fed, as long as the Fed **DECIDES** to clear the checks?

Fed Chairman: Correct again, sir.

Senator X: So a Social Security check won't ever bounce, regardless of trust fund balances, if the Fed **DECIDES** to clear the check?

Fed Chairman: Yes. There is no operational danger of Social Security checks not clearing if Congress mandates that the checks clear.

Senator Z: Even with no money in the Social Security Trust Fund?

Fed Chairman: Correct; even with no money in the Social Security Trust Fund.

Senator Y: So what is the risk of the trust fund running out?

Senator X: Mr. Chairman, isn't it about inflation, not solvency? I offer this quote from former Chairman Greenspan in response to Congressman Ryan:

Ryan: "Do you believe that personal retirement accounts can help us achieve solvency for the system and make those future retiree benefits more secure?"

Greenspan: "Well, I wouldn't say that the pay-as-you-go benefits are insecure, in the sense that there's nothing to prevent the federal government from creating as much money as it wants and paying it to somebody. The question is, how do you set up a system which assures that the real assets are created which those benefits are employed to purchase."

Fed Chairman: Yes.

Senator X: So collecting taxes is also about controlling inflation? As we just showed, the government shreds the currency when taxes are paid in cash, and paying by check doesn't give the government anything that is actually operationally spent; so it must be about inflation?

Fed Chairman: Correct.

Senator X: Thank you. And, just to clarify, when someone gets a Social Security payment, all the government does is increase the figure in that person's bank account, either directly (when direct deposit is utilized) or when the recipient deposits the check?

Fed Chairman: Yes.

Senator X: So the government doesn't lose anything "real" when it spends?

Fed Chairman: Correct.

Senator X: Would you agree that this is much like what happens when you go bowling? When you knock down 5 pins and your score changes from 20

to 25, no one questions where the bowling alley gets the points. Or, when you kick a field goal and the scoreboard changes from 7 points to 10 points, no one questions where those points come from.

Fed Chairman: Yes. Today's monetary system is very much akin to scorekeeping.

Senator X: So, just as no one would demand that a bowling alley keep 100,000 points in reserve in case a lot of people came in to bowl, it serves no operational purpose for the government to keep its dollars in reserves?

Fed Chairman: Yes, I would agree with that.

Senator X: Now let's move on to inflation . . . which is the real danger of overspending—not solvency, default, or bankruptcy. Is that correct?

Fed Chairman: Yes, agreed.

Senator X: So, let's take Social Security again. Might it be more useful to “score” the future of Social Security by the inflation it might create, rather than by the size of the trust fund or by the size of a future deficit it might create?

Fed Chairman: Absolutely.

Senator X: Is the same true for healthcare proposals?

Fed Chairman: Yes.

Senator X: So, again, Mr. Chairman, collecting taxes functions to reduce inflation, not raise revenue per se?

Fed Chairman: That is correct.

Senator X: Very interesting, because we've been led to believe that inflation is a “monetary phenomena”—whatever that means—and therefore it is “monetary policy” that matters for inflation; and now you're saying that fiscal policy is also a contributing factor?

Fed Chairman: Yes. Technically, both contribute to inflation.

Senator X: Thank you, Mr. Chairman, for your enlightening testimony.

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THE WORKINGS OF FEDERAL FINANCE: AN OVERVIEW

This policy tutorial should dispel your conventional beliefs regarding government finance and its effects on the economy.

Can the federal government run out of money? While they can overspend and drive up prices, sovereign governments with flexible exchange rate regimes cannot become insolvent. In other words, such governments can never run out of money and be forced to default on their payment commitments. All constraints on government spending, such as principles of “sound finance” and balanced budgets, are self-imposed, i.e., they can be removed, given a willingness to do so.

Do tax receipts generate cash for the Treasury? Government tax receipts do not “provide” funds for government expenditures. In the US, tax payments “clear” when the Fed debits a private bank’s account and credits the Treasury’s account at the Federal Reserve. Tax collections serve as an aggregate demand management tool and as an instrument to control aggregate financial reserves in the economy; but they *never* serve as a means of generating cash receipts in order to “finance” government expenditures.

What role do bond sales play in federal finance? The federal government does not need to collect money by taxing or borrowing in order to spend. So it does not need to issue and sell government bonds in order to generate revenue receipts.

The sale of government bonds on the open market by the US Federal Reserve Bank serves other purposes, such as controlling commercial banks’ idle reserves, to maintain the stability of the Fed funds rate, but it is not a collection tool to actually pay for government expenditures. Briefly, since excess commercial bank reserves would put a downward pressure on the Fed funds rate, the sale of bonds to the banks would drain the excess reserves and restore the target rate for the Fed funds rate. The purpose of bond sales is, thus, not to generate government revenues but to support and stabilize interest rates.

How does the federal government make expenditures? If the government does not, operationally, need to collect taxes or sell bonds in order to spend, how does it spend? The answer is that the government spends by issuing checks or by directly crediting bank deposits. The Treasury issues checks by drawing on its account at the Federal Reserve. And, if the Treasury wants to spend in excess of its current balance, even if there is no money in the Treasury’s account at the Fed, the Treasury can still write checks and they will not bounce as long as the Federal Reserve decides to clear them.

How does the federal government pay for Social Security benefits? As long as the Federal Reserve Bank—an arm of the government—continues to clear the Social Security checks issued by the Treasury—also an arm of government—the US government will never default on its Social Security payment commitments. When a Social Security check is issued to a beneficiary, a check is issued by the Treasury, drawn on its account at the Federal Reserve; the recipient deposits it in a commercial bank, and

the check is said to “clear.” This means the Fed has changed the numbers in various accounts, “adding” to the beneficiary’s account and to the reserve balance of his bank. The government does not need any “cash” in the Social Security Trust Fund in order to make Social Security payments, because, effectively, the government spends by simply changing the numbers in the recipient’s bank accounts. The Social Security Trust Fund does “exist,” but only in the sense that the score of a football game “exists.” The image of a safe-deposit box where payroll tax receipts are locked away for future payments to beneficiaries is not applicable. Payroll taxes are accounted for in the trust fund, but this “account” is after-the-fact recordkeeping, not an operational constraint. The trust fund balances are irrelevant regarding the ability of the government to make payments. As long as Congress stipulates that Social Security checks be cleared, they will be cleared, no matter how much (or little) “money” there is in the Social Security Trust Fund or in the Treasury’s account at the Fed. The federal government can always make all payments as they come due, just like it is able to make the military payroll, whether the budget is in surplus or deficit, despite the fact that there are no “reserves” for military spending.

What should be Social Security recipients’ main concern? What Social Security beneficiaries should worry about is the ability of the economy to produce *real* goods and services to support them during their retirement. What the government must ensure is that there are sufficient human and natural resources to provide Social Security beneficiaries with real goods and services that will be purchased with their Social Security payments. Therefore, the issues involved with Social Security are real, *not* financial. Again, the issue is not a lack of tax collections to support Social Security payments; the issue is a possible—but unlikely—lack of human resources capable and willing to work, which may lead to a deficiency of goods and services produced.

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