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Report No. 76-19 E

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THE NATIONAL DEBT: A DISCUSSION  
OF THE ISSUES INVOLVED

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## THE NATIONAL DEBT: A DISCUSSION OF THE ISSUES INVOLVED

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## THE NATIONAL DEBT: A DISCUSSION OF THE ISSUES INVOLVED

### I. Introduction

The practice of government borrowing from the public to finance its activities has been a controversial area for decades. The shades of opinion on national debt have ranged from those who condemn deficit financing as an unmitigated evil eventually leading to impoverishment and bankruptcy to those who view a rising national debt as an indicator of prosperity and a stimulator of economic growth. Why is there such a wide span of opinion? Interpretations of national debt statistics are very much a part of one's outlook and thinking on government spending and the proper role of government in the economy. Speaking in general terms, the less scope afforded governmental intervention in the economy, the less favorable is the outlook on deficit spending.

This paper is an attempt to integrate a great deal of diverse material on the national debt into a cohesive form. It is meant to serve as a briefing for those not familiar with the issues engendered by the national debt and deficit spending. To the extent that we may have attempted to integrate too much material, the objective of cohesiveness may have been compromised. Indeed, certain sections of this paper could stand alone as examinations of specific parts of the general topic.

This paper is not intended to provide a specific answer to the question, "How big can the national debt become?" To our knowledge, no one has attempted to specify an amount in answering this question. Rather, the discussion revolves around the financing of the deficit in a given year, and the effect it may have on the economy.

Because of the wide range of subjects covered, this paper is not intended to be a definitive, comprehensive study; especially in the area of macroeconomics, we have oversimplified. However, this is in line with the objective of the paper. Those interested in a more sophisticated examination of the economics involved should refer to texts on the subject. For those seeking more specific material on the national debt, we refer you to two Congressional Research Service multiliths--74-172E, National Debt of the United States: Historical Survey and Analysis, and 75-179E, Public Debt Limit Legislation: A Brief History and Some Arguments for and Against It.

## II. The Development of Economic Perceptions on the National Debt

### A. The Classical Point of View

The classical view goes back to the British and French classical economists of the late eighteenth and early nineteenth centuries. In their thinking, the government had only a very limited role to perform in the economy. Legitimately it should spend only for protection and certain objects of "permanent public benefit," e.g., roads, canals, etc. These expenditures should be paid for out of current receipts; the budget should be balanced.

Underlying this prescription of a balanced budget was a presumption that government spending is unproductive and that the most efficient allocation of productive resources could be attained only by private spending in the assumably competitive market. Individuals guided in their buying and selling solely by the desire to maximize

their personal benefit would at the same time of necessity do what the maximization of public good and economic growth required. Thus government spending, by interfering with the efficient allocations achieved by a freely operating competitive market, was wasteful spending, most of which was splurged on irresponsible wars or on maintaining the pomp and circumstance of the ruling elite.

There is this grand distinction between an individual borrower and a borrowing government, that, in general, the former borrows capital for the purpose of beneficial employment, the latter for the purpose of barren consumption and expenditure. 1/

An individual is fully sensible of any value of the article he is consuming; it has probably cost him a world of labour, perseverance and economy; he can easily balance the satisfaction he derives from its consumption against the loss it will involve. But a government is not so immediately interested in regularity and economy, nor does it so soon feel the ill consequences of the opposite qualities. 2/

Restricting government expenditures to current receipts served as a method of placing a brake on wasteful spending. Governmental responsibility would be encouraged since the government in financing its activities, would be dependent solely on its receipts.

The early economists were also concerned about the effect of an unbalanced budget on industry and commerce. They concluded that government borrowing lessened the amount of capital available to

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1/ Say, Jean Baptiste. A Treatise on Political Economy; or, the Production, Distribution, and Consumption of Wealth. (London) 1821. p. 418.

2/ Ibid., p. 418.

industry for productive purposes. Deficit financing took money out of the hands of merchants, who would have used it to further trade or enlarge the stock of capital, and placed it in the hands of the government to be used inefficiently.

In further support of their antipathy to government borrowing, the classical economists advanced a line of reasoning which even today underlies much of the public concern over the size of the national debt. This line of reasoning is that government borrowing and spending is analogous to private borrowing and spending. While this notion is generally condemned by contemporary economists, it continues to have appeal among the general public.

Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.

To the classical economists' way of thinking, this famous Dickens maxim was just as applicable to government as to private families. Economic morality required the virtue of thrift. Failure on the part of the public household to live within its income would result in the same unhappy consequences as when individuals incur financial obligations in excess of their means.

. . . Should an individual take it into his head, that the more he spends the more he gets, or that his profusion is a virtue; or should he yield to the powerful attractions of pleasure, . . . he will in all probability be ruined, and his example will operate upon a very small circle of his neighbours. But a mistake of this kind in government, will entail misery upon millions and possibly end in national downfall and degradation. . . . Economy and order are virtues in a private station; but, in a public station, their influence

upon national happiness is so immense, that one hardly knows how sufficiently to extol and honour them in the guides and rulers of the national conduct. 3/

Early economists were also apprehensive about tax burdens which they claimed resulted from deficit spending. Although opinion on the exact nature of this burden varied, they tended to associate rising deficit spending with rising taxes. Later economists became more concerned with the idea that the burdens of deficit spending are shifted to future generations.

Briefly, the basic outline of traditional thinking on public debt management can be summed up as follows: That the principles of sound financial management applicable to private households are equally applicable to the public household, that public debt imposes interest burdens paid for by higher taxes, that public debt constitutes a burden passed on "to our grandchildren," that government debt is unproductive and inflationary.

Few of the classical economists supported completely all of the above statement. Even in their earliest writings there were more optimistic views of public debt. However, the generally shared perception that, under some circumstances, public deficit spending represents a normal and expected state of affairs is a development of recent decades.

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3/ Ibid.



### B. The Contemporary Point of View

The shift in economic thinking away from the ideal of the balanced budget was in good part occasioned by the depression of the early 1930's. Economists increasingly abandoned their belief in the merits of a balanced budget because tax increases did not, and apparently could not, balance the budget. Deflation fed on itself instead of acting as a corrective to bring a new period of expansion of private enterprise, and extremes of unemployment and hunger demanded relief.

Economists began to struggle away from the classical belief that savings must be accumulated by each investor prior to his investment. They began to accept the Keynesian notion that what was important was that total savings equal total investment in an economic system. If the government, through deficit spending, provided an outlet for savings not being otherwise employed in investments, income could be generated and the downward spiral of deflation caused by excessive savings might be slowed or reversed. Economists could then contend that government expenditures are productive in the sense that they generate income, satisfy demands for public goods, and employ resources that would otherwise be idle. This realization grew with the size of the public sector, as the interdependency of the public and private sectors became clearer. It provided a rationale for active government participation in the economy, and did substantial damage to the classical argument that government spending is inherently wasteful and that

therefore deficits, by removing capital from productive use, necessarily contributes to economic stagnation.

National debt can be just as effective a means of activating idle savings as private debt. Not only does national debt serve as a method of mobilizing idle funds for useful public purposes, but it provides private investors with earning assets readily convertible into cash. Such an investment outlet is important to commercial banks, trust funds and other investors who require maximum safety as well as a good return on investments. As a result, the national debt has become part of our nation's financial system.

### III. The National Debt and the U.S. Economy: Some Comparisons

At the end of fiscal year 1975, the national debt stood at \$534 billion. To understand the effect of the size of debt on the economy, it is first necessary to make some comparisons of debt and debt charges with the wealth and income of the nation.

Since the end of World War II, the public debt as a percentage of gross national product (GNP) has fallen significantly. From a high of 129 percent of the GNP in 1946, it has fallen to 33.8 percent by

the end of fiscal year 1974. Because of the economic recession and inflation, it is expected to rise to 37.6 percent of GNP by the end of fiscal year 1977. The interest paid to support the public debt each year, the standard measure of the "cost" of the debt, has fluctuated as a percentage of GNP. From a high of 2.24 percent in 1946, it fell to 1.60 percent by 1966. Since then it has again risen to 2.24 percent of GNP in fiscal 1975. If, however, we subtract from the figure the \$7,769 million in interest paid to the government trust funds, the figure drops to 1.70 percent of GNP. This \$7,769 million represents interest earned by trust funds on government securities owned by them. By law, trust fund surpluses must be invested in Federal securities.

Some other statistics also provide a useful perspective on the debt. For example, between December 1945 and December 1974, the debt of the Federal Government and its agencies increased by 80 percent. During the same period, the debt of State and local governments increased 1,208 percent, that of corporate business 1,415 percent, and that of individuals and non-corporate businesses 1,509 percent. Finally, between 1945 and 1974, the ratio of per capita public debt to per capita personal income fell from 154 percent to approximately 41 percent.

On the bases of such statistical comparisons most economists have come to agree that, although the national debt and national debt interest

payments appear large in absolute terms, when viewed in the context of the size of our national economy, they are manageable. At current growth levels most economists see no danger of some sort of national economic collapse due to the size of our national debt.

#### IV. Misconceptions About the National Debt

##### A. The Analogy Between Family and National Debt

Most contemporary economists approach cautiously the idea that there is a valid analogy between personal and national debt. The traditional economic wisdom portraying any debt as intrinsically bad is not applicable to national budgeting.

Debt, of course, has a cost for either a government or an individual wage earner. But the benefits can justify the cost. The benefits of private consumer debt are recognized by the borrowers and by the merchants and manufacturers whose sales depend on it. The advantages of public debt are equally clear to those who benefit from programs financed through government borrowing.

The national debt is principally an internally held debt. That is, we owe most of it to ourselves. Taxes imposed to service the national debt are collected from some Americans and paid other Americans. In many instances, those taxed to service the debt and those receiving interest payments are the same.

The exception to this is the slightly more than 12 percent of the national debt that is owned by foreign official institutions and citizens of other countries. Foreign ownership of the national debt has grown rapidly in recent years. This is a natural consequence of increasing wealth in other parts of the world.

The interest paid to support this foreign-held debt is the only loss of disposable income involved in the national debt. Within the nation, unlike within a family, everybody's borrowing is somebody else's credit. The burden placed on the economy is minimal.

Contemporary economists stress a second way in which public debt differs from private debt. A family which continuously incurs large deficits may endanger its credit rating. An individual's credit rating is for the most part based on his limited amount of income and wealth. As his debt grows large in relation to these assets, his creditors become reluctant to grant additional loans for fear of failure to repay. Unlike the individual, the debt-carrying capacity of the United States is, for practical purposes, unlimited in the foreseeable future. Securing the credit rating of the nation are the powers to tax and to create currency as well as a vast amount of real wealth. These are formidable assets which not even the wealthiest individuals or the largest corporations have. For this reason the United States credit rating is secure and a United States government bond is regarded as free of danger of default.

B. Borrowing Versus Taxation

Some writers contend that government borrowing imposes a burden which would not be imposed by taxes. Economists acknowledge that deficit spending may occasion difficulties arising from the process of transferring resources from private to public uses. However, since public goods as well as private goods are valuable and in demand, a burden in the economic sense can only be said to exist if the public uses of resources result in a greater waste of productive efficiency than if those resources were employed in private use. But such a burden, caused by inefficient use of resources, can occur with any type of governmental spending, whether tax or deficit financed. With the economy operating at less than full employment, this burden should not occur since, in theory, government deficit spending utilizes resources that otherwise would go unused.

C. Income Redistribution

Another type of burden frequently cited involves the redistribution of income caused by interest paid on the principle of the debt. It is contended that these payments are taken from the less well-off to pay the more advantaged, since it is the more advantaged who own interest bearing assets such as Federal securities. The effect would be that of a regressive tax at variance with the notion of equity expressed in our progressive income tax system.

It seems unlikely that there is a significant relationship between

the taxes an individual or institution pays to support the debt, and the interest payments they receive. There does exist a correlation between income and overall interest received. But this includes interest from many sources other than U.S. Government securities. Even if debt financing could be shown to have the postulated regressive effect on income distribution, several factors would work to minimize it. First, the national debt is very widely held. Nearly everyone, either directly or indirectly, owns part of it, and thereby receives some interest. Direct ownership involves the purchase of savings bonds or other government securities. Indirect participation occurs through associations, such as banks and insurance companies, that invest in large denomination Treasury securities. Even wider participation occurs through ownership of public debt securities by the Federal trust funds.

Secondly, this postulated regressive effect would be offset by the progressive nature of the income tax structure. That is, those who received more interest would probably be paying more taxes. Interest on Federal debt issues is taxable at the same rate as other personal income.

#### D. National Debt Burdens and Our Grandchildren

Some have advanced the argument that future generations will have to repay the debt we incur. This burden (if, as we discussed earlier, it is a burden) cannot possibly be shifted to future generations. The present generation can employ only resources currently existing. It

cannot utilize those which do not yet exist, thereby depriving future generations of them. It is the present generation which must utilize fewer private goods in order to have more public ones.

Economists emphasize that though the debt will not be retired by the present generation, neither will the next generation have to pay for it. Although the individual securities will be paid off as they mature, they can always be replaced with new ones. There is no need ever to pay off the national debt. Even if the national debt were to be repaid by the next generation, that same generation would receive the payments. The next generation will inherit the securities which represent claims against the national debt as well as the responsibility to repay the debt. By the same reasoning, if we of this generation were to repay the debt, we could not say that our children would be better off. They would inherit cash or securities less secure than those issued by the Federal Government. Again, it should be pointed out that this does not apply to that part of the debt that is foreign-owned.

#### V. The National Debt and Inflation

It is usually assumed by the layman that there is always a direct and significant correlation between deficit spending and inflation. Contemporary economists feel that this assertion of a necessary link between the two is based on an incomplete understanding of government



spending and the causes of inflation. While increased government spending was a factor in the very serious inflation experienced in our history, the inflation was able to grow to chronic proportions due to the stress placed on productive capacity by periods of war and the peculiar inability of government at such times to direct its economic affairs to alleviate inflation.

On the basis of historical data, economists have concluded that there is no observable systematic relation between large government deficits and rising price levels. The table below tends to confirm this by comparing fiscal year deficits or surpluses with the change in the consumer price index for the associated calendar year.

<u>Year</u>	<u>Surplus or Deficit (in billions)</u>	<u>Percent Change in CPI</u>
1951	+6.1	+ 5.9
1952	-1.5	+ .9
1953	-6.5	+ .6
1954	-1.2	- .5
1955	-3.0	+ .4
1956	+4.1	+ 2.9
1957	+3.2	+ 3.0
1958	-2.9	+ 1.8
1959	-12.9	+ 1.5
1960	+.3	+ 1.5
1961	-3.4	+ .7
1962	-7.1	+ 1.2
1963	-4.8	+ 1.6
1964	-5.9	+ 1.2
1965	-1.6	+ 1.9
1966	-3.8	+ 3.4
1967	-8.7	+ 3.0
1968	-25.1	+ 4.7
1969	+3.2	+ 6.1
1970	-2.8	+ 5.5
1971	-23.0	+ 3.4
1972	-23.2	+ 3.4
1973	-14.3	+ 8.8
1974	-3.5	+12.2

Budget deficits and inflation cannot be correlated either in direction or magnitude. There have been budget surpluses corresponding with large increases in the CPI, as in 1969. There have been large deficits when only small increases in the CPI were reported, and small deficits with large increases in the CPI. Compare the years 1971 and 1972 with 1974. In some years, as in 1968, the traditional relationship has appeared valid. This does not mean that Federal deficit spending is not a factor in inflation, but it does indicate that other considerations are also important.

The classical condition of inflation, as it relates to Federal spending, occurs in the following manner: Government deficit spending adds additional demands for goods and services to the normal level of demand. This increase in demand stimulates a greater amount of productive activity, employing more persons at higher wages. Taxes tend to lag behind wage increases, leaving workers with augmented disposable incomes. They are now able to buy more goods and services. However, the amount of goods and services available for private consumption does not increase at a rate complimentary to increases in income, because resources which normally would go for private consumption are being transferred to public uses. Thus, too many dollars are chasing too few goods, and prices are bid up.

Most economists would say that to ascertain whether a given increase in government spending (or private spending for that matter)

will occasion inflation, it is necessary to look at the factors of supply and demand operating.

Under conditions where the economy is depressed, there are many idle resources. Deficits would be more likely to lead to an increase in production and employment than to inflation. As the government spends more, additional workers will be hired and unused productive capacity will be put to use. As employment increases, consumption will also increase. This will set off another round of employment, production and spending. At the onset, prices may rise slightly, but as businesses compete for more sales, more unemployed factors of production will be utilized to extend the supplies, and prices will stabilize. The important point is that demand increases only as production grows. Demand does not exceed supply as in the classical case of inflation described above. In the opposite situation of economic growth, increased government spending in the absence of an offsetting decline in private spending has the potential to be inflationary.

Finally, let us examine the source of the current record deficits, keeping in mind the conditions under which deficit spending may or may not be inflationary. Current economic theory estimates that each percent of unemployment over four percent costs the Federal Government approximately \$16 billion. (Tax revenues decline \$14 billion as income drops. Outlays increase by \$2 billion for employment-related programs such as food stamps and unemployment benefits.) Therefore, the current condition of the economy itself (with unem-

ployment conservatively estimated at 8 percent) makes a budget deficit of \$64 billion almost unavoidable.<sup>4/</sup> Yet we can see from the above discussion this deficit need not be inflationary. That part of it generated by declining revenues (\$56 of the \$64 billion in our example) does not represent an inflationary increase in government demand for goods and services. The \$8 billion that does represent increased spending only partially offsets the decline in private demand it is supposed to accommodate. Some responsible economists, in fact, have argued that the expected fiscal 1976 deficit will have, at best, a neutral effect on the economy. They point out that if the deficit is to assist in the recovery, it must be large enough to generate additional demand--not just replace that lost to the recession.

The above discussion reflects traditional economic arguments that were, until recently, generally accepted as true. However, the recent phenomenon of economic recession coupled with inflation has caused these arguments to be questioned. In the context in which it was first constructed traditional theory may still be valid. But changing circumstances have added variables for which it has trouble accounting.

A significant part of the inflation we have experienced recently has been caused by shortages of supply instead of increased demand. This trend has been especially noticeable in the areas of food and petroleum products. As previously discussed, inflation thought to result

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<sup>4/</sup> On January 15, 1976, Nancy Teeters, Assistant Director for Economic Analysis of the House Budget Committee, in a Congressional Research Service seminar on budgeting, estimated that if the deficit ran to \$75 billion in fiscal year 1976, \$73 billion of it would be attributable to these recession-induced changes in receipts and outlays.

from deficit spending is usually associated with excess demand.

In past recessions, prices have dropped as demand fell, and businesses have usually increased their prices when rising demand signaled the end of recession. This time, the list prices of most industrial goods did not decline, and businessmen began to raise them very early in the recovery. Businessmen explain these trends by pointing to the failure of their costs to decline during this recession, as they have in past ones, due to the rising costs of energy, labor, and raw materials.<sup>5/</sup>

Part of the explanation may also lie in changes in the economic structure of this country. Many businessmen perceive that a large number of industries have become oligopolistic<sup>6/</sup> in nature. Prices in such industries generally fluctuate less widely than those in more competitive industries. Each seller hesitates to lower prices because he knows that his few competitors will immediately match the cuts, leaving him with approximately the same share of the total market and lower profits. This hesitancy has also been encouraged by an unusual willingness on the part of consumers to tolerate higher prices.<sup>7/</sup>

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<sup>5/</sup> Anderson, Harry B. Price Rise Resurgence Despite Idle Capacity Stirs Debate on Causes. Wall Street Journal, August 22, 1975: 1, 6.

<sup>6/</sup> An oligopoly is a type of market structure in which a small number of firms supply the major portion of an industry's output. The best known example in the U.S. economy is probably the automobile industry.

<sup>7/</sup> Op. cit., Anderson.

The relationship between deficit spending and inflation postulated by economic theory is a viable one. But in the simplified form by which it is usually applied by the layman, i.e. that deficit spending directly causes inflation, it cannot be empirically verified. Inflation results from the interaction of a number of variables, of which deficit spending is only one.

#### VI. Financing the Deficit

The evidence overwhelmingly supports the position that the total size of our national debt and the cost of supporting it pose little, if any, difficulty for our economy. On the other hand, it is possible that the intrusions of the Treasury Department into the capital markets to obtain funds to support new debt and to refinance old debt has the potential to cause disruption in our economy. Whether or not such damage will occur, under what circumstances it could occur, and how serious it might be is a controversial subject.

##### A. The Nature of the Controversy

The total funds available to all classes of borrowers consists of the total of business savings, personal savings, and inflows of foreign funds.<sup>8/</sup> This is the amount available to finance all investment plus

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<sup>8/</sup> The Federal Reserve, in its capacity as the nation's money manager, also influences this total through open market operations, changes in the reserve requirement for member banks, and changes in the rate at which it lends funds to member banks.

the government deficit. The mechanism for financing most investment and government deficits is borrowing (some private investment is financed through earnings). The competitive allocation of available funds in the money market is determined by the variable interest rate.

The Federal Government finances deficit spending in the same manner as an individual or a corporation; by competing for available funds in the money market. It is true that the scale of borrowing differs substantially from that of other borrowers, but the process is similar. The government must offer an interest rate high enough to make the securities it offers attractive to potential investors.

Traditionally, a supply of funds greater than the demand for funds should cause the interest rate to decline, thereby making some investments seem more attractive (by making them less expensive) and increasing money demand. This process should continue until money demand begins to exceed supply. Then, interest rates begin to rise again, discouraging investment and restoring equilibrium between money demand and supply. Recently, however, we have been experiencing the phenomenon of high interest rates coupled with low demand for funds. This may be partly explained by the high rate of inflation. A lender who does not receive an interest rate equal to or greater than the rate of inflation will lose money over the term of the loan. While recession keeps demand for funds low, inflation assures the maintenance of high interest rates. Additionally, many experts,

including Federal Reserve Chairman Arthur Burns, have suggested that certain noneconomic factors, such as public perception of the state of the economy, affect the supply and demand of funds.

The supply of funds available for investment depends on the total amount saved and the results of the Federal Reserve's attempts to regulate the money supply. The amount saved is determined not only by the interest rate, but by the state of the economy and the savers' perception of it. The demand for funds is most affected by the state of the economy. Economic growth involves the expansion of investment, accompanied by a strong demand for funds to finance it. Conversely, conditions of recession result in a significant drop in investment. The demand for money falls.

The Federal Government, borrowing to finance its deficits, is competing with private borrowers who need funds to invest in such things as new housing or productive capacity. A record deficit, caused by a serious economic slump, forces the government to borrow unprecedented amounts of money in a short period of time. The same slump causes a decline in demand for funds in the private sector.

With the above discussion as background, the controversy which arises can be stated as follows: Will the massive increase in Federal borrowing occasioned by the record deficits be offset by an equal or greater decline in investment in the private sector? Those who answer this question affirmatively assert that financing the deficit



will not cause serious economic difficulties or threaten the recovery. Indeed, they see the deficit as performing a crucial role in utilizing productive capacity that would otherwise be left unused, thereby aiding the recovery. One well-known liberal economist has stated this argument in the following manner:

. . . the very forces of rampant recession that make tax and budgetary stimulus so imperative are the forces that open up a yawning financial gap for the deficit to fill. The deeper the plunge of the economy, the greater the shrinkage of private outlets for savings in the form of corporate borrowing, mortgages, and consumer installment debts. In an economy running \$175 billion below its potential, the deficit will help fill the void, not elbow out private borrowing. 9/

Those on the other side of the controversy insist that the drop in private investment caused by the recession will not be large enough to offset the record government demand for funds. They foresee, to use the popular term, "crowding out." Private investors with poor credit ratings, unable to pay the high interest rates caused by the massive Federal demand for funds, will find themselves unable to obtain the funds they need to undertake investments. Due to their inability to compete with the Federal Government, they will find themselves "crowded out" of the financial markets.

An alternative, according to this view, is for the Federal Reserve to expand the money supply at an accelerated rate to supply the demand

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9/ Heller, Walter W. Deficit: Where is Thy Sting? Wall Street Journal, v. 185, March 7, 1975: 10.

funds. This procedure could lead to renewed inflation. Saloman Brothers saw the dilemma this way:

The consequences of a U.S. budget deficit substantially greater than the nearly \$50 billion estimated by us for calendar 1975 should be clearly recognized. Such a deficit could be reasonably financed only if the economic contraction this year is much greater than we expect. Otherwise the budget deficit would either lead to a vicious struggle for funds between private borrowers and the government, or the Federal Reserve would have to supply funds without regard to its long-range responsibilities. In any event, a larger than expected deficit would threaten economic recovery, despite the best intentions of government, by crowding out medium to lower rated borrowers, many of whom are already in peril, and mortgage borrowers as well, thus aborting recovery in housing activity. 10/

#### B. Picking a Side: Savings Versus Investment

There is little disagreement over the economic theories involved in this controversy. Most economists agree on the several mechanisms through which crowding out may occur. However, they differ as to which are the most important. Whether or not one believes that crowding out will be a problem, and when one believes it will occur, depends on which figures one accepts as representative of savings and investment to be undertaken this year.

The Wall Street Journal, for example, estimated that in calendar year 1975, the demand for borrowed funds (projected investment plus the Federal deficit) would exceed the savings pool (funds available for borrowing) by \$35 billion. Since the borrowing of the Federal Government always has first priority, \$35 billion in private investment would

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10/ The Wall Street Journal. Crowding Out. v. 185, March 13, 1975: 16.

be crowded out. The Journal, while acknowledging that its estimates may be off to some extent, insisted that the estimate was a conservative one. <sup>11/</sup>

Responding to this analysis, Mr. Larry Chimerine, manager of U.S. Economic Forecasting for IBM, suggested that the Journal's estimate of total private investment in 1975 was much too high. His own estimate of \$176.4 billion is almost \$30 billion below that of the Journal. <sup>12/</sup> Mr. Chimerine's figures, if correct, would mean the effective elimination of the problem of crowding out, at least in 1975. Resultingly, interest rates would not rise dramatically and the recovery would not be threatened.

Crowding out is always occurring. As economic conditions change, some borrowers can afford to obtain the funds they need, and others cannot. This is the way the financial markets function. The question in 1975 was whether intensive government borrowing would crowd out so many borrowers as to threaten the recovery. Crowding out never appeared in a serious way, and corporate borrowing in the bond market was in record volume. <sup>13/</sup>

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<sup>11/</sup> Ibid.

<sup>12/</sup> The Wall Street Journal. Letters on Deficit Financing. v. 185, April 2, 1975: 16.

<sup>13/</sup> Morgan Guaranty Survey, The Economy at Yearend--Review and Outlook. December 1975. p. 6.

## VII. Summary

The role of the national debt in public finance is complicated. It must be viewed from several different perspectives. Looking at the total amount of the debt, and the cost of supporting it, the economic problems involved seem manageable. We can afford to support the current debt and, if we chose, additional debt. This is not to support continued deficit spending, but simply to say that it is economically possible. No serious consequences can be predicted because of the size of the debt. There is no apparent or predictable magnitude of debt at which level difficulties develop.

The effects of financing a deficit in a given year, on the other hand, are seriously debated by economists. Recently, this debate has occasioned by the seriousness of the recession. One side sees the deficit as filling the gap in demand left by the decline in private demand during a recession. The other side fears that financing of the deficit will result in significant crowding out, which in and of itself is seen as a potentially serious blow to economic recovery. The mechanism by which crowding out occurs is one that most economists agree upon. The perception of the seriousness of the problem depends upon one's view of the solution of the economy.

Due to the polarization of these two viewpoints in 1975, the issue became clouded, with one side warning of dire consequences and the other being optimistic on the effects of the deficit. The adoption of a

middle ground between these two positions provides a more reasonable perspective. Crowding out is the normal process through which funds are allocated in the money markets. It is not a process which has suddenly materialized this year because of economic conditions as the publicity it has received might lead one to believe. In fact, crowding out did not occur in any important way in 1975. Nevertheless, it is a continuing and significant phenomenon, and merits attention.

Over the years, the traditional arguments condemning government spending and all forms of debt have been eroded by a changing economic structure and the development of economic theory. Debt has become an integral, and necessary, mechanism in the functioning of our economy. Yet this need not indicate that continually expanding government (or private) debt is good. Since 1931, only seven Federal budgets have shown surpluses. Most of increases in the national debt have resulted "by accident" rather than by formulated policy. While this trend need not be seen as giving rise directly to economic difficulties, it is disturbing in another sense. The growth of our national debt may be seen as a symptom of our inability to control the expenditures of the Federal Government. Given the working interrelationship between the economy and the government, this is a problem to be considered seriously. Even if the national debt does represent a serious problem, or is symptomatic of one, it will not be solved by quick fix or simple solutions. The ultimate question concerns the role

of the Federal Government in our economy, and it is from that point of view that the national debt shall be viewed.