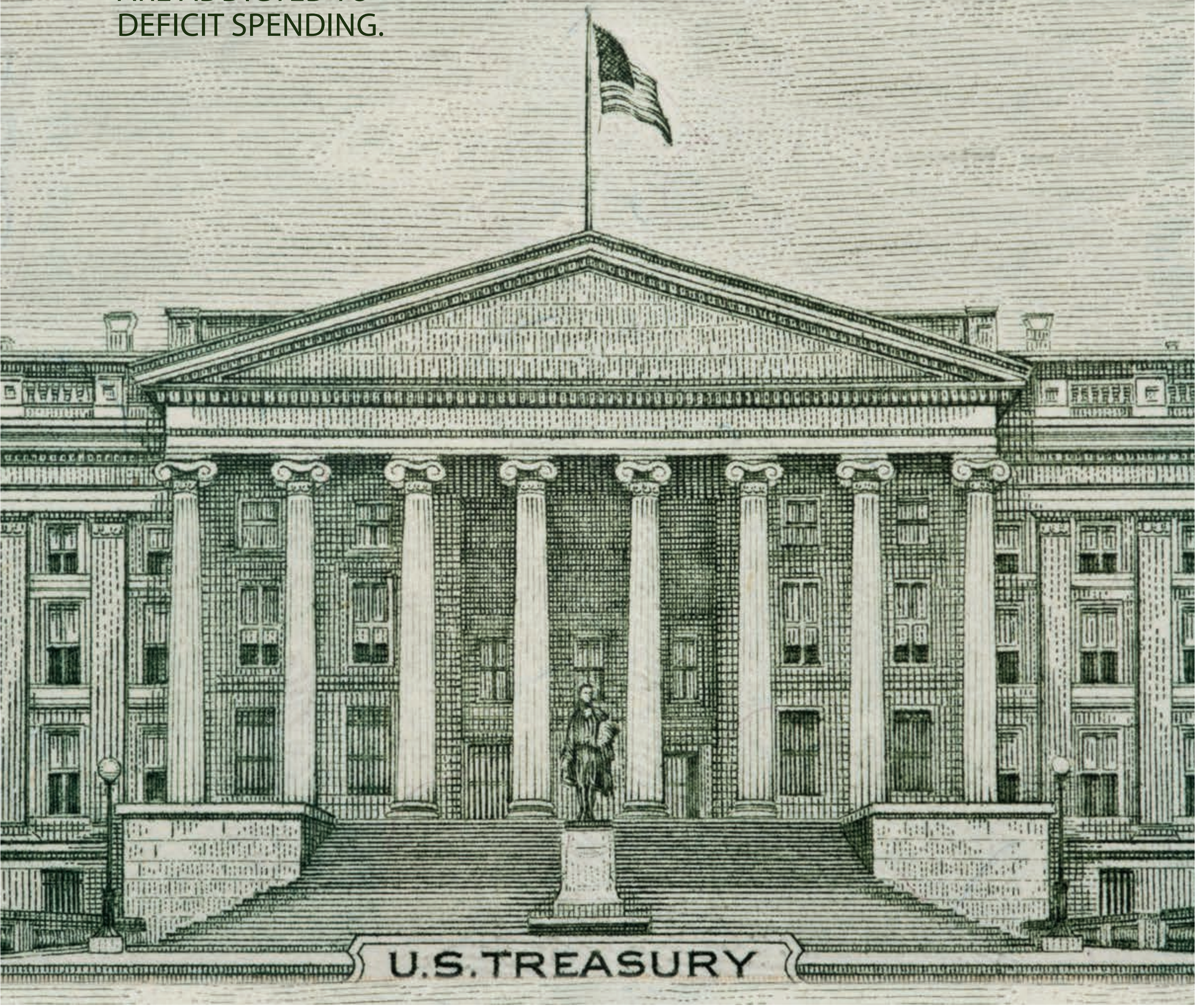
ADDICTED TO DEBT

DON TURKINGTON EXPLAINS WHY GOVERNMENTS ARE ADDICTED TO DEFICIT SPENDING.



DON TURKINGTON
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The US national debt has increased under Barack Obama more than any other president

Underlying the explosion of public debt and emergence of unconventional monetary policies is the tendency of modern governments to spend more than they earn. Deficit spending, however, was not always the norm. Governments historically tended to balance their budgets over the long term. In times of war, deficits were incurred only to be paid down through surpluses with the re-emergence of peace. This began to change with the inexorable rise in government spending so that by the 1960s deficits had become chronic.

Though surpluses were rare, the cumulative effect of past deficits as measured by the public debt was modest at the beginning of this century. In 2000, gross US federal debt was $5.6 trillion or 57 per cent of GDP. This changed with the election of George W. Bush who followed the dictum of his vice president, Dick Cheney, that deficits don't matter. Bush increased spending on most things while simultaneously reducing taxes. By the end of his second term in 2008 gross debt was $10 trillion or 70 per cent of GDP.

Spending in the Obama years has risen dramatically while revenues have changed little. The result is deficits on steroids and a corresponding leap in the public debt. The federal deficit peaked at $1.4 trillion (10.1 per cent of GDP) in 2009 and has not been below a trillion since.

A way of looking at the deficit is the extent to which government's receipts cover expenditures. In 2011, for example, receipts were only 64 per cent of expenditures with the balance of 36 per cent of expenses being added to the public debt. Gross US federal debt equalled the size of GDP by 2011 and is now over 100 per cent, a level in the same league as Ireland and Portugal and considerably higher than Spain.

The comparison of government debt with GDP is not particularly meaningful in that government does not have access to total output. What it does have access to is its current revenue which is a better yardstick for gauging the size and burden of public debt. In 2011, gross federal debt was approximately $15 trillion while total revenue was $2.3 trillion. So the ratio of debt to revenue was 652 per cent. If all government revenue was devoted to debt repayment so there were no other expenditures, it would take six and a half years of revenues at 2011 levels to repay the debt (forgetting about any interest in the meantime).

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As an aside, governments prefer to use net rather than gross debt because the former is a smaller number, which is misleading because government financial assets are not usually available to service or repay debt.

As staggering as these numbers are, they understate the size of the deficit. US government accounting standards are antediluvian and result in an understatement of spending. Moreover, the unfunded liabilities in existing entitlement programs such as Medicare and Social Security are ignored yet have been conservatively estimated at $60 trillion or more (compared with a stated gross federal debt of about $17 trillion).

The US experience is far from unique. Britain's public debt to GDP ratio has doubled since 2007 to 90 per cent, a level similar to that of France. Japan has run substantial deficits since the mid 1990s but recent ones are large even by Japanese standards, resulting in eye-watering levels of government debt (240 per cent of GDP, the largest in the world).

Australia has also obviously succumbed to the deficit spending bug over the last four years or so. Gross federal government debt as a proportion of GDP fell for 13 successive years to a mere 9.7 per cent in 2007. This reversed dramatically with gross debt more than doubling in only three years to 23 per cent of GDP in 2011.

NOT ONLY HAVE DEFICITS GROWN MASSIVELY THIS CENTURY, **THEY ARE ALSO PROJECTED TO CONTINUE INTO THE FUTURE**

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The states were also engaged in their own spending sprees running up total debt of at least $215 billion (17.5 per cent of GDP) giving combined government gross debt of approximately 40 per cent of GDP. While low by international standards, this is high by historic Australian standards and much higher than Australian governments acknowledge.

Not only have deficits grown massively this century, they are also projected to continue into the future. Indeed, US budget forecasts now never project a surplus. Despite the fact that all analyses of the US deficit declare it to be unsustainable, all official forecasts have it persisting ad infinitum. Deficits are the new norm.

Why has the fiscal orthodoxy of old been turned on its head with the emergence of a big and chronic deficit economy almost everywhere?

The welfare state started small and selective in the context of a widespread aversion to being 'on welfare'. Over time that changed. Governments came to realise that where Peter was robbed to pay Paul, they could always rely on the vote of Paul. So there has been an inherent tendency for the welfare state, and with it the state in general, to expand. The welfare or entitlement state has expanded to the point where need is often not an issue. A good example of this middle class welfare is the Working for Families scheme in New Zealand, where families with four children qualify for payment of benefits, providing family income is less than NZ$125,000 a year. This is a country where the median family income is around NZ$68,000. Such payments are common in many other countries. Where all people over a certain age receive a benefit and three quarters of families receive another benefit, the constituency for the entitlement state becomes enormous.

The deficit economy and the entitlement state have grown hand in hand. In the US, federal transfers to individuals totalled about $24 billion in 1960. By 2010 they were almost 100 times larger in current dollar terms. Adjusting for inflation and population growth, real transfers per head grew 7.3 times over those 50 years. Nearly half of all American households receive transfer benefits from the government.

While more and more Pauls have received ever greater benefits from a beneficent state, the same forces have also encouraged Western governments to shift the burden of taxation with an increasingly large proportion of the population not being liable to pay income tax. In the United States, for example, roughly 47 per cent of Americans did not pay federal income tax in 2010 as compared with only 27 per cent in 1992.

Despite the movement of the tax burden up the income scale, the shrinking tax base has led to total income tax as a proportion of GDP falling in many Western countries. With the dramatic growth in entitlements and shrinking of the tax base, any attitude of self-reliance and independence has reversed, making an effective majority now in favour of entitlements and nil tax. Voters in many Western democracies are incentivised towards larger rather than smaller deficits.

Politicians, for their part, want to win elections or, at least, stay elected. Facing such an electorate there can be little surprise that governments give the voters what they want. And this is true irrespective of the political persuasion of those elected. Politicians of the Right pay lip service to their traditions of fiscal responsibility while behaving in the exact opposite way, while those of the Left cloak their tendency to

GROSS FEDERAL GOVERNMENT DEBT FACTS

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fuel the deficit fires in language of responsibility and well-being for all.

The deficit economy is also a reflection of the growth of the public sector. In Britain, for example, public sector employment in the decade ending 2009 grew at over twice the pace of growth in total employment (to 6.3 million). And the average public sector worker in the UK is paid 14 per cent more than their private sector counterparts, with the public sector 'premium' as high as 25 per cent in some places. In parts of Europe such as Greece, this premium has reached ridiculous proportions.

Economists such as James Buchanan have used 'fiscal illusion' to explain the growth of deficit spending. At its broadest, fiscal illusion obscures the true cost of public expenditure. Fiscal illusion is compounded by the invisibility of many taxes which produces a further disconnect between benefits received from public spending and their perceived cost. In many countries, wages and salaries are taxed at the source so workers never get to see this money. This leads to the irony of appearing to receive something from the government for no cost—little wonder government spending is so popular.

In practice, budget deficits and the resulting debt are financed to an extent through inflation which lowers the real value of the debt and of everything else. Again, individuals have little direct awareness of the costs of inflation. There is thus a general muddying of the true costs of running deficits and so of the actual net benefits received.

The growth in budget deficits accelerated sharply with the onset of the financial crisis in 2007-08. While the crisis arose because of excess debt in Western countries, this did not stop governments responding with sharp increases in deficit spending and debt, a case of fighting fire with fire. On the fiscal front, this meant massive 'stimulus' which self-evidently would revive flagging demand. President Obama put it this way: 'When we've got new teachers doing great work with our kids, then you know what, they go to a restaurant and spend that money. And so suddenly businesses are doing well, the economy is doing well, and we get into a virtuous cycle. And we go up.' Thus deficit spending in a time of crisis acquires a moral dimension which politicians have eagerly exploited. The state was already growing rapidly prior to the financial crisis which provided the impetus for even faster growth.

The basis of Keynesian economics is the argument that aggregate demand and supply in the economy will not necessarily equate, with the result that resources can remain unemployed. Government intervention through deficit spending may therefore be necessary to boost aggregate demand and so employment of resources. Some Keynesians even saw an extra dollar of public spending producing more than a dollar of output as the spending circulated around the economy, the so-called 'multiplier' effect.

For politicians who, in league with their voters, had already been increasing the size of the state, Keynes' argument that governments can come to the rescue was appealing indeed.

The argument that government intervention in the economy is justified by its imperfect workings has led not only to an increase in deficits but also regulation. They are the two sides of the one coin. Governments, through their deficits and regulation, provide something the economy lacks. Market failure is often used to justify regulation and spectacular 'failure' such as the financial crisis, justifies even greater regulation. The fact that existing regulation failed to prevent, and may have exacerbated, the crisis does not enter into it.

The forces propelling the deficit economy are strong and may prove irresistible. Change and genuine reform are difficult. It is to be hoped that the need for change is recognised before it is forced on us.

In 2011, gross US federal debt was approximately

$15 TRILLION

In 2011, the total US government revenue was

$2.3 TRILLION

The ratio of US debt to revenue was

652%