I watched the Congressional debate which led to passage of the 1990 tax increase. Not a single Congressman mentioned inflation and not a single Congressman acted prIo-agenda.

Comments on the Current U.S. Budget Debate

"We all agree on the problem...."

by
Warren B. Mosler

The assumptions underlying the current budget debate are erroneous. Historical analogies include “the earth is flat” and “the earth is the center of the solar system.” Chicken Little has returned, and the consequences are counter agenda for all parties.

The noble attempt by Congress to balance the budget will result in a weaker economy with a true depression a possibility. Every time there is a drop in the budget deficit, as a percent of GDP, the GDP growth rate drops a few quarters later. It is only after the deficit begins to expand again that the economy recovers. The historical correlation is 100%. Lowering interest rates, in an attempt to boost the economy, is seldom effective. Since the government is a net payer of interest, lower rates reduce spending, thereby increasing fiscal drag.

Governments are monopoly issuers of fiat currency. The incorrect , but prevalent, understanding is that issuers of fiat currency must tax, borrow, or otherwise raise revenue so they can spend it. Taxing and borrowing are considered “funding” operations. Consequently, the discussions revolve around how governments can raise “needed revenue” to fund spending. Revenue shortfalls are of great concern; witness the latest government shutdown.

Contrary to general perception, fiat money is driven by the fact that taxpayers need the government’s money to pay their taxes. By levying a tax, the government creates a need for its fiat currency. It creates this need, presumably, so it can obtain the real goods and services it desires via the spending of its currency.

From inception, the only source of money needed to pay taxes is the issuing government. The government cannot actually collect the tax it has levied, nor borrow any of its fiat currency, until it first spends, or otherwise provides, the funds.

A balanced budget, from inception, is therefore the theoretical minimum that a government can spend. The previous statement represents an accounting identity. If individuals and businesses desire to hold actual cash, that money must be “left over” after taxes are paid. All cash held by the public must be money provided by the government in excess of the need to pay taxes (deficit spending). This is also true for all dollars held by foreign central banks at the Fed. For these, and other structural reasons, the possibility of a balanced budget does not exist, and the current attempt to balance the budget will likely result in severe deflation. When the government does not spend enough to cover the total need for dollars created by taxes, the usual result is a recession and a concurrent shortfall in revenues. A deficit remains. Accounting identities have a way of being satisfied, one way or another.

Likewise, the government can borrow its currency only after it has provided it to the private sector. Government borrowing, therefore, functions to support interest rates, not as a funding operation. Nominal savings is not diminished, nor displaced - it is given a place to earn interest. If the government were to spend more than it subsequently collected in taxes, and did not offer securities for sale, the fed fund rate would immediately fall to 0% bid. Treasury spending is a reserve add. Selling securities, by the Fed or Treasury, is simply a reserve drain, a monetary operation. This underlies the empirical evidence that nations can run any debt ratios they want, in their own fiat currencies, and still “fund the debt.”

For all practical purposes, there is no such thing as a balanced budget. Singapore, for example, shows a budget surplus, but that does not include all government spending in excess of collected taxes. The central bank spends Singapore dollars to buy foreign currencies. This “off balance sheet” spending brings the consolidated spending to about 2% higher than collected taxes. The same happens in Czechoslovakia - fiscal policy is tight enough that the only way to get enough local currency to pay taxes is selling foreign currencies to the central bank. When the central bank makes the taxpayers “beg”, as evidenced by currency appreciation, the economy gets softer (Japan is another good example).

Consider inflation. Because the taxpayers need the government’s money, the government is able to define its currency by what it pays for goods and services. By changing what it pays, the government redefines its currency. Currently, the government fights inflation by maintaining an economy weak enough for the private sector to be under pressure to sell goods and services. This selling pressure keeps prices from rising.

How large a deficit is prudent? Let the market decide! This option has not even been considered. For example, the government could offer a job to anyone who wanted one, at some minimum rate of pay deemed appropriate, and let the deficit float. This would end unemployment and unemployment compensation, eliminate the need for minimum wage laws, and promote price stability. Employment (rather than unemployment) would define the currency and become the stabilizer. The price of labor would be stable. Private sector wages would be related to the benchmark of government employment. If the government labor force were larger than needed by the government, taxes could be lowered. This would result in fewer government workers and reduced government spending as the private sector hired these workers.

The Fed sets short term rates. Congress has ultimate control over the Fed. Short term rates go up because the Fed, and ultimately Congress, wants them to - not because of market forces. These rates are not determined by market forces. Treasury securities are not necessary unless the government wishes to support higher long term rates. Short term rates could be maintained simply by paying interest on excess reserves held at the Fed.

The Federal debt is all the money spent but not taxed. It was borrowed after it was spent, so the holders of the money might earn interest. The government pays interest, voluntarily, depending on how much it wants savers to be able to earn. Have you ever heard an owner of government securities say, “I wish the government would stop selling securities so I can get my money back!”?

The current budget debate is based on erroneous assumptions. Washington does not understand fiat money. Until it does, efforts to reduce the deficit will continue, and the economy will continue to underperform.

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