

GEORGE WASHINGTON

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# CHECKS

BY ROBERT E. WRIGHT

“TODAY,” PRESIDENT BILL CLINTON (1993–2001) said on January 6, 1999, “I am proud to announce that we can say the era of big deficits is over.”<sup>1</sup> Clinton’s pronouncement was profoundly premature, a fact underscored by the debt ceiling impasse and Treasury bond downgrade of 2011. Unless the US economy improves faster than even the most optimistic economist now forecasts, huge federal deficits will be in America’s future for many years to come. That means the national debt, already at almost \$15 trillion and 100% of GDP, will continue to grow, putting more downward pressure on the government’s

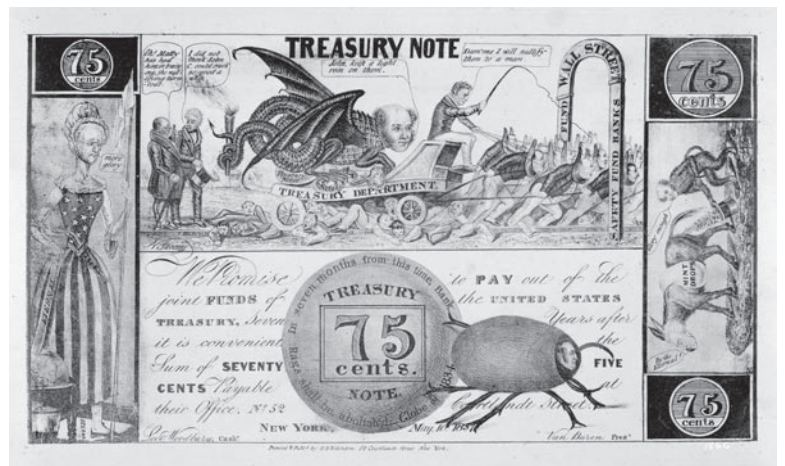
bond rating and additional upward pressure on interest rates. Many Americans believe that more dangerously destabilizing political squabbles over taxes and social programs are forthcoming, with results that no one with a decent respect for the intricacies of politics and economics dares to predict.

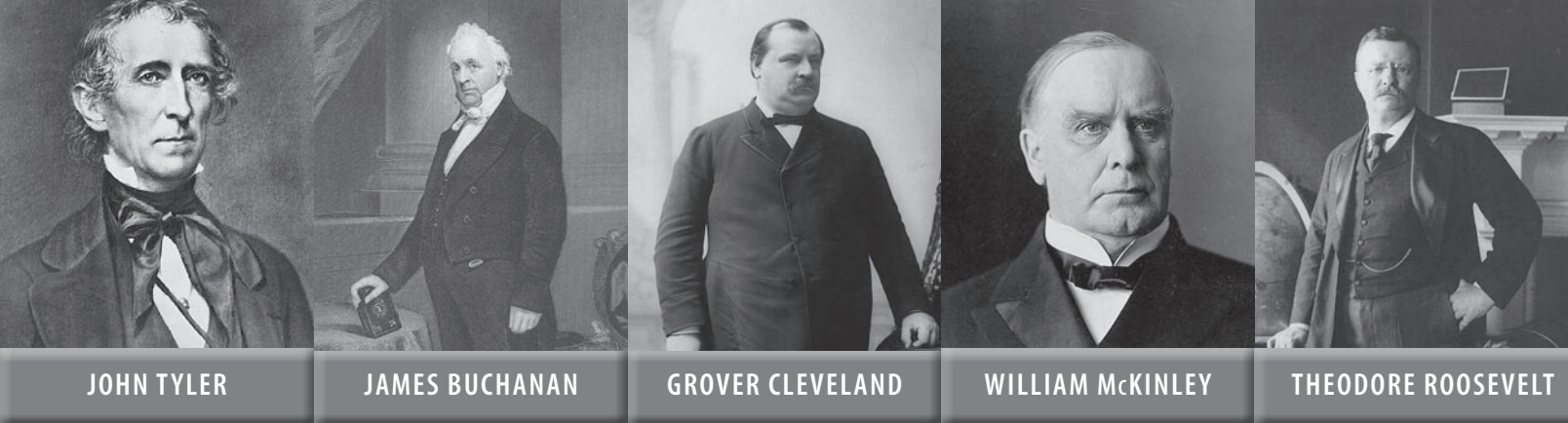
How and why did Clinton’s optimism turn so quickly to such despair? It is easy for Republicans to blame the policies of Barack Obama (2009–present) and for Democrats to blame those of George W. Bush (2001–2009) but the ultimate cause of the government’s current fiscal

predicament was the Great Depression (1929–1933, strictly speaking). That massive downturn, and the policies and economic theories it spawned, shattered the government’s longstanding commitment to peacetime balanced budgets and thereby laid the foundations for its current budgetary woes.

The history of the US government’s management of its budget can be divided into three great epochs, each of which is depicted graphically in the accompanying figures. During the first, the age of surpluses, which lasted from the administration of George Washington (1789–1797)

A parody of the often worthless fractional currencies issued by banks, businesses and municipalities in lieu of coin. These notes proliferated during the Panic of 1837 with the emergency suspension of specie (i.e., gold and silver) payments by New York banks on May 10, 1837. The artist broadly attacks President Van Buren’s pursuit of predecessor Andrew Jackson’s hard-money policies as the source of the crisis.





# BALANCES

## THREE EPOCHS OF FEDERAL BUDGET MANAGEMENT

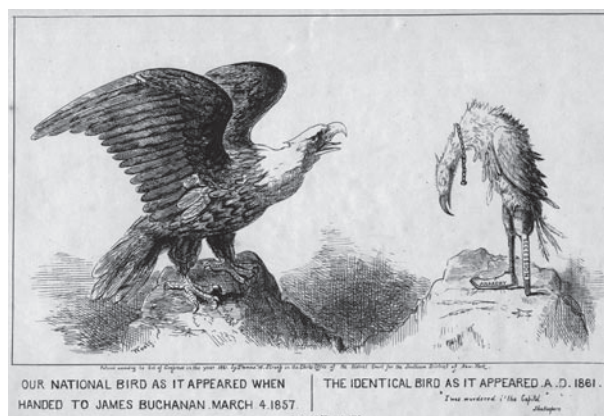
through that of Calvin Coolidge (1923–1929), the federal government ran large deficits (>2% of GDP) only in wartime and paid down the resulting national debt by consistently running peacetime surpluses. During the second, the age of transition, which began during the administration of Herbert Hoover (1929–1933) and lasted through that of Richard Nixon (1969–1974), large deficits were tolerated during recessions or, under the influence of British economist John Maynard Keynes (1883–1946) and his followers, were encouraged in the name of macroeconomic stabilization. The ostensible goal of those administrations was to balance the budget across the business cycle rather than across the war-peace cycle. During the third epoch, the age of deficits, which began during the administration of Gerald Ford (1974–1977), deficit finance became a structural part of the US economy. To justify persistent, large deficits politicians began to point to the costs of fighting minor wars, establishing or maintaining social justice and stimulating economic growth.

The US government ran consistent peacetime surpluses during its first 140 years because everybody wanted it to. Even

Alexander Hamilton, perhaps the most pro-debt policymaker of the first epoch, argued that a national debt was a blessing only if it was not “excessive.” Presidents virulently opposed to peacetime deficits, including Thomas Jefferson (1801–1809) and Andrew Jackson (1829–1837), did everything in their power to run surpluses and were generally successful at doing so. Thanks to a string of post-War of 1812 surpluses interrupted by only three years of small deficits, Jackson was able to retire the national debt entirely at the end of 1834.

The largest peacetime deficit in real or percent of GDP terms in the first epoch took place in 1837, the first year of Martin

Van Buren’s presidency (1837–1841). It registered only .80% of GDP and was caused in large part by a 50% reduction in federal revenues following a financial panic and economic contraction. Nevertheless, it cost Van Buren considerable political clout. Two subsequent deficits, in 1838 and 1840, also hurt Van Buren, who found his fiscal policy difficulties excoriated in political cartoons and commentaries. Virginia politician William C. Rives (1793–1868), for example, asked a correspondent if there ever existed “a cooler piece of hypocrisy” than a Van Buren speech preaching “economy, in the face of the most lavish expenditure of the public Treasury by



Political cartoon criticizing James Buchanan, whose administration ran deficits in three years including the largest nominal peacetime deficit prior to 1894.



WILLIAM TAFT



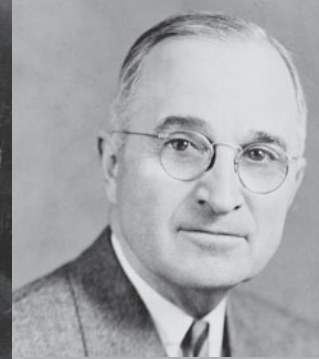
WOODROW WILSON



HERBERT HOOVER



FRANKLIN ROOSEVELT



HARRY TRUMAN

himself—to deprecate and denounce a *public debt*, when he is the only President who ever *created* one, in time of peace.”<sup>2</sup> Nicknamed the “Little Magician” and the “Red Fox of Kinderhook” (New York, his hometown) in recognition of his considerable political prowess, Van Buren was neither sly nor magical enough to overcome the political burden of having resurrected the national debt. Although he managed to receive almost 47% of the popular vote in 1840, Van Buren handily lost to William Henry Harrison (1841) in the electoral college, 234 to 60.

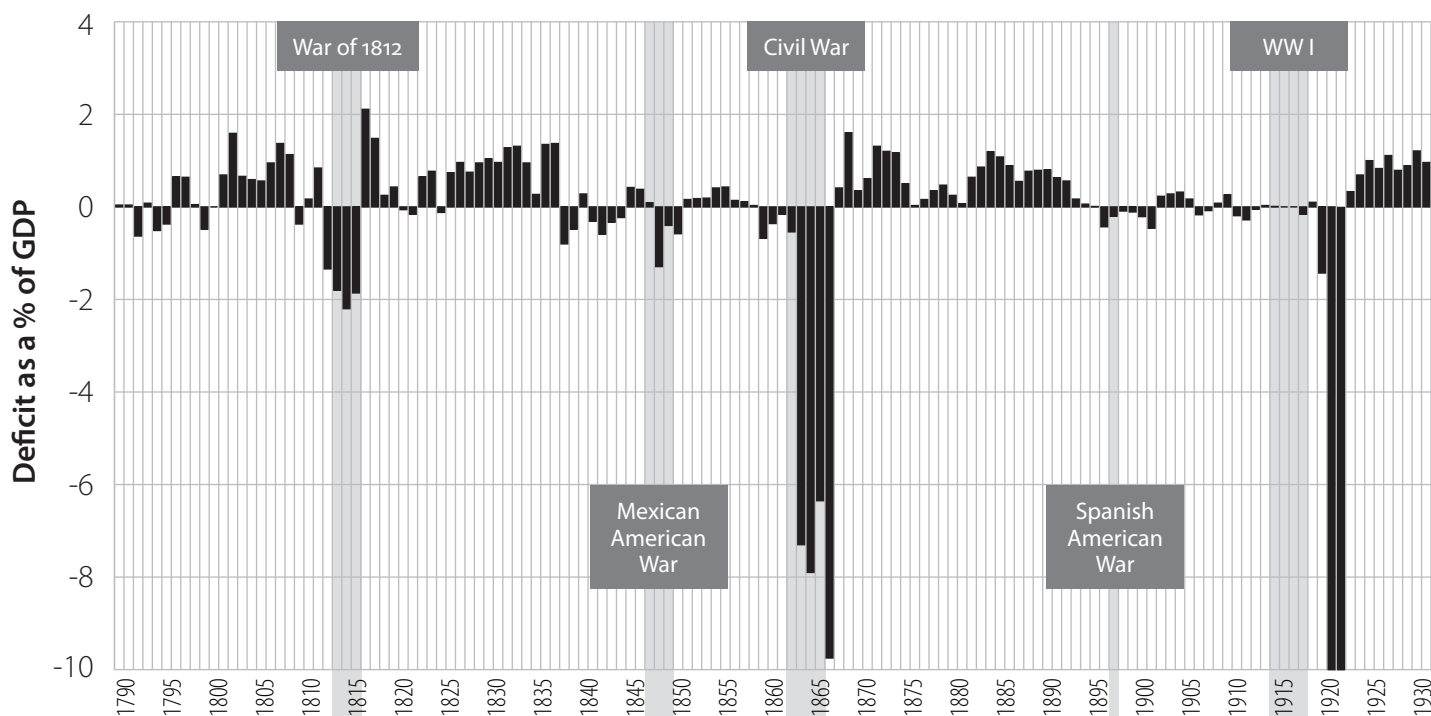
After Harrison died just a month into his term, his successor John Tyler

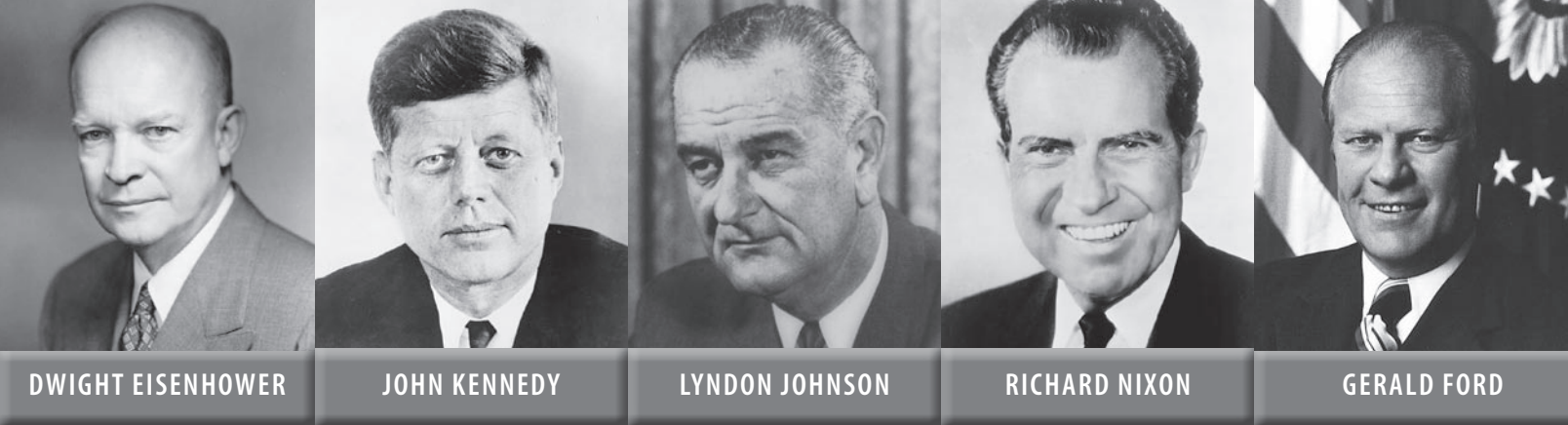
(1841–1845) also ran three small deficits and also paid for it politically, though “His Accidency,” as Tyler was dubbed, probably would not have won re-election even if his administration had run surpluses. Another despised one-term President, James Buchanan (1857–1861), also ran deficits in three years, including, in 1858, the largest nominal peacetime deficit (\$27.5 million) prior to 1894. The Panic of 1857 was mostly to blame for the large shortfall because federal revenues fell from \$74 million in 1856 to just \$46.7 million in 1858. More controversially, Buchanan increased expenditures from \$69.6 to \$74.2 million over the same span. Like Tyler, however,

Buchanan’s relative fiscal profligacy played only a small role in his ouster.

After the Civil War, the federal government ran surpluses for almost three consecutive decades, even during economic downturns. By the early 1890s, however, the surpluses had shrunk from generally robust ones in the double and triple digits to just a few million dollars. When revenues collapsed in the wake of a financial panic, from \$385.8 million in 1893 to \$306.3 million in 1894, a fairly sizeable deficit of .43% of GDP occurred despite a simultaneous retrenchment in government expenditures of some \$16 million. Deficits continued to dog the second administration of Grover

## EPOCH I THE AGE OF SURPLUSES





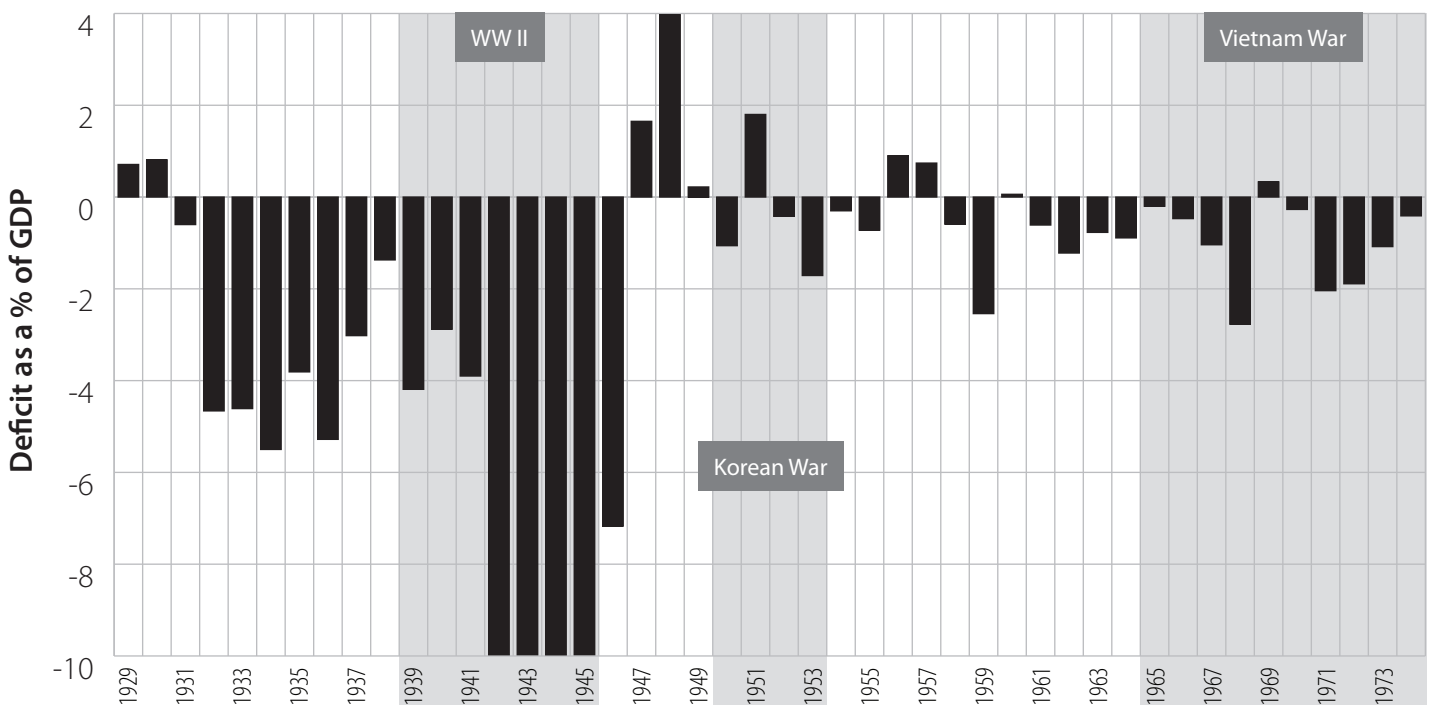
Cleveland (1885–1889; 1893–1897) and the first three years of the presidency of his successor, William McKinley (1897–1901). Tellingly, however, McKinley ran a surplus heading into the 1900 election, which he won, only to be assassinated the following year.

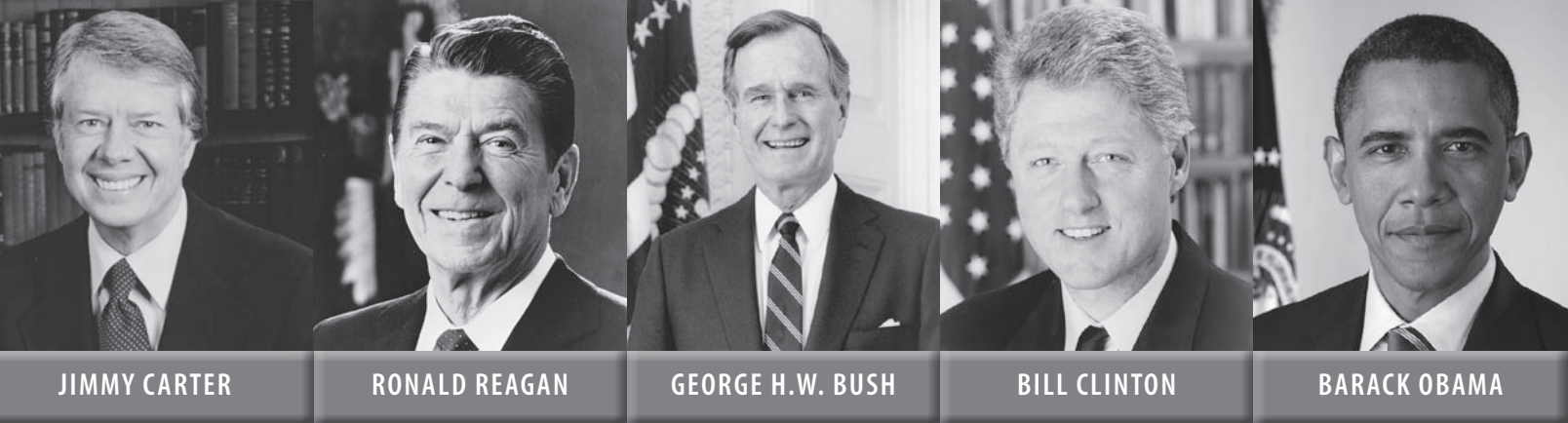
With the national debt almost extinguished in real terms, dropping under 5% of GDP in 1902, Presidents Theodore Roosevelt (1901–1909), William Taft (1909–1913) and Woodrow Wilson (1913–1921) found it politically expedient to run a few, small peacetime deficits. The national debt grew slightly in nominal terms during their presidencies, but continued economic

growth meant that by 1916, the last full year before US military involvement in World War I, it stood at a mere 2.47% of GDP, its lowest level since the Civil War. The government ran a large deficit in 1919 due to engagements entered into before the war ended in November 1918, but true to form it enjoyed surpluses averaging .85% of GDP throughout the 1920s. By 1929 the national debt stood at only 16.34% of GDP and about \$17 billion, down from 32.53% and \$25.5 billion a decade earlier. Had the Great Depression not occurred, the US government would have continued running surpluses and paying down the debt until World War II.

The Depression did happen, however, and the nation has been paying for it ever since. The rhetoric of balanced budgets remained virulent for a long time. Both Herbert Hoover (1929–1933) and Franklin Roosevelt (1933–1945) repeatedly stated that in peacetime the government should at least balance the budget if not run surpluses. But the reality was different. After running surpluses in 1929 and 1930, the Hoover administration ran slightly into the red in 1931 at .6% of GDP, a common occurrence during recessions as described above. In 1932, however, Hoover busted all previous records with a peacetime deficit of \$2.7 billion or 4.66% of a rapidly

## EPOCH II THE AGE OF TRANSITION





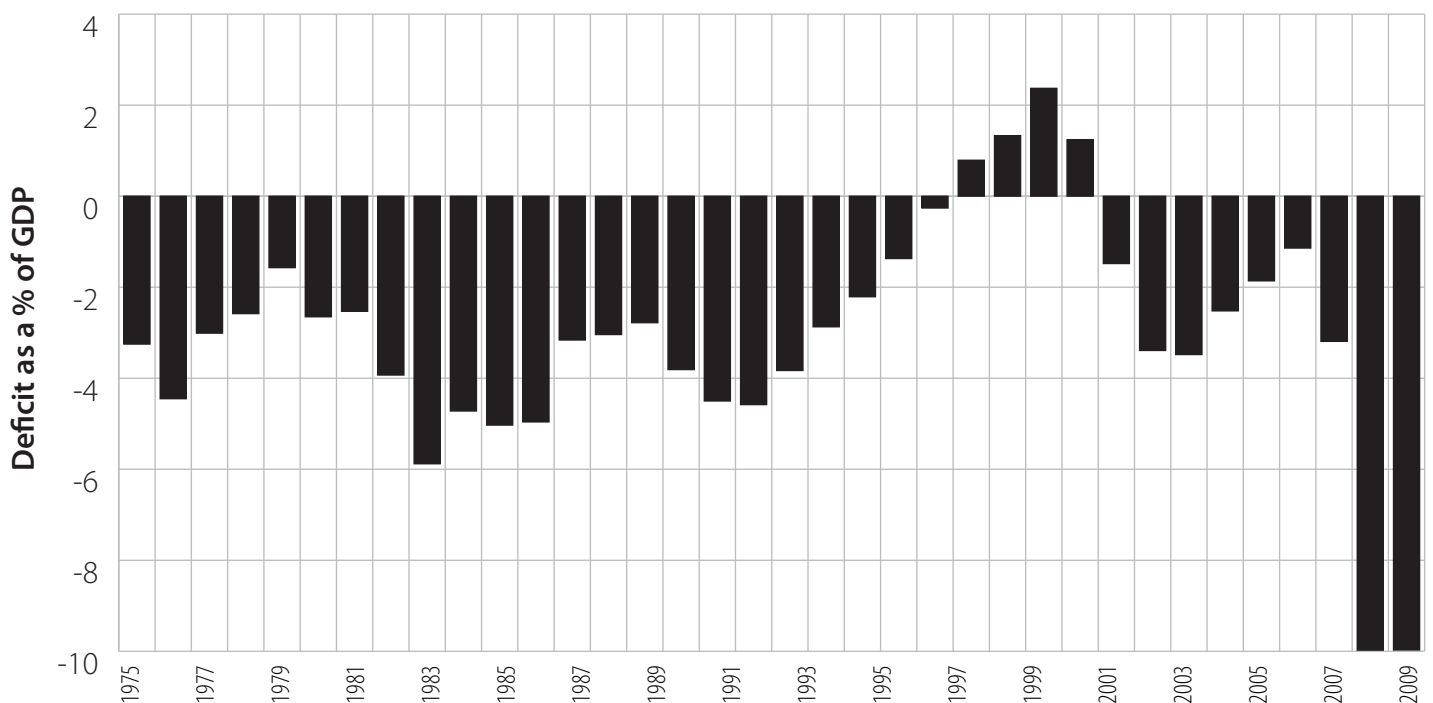
shrinking GDP. A precipitous drop in revenues from \$3.1 to \$1.9 billion was the primary culprit, but Hoover in his final year also increased government spending from \$3.6 to almost \$4.7 billion. Roosevelt ran deficits every year of his presidency, an average of 3.84% of GDP through 1941. By then, federal revenues had rebounded to \$8.7 billion but expenditures grew even more quickly, to \$13.6 billion, partly due to New Deal programs and partly due to military mobilization.

After the war, the US national debt stood at an unprecedented 122% of GDP. After demobilization was complete in 1946, Harry Truman (1945–1953) ran several surpluses, including an impressive \$11.8 billion

(4.38% of GDP) one in 1948. Thereafter, however, surpluses became smaller and less frequent. Wars in Korea and Vietnam, other foreign policy obligations, the space race, and the continued growth of New Deal and New Society entitlement programs stymied all attempts to balance the budget. Dwight Eisenhower (1953–1961) managed it only three years, and the last time only barely. The administrations of John F. Kennedy (1961–1963) and Lyndon Johnson (1963–1969) were in deficit every year, though only once, in 1968, at more than 2% of GDP. Richard Nixon (1969–1974) managed only one small surplus, in 1969, but two years later put the government in the red by over 2% of GDP.

But the track record of the Presidents during the second epoch was downright fiscally conservative compared to that of the Presidents since Nixon. In only one year during the administrations of Gerald Ford (1974–1977), Jimmy Carter (1977–1981), Ronald Reagan (1981–1989) and George H. W. Bush (1989–1993) was the deficit less than 2% of GDP. Reagan ran the two biggest in real terms, in 1983 and 1985. During his first term in office, Bill Clinton (1993–2001) and an increasingly buoyant economy sliced the deficit from 3.83% of GDP to just .26%. In his second term, the government ran the only surpluses of the third epoch. Deficits returned during both of » *continued on page 36*

## EPOCH III THE AGE OF DEFICITS



# Checks and Balances

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George W. Bush's terms, however, and half of them were over 2% of GDP. Under Obama, government deficits have topped 10% of GDP, twice those recorded under Reagan and completely unprecedented in peacetime.

Partisans naturally want to blame their political enemies for this stark disintegration of federal fiscal discipline, but clearly long-term forces were at play. During the third epoch government expenditures grew in nominal terms every year but revenue growth was much more sporadic and sometimes negative. Revenue growth exceeded expenditure growth in 20 out of the last 36 years, but total expenditure growth over the period outpaced total revenue growth by some 50%. The cause of chronic deficits was therefore two-fold: expenditures increased faster than revenues on average and revenues were much more volatile than expenditures.

Both of those problems can be traced to the Great Depression. Nominal government expenditures have increased every year since 1965 because entitlement programs like Social Security and Medicare grow ever larger due to demographic changes (e.g., an aging population), general inflation and runaway medical costs. Social Security was of course a New Deal program. Its biggest fault was that it provided a permanent solution to a temporary problem, the growth in the number of the aged indigent. Before the Depression, the elderly were no more likely to live in poverty than members of any other age group were. As their wages declined as they aged, most Americans compensated by investing in financial (e.g., annuities), real (e.g., rental houses) and familial (e.g., working children) assets.

The Depression temporarily depressed all three income streams, leaving many retirees destitute. Instead of seeing them through the crisis and allowing the private security system to continue to evolve, the government instead enacted Social Security, in part to prevent the passage of even more radical plans like that of Francis Townsend (1867–1960). Forced to save through Social Security, many postwar Americans allowed the private security safety net to wither and thus became increasingly reliant on the government to provide for their retirement. Soon Social

Security became the third rail of US politics, a program often expanded but only occasionally and marginally retrenched.

Medicare's connection to the Depression was less direct but no less real. During the Depression, the government disassembled the nation's first health insurance system, which was dominated by low cost mutuals and pre-paid medical care providers compensated for curing patients rather than just seeing them. In its place, the government encouraged the creation of a new system based on for-profit insurers, employer-provided insurance and a pay-for-service model. All three innovations encouraged continual cost increases to satiate stockholders and healthcare providers. By the 1960s, many older Americans found it increasingly difficult to obtain or pay for healthcare. Rather than try to reduce costs, the government provided retirees with a heavily subsidized healthcare program that actually accelerated healthcare cost pressures in myriad ways. Those costs, which continue to rise faster than inflation, combined with increases in longevity mean that Medicare, not Social Security, is currently considered the nation's biggest budget buster.

The variability of government revenues is a by-product of Keynesian economics, another Depression-era innovation. According to Keynesians, governments should increase spending during recessions in order to stimulate the economy. (Output equals consumption plus business investment plus government spending plus net exports. Increases in government spending, Keynesians claim, can offset decreases in the other three, especially investment.) Of course government revenues drop during recessions, so the increased spending Keynesians call for must be financed by borrowing. Although few describe themselves as Keynesians, most postwar US Presidents have increased government spending during recessions. Revenues turned negative during three of the last four recessions, but expenditures continued to grow and even accelerated during the last two. Roosevelt's failed attempt to balance the budget in 1937, which according to Keynesians caused that year's recession, was invoked as recently as the Great Contraction of 2008–9 to justify various economic stimulus plans

and continued high levels of government expenditure. So while the effectiveness of Keynesian stimulus is hotly debated among academics, no President is likely to move significantly toward a balanced budget when the economy is on the skids. This *de facto* Keynesian policy consensus has precluded serious consideration of alternative tax regimes. Contingent or standby taxes that would kick in when large deficits loomed were briefly employed during the Reagan administration, but the 18th-century notion of directly tying taxes to expenditures in peacetime has largely been lost and is unlikely to be resuscitated as long as policymakers continue to think of deficit financing as a key macroeconomic stabilizer.

So the next time you want to bash your favorite political enemy over the head, think about blaming the Great Depression instead. Maybe then we can work together to actually end the age of deficits. **\$**

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## Notes

1. <http://archives.clintonpresidentialcenter.org/?u=010699-speech-by-president-on-the-surplus-for-fy.htm>
2. Emphasis in original as quoted in Wright, *One Nation Under Debt*, 274.