

Executive Summary

It's been 25 years since the federal government balanced a budget, and the prospect of a balanced budget in the near future seems remote. This failure to balance the books has left the federal government with a \$4.35 trillion national debt. But this debt figure is only the tip of the iceberg, massive and foreboding itself, but concealing a much greater danger. All told, taxpayers face debt, insurance commitments, and contingent liabilities of approximately \$15 trillion.

The National Debt

At the end of fiscal year 1993, the gross federal debt was \$4,351,000,000,000:

- The American public holds about half of the national debt, \$2.3 trillion;
- Foreign investors hold 13 percent, approximately \$592 billion;
- The Federal Reserve holds about 7.5 percent, approximately \$326 billion; and
- Government trust funds (principally Social Security and the Civil Service Retirement Fund) hold about 25 percent, or \$1.1 trillion of the national debt.

Because trust fund purchases of debt never leave government accounts, they obscure the true size of the deficit:

- In fiscal year 1993, the actual federal deficit was \$100 billion higher than the official figure of \$255 billion.

Credit and Insurance Programs

On top of the national debt, the federal government has amassed over \$7 trillion in potential liabilities for a myriad of insurance and credit programs. These include:

- \$5 trillion in insurance commitments, including deposit insurance, private pension insurance, and disaster insurance;
- Approximately \$850 billion in direct and guaranteed loans to farmers, students, home buyers, and private companies; and,
- Government sponsored enterprises — private companies chartered and implicitly guaranteed by the federal government — have outstanding liabilities of over \$1.2 trillion.

Actuarial Liability

In addition to these commitments and contingencies, the federal government has also assumed \$3.5 trillion in pension and actuarial liabilities, mainly for federal employee pension programs and Social Security.

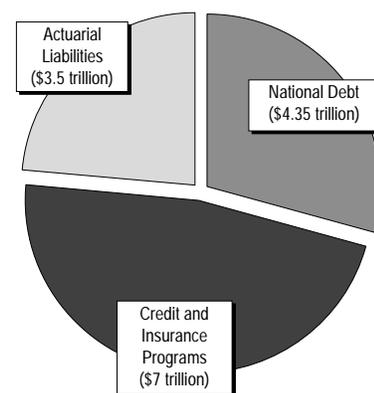
- The actuarial liability of the Social Security system is estimated at \$1.8 trillion as of September 30, 1992.

As large as this liability is of even greater concern is the fact that it is rising rapidly. In fact, since 1983, the actuarial deficit of the Social Security system has increased by \$1.7 trillion.

Taxpayers have unwittingly cosigned trillions of dollars of contingent liabilities, beyond paying off an ever-increasing national debt of \$4.35 trillion. As the S&L crisis painfully demonstrated, these liabilities can be very expensive. If we don't recognize the risks and costs of these obligations now, taxpayers will be footing the bill for commitments they didn't even know existed.

All told, taxpayers face debt, credit and insurance commitments, and actuarial liabilities of approximately \$15 trillion.

Total Liabilities of the U.S. Government



I. INTRODUCTION

The national debt has been a matter of controversy ever since the founding of the republic.¹ Thomas Jefferson, for example, considered the public debt "as the greatest of the dangers to be feared." Andrew Jackson thought it to be "a national curse" and vowed to pay it off. Alexander Hamilton, on the other hand, believed the debt to be "a national blessing" if not excessive. But whether a curse or a blessing, the debt has been an constant element of government policy for over 200 years.

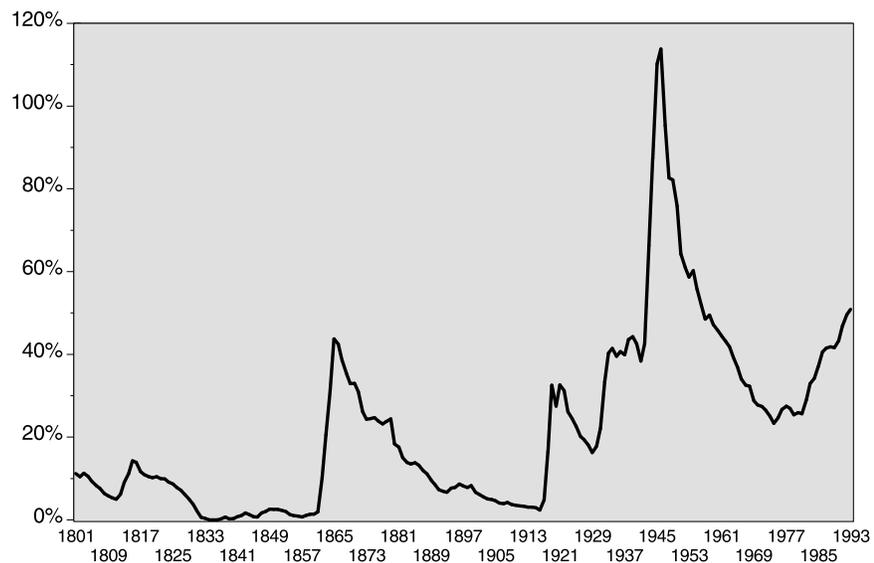
Each time Congress raises the debt limit, a great fuss is made about the size of the debt. But it is never pointed out that the debt limit upon which Congress votes represents only a fraction of the government's indebtedness. For the federal government has not only borrowed money in its own name, it has also cosigned many loans taken out by others. It has also made many promises to pay in the future, and has offered insurance for many purposes.² All of these are liabilities of the government and are thus part of its debt. The purpose of this paper is to review these many elements of the national debt and discuss their economic impact.

Growth of the National Debt

Figure 1 illustrates the federal debt as a share of gross national product since 1799. Historically, the debt has risen sharply during wartime, and has declined afterward. Although occasionally, as during the Jackson Administration, conscious efforts have been made to pay off or at least pay down the national debt, the decline of debt as a share of GNP has generally come about as the result of economic growth. If the debt remains constant or grows at a rate slower than nominal GNP, then over time the ratio of debt to GNP will naturally fall.

Unfortunately, it is not as easy as one might think to tell exactly what the debt is. From the earliest days of the nation there have been disagreements about what items should be included and excluded from the official debt figures.³ Although politics plays a part in this — every administration wants to make the debt appear as small as possible — there are also important conceptual issues.

Figure 1
Federal Debt as a Share
of GNP, 1799-1993⁴



II. GROSS DEBT vs. DEBT HELD BY THE PUBLIC

One of the most important conceptual questions in defining the national debt is the distinction between the *gross public debt* and the *debt held by the public*. The difference between the two is the debt held within government accounts, primarily trust funds such as the Old Age and Survivors Insurance Trust Fund (i.e., Social Security). Because Social Security taxes have raised more revenue for some years than was needed to pay benefits, in those years a surplus was recorded by the trust fund.⁵ By law, such surpluses can only be invested in U.S. Treasury securities, and interest on these securities is credited to the trust fund account.

However, because the securities acquired by the various trust funds never actually leave the government — it is, in essence, a bookkeeping transaction — they are not considered to be held by the public. That is, the Treasury does not need to go into the open market and sell bonds, notes and bills to pay for the full amount of the federal government's annual deficit because the government, in a sense, buys some of them itself to deposit into trust funds.

This may sound a bit like musical chairs, but it is an important distinction. At the end of fiscal year 1993 the gross federal debt was \$4.35 trillion, of which \$1.1 trillion was held by government trust funds. Thus the debt held by the public was \$3.25 trillion, or 25% less than the gross public debt.

The distinction between the gross public debt and the debt held by the public also affects the figures for the budget deficit, which is the annual addition to the national debt. Thus in fiscal year 1993 the actual federal budget deficit was \$100 billion higher than the official figure of \$254.7 billion. The difference is due to the investment in Treasury securities by government trust funds. In fiscal year 1993, the principal purchasers of federal debt were the Social Security trust fund (\$49 billion) and the civil service retirement fund (\$27 billion). The rest was divided up among dozens of federal agencies and accounts.⁶ **Figure 2** illustrates the growth of the gross public debt and debt held by the public.

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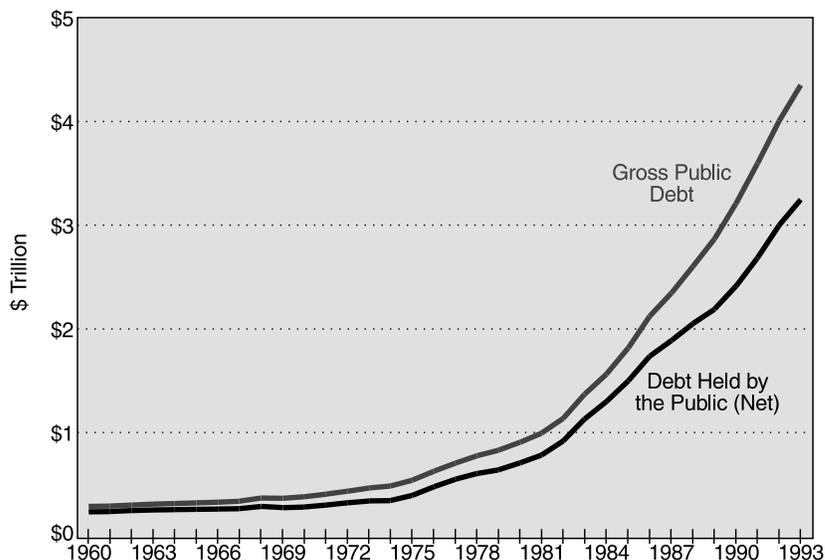


Figure 2
Gross and Net
Federal Debt

Source: Budget of the United States Government, Fiscal Year 1995: Historical Tables (Washington: U.S. Government Printing Office, 1994), p. 89.

III. OWNERSHIP OF THE DEBT

Of the debt held by the public, two additional points need to be made. The first is that the Federal Reserve, our nation's central bank, holds a considerable share of this debt. Although part of the Federal Government, the Federal Reserve is treated as part of the private sector for the purpose of determining debt held by the public. Thus its holdings of Treasury securities are excluded from the figures of government holdings discussed previously.

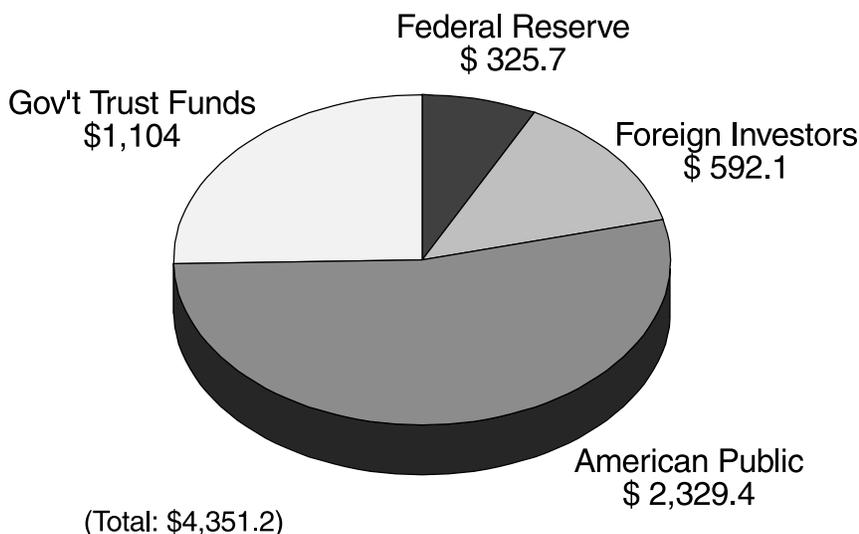
The Federal Reserve

However, when the Federal Reserve holds Treasury securities, the economic effects are similar to when the government holds debt in trust fund accounts, because they are, in effect, permanently removed from the credit market. The Fed uses these securities to conduct open-market operations, which increase or reduce the nation's money supply. When the Fed buys Treasury securities it does so on the open market; it never buys securities directly from the Treasury, as is the case in many foreign countries.⁷ The Fed "pays" for these securities by, in effect, creating money out of thin air, by crediting the seller's account at the Federal Reserve.⁸ This is how the Fed increases the money supply. If it chooses to reduce the money supply it will sell some securities from its holdings. The payments it receives from buyers are thereby removed from the money supply.⁹

Thus the Federal Reserve is, in a very real sense, paying off the national debt, though this means of paying off the debt comes at the high cost of inflation to American families and businesses. The bonds purchased by the Federal Reserve for its portfolio are effectively removed from the market forever, just as if the government had paid them off by running a budget surplus, but the expansion of the money supply resulting from this action has the further effect of eroding the value of the debt. When the U.S. has an inflation rate of 2.5%, as it does now, this means that 2.5% of the existing stock of debt essentially has been eliminated permanently.¹⁰

Of course, this process has its limitations. Eventually, buyers of Treasury securities come to realize that some percentage of their investment may be eroded by inflation, so they demand higher interest rates to compensate them for this risk. These higher

Figure 3
Ownership of the Gross
Public Debt, 1993
(\$ billions)



Source: Office of Management and Budget (OMB)

interest rates increase the government's interest expenses — the third largest item in the federal budget — which increases the deficit.¹¹ Thus, contrary to popular belief, the government can never completely inflate away the national debt.¹²

Although the Fed may buy or sell Treasury securities on a day to day basis, at the end of the year it is always a net buyer. Thus the Fed's holdings of Treasury securities have risen year after year, as shown in **Figure 4**. At the end of fiscal year 1993 the Fed owned \$325.65 billion of Treasury notes, bonds and bills—about 10% of the debt held by the public, down from almost one-fourth in the mid-1970s, also shown in Figure 3. The Treasury pays interest to the Fed on these holdings just as it does to private citizens.¹³ The Fed uses some of this income to pay its own expenses and returns the balance to the Treasury. In fiscal year 1993 the Fed returned \$14.9 billion in interest to the Treasury.¹⁴

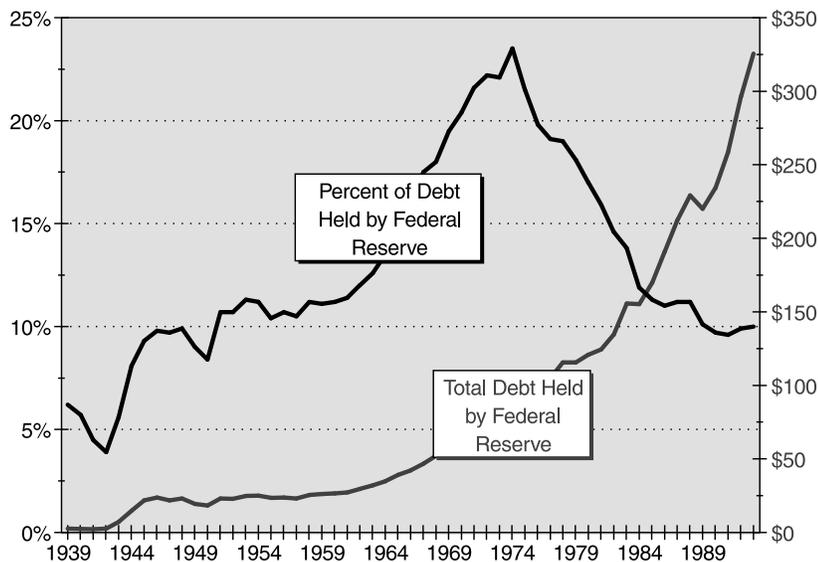


Figure 4
Federal Reserve Share of
Debt Held by the Public

Source: Budget of the United States Government, Fiscal Year 1995: Historical Tables (Washington: U.S. Government Printing Office, 1994), p. 89.

A second major element in the nature of the debt held by the public concerns the amount of Treasury securities owned by foreign investors. This is important because to the extent that the national debt is held by Americans, the debt is owed to ourselves, at least in the aggregate. However, when foreigners buy Treasury securities then the interest and principal are a liability to the country as a whole. This may influence the exchange rate of the dollar, as foreigners exchange the dollars received in interest for other currencies, and it may have an important influence on our trade and investment policies.¹⁵ At the end of fiscal year 1993 foreigners owned 18.2% of the debt held by the public. Although this is up from the recent low of 13.5% recorded in 1984, it is still below the peak of 19.9% in 1978.¹⁶

Debt Held by Foreign Investors

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IV. OTHER FEDERAL BORROWING

Although financing the budget deficit is the main reason why the federal government borrows money from the private sector, it is not the only reason. First, the Treasury must borrow to redeem securities that have come due. Thus the Treasury must borrow to repay funds already borrowed on top of the new money it must borrow each year to cover the deficit. This adds hundreds of billions of dollars each year to the amount the Treasury must borrow. At the end of fiscal year 1993, \$858 billion, or one-third of the privately-held national debt, was due to mature within one year.¹⁷

Government-Sponsored Enterprises

Second, and more importantly, the Federal Government also borrows on behalf of government-sponsored enterprises (GSEs) and guarantees many loans made by private lenders. GSEs are private financial institutions set up by the federal government to direct credit into such areas as housing, agriculture and higher education. The principal GSEs are:

- The Farm Credit System.
- The Federal National Mortgage Association (known as "Fannie Mae").
- The Federal Home Loan Mortgage Corporation (known as "Freddie Mac").
- The Federal Home Loan Banks.
- The Student Loan Marketing Association (known as "Sallie Mae").

Although nominally private companies, GSEs are still quasi-governmental institutions because they receive implicit government guarantees on their loans. Because of this implicit guarantee, they receive better terms when they borrow in financial markets.¹⁸ They then use the funds raised to buy mortgages and other loans from lenders. This encourages lenders to make loans which would otherwise be too risky or unprofitable. At the of fiscal year 1993 these GSEs (excluding Sallie Mae) owned \$1,255,000,000 worth of loans (at face value). Should all or any portion of these loans go bad and not be repaid by the borrowers, the U.S. taxpayer will most likely be required to make up the difference.¹⁹

Federal backing for government-sponsored enterprises that operate with low capital and limited federal oversight helps to continue the practice of trading potentially great taxpayer exposure for limited benefits to the credit markets. The largest financial institutions in America are Fannie Mae and Freddie Mac. Each of these GSEs finances about half a trillion dollars of home mortgages, either by buying the mortgages or by converting them into mortgage backed securities. Yet, in return for the trillion dollars of taxpayer contingent liability for these GSEs, homebuyers have their mortgage rates reduced by only a fraction of a percentage point.

So long as times remain prosperous for the GSEs, the small reduction in mortgage rates seems to be without cost. But, just as with the S&L debacle, these massive taxpayer contingent liabilities are not risk-free. With responsibility for overseeing these massive enterprises lodged in the Department of Housing and Urban Development — a department that has not been conspicuously successful at managing its own programs — taxpayers would seem to have little protection if something ever went wrong with one of these GSEs.

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GSEs can and do fail.²⁰ The Farm Credit System failed in the mid-1980s as a result of imprudent lending practices and its heavily-subsidized loans to farmers. The System failed after losing \$4.6 billion in two years and required a federal loan to return to solvency.

Fannie Mae almost failed in 1981 as a result of excessive risk-taking. This took the form of "lending long and borrowing short." In other words, the GSE took on large amounts of short-term debt to fund long-term mortgages, only to find itself billions of dollars in the red after interest rates jumped. New management, federal support (including a special tax break) and a successful gamble on interest rates in the early 1980s helped restore profitability.

Not all federal credit programs promise to be as costly. Some, such as the recently-terminated Private Sector Investment program of the US Agency for International Development, actually accomplish their public purposes while making a slight profit. Two government sponsored enterprises — Sallie Mae and the Federal Home Loan Bank System — also appear to be exceptionally sound. A 1991 Treasury Department report concluded that each of these enterprises would obtain the highest ("AAA") rating from the Standard & Poor's Corporation even without the implied federal backing of their obligations.

Yet even profitable federal credit programs raise important questions. If federal investment in a particular credit activity is profitable, why do we need federal involvement? There is a serious question, for example, whether there is a need today for a Federal Home Loan Bank System. This \$80 billion institution lends in a way that in today's markets has little relationship to any significant public purpose, and only to profitable savings and loans. Similarly, Sallie Mae passes on virtually none of the benefits of its implied federal guarantee to lower borrowing costs for students. Instead, the benefits flow directly to Sallie Mae's shareholders, who have enjoyed federally-backed profits of 30% to 40% for the past decade.

Economists contend that the most useful government intervention into the credit markets is to overcome so-called market imperfections. Most such imperfections have been caused by the government itself, in the form of restrictive laws and regulations that created impediments to the efficient flow of capital in the credit markets. For decades, federal and state laws restricted banks and savings and loan associations so that they could serve local markets without nationwide (or even statewide) branching. This created oligopoly markets for local banks and S&Ls, and also restricted the flow of capital across the country.

The federal government created the Federal Home Loan Bank System in 1932 and Fannie Mae (originally a subsidiary of the Reconstruction Finance Corporation) in 1938 to help overcome these legal impediments. Because of their legal authority to borrow money and lend it across the country, these new credit institutions helped to improve the flow of mortgage money from areas with available investment funds (generally the Northeast) to those western and midwestern states where much of the development was taking place. In addition, the government backing for obligations of these new institutions helped to overcome the reluctance of private investors who, because of their experiences in the Depression, needed such encouragement before they would commit funds to the mortgage market.

Today investors are willing to commit ample funds to the mortgage market even without a government guarantee. Moreover, many of the legal impediments to geographic expansion of banks and S&Ls have been reduced or eliminated. A Federal Home Loan Bank System, once useful, is now largely irrelevant to the efficient flow of capital into the mortgage market.

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Loan Guarantees

In addition to guaranteeing funds borrowed by GSEs, the federal government also guarantees loans made by private banks for various specialized purposes.²¹ Probably the best known of these programs are those that guarantee mortgages through the Department of Veterans Affairs and the Federal Housing Administration. Again, if such loans should ever go into default, the taxpayer is responsible for making up the difference. Outstanding loans of this type amounted to \$693 billion (face value) at the end of 1993.

Another category of federal intervention in credit markets involves direct loans made by the federal government. Such loans are made to encourage rural development, exports, international development, and small businesses. Among the lending institutions are the Export-Import Bank, the Rural Electrification Administration, and the Agency for International Development. The face value of the outstanding loans from these institutions was \$151 billion at the end of 1993. Although nominally such loans are assets of the federal government, they are really more akin to liabilities because such loans are often not repaid.

The greatest losses in federal direct loans and loan guarantees recently have come from the federal guaranteed student loan program. The government estimates that the \$52 billion of student loans outstanding in FY 1992 will result in \$20-30 billion of losses (in present value terms). The federal government estimates that over one-third of all loans in default were taken out by students of proprietary schools. Those students tend to be the poorest. They may enter vocational training programs to become beauticians, barbers, electricians, or truck drivers, with the funding provided through a guaranteed student loan. Once enrolled, however, many students drop out when they find that the actual courses do not live up to expectations. Of course, they are still responsible for repaying their loan, an obligation which will be enforced by the Internal Revenue Service and other collectors on behalf of the federal government. However, because these students tend to be poor, it is very difficult to collect these debts.

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Farmers too have felt the burdens of federally subsidized credit. In the 1970s the value of American farmland literally doubled. Riding a tide of prosperity, farmers began to borrow money. Credit-worthy farmers took out loans from the Farm Credit System (FCS), a government sponsored enterprise. Less credit-worthy farmers borrowed through the Farmers Home Administration, another federal agency. By early 1981, the FCS was offering loans priced five percentage points below the market rates that commercial banks could afford to offer.

When the agricultural economy collapsed in the early 1980s, farmers found themselves unable to service their excessive debt. The availability of cheap federally backed credit had meant that many farmers had taken out more debt than they could afford. Also, because their loans were often variable rate loans, their previously generous credit terms became onerous in the high interest rate environment of the early 1980s.

The result was suffering and hardship for many farmers and their families. By the mid-1980s, some two to three hundred thousand farmers had failed financially. This amounted to one out of five farmers who were forced out of business. While these failures were due to a number of factors relating to the collapse of farm incomes, it is clear that cheap federal credit exacerbated the results.

Federal Insurance Programs

Lastly, there are various insurance programs which the federal government also guarantees.²² The largest of these programs is the Federal Deposit Insurance Corporation (FDIC), which protects the deposits at all U.S. banks. The federal government also guarantees deposits at thrift institutions and credit unions, as well as pension fund assets and disaster insurance. At the end of fiscal year 1993 the FDIC program alone had insurance commitments of almost \$2 trillion (\$1,889 billion). Outstanding insurance on thrift deposits amounted to \$707 billion and insurance on credit unions came to \$237 billion. The Pension Benefit Guaranty Corporation, which protects pension funds, insured \$950 billion worth of assets. Various other insurance programs added \$1.2 trillion to the total. Total insurance commitments amounted to just over \$5 trillion at the end of 1993. All loan guarantees and insurance commitments together amounted to just over \$7 trillion at the end of 1993, as detailed in **Table 1**.

Program		\$ Billion
Direct Loans:	Farm Service Agency, Rural Development Administration	\$ 49
	Rural Electrification Administration, Rural Telephone Bank	36
	Export-Import Bank	9
	Agency for International Development	14
	Public Law 480	12
	Foreign Military Financing	9
	Small Business	6
	Other Direct Loans	16
	Subtotal	\$ 151
Guaranteed Loans:	FHA Single Family	292
	VA Mortgage	161
	FHA Multi-Family	81
	Federal Family Education Loan Program	85
	Small Business	20
	Farm Service Agency	7
	Export-Import Bank	12
	Commodity Credit Corp. (CCC) Export Credits	9
	Other Guaranteed	26
	Subtotal	\$ 693
Federal Insurance:	Banks	1,889
	Thrifts	707
	Credit Unions	237
	Pension Benefit Guarantee Corp. (PBGC)	950
	Disaster Insurance	722
	Other Insurance	511
	Subtotal	\$ 5,016
GSEs:	Freddie Mac	474
	Fannie Mae	622
	Federal Home Loan Banks	107
	Farm Credit Administration	52
	Subtotal	\$ 1,255
	Total:	\$ 7,115

Table 1
Value of Federal Credit and Insurance Programs (face value 1993)

Source: Budget of the United States Government, Fiscal Year 1995: Analytical Perspectives (Washington: U.S. Government Printing Office, 1994), p. 134

In recent years, the PBGC has aroused particular concern regarding its potential for taxpayer risk. The PBGC was established by the Employee Retirement Income Security Act of 1974 (ERISA) to insure the benefits of most defined-benefit plans.²³ Should such plans terminate, such as through a corporate bankruptcy, the PBGC acquires both their assets and liabilities and pays out the promised benefits itself. Should the PBGC's own assets from premiums assessed on covered pension plans be insufficient to cover any shortfall, taxpayers would ultimately be liable.

Companies are required to report to the IRS annually on the assets of their defined-benefit plans and the present value of their liabilities. Unfortunately, some companies report unfunded liabilities. Moreover, some companies have underestimated the amount of such liabilities, causing concern that the PBGC's potential risk may be greater than it appears. At the end of fiscal year 1991 the PBGC reported an unfunded liability of \$40 billion in the plans it insures. Its true liability could be much greater.²⁴

V. FEDERAL PREEMPTION OF CREDIT

There is considerable debate about the exact nature of direct government loans, loan guarantees and insurance programs.²⁵ Prior to the savings and loan bailout it may have been possible to view these programs as relatively benign. However, since the bailout, which cost taxpayers some \$150 billion, it is no longer possible to do so. Consequently, these loan guarantees and insurance commitments ought to be considered as part of the national debt, just as Treasury securities are. They are a liability to the taxpayer in exactly the same way and ought to be viewed as such. At a minimum, loan guarantees preempt resources which could otherwise be put to use by the private sector. Such preemption creates "crowding-out" and raises interest rates for private borrowers. This can only be justified if one believes that the federal government's use of the economy's scarce financial resources is more efficient than the private sector's — an unlikely prospect, given the government's propensity for waste and inefficiency. **Table 2** shows the federal government's participation in financial markets. As one can see, in recent years the federal government has preempted well over three-fourths of all lending in financial markets.

These loan guarantees and insurance commitments ought to be considered as part of the national debt, just as Treasury securities are.

Year	Federal & Federally-Assisted Borrowing (\$ billions)	Percent of Total Credit Market
1965	10.1	15.1
1970	16.2	18.4
1975	65.0	38.3
1980	122.5	37.7
1985	278.9	34.7
1990	377.1	54.6
1991	424.3	84.2
1992	481.2	87.0
1993	415.5	76.3

Table 2
Federal Participation in the Credit Market (\$ billions)

Source: Budget of the United States Government, Fiscal Year 1995: Analytical Perspectives (Washington: U.S. Government Printing Office, 1994), p. 194

VI. ACTUARIAL LIABILITIES

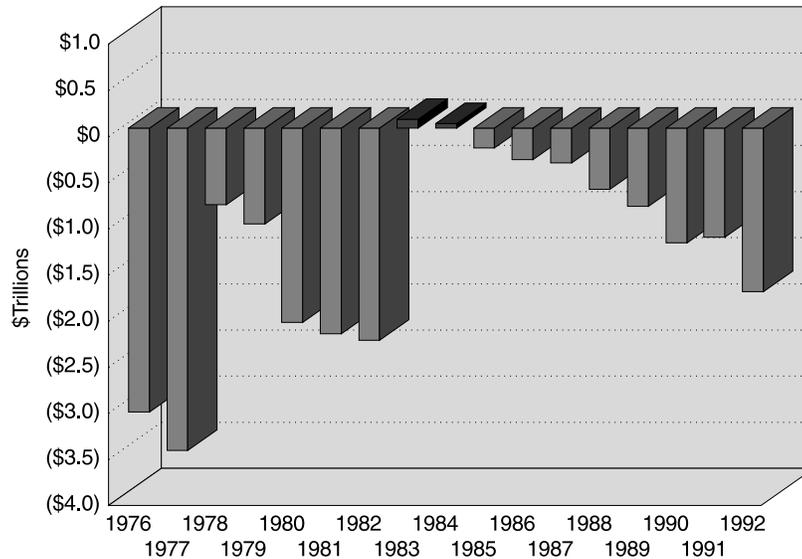
In addition to these commitments and contingencies, the federal government also has considerable pension and actuarial liabilities. These are mainly for federal employee pension programs and for Social Security. As of September 30, 1991 the federal government had accumulated \$695 billion in accrued obligations for federal civil service employees retirement benefits, \$526 billion for military personnel and \$24 billion for other pension obligations. On top of this, the federal government has an actuarial liability of \$190 billion for veterans compensation and \$49 billion for other compensation programs.²⁶

Because military personnel and federal civilian employees are also entitled to federal health benefits after retirement, the federal government has an additional liability for these benefits as well. Unfunded military health benefits are estimated at \$410 billion, and \$115 billion is the estimate for federal employees health benefits.²⁷

Social Security

The actuarial liability of the Social Security system is estimated at \$1,772,600,000 as of September 30, 1992. This represents the difference between expected revenues over the next 75 years of \$17.7 trillion and expected benefit payments of \$19.5 trillion. As large as these numbers are, however, what is of even greater concern is the fact that they are rising rapidly, as illustrated in **Figure 5**. Since 1983 the actuarial deficit of the Social Security system has increased by \$1.7 trillion.²⁸

Figure 5
Actuarial Liability/Surplus
of the Social Security
System



Source: Statement of Liabilities and Other Financial Commitments of the United States Government (Washington: U.S. Treasury Department, Financial Management Service, various years).

Of course, the federal government has assets as well as liabilities, the most important being its ability to tax. However, it also has tangible assets, including the ownership of land, buildings and the like.²⁹ **Table 3** compares the federal government's assets to its liabilities, indicating an excess of liabilities over assets of \$3.1 trillion as of September 30, 1991. And this is a very conservative calculation which excludes a number of liabilities discussed above, such as the actuarial deficit of the Social Security system. However, assets are also undervalued, generally being listed at acquisition cost rather than market value. (What would be the market value of, say, the White House?)

VII. BURDEN OF THE DEBT

The question of what the burden of these debts is has been a matter which economists have debated for hundreds of years, without achieving a consensus.³⁰ A critical question is whether net additions to debt (i.e., the budget deficit) constitute a shifting of financial burdens from the present to future generations. Again, this is a matter which economists have debated for some time without resolving the question.³¹ In recent years debate has focused on the so-called Ricardian Equivalence Theorem, which says that debt and taxes are essentially interchangeable.³² Another way of putting it would be to say that the burden of government spending is always borne by the current generation, because government can only consume currently existing resources. It is impossible to bring real resources forward from the future because they have not been produced yet. Thus there is no extra burden on future generations due to deficit financing. Given the same level of government spending, the burden would be the same even if the government had raised taxes to maintain budget balance.³³ In the end, the burden of government is what it spends regardless of the method of finance.

Assets/Liabilities	\$ Billion
Assets:	
Cash	41.5
Other monetary assets	118.6
Accounts receivable, net of allowances	57.4
Inventories, net of allowances	127.8
Loans receivable, net of allowances	147.9
Property, plant, and equipment, net of depreciation	600.3
Investments in international organizations	26.7
Deferred retirement costs	25.2
Financial Assets	83.1
Other assets	165.2
Total Assets	1,393.7
Liabilities	
Checks outstanding	34.4
Accounts payable	99.6
Interest payable	43.6
Accrued payroll and benefits	18.2
Unearned revenue	66.7
Debt issued under financing authority	2,687.2
Pensions and actuarial liabilities	1,483.2
Financial liabilities	47.4
Other liabilities	59.8
Total Liabilities	4,540.1
Assets less liabilities	(3,146.4)

Table 3
Consolidated Financial Statement of the United States Government (as of September 30, 1991)

Source: U.S. Treasury Department, Financial Management Service, Consolidated Financial Statements of the United States Government: Prototype 1991 (Washington: U.S. Government Printing Office, 1992), p. 13.

In response, one might ask, "What about interest on the debt? Doesn't that constitute a burden on future generations?"³⁴ Basically, the answer is no because interest payments are really just a transfer between the government and the people who buy bonds. As **Figure 6** illustrates, interest payments constitute a large percentage of the deficit. In other words, if the debt disappeared we would essentially have a balanced budget. So in a sense, all we are doing is borrowing money from

Interest on the Debt

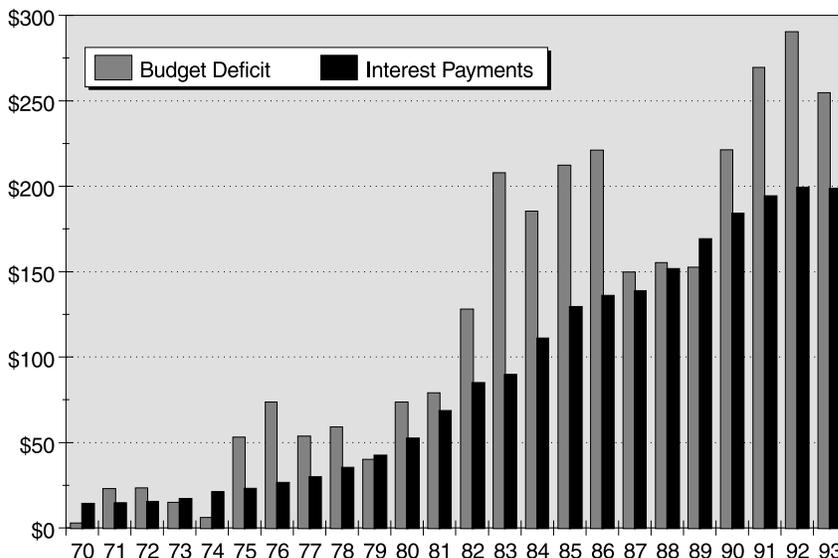


Figure 6
Federal Budget Deficit and Net Interest Paid

Source: Budget of the United States Government, Fiscal Year 1995: Historical Tables (Washington: U.S. Government Printing Office, 1994), pp. 14, 95.

people and then making interest payments of the same amount to those same people. There is no real impact on the non-interest portion of the budget or on the economy.³⁵

Still, it would be better not to have a national debt, but we must be careful that the cost of extinguishing the debt does not exceed to cost of carrying it. John Stuart Mill, for one, clearly believed that reduction in the debt should not stand in the way of tax reduction:

When a country, wisely or unwisely, has burdened itself with a debt, is it expedient to take steps for redeeming that debt? In principle it is impossible not to maintain the affirmative. It is true that the payment of interest, when the creditors are members of the same community, is no national loss, but a mere transfer. The transfer, however, being compulsory, is a serious evil, and the raising of a great extra revenue by any system of taxation necessitates so much expense, vexation, disturbance of the channels of industry, and other mischiefs over and above the mere payment of the money wanted by the government, that to get rid of the necessity of such taxation is at all times worth a considerable effort. The same amount of sacrifice which would have been worth incurring to avoid contracting the debt it is worthwhile to incur, at any subsequent time, for the purposes of extinguishing it.³⁶

It is not, however, advisable in all cases to maintain a surplus revenue for the extinction of debt. The advantage of paying off the national debt of Great Britain, for instance, is that it would enable us to get rid of the worse half of our taxation. But of this worse half some portions must be worse than others, and to get rid of those would be a greater benefit proportionally than to get rid of the rest. If renouncing a surplus revenue would enable us to dispense with a tax, we ought to consider the very worst of our taxes as precisely the one which we are keeping up for the sake of ultimately abolishing taxes not so bad as itself. In a country advancing in wealth, whose increasing revenue gives it the power of ridding itself from time to time of the most inconvenient portions of its taxation, I conceive that the increase of revenue should rather be disposed of by taking off taxes, than by liquidating debt, as long as any very objectionable imposts remain.³⁷

As Mill's comments demonstrate, there are costs associated with raising taxes to eliminate deficits and reduce national indebtedness. At best, tax increases are an unreliable way to reduce the debt. Historically, higher taxes have never led to debt reduction; that has come about only through economic growth.³⁸ As Senator Bob Packwood of Oregon recently put it, "The history of the U.S. Government is that when we increased taxes, we spent them; we did not apply it to the deficit."³⁹ This is especially the case when the opportunity presents itself to reduce or abolish taxes which are particularly inhibiting to economic growth, because growth is the best way of reducing the burden of the debt and creating the means for paying it off.

Yet, just last year, President Clinton justified an increase in the top income tax rate solely in order to reduce the budget deficit.⁴⁰ These higher taxes are already having a negative effect on the economy which greatly outweigh any positive impact from a lower deficit.⁴¹ Thus the true cost of the debt may be political. It inhibits Congresses and Administrations from taking action against punitive taxation and encourages the adoption of still more punitive forms of taxation.

And the blame does not belong only to Democrats like Bill Clinton. Republicans like Eisenhower have been equally guilty of putting debt repayment above tax cuts. During the 1950s Eisenhower strenuously fought any effort to reduce the high World War II and Korean War tax rates until the debt was eliminated.⁴² Although some budget surpluses were recorded, the price was high. Economic growth remained slow throughout the fifties and, in 1960, the American people turned away from Republican austerity and embraced a young Democrat, John F. Kennedy, who

promised to get the country moving again by cutting taxes. The faster growth resulting from the Kennedy tax cut did far more than Eisenhower's austerity to reduce the burden of the public debt as a share of GNP.

In conclusion, the debt is certainly a problem. But ironically, the aspect of the debt people seem most concerned about — the debt held by the public — is in fact the least harmful element of the federal government's liabilities. Of far greater concern is the rapidly growing contingent liabilities and commitments and off-budget credit programs which impact on credit markets the same way direct federal borrowing does. Yet the balanced budget amendment to the Constitution, which was recently debated (and defeated) in Congress, would have applied only to the former while exempting the latter entirely. And concern about deficits and the debt has been an effective argument for adopting budget restraints which have made it all but impossible to cut federal taxes, thereby condemning our country to economic growth well below our potential.

Bruce Bartlett is a Senior Fellow with the Alexis de Tocqueville Institution who has held positions at the Treasury Department, the White House, and on Capitol Hill. Most recently he was Deputy Assistant Secretary for Economic Policy at the U.S. Treasury. Mr. Bartlett is also the author of IPI Policy Report No. 122, *The Clinton Economic Stimulus Plan: Jobs and Hope or Pig in a Poke?*

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Nothing written here should be construed as necessarily reflecting the views of the Institute for Policy Innovation, or as an attempt to aid or hinder the passage of any bill before Congress.

- 1 See James D. Savage, *Balanced Budgets and American Politics* (Ithaca: Cornell University Press, 1988).
- 2 The Federal budget contains annual data on gross federal borrowing, debt held by the public, and federal loan. However, the data on total federal liabilities can only be found in an unpublished report called, "Statement of Liabilities and Other Financial Commitments of the United States Government as of September 30, year," compiled by the Treasury Department's Financial Management Service, and required by law since 1967. A summary appears in the March issue of the *Treasury Bulletin*. Since 1977 the Financial Management Service has also published a prototype report combining the federal government's assets and liabilities, called the "Consolidated Financial Statement of the United States Government." A summary of this report appears in the September issue of the *Treasury Bulletin*. The only published discussions of all the various aspects of the national debt are found in Rudolph G. Penner, "How Much Is Owed by the Federal Government?" *Carnegie-Rochester Series on Public Policy*, vol. 16 (1982), pp. 233-256; and Roy H. Webb, "The Stealth Budget: Unfunded Liabilities of the Federal Government," *Federal Reserve Bank of Richmond Economic Review* (May/June 1991), pp. 23-33.
- 3 See Paul B. Trescott, "Some Historical Aspects of Federal Fiscal Policy, 1790-1956," in U.S. Congress, Joint Economic Committee, *Federal Expenditure Policy for Economic Growth and Stability: Papers Submitted by Panelists before the Subcommittee on Fiscal Policy*, Joint Committee Print, 85th Congress, 1st session (Washington: U.S. Government Printing Office, 1957), pp. 60-83.

Conclusion

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Notes

- 4 GNP numbers from 1799 through 1859 are adapted from Robert F. Martin, *National Income in the United States, 1799-1938* (New York: National Industrial Conference Board, 1939), pp. 6-7. GNP figures from 1869 to 1928 are from Christina D. Romer, "The Prewar Business Cycle Reconsidered: New Estimates of Gross National Product, 1869-1908," *Journal of Political Economy*, vol. 97, no. 1 (February 1989), pp. 22-23. GNP figures since 1929 can be found in the *National Income and Product Accounts* published by the U.S. Commerce Department. Debt figures from 1799 to 1939 are from U.S. Commerce Department, *Bureau of the Census, Historical Statistics of the United States: Colonial Times to 1970*, 2 vols. (Washington: U.S. Government Printing Office, 1975), vol. 2, p. 1117. Debt figures from 1940 to 1993 are from *Budget of the United States Government, Fiscal Year 1995: Historical Tables* (Washington: U.S. Government Printing Office, 1994), p. 89. Data are for debt held by the public.
- 5 In future years these surpluses will be drawn down to pay benefits for future retirees. At that point current Social Security taxes will be insufficient to pay current benefits.
- 6 Details can be found in the *Budget of the United States Government, Fiscal Year 1995: Analytical Perspectives* (Washington: U.S. Government Printing Office, 1994), pp. 185-193.
- 7 This would make it too easy for the government to cover its debts by, in effect, printing money. Although this is in fact what the Fed does when it buys Treasury securities, it does so only on its own initiative. This may seem like a meaningless distinction, but research indicates that countries which maintain an independent central bank have lower inflation on average than those where the central bank is simply an arm of the finance ministry. See Patricia S. Pollard, "Central Bank Independence and Economic Performance," *Federal Reserve Bank of St. Louis Review*, vol. 75, no. 4 (July-August 1993), pp. 21-36; Alberto Alesina and Lawrence H. Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," *Journal of Money, Credit, and Banking*, vol. 25, no. 2 (May 1993), pp. 151-162; Alex Cukierman, Steven B. Webb, and Bilin Neyapti, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes," *World Bank Economic Review*, vol. 6, no. 3 (September 1992), pp. 353-398.
- 8 This is the modern variation of the concept known as "seigniorage," which is the margin between the metal content of coins and their face value. Traditionally, governments have maintained a monopoly on coinage precisely in order to capture these profits. In fact, the federal government still lists seigniorage on the minting of coins as a revenue item in the budget. In fiscal year 1993 it contributed about \$400 million in revenue to the government. However, in the larger sense of the term, the vast bulk of what might be called seigniorage is captured by the Federal Reserve, which "buys" Federal Reserve notes from the Treasury's Bureau of Engraving and Printing for about 3 cents per bill and then issues them at face value. Eventually, the profits on this transaction come back around to the Treasury when the Fed returns its excess revenue. For a discussion of seigniorage, see Manfred J.M. Neumann, "Seigniorage in the United States: How Much Does the U.S. Government Make from Money Production?" *Federal Reserve Bank of St. Louis Review*, vol. 74, no. 2 (March-April 1992), pp. 29-40; Martin Klein and Manfred J.M. Neumann, "Seigniorage: What Is It and Who Gets It?" *Weltwirtschaftliches Archiv*, vol. 126, no. 2 (1990), pp. 205-220; Daniel L. Thornton, "Monetizing the Debt," *Federal Reserve Bank of St. Louis Review*, vol. 66, no. 10 (December 1984), pp. 30-43.
- 9 On a day to day basis the Federal Reserve and the Treasury Department must coordinate their actions very carefully because the Treasury uses the Federal Reserve as its own banker. When tax revenues are received by the Treasury they are deposited at the Fed and when checks are written they are drawn against the Treasury's account at the Fed. Consequently, in the absence of Federal Reserve action, the Treasury's fiscal operations could affect the money supply. However, the Fed offsets the Treasury's actions on a daily basis by either buying securities on the open market to offset Treasury deposits or selling securities to offset withdrawals. Thus even when the Fed is making no effort to increase or reduce the money supply, it must constantly buy and sell securities to offset the Treasury's actions. In order to help people in financial markets interpret the Fed's actions, the Treasury discloses its cash position daily in the *Daily Treasury Statement*, published by the U.S. Government Printing Office.
- 10 Charlotte E. Ruebling, "Financing Government Through Monetary Expansion and Inflation," *Federal Reserve Bank of St. Louis Review*, vol. 57, no. 2 (February 1975), pp. 15-23; Robert Eisner, *How Real is the Federal Deficit?* (New York: Free Press, 1986), pp. 9-25.
- 11 The Office of Management and Budget estimates that a sustained one percentage point increase in interest rates would increase the deficit by the following amounts (billions of dollars):

1994	1995	1996	1997	1998	1999
4.6	13.4	18.9	24.0	29.0	41.2

- 12 See Joe Cobb, "A Dubious Debt Doubt," *Reason*, vol. 17, no. 3 (August 1985), pp. 34-36.
- 13 The vast bulk of the Fed's holdings of Treasury securities are Treasury bills, securities which mature in less than one year. Thus, as these bills mature and are paid off, the Fed must repurchase new securities on the open market to maintain its holdings and avoid impacting on the money supply. These data are published monthly in the *Federal Reserve Bulletin*. At the end of November

1993, the Federal Reserve owned \$327 billion in Treasury securities; \$6 billion consisted of securities maturing within 15 days, \$85 billion maturing within 16 to 90 days, \$105 billion maturing between 91 days and 1 year, \$77 billion maturing between 1 and 5 years, \$24 billion maturing between 5 and 10 years, and \$31 billion maturing in more than 10 years.

- 14 Interestingly, the Fed's "profits" that are paid to the Treasury appear in the National Income and Product Accounts as corporate profits and also as corporate tax payments. In other words, the Fed is paying a tax rate of 100%. The effect is to make it appear that the overall burden of corporate taxes is higher than it actually is. This is especially the case when looking at the profits and taxes of the finance, insurance and real estate sector, where the Fed accounts for about half of all profits and taxes paid. See Robert J. Barro, "Measuring the Fed's Revenue from Money Creation," National Bureau of Economic Research Working Paper No. 883 (April 1982).
- 15 To the extent that foreign inflows of capital are invested in Treasury securities, it reduces the need for the Treasury to borrow in domestic markets, thus freeing up domestic saving for private investment. Consequently it is important for the U.S. to maintain an open climate for foreign investment in order to sustain this flow of foreign capital. And since capital flows and trade flows are closely related, this also means that the U.S. needs to maintain an open trading system as well.
- 16 It should be noted also that these figures are estimated. Because the nominal purchaser of a bond may not be the ultimate owner, as when a money market mutual fund purchases securities, and because foreigners may hold their securities in the U.S. there is really no way of knowing exactly what the foreign ownership of debt actually is.
- 17 *Treasury Bulletin* (December 1993), p. 39.
- 18 GSEs borrow through an entity known as the Federal Financing Bank, a part of the Treasury Department. Although they could go to the market directly, they generally get better terms by going through the FFB. On the FFB, see "The Federal Financing Bank: A Department of the Treasury," *International Currency Review*, vol. 12, no. 5 (1980), pp. 14-22; John J. Fialka, "Obscure U.S. Lender, Bigger than Citibank, Irks Budget Watchers," *Wall Street Journal* (December 15, 1981); Congressional Budget Office, *The Federal Financing Bank and the Budgetary Treatment of Federal Credit Activities* (Washington: U.S. Government Printing Office, January 1982).
- 19 There is a large literature on the problems and risks associated with GSEs. Among the more important recent contributions are U.S. Treasury Department, *Report of the Secretary of the Treasury on Government Sponsored Enterprises, May 1990* (Washington: U.S. Government Printing Office, 1990); U.S. Treasury Department, *Report of the Secretary of the Treasury on Government Sponsored Enterprises, April 1991* (Washington: U.S. Government Printing Office, 1991); U.S. General Accounting Office, *Government-Sponsored Enterprises: The Government's Exposure to Risks*, GAO/GGD-90-97 (August 1990); U.S. General Accounting Office, *Profiles of Government-Sponsored Enterprises*, GAO/AFMD-91-17 (February 1991); U.S. General Accounting Office, *Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks*, GAO/GGD-91-90 (May 1991); Thomas H. Stanton, *Government Sponsored Enterprises: Their Benefits and Costs as Instruments of Federal Policy* (Washington: Association of Reserve City Bankers, April 1988); Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises* (Washington: U.S. Government Printing Office, April 1991).
- 20 According to the Office of Management and Budget, the default and write-off rate for all federal direct loans and guaranteed loans was 18.7% in 1993. *Budget of the United States Government, Fiscal Year 1995: Analytical Perspectives* (Washington: U.S. Government Printing Office, 1994), p. 151. See also Nathaniel Nash, "Hidden U.S. Losses in Loan Programs Reach High Levels," *New York Times* (December 24, 1988); Janet Novack, "Let's Make a Deal," *Forbes* (January 23, 1989), p. 48; Jonathan Rauch, "You Lose, We All Pay," *National Journal* (April 6, 1991), pp. 784-88.
- 21 Joel Fried, "Government Loan and Guarantee Programs," *Federal Reserve Bank of St. Louis Review*, vol. 65, no. 10 (December 1983), pp. 22-29.
- 22 Insured institutions pay premiums for such insurance and these fees generally cover the cost of defaults. However, as in the case of the massive savings and loan bailout, if such premiums are insufficient to cover the losses, taxpayers must make up the difference. Thus although the insurance commitments listed below are, in a sense, theoretical, they still represent a risk borne by all taxpayers.
- 23 In a defined-benefit plan, companies promise a particular future pension benefit and are required to have assets sufficient to pay such benefits. The level of assets necessary is calculated on the basis of complex actuarial methods and are highly sensitive to assumptions about future inflation, interest rates and rates of return on pension assets. Because the time periods over which assets are accumulated and benefits paid can be quite long, even small changes in assumptions can have enormous impact on the actuarial status of a given pension plan. In recent years, companies have begun switching their pension plans from those with defined benefits to those with defined contributions. In such plans a company only promises to put away a fixed amount of

assets each year, which the employee owns and often manages himself. Thus the risk and responsibility for acquiring sufficient pension assets to fund retirement is being shifted away from the company and onto the employee.

- 24 U.S. General Accounting Office, *Pension Plans: Hidden Liabilities Increase Claims Against Government Insurance Programs*, GAO/HRD-93-7 (December 1992); Congressional Budget Office, *Controlling Losses of the Pension Benefit Guaranty Corporation* (Washington: U.S. Government Printing Office, 1993); Congressional Budget Office, *Federal Insurance of Private Pension Benefits* (Washington: U.S. Government Printing Office, 1987).
- 25 See Barry P. Bosworth, Andrew S. Carron, and Elisabeth H. Rhyne, *The Economics of Federal Credit Programs* (Washington: Brookings Institution, 1987); Dennis S. Ippolito, *Hidden Spending: The Politics of Federal Credit Programs* (Chapel Hill: University of North Carolina Press, 1984); Clifford M. Hardin and Arthur T. Denzau, *The Unrestrained Growth of Federal Credit Programs* (St. Louis: Center for the Study of American Business, Washington University, 1981); Dan Larkins, *\$300 Billion in Loans: An Introduction to Federal Credit Programs* (Washington: American Enterprise Institute, 1972).
- 26 U.S. Treasury Department, Financial Management Service, *Consolidated Financial Statements of the United States Government: Prototype 1991* (Washington: U.S. Government Printing Office, 1992), p. 25.
- 27 *Ibid.*, p. 27.
- 28 Congress enacted major Social Security rescue plans in 1977 and 1983, both of which largely consisted of tax increases rather than benefit reductions. As a consequence, the combined Social Security tax rate (on both workers and employers) has risen from 11.7% on the first \$16,500 of wages in 1977 to a rate of 15.3% on earnings of \$57,600 in 1993. Thus the maximum contribution per year has risen from just \$1,930 in 1977 to \$8,813 in 1993.
- 29 Many economists have suggested that the federal government divide its expenditures into operating and capital expenses in order to better gauge the economic impact of its spending. The idea is that borrowing for capital projects, such as roads and bridges, is fundamentally different than spending for pure consumption, just as an individual's borrowing to buy a house is different than borrowing to take a vacation. Since such capital projects presumably create value for society over their useful lives, it would therefore seem appropriate to at least expense them over a period of time. For a discussion of these issues, see the following reports from the U.S. General Accounting Office: *Pros and Cons of a Separate Capital Budget for the Federal Government*, GAO/PAD-83-1 (September 22, 1983); *Capital Budgeting for the Federal Government*, GAO/AFMD-88-44 (July 1988); *Restructuring the Federal Budget--The Capital Component*, GAO/AFMD-89-52 (August 1989); *Incorporating and Investment Component in the Federal Budget*, GAO/AIMD-94-40 (November 1993). For the views of some economists, see Richard A. Musgrave, "The Nature of Budgetary Balance and the Case for the Capital Budget," *American Economic Review*, vol. 29 (June 1939), pp. 260-71; James Maxwell, "The Capital Budget," *Quarterly Journal of Economics*, vol. 57, no. 3 (May 1943), pp. 450-65; Richard Goode and Eugene Birnbaum, "Government Capital Budgets," *IMF Staff Papers*, vol. 5, no. 1 (February 1956), pp. 23-46; Richard A. Musgrave, "Should We Have a Capital Budget?" *Review of Economics and Statistics*, vol. 45 (May 1963), pp. 134-137; Robert Eisner, *How Real is the Federal Deficit?* (New York: Free Press, 1986), pp. 26-32.
- 30 For the classical economists' views on public debts, see Seymour E. Harris, *The National Debt and the New Economics* (New York: McGraw-Hill, 1947), pp. 51-76; and Charles K. Rowley, "Classical Political Economy and the Debt Issue," in James M. Buchanan, Charles K. Rowley and Robert D. Tollison, eds., *Deficits* (New York: Basil Blackwell, 1987), pp. 49-74.
- 31 See the papers contained in James M. Ferguson, ed., *Public Debt and Future Generations* (Chapel Hill: University of North Carolina Press, 1964).
- 32 The principal exponent of this view is Robert J. Barro of Harvard. His original contribution to the debate was, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, vol. 82, no. 6 (November/December 1974), pp. 1095-1117. Since then there have been many, many articles on the issue both pro and con. For a recent survey of the debate, see *The Economist* (November 24, 1990), pp. 77-78.
- 33 See David Ricardo, *The Principles of Political Economy and Taxation* (New York: E.P. Dutton, 1911), p. 161.
- 34 For a discussion of federal interest payments, see Congressional Budget Office, *Federal Debt and Interest Costs* (Washington: U.S. Government Printing Office, May 1993).
- 35 Wall Street economist Peter Bernstein has made this argument for some years. See Peter L. Bernstein, "When Public Borrowing Isn't a Burden," *Wall Street Journal* (January 8, 1985); Robert Heilbroner and Peter Bernstein, *The Debt and the Deficit: False Alarms/Real Possibilities* (New York: Norton, 1989).

- 36 John Stuart Mill, *Principles of Political Economy*, ed. Sir William Ashley (London: Longmans, Green, 1909), p. 876.
- 37 *Ibid.*, pp. 878-79.
- 38 As the great historian Thomas Babington Macaulay put it, "The power of a society to pay its debts is proportioned to the progress which that society has made in industry, in commerce, and in all the arts and sciences which flourish under the benignant influence of freedom and of equal law." *The History of England from the Accession of James II*, 5 vols. (Philadelphia: J.B. Lippincott, 1868), 4: 265. See also Fernand Braudel, *The Perspective of the World* (New York: Harper & Row, 1984), p. 310. In large part, the failure of higher taxes to reduce debt is because such taxes tend to cause higher spending. See Neela Manage and Michael L. Marlow, "The Causal Relationship between Federal Expenditures and Receipts," *Southern Economic Journal*, vol. 52, no. 3 (January 1986), pp. 617- 629; and Paul R. Blackley, "Causality Between Revenues and Expenditures and the Size of the Federal Budget," *Public Finance Quarterly*, vol. 14, no. 2 (April 1986), pp. 139-56.
- 39 *Congressional Record*, daily ed. (May 18, 1993), p. S 5987.
- 40 See Bruce Bartlett, "The Clinton Tax Plan: Redefining 'Rich' in America," Institute for Policy Innovation *Issue Brief* (March 10, 1993).
- 41 See, for example, "Wealthy Taxpayers Rein in Their Spending to Pay for Tax Increase," *Wall Street Journal* (January 11, 1994), p. 1.
- 42 Eisenhower even worked to defeat Republican tax cut efforts in Congress--the last Congress in which both houses were controlled by the Republicans. As he explained at a press conference on February 17, 1953: "The fact is there must be balanced budgets before we are again on a safe and sound system in our economy. That means, to my mind, that we cannot afford to reduce taxes, reduce income, until we have in sight a program of expenditures that shows that the factors of income and outgo will be balanced."