FRASER INSTITUTE
2022

SECOND ESSAY

James M. Buchanan and the Political Economy of Debt Financing

Donald J. Boudreaux

DO BUDGET DEFICITS MATTER?

Essays on the Implications of Government Deficits and Debt

CHAPTER 2

James M. Buchanan and the Political Economy of Debt Financing

By Donald J. Boudreaux

Introduction

The car that Jones currently owns and drives is 20 years old and is no longer reliable. And so Jones is considering buying a better vehicle. But not being a multi-millionaire, Jones can't afford the luxury of making a decision rashly. After careful pondering, Jones decides to buy a used ("previously owned") two-year-old Toyota. For a moment Jones considered buying a brand-new car, but realized that the higher price of the new car makes such a purchase unwise, despite the fact that the new car is a better vehicle than is the used Toyota.

But en route to the used-car dealership Jones encounters a splendid stroke of good luck when he helps two little old ladies cross the street while telling them that he's on his way to buy a used car. "My dear boy, thank you!" say the old ladies in unison. "We have more money than we know what to do with, and so we'll pay for your new vehicle. Price is no object! Splurge!"

Jones then rushes off and buys a fully loaded, shiny new Porsche 718 Boxster S.

And herein lies one important lesson emphasized by the late Nobel-laureate economist James Buchanan about government financing. The lesson, specifically, is that we spend other people's money more profligately than we spend our own.

Debt-financed government spending is paid for by future generations

James Buchanan (1919-2013) is best known for co-founding, along with his long-time colleague and co-author Gordon Tullock, public-choice economics. Scholars working in this sub-discipline of economics use the same tools of economic analysis that have proven to be so successful at explaining processes and outcomes observed in private markets to examine processes and outcomes in political "markets." But the specific subject matter of Buchanan's earliest work, which he often returned to throughout the six decades of his career, was public finance. Public-finance economists study the causes and consequences of government fiscal budgeting. They do so by looking at both sides of government budgets, the revenue side—that is, taxation—and at the expenditure side.

Buchanan's first major publication, "The Pure Theory of Government Finance," appeared in the *Journal of Political Economy* in 1949 and challenged his fellow public-finance economists to abandon the naïve assumption that government is a sentient creature with a single "fiscal brain" and motivated by nature to pursue the public good. Buchanan encouraged the more realistic approach of treating politicians and voters as individuals each with his or her own interest. When these self-interested people come together politically, each encounters incentives—costs and benefits—that affect their resulting political choices.

If, for example, a democratically elected government is constitutionally required to tax all incomes at the same rate—that is, required to use proportional ("flat") taxation—the result will likely be an average rate of income taxation lower than that which would prevail if government is able to tax higher incomes at higher rates than those imposed on lower incomes. The reason for the rate difference is that the majority of voters would avoid imposing on themselves the same high tax rates that they would, if they could, impose only on the super-rich. Observed patterns of tax rates and tax revenues are thus explained not as the intentional results of a god-like Leviathan pursuing the public good but, instead, as the often unintentional results of self-interested voters and politicians each responding to the incentives that he or she encounters.

Among the most notable ways that government budgeting differs from private-household budgeting is that, in the former, unlike the latter, the money spent belongs to other people. Although formally all tax revenues "belong" to the citizens as a group—and formally the citizens as a group, usually through their representatives, make all spending decisions—the reality is very different. In reality, government spending decisions are necessarily made by a relatively small handful of particular

government officials. And the money these officials spend is not only not theirs, they cannot lawfully appropriate it for their own private use.

Buchanan realized that this reality has significant consequences for both the tax and spending sides of fiscal budgets.

In his first book, *Public Principles of Public Debt* (1958), Buchanan explained—contrary to the prevailing view of mid-20th-century economists, perhaps most notably Abba Lerner (1948)—that when government spending is financed with debt, the individuals who repay the borrowed sums are *tomorrow's* citizen-taxpayers, that is, individuals other than those who make the decision to borrow and spend. No fiscal institution so surely enables today's citizen-taxpayers, and their political representatives, to spend other-people's money than does debt financing.

The fact that those who pay for today's government programs financed with borrowed money are *tomorrow's* citizen-taxpayers is easy to see. Suppose government builds a vehicular bridge costing $1 billion. If government draws all of this $1 billion from current revenues, the individuals who pay for this bridge are today's citizen-taxpayers. They do so either by paying to government $1 billion more in taxes or by taking $1 billion fewer in government services (or by some combination of both).

But if instead government obtains the $1 billion through borrowing, today's citizen-taxpayers are spared the need to pay more in taxes or to take fewer government services. So the bridge is not paid for by today's citizen-taxpayers. Indeed, the very point of debt financing by government is to relieve today's citizen-taxpayers of the obligation to pay for whatever programs are funded with debt.

Because all funds for building the bridge are loaned to the government by creditors, a casual observer might conclude that the bridge is paid for by the creditors. But this conclusion is mistaken. The creditors are no more the purchasers of the bridge—and, hence, no more the ultimate payer for the bridge—than is a bank that lends money to a car buyer the purchaser of the car. In both cases, the purchaser is the borrower. In both cases the creditors supply only the liquidity that enables the purchases to be made by the *borrowers*. In both cases, what the creditors seek and receive from the transactions are not titles to or rights to use the items that are purchased. What creditors seek and receive are assets—bonds—that creditors expect will increase their net monetary wealth over time, with this increase coming in the form of repayment to them of principal plus interest.

Yet *someone* must pay for the bridge. If the payer is neither today's citizen-taxpayers nor the creditors who lend funds to the government, who is it? Answer: It's the citizen-taxpayers who are responsible for repaying the creditors. If the government bond matures 30 years after it is

issued, citizen-taxpayers 30 years down the road must, in order to retire the bond, either pay an additional $1 billion in taxes or suffer a $1 billion reduction in the value of government services they receive.

The only way future citizen-taxpayers can escape this payment obligation is for the government to default, in which case the bridge comes to be paid for, unwillingly, by the holder of the bond when it matures. Even in this circumstance, however, the bridge is still *not* paid for by those citizen-taxpayers who, 30 years earlier, chose to have government build the bridge.[1]

Future citizen-taxpayers are not today's citizen-taxpayers

The fact that debt financing of government spending today pushes the burden of payment onto citizen-taxpayers tomorrow would lose nearly all of its relevance if tomorrow's and today's citizen-taxpayers were the same flesh-and-blood individuals. In such a case, the individuals who use debt financing to purchase some good or service through government are the same individuals who must eventually pay for what they purchase and consume. We can assume that, under these circumstances, spending decisions made today by citizen-taxpayers would be reasonably prudent given that those same citizen-taxpayers know that they, personally, will eventually have to fork over their own funds to pay for the debt-financed government programs. These programs would not be paid for with other people's money.

But in reality tomorrow's citizen-taxpayers are never the same individuals as are today's citizen-taxpayers. Individuals die; others are born. Individuals leave the workforce; others join the workforce. Individuals emigrate out of, while others immigrate into, the jurisdiction. Individuals suffer unexpected losses of income; others enjoy unexpected gains. Such changes happen even over a matter of days, and over time they accumulate. Citizen-taxpayers who today must repay loans taken out decades earlier are not remotely the same group of individuals who years ago voted to have the government borrow and spend the money that must now be repaid. And today's citizen-taxpayers surely are aware of this fact—meaning that they are also aware that, by today paying for today's government

[1] For a fuller exposition of Buchanan's demonstration that the persons who pay for debt-financed government projects are future citizen-taxpayers, see "Chapter 2: On the Burden of Government Debt" in *The Essential James Buchanan* by Boudreaux and Holcombe (2021).

programs with borrowed funds, they, personally, escape the obligation of having to pay for these programs.

The result is obvious: Easy access to debt financing prompts government to spend imprudently. Thus, the fact that voters overwhelmingly support an increase in government expenditures on, say, health care and national defense is not evidence that these programs are worthwhile; it is not evidence that these programs pass a reasonable cost-benefit test. Because the individuals who vote to increase spending on these programs are not the same individuals who will pay for these programs, voters today are too likely to "purchase" government programs that are excessively costly.

The temptation to spend more on one's personal consumption if other people will pay the tab is naturally strong. It's stronger yet if the other people who will pay the tab are abstract and faceless. And no people are more abstract and faceless than are people still unborn. People still unborn not only have no ability to express their preferences by voting in today's elections, they are utterly invisible to—and likely not even considered by—those who *do* today express their preferences by voting. Easy access to debt financing causes government to spend too much and in ways that do not pass cost-benefit muster. Further, while he recognized the potential appropriateness of deficit financing of infrastructure and other capital projects that will yield the bulk of their benefits on future generations, Buchanan nevertheless worried that elected officials will be too easily tempted to deceptively classify *all* expenditures as ones that yield large streams of future benefits.

For these reasons, Buchanan advocated strict constitutional limitations on government's ability to borrow. One of the few political movements that he actively participated in was the effort in the United States, during the 1980s and 1990s, to enact a balanced-budget amendment to the US Constitution. The failure of that effort deepened Buchanan's pessimism about the long-run prospects of the American economy.

Democracy in deficit

Buchanan's clear-eyed focus on the incentives that confront individual political decisionmakers revealed to him the manner in which the Keynesian "revolution" in economic theory and policy only further fuels fiscal imprudence.

As Buchanan explained most fully in his 1977 book with Richard Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes*, until the mid-20th century politicians were constrained by informal norms or moral qualms from resorting to reckless debt financing. Debt was frowned

upon. Also frowned upon was the fact—a fact widely understood until John Maynard Keynes published his extraordinarily influential *General Theory of Employment, Interest, and Money* in 1936—that government projects funded with debt are indeed paid for by future generations. Keynes and Keynesianism, however, destroyed these norms and quashed these qualms.

According to Keynes, the overwhelming problem confronting mature capitalist economies is that consumers spend too little to keep everyone fully employed. Central to the Keynesian vision is the so-called "paradox of saving"—meaning that, while each individual person or household benefits from saving larger shares of their incomes, if too much such saving occurs the economy falls into recession. The recession, in turn, only further encourages people who are still employed to save even more, thus worsening the problem. Individual virtue—savings—produces a collective vice—recession.

Keynes insisted that the only reliable solution to this problem is government spending financed with debt. (For Keynesians, it's generally more effective, although not strictly necessary, for the treasury to sell bonds, not to the public, but instead to the central bank in exchange for newly created money.) The Keynesian notion is that only government, taking an eagle-eyed view of the entire economy, has the incentive and ability to offset excessive private saving with an amount of new spending that drives the economy to full employment and keeps it there.

But—and this "but" is important—once the economy reaches full employment there's no further need for government to "stimulate" it with debt-financed spending. Should the government continue to spend in this way once full employment is reached, the result will be inflation.

The Keynesian policy prescription can be summarized thus: When the economy is at less than full employment, government should engage in debt-financed ("deficit") spending; when the economy is *at* full employment with no inflation, government should balance its annual budget; when the economy is at full employment *with* inflation, government should run annual budget surpluses. Thus will the economy remain "fine-tuned."

Most of debate surrounding Keynesian economics focuses on technical or theoretical questions. For example: How sticky *are* wages? Does government spending crowd out private spending? Is there really a tradeoff between inflation and unemployment?

But in their 1977 book, Buchanan and Wagner took a different tack. They argued that even if Keynesian *theory* is correct, the guidance that it offers for public policy is politically naïve. While politicians will—as Keynesianism counsels—eagerly borrow and spend during periods of

unemployment, politicians will stubbornly *not* follow Keynesian policy prescriptions during times of full employment or inflation. During times that call for tight fiscal policy, no less than during times of unemployment, politicians will engage in debt-financed spending. The reason is that spending more today without simultaneously raising taxes is nearly *always* a good strategy for winning votes, for it allows citizen-taxpayers today to consume government programs today that will be paid for by future generations. As Buchanan and Wagner summarize, "the Keynesian theory of economic policy produces inherent biases when applied within the institutions of political democracy" (1977: Preface).[2]

Buchanan's and Wagner's criticism of Keynes went still further. Keynes and his disciples, argued Buchanan and Wagner, undermined the moral aversion to debt-financed spending not only by actively encouraging such spending whenever a case can be made that aggregate demand is too low, but Keynesians also rejected the long-standing view of economists that debt-financed spending is paid for by future generations. Keynesians rejected this view by insisting that government debt that is "owed to ourselves" is no burden on future generations.

The Keynesian argument regarding debt that "we owe to ourselves" is that the losses to the citizen-taxpayers who must pay the bondholders are offset by the gains received by the bondholding citizens**.** *Voila!* Debt creates no net burden on future generations! But this argument, whatever its other flaws, ignores the fact that debt financing nevertheless allows some people (namely, today's citizen-taxpayers) to spend money belonging to other people (namely, tomorrow's citizen-taxpayers). And thus debt financing encourages excessive government spending.

But no matter. Widespread acceptance of this Keynesian argument conveyed the false impression that debt financing imposes no burden on future generations. Thus today's citizen-taxpayers are relieved of qualms they once suffered about government spending borrowed funds. The resulting explosion of government's net indebtedness, both in Canada and in the US, was no surprise to Buchanan, but it was a source of great worry. That worry now seems justified. And if we ever restore a sense of fiscal responsibility, we'll owe to Jim Buchanan a debt of gratitude for the insight and inspiration that will fuel this restoration.

[2] Alesina and Perotti (1994) challenge the empirical accuracy of the Buchanan-Wagner thesis. More recently, however, Geloso and Shera (2021) found empirical support for this thesis.

References

Alesina, Alberto, and Roberto Perotti (1994). *The Political Economy of Budget Deficits*. Working Paper number 4637. National Bureau of Economic Research. <https://www.nber.org/papers/w4637>, as of April 20, 2022.

Boudreaux, Donald J., and Randall G. Holcombe (2021). *The Essential James Buchanan*. The Fraser Institute. <https://www.fraserinstitute.org/sites/default/files/essential-james-buchanan.pdf>, as of April 20, 2022.

Buchanan, James M. (1949). The Pure Theory of Government Finance: A Suggested Approach. *Journal of Political Economy* 57, 6 (December): 496-505. <https://www.jstor.org/stable/1826554>, as of April 20, 2022.

Buchanan, James M., and Richard E. Wagner (1977). *Democracy in Deficit: The Political Legacy of Lord Keynes*. Academic Press.

Geloso, Vincent, and Marcus Shera (2021). *Presidents in Deficit: Are There Historical Rewards to Deficits*? GMU Working Paper in Economics number 21-32. George Mason University. <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3950744>, as of April 20, 2022.

Lerner, Abba (1948). The Burden of the National Debt. In Lloyd A. Metzler, et al. (eds.), *Income, Employment and Public Policy* (W.W. Norton): 255-75.

About the author

Donald J. Boudreaux is a Professor of Economics and former Economics Department Chair at George Mason University and a Senior Fellow with the Fraser Institute. He is also a Senior Fellow with the F.A. Hayek Program for Advanced Study in Philosophy, Politics, and Economics at the Mercatus Center at George Mason University, and holds the Martha and Nelson Getchell Chair for the Study of Free Market Capitalism at the Mercatus Center. He has a Ph.D. in economics from Auburn University and law degree from the University of Virginia.

Professor Boudreaux is committed to making economics more accessible to a wider audience, and he has lectured across the United States, Canada, Latin America, and Europe on a wide variety of topics, including the nature of law, antitrust law and economics, and international trade. He is published in a variety of newspapers and journals, including The Wall Street Journal, The Washington Times, and The Supreme Court Economic Review and writes a blog (with Russell Roberts) called Café Hayek, cafehayek.com.

Acknowledgments

The author thanks the unidentified reviewers for their helpful comments on an earlier draft. Any remaining errors are the sole responsibility of the author. As the researcher has worked independently, the views and conclusions expressed in this essay do not necessarily reflect those of the Board of Directors of the Fraser Institute, the staff, or supporters.

Publishing information

Distribution

These publications are available from <http://www.fraserinstitute.org> in Portable Document Format (PDF) and can be read with Adobe Acrobat® or Adobe Reader®, versions 8 or later. Adobe Reader® DC, the most recent version, is available free of charge from Adobe Systems Inc. at <http://get.adobe.com/reader/>. Readers having trouble viewing or printing our PDF files using applications from other manufacturers (e.g., Apple's Preview) should use Reader® or Acrobat®.

Ordering publications

To order printed publications from the Fraser Institute, please contact:

- e-mail: sales@fraserinstitute.org
- telephone: 604.688.0221 ext. 580 or, toll free, 1.800.665.3558 ext. 580
- fax: 604.688.8539.

Media

For media enquiries, please contact our Communications Department:

- 604.714.4582
- e-mail: communications@fraserinstitute.org.

Copyright

Copyright © 2022 by the Fraser Institute. All rights reserved. No part of this publication may be reproduced in any manner whatsoever without written permission except in the case of brief passages quoted in critical articles and reviews.

Date of issue

May 2022

ISBN

978-0-88975-695-3

Citation

Jake Fuss (ed.) (2022). *Do Budget Deficits Matter? Essays on the Implications of Government Deficits and Debt.* Fraser Institute. <http://www.fraserinstitute.org>.

Supporting the Fraser Institute

To learn how to support the Fraser Institute, please contact

- Development Department, Fraser Institute
  Fourth Floor, 1770 Burrard Street
  Vancouver, British Columbia, V6J 3G7 Canada
- telephone, toll-free: 1.800.665.3558 ext. 548
- e-mail: development@fraserinstitute.org
- website: <http://www.fraserinstitute.org/donate>

Purpose, funding, and independence

The Fraser Institute provides a useful public service. We report objective information about the economic and social effects of current public policies, and we offer evidence-based research and education about policy options that can improve the quality of life.

The Institute is a non-profit organization. Our activities are funded by charitable donations, unrestricted grants, ticket sales, and sponsorships from events, the licensing of products for public distribution, and the sale of publications.

All research is subject to rigorous review by external experts, and is conducted and published separately from the Institute's Board of Trustees and its donors.

The opinions expressed by authors are their own, and do not necessarily reflect those of the Institute, its Board of Trustees, its donors and supporters, or its staff. This publication in no way implies that the Fraser Institute, its trustees, or staff are in favour of, or oppose the passage of, any bill; or that they support or oppose any particular political party or candidate.

As a healthy part of public discussion among fellow citizens who desire to improve the lives of people through better public policy, the Institute welcomes evidence-focused scrutiny of the research we publish, including verification of data sources, replication of analytical methods, and intelligent debate about the practical effects of policy recommendations.

About the Fraser Institute

Our mission is to improve the quality of life for Canadians, their families, and future generations by studying, measuring, and broadly communicating the effects of government policies, entrepreneurship, and choice on their well-being.

Notre mission consiste à améliorer la qualité de vie des Canadiens et des générations à venir en étudiant, en mesurant et en diffusant les effets des politiques gouvernementales, de l'entrepreneuriat et des choix sur leur bien-être.

Peer review—validating the accuracy of our research

The Fraser Institute maintains a rigorous peer review process for its research. New research, major research projects, and substantively modified research conducted by the Fraser Institute are reviewed by experts with a recognized expertise in the topic area being addressed. Whenever possible, external review is a blind process. Updates to previously reviewed research or new editions of previously reviewed research are not reviewed unless the update includes substantive or material changes in the methodology.

The review process is overseen by the directors of the Institute's research departments who are responsible for ensuring all research published by the Institute passes through the appropriate peer review. If a dispute about the recommendations of the reviewers should arise during the Institute's peer review process, the Institute has an Editorial Advisory Board, a panel of scholars from Canada, the United States, and Europe to whom it can turn for help in resolving the dispute.

Editorial Advisory Board

Members

Prof. Terry L. Anderson
Prof. Robert Barro
Prof. Jean-Pierre Centi
Prof. John Chant
Prof. Bev Dahlby
Prof. Erwin Diewert
Prof. Stephen Easton
Prof. J.C. Herbert Emery
Prof. Jack L. Granatstein
Prof. Herbert G. Grubel
Prof. James Gwartney
Prof. Ronald W. Jones
Dr. Jerry Jordan
Prof. Ross McKitrick
Prof. Michael Parkin
Prof. Friedrich Schneider
Prof. Lawrence B. Smith
Dr. Vito Tanzi

Past members

Prof. Armen Alchian*
Prof. Michael Bliss*
Prof. James M. Buchanan*†
Prof. Friedrich A. Hayek*†
Prof. H.G. Johnson*
Prof. F.G. Pennance*
Prof. George Stigler*†
Sir Alan Walters*
Prof. Edwin G. West*

* deceased; † Nobel Laureate