EDITOR'S CORNER

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Making dollars and sense of the U.S. government debt

Abstract: *This paper explain why, given Keynes's General Theory, worries over the size of the government's national debt per se is foolish. It is more important to educate politicians and the public that government fiscal policy should be designed to make sure that aggregate market demand will produce sufficient profits so that entrepreneurs will hire all domestic workers willing and able to work. Empirical evidence is provided to demonstrate the correctness of this concept of fiscal policy of the balancing wheel for full employment effective demand.*

Key words: *deficits, national debt.*

No economic topic encourages more political demagoguery than the "unsustainable" national deficits that face the Obama administration as it tries to extricate the economy from this Great Recession that began in 2007. Even President Obama has appointed a commission to develop a plan to assure a reduction in future deficits by lowering government expenditures or raising taxes.

A sage once said, "Those who cannot remember the past are condemned to repeat its errors." So let us review the past history of the national debt to make sure we avoid its errors and repeat its successes.

Is the national debt too large? In 1790, the newly founded U.S. government assumed the debts that had been incurred during the Revolutionary War. Thus, from the very beginning, the U.S. national debt was approximately $75 million. In 1835, President Jackson reduced the debt to close to a zero balance. By 1837, however, the economy went into a steep recession that lasted approximately six years and the national debt increased dramatically. Since then, the U.S. government has always had a significant outstanding debt.

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Journal of Post Keynesian Economics/Summer 2010, Vol. 32, No. 4 663

0160–3477/2010 $9.50 + 0.00.
DOI 10.2753/PKE0160-3477320410

During World War I, the national debt increased substantially from approximately \$6 billion in 1916 to over \$27 billion in 1919. The prosperous decade of the "roaring twenties" saw a decline in the national debt as tax receipts exceeded government spending. By 1929, the total debt had been reduced to \$16.9 billion. This 1920s experience indicates that when the private sector is spending sufficiently to buy all the products that industry can produce in a fully employed economy, then there is no need for the government to deficit spend merely to maintain a prosperous economy. The 1920s prosperity, however, was partly the result of significant bubbles in the stock market and in real estate. (Shades of the dot.com bubble of the 1990s and the housing bubble of early 2000s.)

In 1929, private spending suddenly slowed causing a devastating drop in business profits. Unemployment rose rapidly as the United States entered the Great Depression. Tax revenues fell from \$4 billion in 1930 to less than \$2 billion in 1932. When Roosevelt took office in 1933, the national debt was almost \$20 billion; a sum equal to 20 percent of the U.S. gross domestic product (GDP).

During its first term, the Roosevelt administration ran large annual deficits between 2 and 5 percent of GDP. By 1936, the national debt had increased to \$33.7 billion or approximately 40 percent of GDP. Many "experts" of that era said disaster awaited the nation if the government continued to deficit spend and thereby burden future generations with this huge debt. Accordingly, as a part of his reelection campaign, Roosevelt's fiscal year 1937 budget submitted to Congress in 1936 cut government spending dramatically. As a result, in 1937, the economy fell into a steep recession. Tax revenues declined and the national debt increased to \$37 billion. The government resumed significant deficit spending in 1938 and the economy quickly recovered. By 1940, the economy had grown substantially while the national debt rose to \$43 billion.

When the United States entered the war in 1941, the fear of deficits and the size of the national debt were forgotten. The important thing was to defeat the enemy. In the war years from 1941 to 1945, the GDP doubled while the national debt increased by more than 500 percent as Roosevelt financed much of the war expenditures by government borrowing. By the end of the war in 1945, the national debt had increased to \$258 billion and was equal to approximately 120 percent of GDP.

Rather than bankrupting the nation, this large growth in the national debt promoted a prosperous economy. By 1946, the average American household was living much better economically than in the prewar days. Moreover, the children of that Depression–World War II generation were not burdened by having to pay off what then was considered a huge national debt. Instead, for the next quarter century, the economy continued on a path of unprecedented economic growth and prosperity with the Eisenhower administration launching the biggest public works project—the interstate highway system—and the Kennedy–Johnson administration spending large sums on sending a man to the moon and the escalating Vietnam War. At the same time, the inequality in the distribution of income was significantly narrowed. It was the golden age of economic development for the United States as the rich grew richer while the poor gained even more in a rapidly rising level of income that created a large American middle class.

As a child of the Depression and a young teenager during the World War II, I have never felt burdened by the huge government deficits that accrued due to government spending during the Great Depression and the war that followed. The legacy that the Great Generation who were adults during the depression and the war left to their children was an economy of abundance and prosperity. I inherited an economy that made finding a good job easy for me and all of my cohorts and provided excellent opportunities to improve our living standards. If this is burdening children and grandchildren, I hope the current generation can create such a "burden" for their progeny.

The moral of this history of the national debt and the economy during the Great Depression and World War II is that we have nothing to fear about running big government deficits when, during a recession with significant unemployment, the federal government is the only spender that can take the responsibility to sufficiently increase the market demand for the products of our industries and thereby maintain a profitable entrepreneurial system. For government to spend less in the hopes of keeping down the size of the national debt will cause market demand to remain slack, thereby impoverishing both our business firms and our workers. The idea that capitalism works best when spenders cause healthy growth in market demands and thereby generate profits and jobs for the community was the basic message of Keynes theory.

This was clearly demonstrated when government spending increased during the years 1933–36 and 1938–45. When Roosevelt cut spending in 1937, the sharp recession showed that at that stage of recovery, no other spenders were willing or able to take over from government the role of generator of market demand and profits for American businesses. Had Roosevelt, in 1938, continued on the path of keeping government spending in check in order not to increase the total national debt, the result would have been to propagate the poorly performing economy of 1937. When the war broke out and no further thought was given to the size of the national debt, government spending quickly pushed the economy to a profitable full employment status. Keynes's ideas that the role of government fiscal policy was to make sure that the total demand for goods and services provided profit opportunities to encourage business firms to hire all workers who wanted a job was validated by this historical record.

Business firms will hire more workers only when they expect the market demand for their products is increasing. Today, who are these buyers who will be willing to buy significantly more products from factories located in the United States in order to end this Great Recession? Clearly households suffering from high unemployment, decreasing market values for their homes, large credit card debt, and shrinking pension funds are not likely to rush to buy significant more goods and services. Entrepreneurs with existing excess facilities and facing declining or at most not rapidly rising market demands are unlikely to invest significantly in new plant and equipment. Moreover, foreigners such as China with its large savings of U.S. dollar earnings appears unlikely to spend more dollars to buy more U.S.-produced goods. With falling property and sales tax revenues, local and state governments such as California are cutting spending on public services and reducing purchases from domestically located firms. Only the Federal government can afford to buy significant additional products to stimulate market demand for American products.

Just as we expect the Federal government to spend whatever is necessary to protect us from foreign enemies during a war, we should also expect the government to spend whatever is necessary to protect us from the economic terrorism of a great recession. The public must be educated to understand that a civilized society is one that assures both domestic workers and enterprises prosper and that the intelligent use of government fiscal policy can assure that total market demand is always sufficient to generate domestic profits large enough to create a fully employed economy.

Some argue that tax revenues must finance all government spending so that the federal budget is always balanced without deficits, or at least annual deficits do not increase the debt-to-GDP ratio. As history shows, however, even during World War II when America was attacked by foreign nations (remember Pearl Harbor?) the U.S. government did not finance the entire defense of this nation by raising taxes. Instead, during the war years, deficits expanded dramatically while no one worried (correctly) about burdening future generations with debt.

If wars are not sufficient (or necessary) reasons to raise taxes or cut government spending sufficiently to balance the budget while protecting the nation, then why should defending the nation against serious economic threats require a balanced budget or a lower deficit? Our politicians and the public must be educated to understand that when total demand for domestically produced goods is low so that recession and depression threaten, then government must deficit spend as much as necessary to encourage domestic entrepreneurs to hire all American workers who are willing and able to work. If, on the other hand, market demand for domestically produced goods and services exceed America's full employment productive capacity, then government must increase taxes and reduce spending in order to reduce aggregate demand to a level that can be met by a fully employed labor force.

When the public and politicians recognize that a primary function of government fiscal policy is to act as a balancing wheel for aggregate demand to be sufficient to encourage America's entrepreneurs to create jobs for all our workers, we will have developed the political will to develop a perpetual prosperous American civilized society.

At that point of time, our next task will be to develop an international financial and payments system that will provide for global full employment and prosperity.