The Debt Retirement Shell Game
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What is going on with the national debt? These past few years we have heard repeated references to budget surpluses and the elimination of the national debt. Indeed, in his January 2000 State of the Union message, President Clinton proposed to use budget surpluses to retire the national debt by 2013. Others have proposed to use the surpluses to reduce taxes instead. Indeed, the choice between retiring debt and reducing taxes was a significant point of contention between the Presidential candidates in the recent election.

There is plenty of scope for people to debate the relative merits of retiring national debt and reducing federal taxes. Regardless of where one might stand in such a debate, however, that debate would be beside the point. The real point is that there is no budget surplus, and never has been in recent memory. If there were truly a budget surplus, the national debt would be falling. But it is not falling. It is continuing to rise, and now stands at its highest level ever.

Our budget situation is reminiscent of a shell game. An expert manipulator sits at a table with a pea and several shells. He hides the pea under one of the shells, moves the shells around rapidly, then asks the viewer to pick the shell that hides the pea. Usually the viewer looses the bet, an outcome that is often summarized by the aphorism that “the hand is quicker than the eye.”

A shell game relies upon a sleight of hand by the expert to deceive the viewer. What is happening with the national debt has the same characteristics as a shell game. The pea is not where it appears to be. Likewise, the budget
surplus is not where it appears to be. It is not even there. It has been replaced
by a deficit through budgetary manipulation by a deft slight of hand.

The key to recognizing the budgetary shell game involves a realization
that there are two types of national debt. One type is held by ordinary private
citizens, and includes debt held by business firms and mutual funds. The other
type is held by government agencies, including the Federal Reserve.

The national debt held by private citizens has been declining. Over the
past four years, it has declined by $400 billion, from $3.8 trillion to $3.4 trillion.
There has been some retirement of this part of the national debt. What puts the
lie to the claim that we are witnessing debt retirement is the strong increase in
the amount of national debt held by agencies of the federal government. Over
the past four years, government agencies have increased their holdings of
national debt by $700 billion, with total holdings rising from $1.6 trillion to $2.3
trillion.

National debt has thus increased by $300 billion over the past four years.
This is not a portrait of debt retirement. It is a portrait of budget deficits, with
government continuing to spend more than it collects in taxes. Budget deficits
have been a continual feature of federal budgeting for more than 30 years, and
this legacy continues in full force. For this reason the national debt continues to
rise. We are watching a debt retirement shell game.

Most of the increase in debt held by federal agencies has occurred within
the four trust funds associated with the social security programs. The national
debt held by those trust funds is described as an “asset” that can be liquidated to
make payments starting in about ten years or so. For taxpayers, however, they are liabilities and not assets. A budget deficit means that present government commitments imply higher taxes in the future. This is how it is with the federal budget. Even with their liquidation of national debt, it is generally acknowledged that the trust funds will soon run out of money, by some projections as early as 2012. This means that present commitments imply higher taxes in the future. The government’s budget is in deficit and not in surplus.

Think for a moment about the impending liquidation of national debt by the social security trust funds. Such liquidation represents a decrease in the demand for government bonds. Bond prices will fall, which implies that interest rates will rise. To the extent this happens, private investment will be crowded out of capital markets. The Federal Reserve might increase its holding of national debt in response to the rise in interest rates. This would be inflationary. In either case, taxes will be higher in the future than they are now, unless social security is reformed dramatically along the lines of the various proposals that have been advanced for privatization. This increase in future taxes is a consequence of deficit finance today. If we genuinely had budget surpluses and debt retirement today, we could expect lower taxes tomorrow. As it stands now, however, only higher taxes loom in our future. This is how it usually goes with shell games.