Using Public Choice Economics to Understand Public Debt[*]

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Abstract: What are the factors that go into the political decisions that determine the national debt? Why and how do federal policymakers engage in deficit spending? What does the growing national debt mean for the average American? In this paper, we show how public choice economics—distinguished from a public interest approach to interpreting political action—can help explain why government officials choose to engage in deficit spending and why this leads to an accumulation of public debt. In addition to tracing out the logic and implications of deficits, debts, and debasement from a public choice perspective, we explore the potential of constitutional change to reform the institutions currently governing fiscal and monetary decision making.

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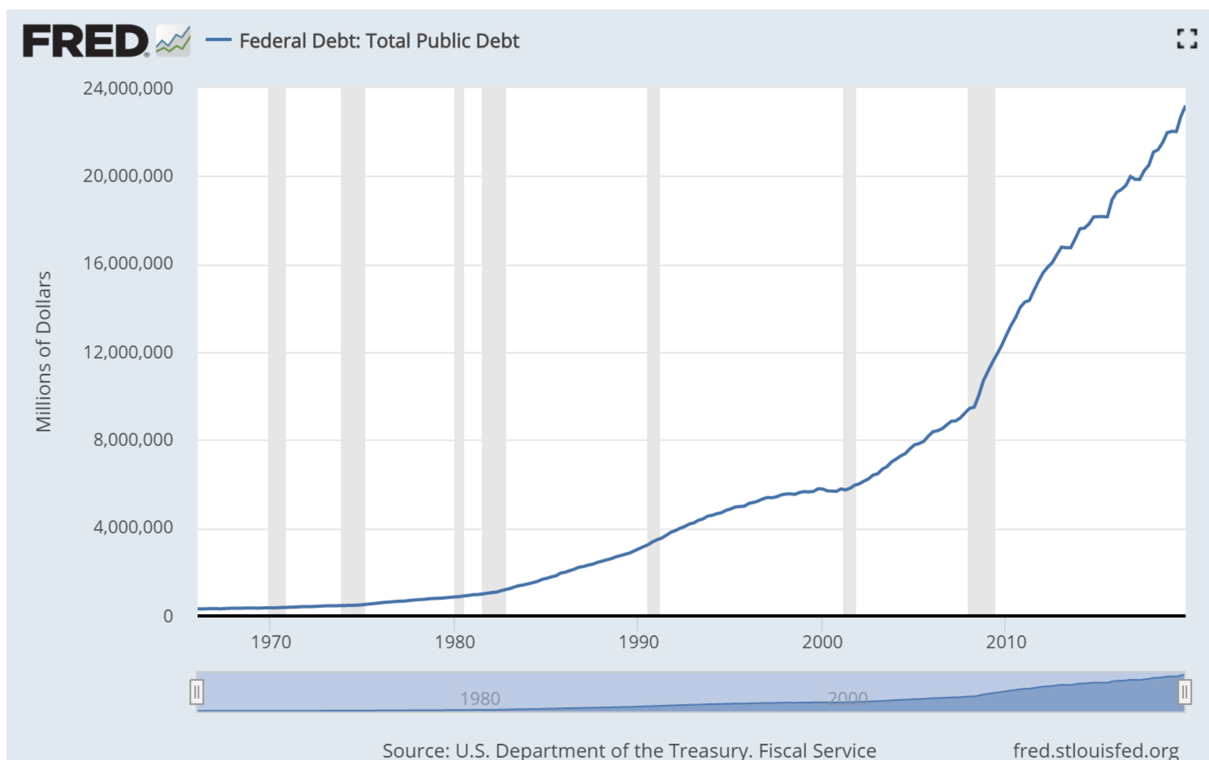
1. Introduction

The national debt, also known as the public debt, is the total amount of money that the federal government has borrowed to finance its operations and has not yet paid back. At the beginning of 2020, the United States government was roughly $23 trillion in debt. Only 20 years before, the national debt was around $5 trillion.[1] In some ways, the process of accumulating national debt is similar to racking up personal debt—just like a person can borrow money on a credit card, the federal government can run a deficit in any given year by borrowing money to finance purchases in excess of tax revenue. The current public debt is the result of many accumulated years of deficit spending.

Figure 1: Federal Debt in Millions of Dollars[2]



[1] U.S. Treasury, "Historical Debt Outstanding - Annual 2000 – 2019," https://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm
[2] Graph created by Federal Reserve Bank of St. Louis, reproduced from https://fred.stlouisfed.org/series/GFDEBTN.

Figure 2: Federal Debt as a Percent of Gross Domestic Product[3]

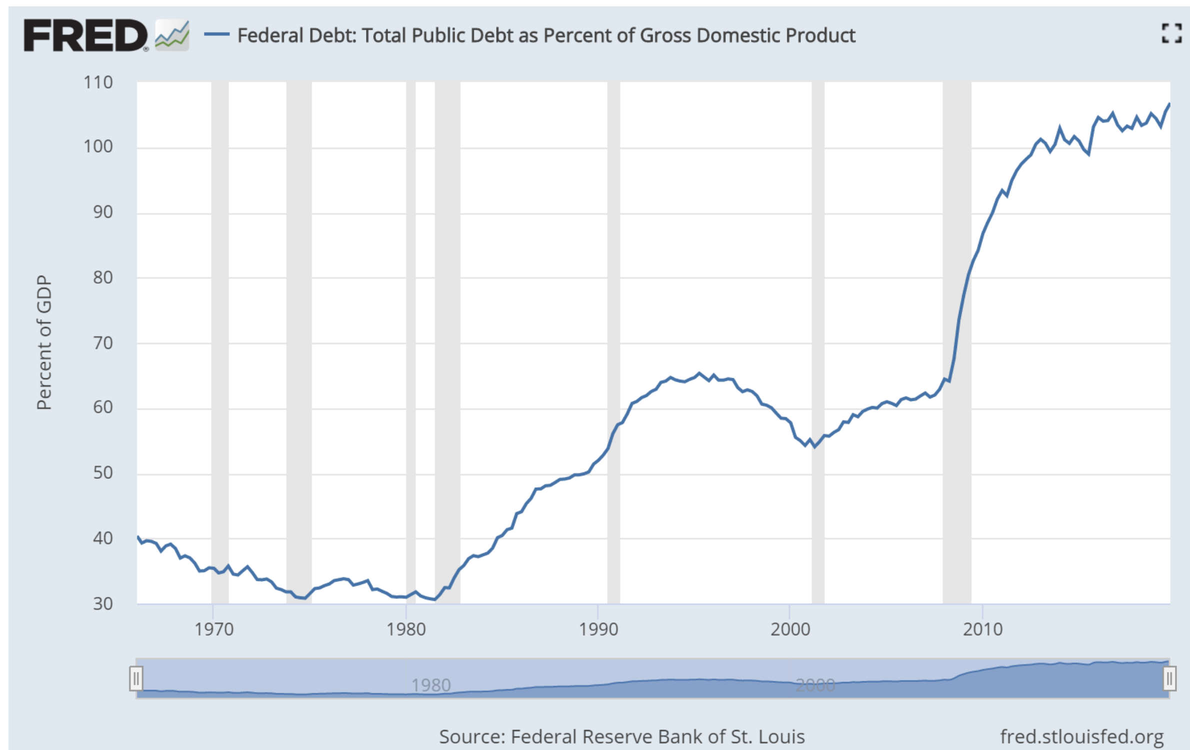


Figure 1, above, shows the steady increase in the dollar value of the federal debt since the 1970s. Figure 2, which shows the federal debt as a percentage of gross domestic product, highlights the extent to which the federal debt has grown in proportion to America's economic productivity since the financial crisis of 2007-08. [4] The fact that our current public spending process is putting the federal government in serious debt is clear. Less clear are the *hows* and *whys* of the situation. What are the factors that go into the political decisions that determine the national debt? Why and how do federal policymakers engage in deficit spending? What does the growing national debt mean for the average American? Understanding the answers to these questions is important not only for pundits and policymakers, but for all who wish to understand the full impact of the public spending decisions made on our behalf.

[3] Graph created by Federal Reserve Bank of St. Louis, reproduced from https://fred.stlouisfed.org/series/GFDEGDQ188S.
[4] Boettke, Peter J., and Christopher J. Coyne. "The Debt-Inflation Cycle and the Global Financial Crisis." Global Policy 2, no. 2 (May 2011): 184–189.

In this essay, we draw on theories and applications from **public choice economics** to address these important questions about the nature and consequences of public debt. Public choice is a subdiscipline within the field of economics that applies the economic way of thinking to decision making in political contexts. Public choice is often described as taking the romance out of politics by focusing on the reality of political institutions and the incentives they create rather than on political ideologies and the identities of particular politicians.[5] The core of public choice is the positive (rather than normative) analysis of political institutions and their predictable consequences. This analysis focuses on statements of fact based on theory and evidence—it describes the world the way it *is,* regardless of how people might like it to be. From that positive analysis, people can draw normative conclusions about what *should be*, but these implications are not determined by the analysis itself. Public choice analysis may reveal serious flaws with a constitutional rule or a political strategy, but it is ultimately up to people to decide what to do with this information. In this sense, the goal of public choice is humble: to provide a more realistic way to understand the political world by focusing on how real people act in real political situations rather than how perfect people might act under ideal circumstances.[6]

The public choice approach starts with three key assumptions. First, all people, including political actors, are assumed to be rational, which means they pursue their goals as best they can, given their limitations and the limitations of their environment. Rational people still make mistakes, but they don't intentionally do senseless things. Second, all people are assumed to be self-interested. It is important to know that self-interest does not necessarily mean selfish. Self-interest is subjective, which means that each person has their own unique interpretation of what is in their self-interest. Each person has different goals, and it is in their self-interest to try to reach those goals. Third, public choice economists use the scientific assumption of methodological individualism, which simply means that individuals, not groups, are the relevant choosers in social scientific analyses. Although people commonly speak of entire large

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[5] James M. Buchanan, "Politics without Romance: A Sketch of Positive Public Choice Theory and Its Normative Implications," in *Collected Works of James M. Buchanan, Volume 1, The Logical Foundations of Constitutional Liberty* (Indianapolis: IN: Liberty Fund, 1999).
[6] Gordon Tullock, "A (Partial) Rehabilitation of the Public Interest Theory," *Public Choice* 42, no. 1, (1984): 89–99.

organizations like "the government" or "the Senate," these organizations are made up themselves of complex rule systems and many individual people who have diverse and sometimes conflicting interests.[7] For example, Congress doesn't "choose" anything because Congress isn't a person. The collective decisions that come from Congress are actually the result of members of Congress interacting with each other—cooperatively, combatively, or otherwise—within a system of rules that can be referred to for dispute resolution and to sanction impermissible conduct.

The main theoretical alternative to public choice theory is public interest theory. In contrast to the public choice assumptions that individuals are generally rational and self-interested, public interest theory presumes that the driving force behind political decision making is the idea of the public good. In this paradigm, political actors are assumed to be capable of identifying and carrying out actions that will be in the general interest of a society unless malevolence or corruption get in the way.[8] Public choice economics is critical of the idea that there is such a thing as a single public good that can be easily identified as a goal for policy.[9] Instead, what is best for one person in a society is not always best for all. In the public choice paradigm, politics is a process of muddling along in search of a set of rules that will allow us to coexist peacefully. Politics is *not* a process of identifying the single best way for people to live and use their resources. Further, even if such a single best path could be identified, it may never be realized. Politicians and bureaucrats are merely human with the same foibles and limitations as everyone else.[10] Even if an outcome seems desirable, political leaders may not possess the knowledge required to bring it about, or the existing social and political incentives may simply be too much at odds with the desired change for it to be sustainable.

With these ideas in mind, this paper discusses how to usefully apply public choice economics to better understand why government officials choose to engage in deficit spending and why this leads to an

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[7] Vincent Ostrom and Elinor Ostrom, "Public Choice: A Different Approach to the Study of Public Administration," *Public Administration Review* 31, no. 2 (1971): 203–216; Elinor Ostrom and Vincent Ostrom, "The Quest for Meaning in Public Choice," *The American Journal of Economics and Sociology* 63, no. 1 (2004): 105–147.
[8] Matthew Mitchell, *The Pathology of Privilege: The Economic Consequences of Government Favoritism* (Arlington, VA: Mercatus Center at George Mason University, 2012).
[9] Buchanan, James M. "Social Choice, Democracy, and Free Markets." *Journal of Political Economy* 62, no. 2 (1954): 114–23.
[10] Buchanan, "Politics without Romance"

accumulation of public debt. The rest of the paper proceeds as follows. In section 2, we present the concept of institutions and the two levels of institutional analysis used in public choice: the constitutional level and the post-constitutional level. In section 3, we trace out the logic of deficits, debts, and debasement from a public choice perspective. In section 4, we explore some constitutional changes that could help reform the institutions that lead to deficits, debts, and debasement. In section 5, we conclude with some public-choice-based suggestions for how the institutions governing public debt and government spending could be adjusted to reduce the level of public debt.

2. Two Levels of Institutional Analysis

2.1 Institutions Matter!

The word institution may bring to mind powerful international organizations and ornate marble buildings. However, when public choice economists talk about institutions, they mean something quite different. Institutions are, in short, the "rules of the game."[11] Some institutions are formal, like the U.S. Constitution, criminal and civil legal codes, and federal and state regulatory systems. Other institutions are informal and may not be enforced by governments or even written down, like the by-laws of a club or religious association, the internal policies of a company, or the social norms of a community. In the public choice view, the exact same person will behave differently in one institutional context than another even though their preferences and values do not change. Different institutional settings yield different behaviors because each institutional setting poses different incentives and constraints.[12]

When it comes to spending, the relevant institutions fall into two general categories. Public spending takes place within a centrally directed process of procurement and distribution, whereas private spending takes place within an individually driven process of economic exchange. People behave differently in these two contexts, not because their motivations are different, but because of the

[11] North, Douglass C. "Economic Performance Through Time." *The American Economic Review* 84, no. 3 (1994): 359–68.
[12] Elinor Ostrom, "An Agenda for the Study of Institutions," *Public Choice* 48, no. 1 (1986): 3–25.

institutional differences between the two spheres. In markets, decisions only occur when both the buyer and the seller perceive that they will be better off. People shop around to compare prices and qualities of the goods and services they might want to buy. Once a consumer finds a good or service that fits her budget and preferences, she makes a purchase. Both the seller and the buyer do so voluntarily, and both sides of the exchange made better off because they both get something that they want. Consequently, in the market, decision-makers capture most of the benefits and bear most of the costs of their choices.

The decision-making process in public spending is fundamentally different. First, a citizen communicates his desire for some public policy or public spending to his elected representatives. However, there is no guarantee that the representatives will listen. If he does listen, the representative must try to convince a majority of the other representatives to support the policy. In the government sphere, there is no guarantee about quality and price—citizens can't directly choose the quality or the price of government-provided goods and services. Citizens indirectly pay for any new services through taxes, but both the taxes and the public services provided are shared by everyone. There is no direct link between purchase and consumption. Consequently, the demand for publicly provided goods and services is much more indirect and complicated than with privately provided goods and services.[13] Further, since individuals must contribute to the public purse regardless of whether or not they use or are happy with the way the money is spent, there is no guarantee that the benefits provided justify the cost. Government officials have the ability to use force to make people comply with their decisions and rarely bear the full cost if the decision turns out to be a bad one.[14]

The fact that decisions around public spending are governed by such a dramatically different set of institutions than those we are accustomed to in our own dealings in the market means that understanding public spending requires a different logical apparatus, one that is designed to understand the mechanics of decision making in the political arena. In the remainder of this section, we will take the

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[13] James M. Buchanan and Richard E. Wagner, *The Collected Works of James M. Buchanan, Volume 8, Democracy in Deficit: The Political Legacy of Lord Keynes*. (Indianapolis: IN: Liberty Fund, [1977] 2000): 129-130.
[14] Richard E. Wagner, *Politics as a Peculiar Business: Insights from a Theory of Entangled Political Economy* (Cheltenham, UK: Edward Elgar Publishing, 2016).

first step towards better understanding the particulars of the public spending process by distinguishing between constitutional and post-constitutional politics.

2.2 Constitutional Analysis and the Fiscal Constitution

Public choice economists recognize that the study of politics requires at least two levels of analysis. The level that we encounter most directly in our interactions with political organizations is what economist J. M. Buchanan called the "post-constitutional" level of analysis. This level of analysis studies individual political actors as they go about attempting to achieve their respective goals within an existing political system that has already established rules about what behaviors are legal and illegal, encouraged and discouraged.[15] However, before this post-constitutional activity can take place, those meta-rules that shape the incentives and constraints involved with day-to-day politics must first be established. The study of how the rules of the political game were created and why they take the forms they do is called the "constitutional level" of analysis.

Not all constitutions have to be as well-known or formal as the U.S. Constitution. Voluntary associations, like clubs and homeowners' associations, also have constitutions that set up the meta-rules for how day-to-day decisions are made. Other government institutions also have constitutions—there are monetary and fiscal constitutions that determine how government officials make day-to-day macroeconomic decisions.[16] For example, Congress created the Federal Reserve in 1913, which was meant to be an independent central bank. Congress placed various constraints on what the Federal Reserve can do. These broad rules serve as a constitution that determine how the Federal Reserve can make day-to-day rules and policies.

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[15] James M. Buchanan and Gordon Tullock, *The Collected Works of James M. Buchanan, Volume 3, The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Indianapolis: IN: Liberty Fund, [1965]1999).; James M . Buchanan, T*he Collected Works of James M. Buchanan, Volume 7, The Limits of Liberty: Between Anarchy and Leviathan* (Indianapolis: IN: Liberty Fund, [1975] 1999); James M. Buchanan and Geoffrey Brennan, *The Collected Works of James M. Buchanan, Volume 10, The Reason of Rules: Constitutional Political Economy* (Indianapolis: IN: Liberty Fund, [1985]1999).

[16] Peter J. Boettke and Christopher J. Coyne, "The Debt-Inflation Cycle and the Global Financial Crisis," *Global Policy* 2, No. 2 (2011): 184–189.

As an example of the distinction between constitutional and post-constitutional activity, consider the relationship between the U.S. Constitution and the agencies that carry out federal regulations. The U.S. Constitution is relatively short and vague. It sets up the general rules for how the federal government operates, and it puts broad constraints on what federal officials can and can't do. The Constitution doesn't spell out specific programs or policies—it outlines the general processes for making specific programs or policies. The Founders, and particularly James Madison who wrote the Constitution, wanted to use reflection and forethought so that the meta-rules would give government officials incentives to work for the public good and constrain government officials so they wouldn't abuse their power.[17] In the case of federal regulators, the Constitution is considered to have established the authority by which the President can create agencies in order to delegate his power to enforce the laws created by Congress. However, the Constitution is both by design and necessity completely silent on the matter of how particular agencies will operate and what rules they might create in the enforcement of legislation such as the Environmental Protection Act or Drug Enforcement Act. It is within the post-constitutional stage that politicians, bureaucrats, and legislators negotiate those specifics.

In the constitutional framework, a fiscal constitution is the nexus of rules—formal and informal, written and unwritten—that govern decisions around how governments spend money and where they choose to get that money from.[18] For example, in the United States, the national, state, and local governments provide funding for roads, schools, and welfare, among many other things. To finance a government's spending for various programs, government officials have three basic choices: raise taxes, borrow money, or print money.

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[17] Alexander Hamilton, "The Federalist No. 1: Introduction," in *The Federalist Papers*, ed. Ian Shapiro, by Alexander Hamilton et al., (New Haven, CT: Yale University Press, 2009), 7–10; James Madison, "The Federalist No. 10: The Same Subject (The Utility of the Union as a Safeguard Against Domestic Faction and Insurrection) Continued," in *The Federalist Papers*, ed. Ian Shapiro, by Alexander Hamilton et al., (New Haven, CT: Yale University Press, 2009), 47–53; James Madison, "The Federalist No. 51: The Structure of the Government Must Furnish the Proper Checks and Balances Between the Different Departments," in *The Federalist Papers*, edi. Ian Shapiro, by Alexander Hamilton et al., (New Haven, CT: Yale University Press, 2009), 263–267.
[18] Brennan, Geoffrey and James M. Buchanan. *The Power to Tax: Analytic Foundations of a Fiscal Constitution*. Cambridge University Press, 1980.

From the time of the American founding until roughly the mid twentieth century, the federal government followed two principles of fiscal responsibility. First, the government should not spend money without imposing taxes. Second, the government should not place future generations in debt by deficit spending that would only provide temporary and short-lived benefits.[19] Policymakers thought that it was prudent to run the government much like a household or a firm—the government shouldn't spend more than it gets from taxes. Tax finance forces citizens to pay when the decision is made, but debt finance postpones payment until later. Financing government spending through debt reduces the financial burdens in the present because it shifts those costs on taxpayers in the future.

Under this set of rules, which economists James M. Buchanan and Richard E. Wagner termed the "classical fiscal principle,"[20] policymakers thought that, in general, public budgets should be in balance, and they also thought that deficit spending should only be used in extraordinary circumstances. In times of economic prosperity, policymakers believed that the government should try to run a budget surplus so that there was a "cushion" when economic hardships arose. Policymakers generally believed that it was improper to burden future taxpayers, except in extraordinary events, like wars, natural disasters, or major depressions.[21] If the government borrows money by issuing bonds, it has to pay bondholders and other lenders back. Borrowing money can help government officials achieve their goals in the short run, but debts have to be paid off with interest. Public debt is essentially "kicking the can down the road" to get benefits now and pay for them later. At some point, borrowing is no longer feasible as the governments' creditworthiness erodes.

In the classical view, irresponsible borrowing is more dangerous for governments than for private families or firms. If a private person irresponsibly borrows on a credit card and can't pay it back, his poor decisions only affect him—he incurs a personal liability and bears the costs of his choices. However, if government officials make irresponsible borrowing decisions, the negative effects are likely to spill over

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[19] Buchanan and Wagner, *Democracy in Defic*it, 23-24.
[20] Buchanan and Wagner, *Democracy in Deficit*, 10.
[21] Buchanan and Wagner, *Democracy in Deficit*, 3-24.

onto everyone in a society. For this reason, it is more important to place stringent constraints on public debts rather than private debt. When a government borrows money, each individual citizen is not assigned a specific share of the fiscal liability of the public debt. The citizen may sense that the whole community has a liability, but he doesn't feel the same sense of liability like he would if it were his own private property on the line. Citizens don't behave as if the public debt is the same as private debt. Due to this difference, people behave somewhat less prudently with public debt than private debt. Without a strong fiscal constitution, government decision-makers are likely to borrow irresponsibly because they do not bear the full costs of their choices and because citizens are further removed from immediate effects of public debt compared to private debt. The classical fiscal constitution helped stop the abuse of public debt. If the classical fiscal constitution didn't exist, politicians who made spending, taxing, and borrowing decisions would have borrowed even when the conditions for responsible debt issues were not present.[22]

Effective democratic government requires institutional arrangements that require public decision makers to face the full consequences of their decisions. Otherwise, it is too easy for the unseen costs of public spending decisions—in particular, the foregone alternative uses of the physical and financial resources spent—to go completely unseen. This is exacerbated by the time inconsistency created by borrowing because when governments borrow, the benefits are immediate and the costs are pushed into the future. This makes it possible for a legislator to enjoy the praise of having funded a program their constituents' value without ever having to confront the costs of that spending. Under the classical fiscal constitution, policymakers generally raised taxes when they implemented new government spending. Policymakers only engaged in deficit spending in emergencies like war. This made citizens more aware of the costs and motivated them to speak out if they saw better uses for that money. During peacetime, policymakers often produced surplus to retire the debt created during war emergencies. This style of financing made it easier for citizens to weigh the costs and benefits of government decisions.[23]

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[22] Buchanan and Wagner, *Democracy in Deficit*, 18-20.
[23] Buchanan and Wagner, *Democracy in Deficit*, 12-16.

2.3 Post-Constitutional Politics

The fiscal constitution sets the stage for public finance decisions, but the daily decisions that go into government spending and finance take place in the realm of everyday politics. This post-constitutional level of political activity is where day-to-day politics plays out as individual political actors work to accomplish their goals within the confines of established constitutional rules. Within the post-constitutional level, public choice economists study several areas of human behavior, including the behavior of voters, special interest groups, politicians, and bureaucrats.

Politicians run for elected offices, and the most common politicians are legislators. The primary motivation of an elected official is to get elected or reelected. They may have many other motivations, but they can't do anything if they aren't in office, which means that being elected or reelected is always the top priority. In order to stay in office, legislators have strong incentives to support programs and policies that provide benefits to the voters in their home districts or states, no matter how irresponsible those programs and policies may be from a national perspective. By providing people in their home districts or states with benefits, legislators increase their chances at reelection.[24] In general, voters like to receive benefits from the government, but they don't like to pay taxes. Thus, politicians have a strong incentive to keep taxes low while also increasing spending to various government programs. Without tax revenue to pay for the government programs, governments must resort to deficit spending.

Besides keeping a majority of voters happy, legislators also care about pleasing special interest groups. Special interest groups are often small and made up of people with strong, specific opinions. Special interest groups are important to politicians because those groups can provide funding for campaigns and rally voters to support the politicians who support the goals of the special interest group. In other words, special interest groups are effective at supplying political pressure and providing political

[24] Gordon Tullock, "Public Choice," in *The Selected Works of Gordon Tullock, Volume 1, Virginia Political Economy* (Indianapolis: IN: Liberty Fund, 2004), 16-26.

support to the politicians who help them. Thus, by catering to the interest of special interest groups, legislators often help small groups at the expense of everyone else.

Since politicians often cater to the demands of well-organized special interest groups, the outcome can be a "tyranny of the minority"—the preferences of a small group of people is imposed on everyone else. Legislators and special interest groups engage in exchanges that benefit both sides, but the costs of those decisions are dispersed on the whole population.[25] Similarly, legislators also exchange with one another in a process called "logrolling," which is another name for favor-trading. Logrolling is a system of "I'll vote for your bill if you vote for my bill." As politicians bargain with special interest groups and with themselves, the amount of public spending can balloon.

Besides legislators and politicians, public choice economists also study how and why bureaucrats do what they do. Bureaucrats are unelected employees of the government. After legislatures make laws, they often delegate responsibility to bureaucrats in government agencies to put the laws into effect and to make rules and regulations under those laws. Ideally, bureaucrats are supposed to be experts because legislators often don't have specific expertise in many fields.

Just like all people, bureaucrats respond to their incentives and constraints. Bureaucrats have many different incentives that they face when trying to do their job. One of the biggest incentives bureaucrats face is budget maximization. The legislature sets the budget for each government agency, and bureaucrats get to spend the money to complete their assigned jobs. Bureaucrats generally want to get the largest budget they possibly can, so they have an incentive to spend all their budgets every year, and sometimes they slightly overspend their budget to prove to the legislature that they need more money. In many cases, bureaucrats are not rewarded for spending their budget in the thriftiest or most efficient way, otherwise the legislature will see that they can get by with a smaller budget. Bureaucrats also want to look

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[25] Gordon Tullock, "The Transitional Gains Trap," in *The Selected Works of Gordon Tullock, Volume 1, Virginia Political Economy* (Indianapolis: IN: Liberty Fund 2004), 212-221.

for opportunities for greater prestige and more discretion. They want to do their job so well that their bosses will promote them to better and higher paying jobs.

Bureaucrats also have many constraints. In the federal government, Congress oversees the bureaucracies, and if bureaucracies don't do their jobs in the manner Congressional leaders like, their budgets may get cut or their discretion may be limited. Within bureaucracies, there is also hierarchical oversight, where the manager makes sure that the people beneath them are doing what they are told. Legal constraints, such as the U.S. Constitutional and federal laws, also constrain what bureaucrats can do.[26]

Using these two levels of public choice analysis, we can understand why federal policymakers choose to engage in deficit spending, why they choose to have such a large national debt. In the next section, we spell out the logic of why politicians and bureaucrats engage in deficit spending, accrue large debts, and choose to debase the currency.

3. Logic of Deficits, Debt, and Debasement

3.1 The Keynesian Logic behind Deficit Spending

In the early 20th century, British economist John Maynard Keynes argued that if the economy was heading into a recession or a depression, a central government could maintain the macroeconomy by supporting economic stability, avoiding deflation, and stimulating the economy. In the wake of the Great Depression, Keynes argued that governments must stimulate aggregate demand, which is the total demand for goods and services within a particular market. In Keynes's view, unless the government spent money to stimulate aggregate demand, unemployment would persist and economic growth would stagnate. It doesn't necessarily matter how the money is spent—even if the government paid people to dig ditches and fill them back in again, it would help stabilize and stimulate the economy.[27]

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[26] Gordon Tullock, *The Selected Works of Gordon Tullock, Volume 6, Bureaucracy*. (Indianapolis: IN: Liberty Fund, 2004).; William Niskanen, *Bureaucracy and Representative Government* (Chicago, IL: Aldine-Atherton, 1971); Anthony Downs, *Inside Bureaucracy* (Boston, MA: Little, Brown, 967).

[27] Buchanan and Wagner, *Democracy in Deficit*, 6-7 and 81-83.

With these recommendations, Keynes rejected classical and neoclassical views of economics that emphasized the built-in equilibrating forces within markets. In the classical view, "shocks" like recessions and downturns do occur, but markets have a remarkable capacity to adapt to these changing conditions. When prices fall during times of recession, the lower resources prices attract investors and entrepreneurs. This new economic activity—often in different industries or carried out in different ways—is capable of bringing about new economic growth, and in a way that is better reflective of new economic conditions than the previously existing patterns of production and consumption. Through this process, which Adam Smith called "The Invisible Hand" and Friedrich Hayek called "spontaneous order," markets create their own new form of stability.[28] Keynes, however, rejected the basic ideas of spontaneous order and the self-correcting nature of the market. Keynes thought that there was no assurance that markets' automatic forces would produce acceptably high and growing real output and high-level employment.[29] In the Keynesian world, the economy is like a boat without a rudder—it drifts aimlessly and will crash and sink, unless policymakers steer it.[30]

Further, Keynesian theory explicitly denied that debt finance places any burden on future taxpayers.[31] Instead, Keynes argued that the government could (and should) borrow to finance stimulus spending during times of recession, and then pay back these loans during times of growth.[32] It is this second half of the equation—paying down debt in good economic times—that is often at odds with the political incentives facing the legislators and bureaucrats who make decisions about public spending. To the extent Keynesian economics works on the blackboard, it falls apart in the real world.

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[28] Adam Smith and Edwin Cannan, *The Wealth of Nations* (New York, NY: Bantam Classic, [1776] 2003); Friedrich A. Hayek, *Law, legislation and liberty: a new statement of the liberal principles of justice and political economy* (Chicago, IL: University of Chicago Press, 1974).

[29] Buchanan and Wagner, *Democracy in Deficit*, *26*-27.

[30] Buchanan and Wagner, *Democracy in Deficit*, 30-31.

[31] Buchanan and Wagner, *Democracy in Deficit*, 16.

[32] John Maynard Keynes, *The general theory of employment, interest, and money* (Basingstoke: Palgrave Macmillan for the Royal Economic Society, 2007).

3.2 The Political Challenges of Responsible Public Spending

Perhaps nobody has explained the problem with the Keynesian approach to public spending more clearly than Nobel laureate James M. Buchanan and Richard E. Wagner in *Democracy in Deficit: The Political Legacy of Lord Keynes.* In this important work, Buchanan and Wagner argue that the Keynesian approach has an inherent bias toward deficit spending once politics is taken into account. When given the choice between financing new spending through tax increases or through borrowing or expanding the money supplyprinting money, politicians will nearly always prefer the latter. Voters do not like paying more in taxes. Tax hikes are unpleasant to voters and therefore costly to any politician who hopes to someday get re-elected. In contrast, borrowing the money to pay for public projects allows politicians to accomplish political goals today, while those in public office ten, twenty, or thirty years down the road are stuck paying the bill. In short, politicians have an incentive to accumulate debt, because it enables them to concentrate the benefits of public policy on well-organized and well-informed special interest groups in the short run while dispersing the costs of public policy on the ill-organized and uninformed masses in the long run.

From Roosevelt's New Deal onward, politicians have been rewarded with favorable election results when they have expanded public spending programs. It is in the direct interest of politicians to give a majority of voters what they want, and if voters reward more public spending, then politicians will rationally do so. Before the 1930s, the only effective constraint on elected politicians was the heritage of our historical fiscal constitution of balancing spending with incoming tax revenues. Once the Keynesian revolution eliminated these constitutional constraints, elected politicians continued to increase public spending, but they did not increase taxes to match the spending.[33]

When a government expands particular spending programs, each one of those programs develops its own beneficiaries. The citizens who benefit from the new spending become a special interest group who don't want those benefits taken away. The bureaucrats who administer the new programs don't want

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[33] Buchanan and Wagner, *Democracy in Deficit*, 52-53.

their jobs taken away. This can encourage the agencies and bureaucrats who administer the public spending to work to ensure that the spending is seen as valuable, even necessary, integrating the new spending projects even further into the lives of citizens, politicians, and bureaucrats.[34] Thus, politicians face a constant pressure from all corners to keep government spending high and keep taxes low, which is impossible to sustain in the long run. Eventually the bills come due.

Once debt balloons past the point that the government can afford to continue to make required payments on time, legislators have two options. First, they can pay off debt with further debt, pushing the problem forward onto future generations. Second, they can print money, potentially causing inflation and contributing to future economic crisis. We will now discuss each of these in turn.

3.3 Voters, Taxpayers, and Fiscal Illusion

The first option available to governments who have accumulated more debt than they can service is to take out more debt in order to make the payments on existing debt. This has the effect of pushing the costs associated with current public spending on to future generations. One obvious problem this raises is, why would citizens allow politicians to get away with such behavior? On a personal level, many citizens act with great concern for the financial well-being of their children, saving up money for college tuition and socking away funds in retirement accounts so as to be able to pay their own expenses late in life. Why should these same people accept expensive public spending programs when they know their children will be stuck paying the bills?

Citizens typically will not possess full knowledge about how they are personally affected by fiscal policies. The bundle of goods or services that a citizen receives from a government are not partitionable or transferable. Additionally, citizens don’t pay a direct price for the government-supplied goods and services, and they don’t get a monthly bill from the government like they do from companies.

[34] Buchanan and Wagner, *Democracy in Deficit*, 73.

Payments for publicly supplied services are extracted from citizens through income taxes, sales taxes, or property taxes, among other taxes.[35]

This disconnect between public spending and the actual public has motivated many economists, including Buchanan, to develop and refine the concept of "fiscal illusion."[36] The theory of fiscal illusion suggests that voters and taxpayers have systematically biased fiscal perceptions because the complex and indirect payment structures skew the way that people perceive and understand costs. Under simple payment structures, like in markets, people can easily weigh the costs and benefits of the choices they make. In government, the payment structures are complex because of the great variety of different taxes and the uncertainty around how debt will affect future tax burdens. Due to this fiscal illusion, people generally perceive the cost of public services as being lower than they actually are, and consequently demand a greater quantity of those services than they might otherwise. Thus, fiscal illusion creates a bias towards higher levels of public spending than would be desired by taxpayers if they fully understood the costs.[37] There is no process through which the taxpayer who has operated under fiscal misperceptions can easily fix those misperceptions.

Contrast the fiscal illusion associated with public spending with individual consumers making decisions in the marketplace. A consumer who uses credit cards for ordinary market purchases may have initial misperceptions about cost, but when the bills are due, the consumer will immediately realize the costs of the decisions. The consumer has the opportunity to learn. Maybe they will return the item, or at least make a different decision in the future. With government services, however, there is no equivalent process of learning and adaptation. Taxpayers have weak incentives to invest time and resources to

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[35] Buchanan and Wagner, *Democracy in Deficit*, 132.
[36] John Stuart Mill, *Principles of Political Economy* (Oxford, U.K.: Oxford University Press [1848] 1994); Buchanan, James M., and Richard E. Wagner. ([1977] 2000). *The Collected Works of James M. Buchanan, Volume 8, Democracy in Deficit: The Political Legacy of Lord Keynes*. Indianapolis: IN: Liberty Fund; James M. Buchanan, *Fiscal Theory and Political Economy* (Chapel Hill: University of North Carolina Press, 1960); Raj Chetty, Adam Looney, and Kory Kroft, "Salience and Taxation: Theory and Evidence," American Economic Review 99, no. 4 (2009): 1145–77. Roger D. Congleton, "Rational Ignorance, Rational Voter Expectations, and Public Policy: A Discrete Informational Foundation for Fiscal Illusion," *Public Choice* 107, no. 1 (2001): 35–64. Vincent G. Munley and Kenneth V. Greene, "Fiscal Illusion, the Nature of Public Goods, and Equation Specification," *Public Choice* 33, no. 1 (1978): 95–100; Richard E. Wagner, "Revenue Structure, Fiscal Illusion, and Budgetary Choice," Public Choice 25, no. 1 (1976): 45–61.
[37] Buchanan and Wagner, *Democracy in Deficit*, 133-134.

estimate their own tax shares, so it is simply too costly for them to justify becoming better informed. Consequently, taxpayers are likely to continue to live under fiscal illusion for as long as it remains difficult to see the true costs and benefits of government spending.[38]

In short, debt financing reduces the perceived prices of publicly provided goods and services, and so taxpayers prefer higher spending levels than they would if fully aware of the long run costs. Politicians rationally cater to those preferences. The possibility of borrowing allows these politicians to expand rates of spending without changing current levels of taxation, which keeps voters happy. Further, if paying off the debt can be continually pushed ever further into the future, taxpayers will not ever necessarily be made aware of their fiscal illusions. New generations of voter-taxpayers may face fiscal burdens that owe their origins to public spending lavished on earlier generations, but the lack of transparency in public budgeting and finance may leave them unable to fully connect the dots and learn from the mistakes of the past. Even if the situation was well understood, not much can be done once the debt has already been incurred. Overall, the pressures on politicians push them to expand spending, with costs borne by future taxpayers who pay for the decisions of their ancestors.[39]

3.4 Central Banks: Default, Debasement, and Inflation

If a government becomes unable to pay off debt by taking on more debt, they may be forced to choose between defaulting on their debts or printing the money they need to make ends meet. Default, including debt restructuring and even bankruptcy, is rare but far from unheard of. The United States government has restructured or defaulted on debt before, and American towns and cities can file for bankruptcy. Detroit is the largest American city to have taken this route, declaring bankruptcy in 2013 after falling behind on an estimated eighteen to twenty billion dollars of debt.[40] However, this option is

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[38] Buchanan and Wagner, *Democracy in Deficit*, 135-141.
[39] Buchanan and Wagner, *Democracy in Deficit*, 144-146.
[40] Monica Davey and Mary Williams Walsh, "Billions in Debt, Detroit Tumbles Into Insolvency," *New York Times*, July 18, 2013, https://www.nytimes.com/2013/07/19/us/detroit-files-for-bankruptcy.html.

usually taken only as a last resort, in part due to the difficulty of obtaining future credit after a bankruptcy.[41]

Governments can also choose to make ends meet by printing money, known as monetization of the debt. Monetizing debt in this way carries with it the risk of inflation. Inflation is the general increase in monetary prices and fall in the purchasing power of money. In other words, when inflation occurs, a dollar buys less than it used to. When a country's money supply grows at a faster rather rate than economic growth (the amount of goods and services in an economy), then inflation will happen. Inflation at low, sustainable levels is not necessarily harmful, though the secondary effects of inflation may not be as benign as commonly presumed.[42] High levels of inflation, called hyperinflation, can destroy whole economies and harm human well-being as the value of currency falls, sometimes until money is worth less than the paper it's printed on.[43]

The opposite of inflation is deflation or a falling price level. When the price level goes down, it can lead to lower production, reduced wages, decreased demand, and continued price declines, particularly in the short term. If the deflation becomes bad enough, consumers and companies could default on paying their debts, which would lead to economy-wide problems. The fear of these potential harms of deflation has led the Federal Reserve to choose an inflation-biased monetary policy since the 1930s.[44]

The Federal Reserve, as the monetary authority, has the power to issue currency and to regulate the banking system. The Federal Reserve is nominally independent of politics, but political pressures influence its operation. The political pressures affect the decisions of the Federal Reserve are somewhat less direct than those facing an elected politician. When the budget is unbalanced and new debts are needed, the Treasury will need to sell bonds to banking institutions and to individuals. This increase in the

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[41] On the historical and continued use of bankruptcy, and why it tends to be a last resort for governments, see, Jerome E. Roos, *Why Not Default?: The Political Economy of Sovereign Debt*. Princeton University Press, 2019.
[42] Steven Horwitz, "The Costs of Inflation Revisited." *The Review of Austrian Economics* 16, no. 1 (2003): 77–95.
[43] Jayson Coomer and Thomas Gstraunthaler, "The Hyperinflation in Zimbabwe," *Quarterly Journal of Austrian Economics* 14, no. 3 (2011), 311–346.
[44] Irving Fisher, "The Debt-Deflation Theory of Great Depressions," *Econometrica* 1, no. 4 (1933), 337–357.

supply of bonds will reduce bond prices and increase bond yields. In the short run, interest rates generally will rise, which in turn will reduce the rate of private investment. The private sector allocation of resources will favor consumption over capital formation if the monetary authority does not do something. In order to keep prices stable, additional money will be required. The monetary authority may choose to monetize some share of the public debt that the deficit financing of government creates.[45]

The indirect pressures on the monetary authorities and the direct pressures on politicians will tend to be mutually reinforcing in the direction of inflation. A monetary decision-maker is only one stage removed from that of the directly elected politicians. Monetary decision-makers are normally appointed by an elected politician. People who are chosen as monetary decision-makers will be likely to take policy stances similar to those desired by the politicians who appointed them. Monetary decision-makers also don't want to upset public opinion or face media pressures. Since monetary decision-makers are like everybody else, they don't enjoy being seen as the villain or being held responsible for massive unemployment, for widespread poverty, for a housing shortage, for sluggish economic performance, and for whatever else that the uninformed and malicious people accuse them of doing. "Easy" money—expanding the money supply—is also easy for the monetary manager because he/she is seen as helping the economy. Tight money—restricting money supply—is extremely unpleasant for monetary managers, even if necessary, because they are the scapegoat for economic problems.[46] Thus, monetary decision-makers behave with natural bias toward inflation.

Inflation, especially unanticipated inflation, can be problematic for several reasons. First, inflation transfers wealth from people who lend money to people who borrow money. This may sound to many of us like a good deal on the surface—lower rent and car payments all around!—but can have a devastating effect on the economy as companies that are owed money struggle to make ends meet and

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[45] Buchanan and Wagner, *Democracy in Deficit*, 115-117.
[46] Buchanan and Wagner, *Democracy in Deficit*, 120-122.

markets for loans collapse. To the extent people can anticipate inflation, these effects can be mitigated as lenders factor inflation into their practices, but inflation is hard to perfectly anticipate.[47]

Second, inflation alters the basic economic structure of production and disturbs the functioning of markets. Since inflation changes relative prices of goods and services, patterns of resource use and production are shifted in ways that may not be sustainable in the long run.[48] These inflation-stimulated structural distortions in the market may result in significant disruptions in capital and labor markets—including potential spikes in unemployment—as economic actors make the readjustments to shift jobs and resources into higher valued uses. Thus, a spiral of inflation and unemployment can result from the inflation induced by monetizing debt.[49]

Third, debasing currency is an implicit or hidden tax on money balances. As prices rise and the value of a dollar falls, every dollar held in savings is now worth less than it was before. The effect is the same as if the government had announced a sudden tax on cash reserves.[50] In terms of the fiscal perceptions of citizens, however, inflation does not seem at all equivalent to a tax. Individual citizens see rising prices and devalued investments but may not understand the cause at all. Psychologically, individuals do not sense inflation as a tax on their money balances and do not connect the decrease of their real wealth to activities undertaken by the Federal Reserve as they seek to manage the ever-expanding public debt.[51]

Finally, inflation may change citizen's perceptions of market activity in a way that further inhibits economic recovery. As people watch private firms charge higher and higher prices for their products due to inflation, they may become upset at the companies themselves. They may call for the government to control the prices charged by firms, even though the price changes were due to government management

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[47] Buchanan and Wagner, *Democracy in Deficit*, 61-62.

[48] Peter J. Boettke and Steven Horowitz, *The House That Uncle Sam Built: The Untold Story of the Great Recession of 2008* (Irvington-on-Hudson, NY, Foundation of Economic Education, 2016), Retrieved from https://fee.org/resources/the-house-that-uncle-sam-built/; Buchanan and Wagner, *Democracy in Deficit*, 62-64.

[49] Buchanan and Wagner, *Democracy in Deficit*, 170-176.

[50] Buchanan and Wagner, *Democracy in Deficit*, 71-72.

[51] Buchanan and Wagner, *Democracy in Deficit*, 147-149.

of money in the first place. In this way, inflation can introduce and reinforce an anti-business bias in public attitudes. Politicians can strategically use this misplaced blame to impose direct controls over large sectors of the economy, enabling political actors to look as if they are doing something to "solve" the problem.[52]

4. Considerations from Constitutional Political Economy

To this point, the analysis may seem fairly discouraging. The strong incentive for governments to accumulate public debt does not sit well with the difficulty of responsibility managing debt once accumulated. The problem, in short, is that the political rules around taking on and managing debt are not incentive compatible with democratic politics as they exist today. What to do?

Fortunately, there is a branch of economic analysis called *constitutional political economy* that deals precisely with the problem of what to do when the constitutional rules in place are falling short.[53] If we want better practices around debt, we need new, better rules to overcome the short-run political incentives that politicians and bureaucrats face. For new constitutional rules to break the cycle of deficit spending, accumulating debt, and eventual debasement of the currency, they must change the short-run political incentives that politicians and bureaucrats face and constrain them from making socially harmful choices. The only way out is radical reform in the rules by which governments are allowed to make spending decisions. In this section, we outline three potential reforms to avoid the trap of deficits, debt, and debasement: (1) balanced budget amendments, (2) sunset clauses, and (3) competitive monetary policy.

[52] Buchanan and Wagner, *Democracy in Deficit*, 64-67.

[53] Buchanan and Wagner, *Democracy in Deficit*; Boettke and Coyne, "The Debt-Inflation Cycle and the Global Financial Crisis"; Richard E. Wagner, *Deficits, Debt, and Democracy: Wrestling with Tragedy on the Fiscal Commons* (Cheltenham, UK: Edward Elgar Publishing, 2012), 151-153.

4.1 Balanced Budget Amendments

Policy institutions must effectively tie the rulers' hands so that they can't use the tools of monetary and fiscal policy to concentrate benefits on special interest groups and disperse costs on everyone else. Even Adam Smith talked about the importance of establishing credible and binding constraints on monetary authorities and government spending nearly 250 years ago. History has shown how difficult it is to establish binding and credible constraints on the monetary and fiscal authorities.

Balanced budget amendments could change the incentives and constraints that policymakers face when choosing how to spend money. Out of all 50 states, 49 have some form of balanced budget rules. In the 1990s, Congress talked about amending the U.S. Constitution to include a provision for a balanced budget. A balanced budget amendment is a budgetary rule that has received a lot of attention over the past 30 years. Balanced budget rules aren't perfect and they often leave room for evasion. With a balanced budget rule, politicians might use regulations to accomplish what a budget deficit might otherwise accomplish. Governments can also form special units that can spend deficits outside the balanced budget rules, which would undermine the effectiveness of a balanced budget amendment.[54]

Without an effective budgetary rule or norm, budgets will continue to be abused in democratic politics. Constitutional constraints can impose discipline on the decisions about size and distribution of annual government budgets. Buchanan and Wagner think that effective balanced budget amendments will have three characteristics. First, the rule must be relatively simple and straight-forward so that members of the public can easily understand it. Second, an effective rule must offer clear criteria for adherence and for violation so that politicians and the public can easily discern when the rule is being broken. Third, the rule must reflect and express values held by the citizenry so that the citizens help keep politicians and bureaucrats accountable.[55] In order to avoid loopholes, Buchanan and Wagner argue that formal rules for budget balance must include a specific adjustment mechanism to be triggered automatically if spending

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[54] Wagner, *Deficits, Debt, and Democracy*, 151-153.
[55] Buchanan and Wagner, *Democracy in Deficit*, 182-183.

exceeds revenue. They suggest an automatic increase in tax rates to close any gap between spending and revenue within a specified period of time. Alternatively, the rule might force the government to cut spending rather than increase tax rates. Either way, a gap between spending and revenue would necessitate some sort of action.[56]

4.2 Sunset clauses

Sunset clauses, also called sunset laws or sunset provisions, are parts of legislation that cause the legislation or regulations to expire on a certain date unless the legislature takes specifically takes action to renew it. The federal government rarely uses sunset provisions, but many state governments use them regularly. The idea behind the sunset process is to help legislatures "eliminate agencies and laws that have outlived their usefulness and to make administrative and budgetary changes to those that still serve the public interest but have become bloated and inefficient."[57] The sunset laws in the various states use many diverse approaches and take many different forms. However, they share the same basic purpose, which is to remove laws and regulations that are no longer useful, feasible, or cost-effective.[58]

One real-world example of a sunset law in action happened in Maryland in a 2002 sunset review. Before 2002, Maryland had a State Board of Electrologists who oversaw the regulation of hair-removal electrolysis that is done by dermatologists. The review recommended that the Maryland government should continue to regulate electrolysis, but it should be regulated differently. Many members of the legislature saw that the State Board of Electrologists had become infeasible because of financial challenges and a declining number of licensees. Maryland's legislature voted to disband the State Board of Electrologists and to establish a more feasible Electrology Practice Committee under the State Board of Nursing.[59]

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[56] Buchanan and Wagner, *Democracy in Deficit*, 184-187.

[57] Brian Baugus and Feler Bose, *Sunset Legislation in the States: Balancing the Legislature and the Executive* (Arlington, VA: Mercatus Center at George Mason University, 2015), 9.

[58] Baugus and Bose, *Sunset Legislation in the States.*

[59] Sara Fiddler, "Preliminary Evaluation of the Electrology Practice Committee," (General Assembly of Maryland: Department of Legislative Services, December 1, 2010), http://dls.state.md.us/data/polana

The federal government could follow the example of these state governments by making more frequent use of sunset clauses. Such an approach may help members of Congress keep the federal budget in check by reducing the number of laws and regulations that are too expensive, impractical, inefficient, or no longer needed. There are potential trade-offs with the expanded use of sunset clauses, however. The sunset process may create political advantages for incumbents or increase rent seeking. The term *rent seeking* describes the process by which special interest groups try to capture benefits by lobbying or otherwise taking advantage of the political system to increase their own wealth at the expense of others.[60] Depending on the broader political context, it is possible that the frequent re-crafting of legislation could create more opportunities for such behavior. Members of Congress would have to craft the sunset clauses carefully so that they solve more problems than they could potentially create.

4.3 Competitive Monetary Policy

A radical constitutional reform would be to institute a competitive monetary policy. Under a competitive banking system, also known as a "free banking," private banks could competitively issue their own bank notes that would be redeemable for "real" monies like gold or silver. [61] Currently, central banks like the Federal Reserve have exclusive monopoly privileges granted to them by their governments. Most governments don't allow for competition in money. Although competition in money and banking has been largely eliminated, systems that resembled free banking existed rather successfully in the past, such as in Scotland (1716-1844), New England (1820-60), and Canada (1817-1914). Historically, competitive banking systems were often less crisis-prone than government-monopoly systems. [62]

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subare/polanasubare_sunrev/Electrology-2010-prelim.pdf.

[60] Roger D. Congleton, Arye L. Hillman, and Kai Andreas Konrad, *40 Years of Research on Rent Seeking* (Berlin: Springer, 2008).

[61] Friedrich A. Hayek, *Denationalisation of Money*, 3d ed. (London, UK: The Institute of Economic Affairs, 1990); Lawrence H. White, "What Kinds of Monetary Institutions Would a Free Market Deliver?" *Cato Journal* 9 (Fall 1989): 367-91.

[62] Lawrence H. White, "Free Banking in Scotland before 1844," in *The Experience of Free Banking*, ed. Kevin Dowd (London: Routledge, 1992), 157–186; George A. Selgin, *The Theory of Free Banking: Money Supply under Competitive Note Issue* (Lanham, MD.: Rowman & Littlefield, 1988); Lawrence H. White, *Competition and currency: Essays on free banking and money* (New York: New York University Press, 1989).

Some groups of citizens, scholars, policymakers have expressed dissatisfaction with the performance of the Federal Reserve System, which has allowed economists to explore the idea of competing money supplies. Competition in the market tends to provide people with goods and services at higher qualities and at lower prices. The same logic behind market competition can be applied to money. Some scholars argue that competition in the issue of money would have better results than central banks in terms of monetary stability and order. [63]

Free banking could help rein in the tendency for central banks like the Federal Reserve to engage in inflation and cater to political whims. Maybe the only way to successfully constrain the government is to take away its power over monetary policy. Rather than a centralized and government monopoly control of the money supply, perhaps we could rely on more decentralized and competitive institutional arrangement. Economists have raised concerns about the difficulty of devising constitutional rules that effectively constrain the monetary authorities, and a system of free making would be a different constitutional setup that would provide a workaround to the problem of constitutionally constraining a central bank.[64]

5. Conclusion

National debt is a serious public problem, and many of the proposed solutions to it are just as problematic. Fortunately, as complicated as the situation is, public choice economics can be useful in two ways. First, public choice economics can provide a way of thinking about the logic of public debt that can help us both better understand the consequences of deficit spending and the accumulation of debt. There are strong inducements for politicians to accumulate debt. Elected politicians enjoy spending public

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[63] George A Selgin and Lawrence H. White, "How Would the Invisible Hand Handle Money?" Journal of Economic Literature 32, no. 4 (1994): 1718–1749; David D. Friedman, "Gold, Paper, Or...Is There a Better Money?". Policy Analysis No. 17, Cato Institute, 1982; Steven Horwitz, *Monetary evolution, free banking, and economic order* (Boulder, CO: Westview Press, 1992); Lawrence H. White, *Competition and currency: Essays on free banking and money* (New York: New York University Press, 1989).

[64] Hayek, *Denationalisation of Money*; Selgin, *The Theory of Free Banking*.

money on projects that benefit their constituents, and further, since citizens don't like tax increases, there is a strong incentive to finance those public projects by taking on debt. Unfortunately, this problem is further exacerbated by fiscal illusions that make it easy for citizens to not be fully aware of what is being done in their name. These incentives to accumulate debt are in some ways inherent to the exercise of political power in a democracy.

However, this does not mean all is lost. Public choice economics can help us imagine ways to design better rules around deficit spending and debt finance. At the time of the American founding, the Federalists asked the first generation of Americans to use logic and reason to come up with ways to constrain and balance power so that it can be exercised with minimal abuse. Today, we can continue to embrace this Madisonian project of using reflection and choice to imagine better fiscal and monetary rules. New institutions can constrain politicians and bureaucrats so that they don't undermine prosperity and liberty. Balanced budget amendments, sunset clauses, competitive monetary policy would be just a few elements in an acceptable constitutional framework. A free society must have constitutional contracts that keep the powers of government effectively harnessed in socially productive ways, not destructive ones.[65]

[65] Buchanan and Wagner, *Democracy in Deficit*, 191-193.

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