

Re: On Budget Deficits

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William F Hummel <wfhummel@comcast.net> wrote in message
news:<90ksh0h445drjb6rftfn6bm34r9n7lcp7a@4ax.com>...

> On 14 Aug 2004 00:22:16 -0700, cantueso@dieznet.com (cantueso) wrote:

>

> > William F Hummel <wfhummel@comcast.net> wrote in message
news:<d8rph0pcm7ac9nr3ph0cllbikfn7j6c2r6@4ax.com>...

> >>

> >> *WHAT the government taxes is a function of how it chooses to
> >> distribute the tax burden. WHY the government taxes is an entirely
> >> different matter. I'll give you an analogy that should explain why
> >> taxes are necessary.*

> >>

> >> *Imagine a hydraulic loop representing the flow of fiat money between
> >> the government and the banking system. We start with a reservoir of
> >> bank reserves created by government spending that contains both
> >> required reserves and excess reserves. The excess reserves must be
> >> continually drained. Otherwise the Fed could not maintain control of
> >> the Fed funds rate, which is the interbank lending rate on reserves.*

> >>

> >> *The government can drain excess reserves in one of two ways, by taxing
> >> or borrowing. Borrowing depends on the willingness of the public to
> >> lend, and is therefore voluntary. However taxes are not voluntary.
> >> They act as the pump in the hydraulic loop. Take away the pump and
> >> there is nothing to ensure the excess reserves can be drained. Note
> >> that the pump only needs to drain what borrowing fails to drain. Thus
> >> the flow through the pump can be a fraction of the total spending by
> >> the government.*

> >>

> >> *To the extent that the government borrows, the public will build up a
> >> separate reservoir of government securities. The financial wealth of
> >> the public increases as the reservoir of securities increases. There
> >> is no practical limit as to how large that reservoir can be, which is
> >> equivalent to saying there is no practical limit to how much the
> >> government can spend.*

> >>>

> >>> *>and could you tell me whether in this regard the US currency is*

> >>> *>different from other currencies?*

> >>>

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- > >> *I don't know of any example of a major currency in which taxes are not*
- > >> *an essential part of the system. However there may be some countries*
- > >> *that can avoid taxes by riding piggy back on the US monetary system,*
- > >> *i.e. pegging their own currency to the dollar.*
- > >
- > >*it is very hard to see things like that.*
- > >
- > >*not too long ago, in some Swiss towns, the taxes were voted by the*
- > >*inhabitants, and most of the tax money was to be spent by the town*
- > >*government. ("do you want a new road? in this case the tax will be 1%*
- > >*more. should the teacher get a raise? in this case we'd have to*
- > >*postpone the acquisition of a new church bell." etc)*
- >
- > *Don't confuse local government entities like cities and states with*
- > *the national government.*

of course. I saw the mistake later, when I started to think.

- > *Cities and states do not create the national*
- > *currency.*

yes. I suppose that most people who are not economists would make the same mistake.

- > *Unlike the national government, they can only spend what*
- > *they receive in tax revenues. They may carry some debt to finance*
- > *capital investments, but that debt must be serviced out of tax*
- > *revenues. If they borrow too much and can't service their debts, they*
- > *will be bankrupt just as a private firm or household would be*
- > *bankrupt. However because the political and economic implications of*
- > *a bankrupt city or state are so dire, they are usually bailed out at*
- > *general taxpayer expense.*

yes. I understand.

- > >
- > >*now I will have to see how what you say fits in. you say there is no*
- > >*practical limit on how much the government can spend. the government*
- > >*spending turns into assets that people keep in their drawers.*
- >
- > *You should read my article again.*
- > *Government spending does not turn*
- > *into assets that people keep in their drawers.*

I meant "To the extent that the government borrows, the public will build up a

- > >> *separate reservoir of government securities."*

- > *All of its spending*
- > *is recaptured through taxes, and the sale of bonds if necessary. That*
- > *balanced reciprocal flow is what enables the central bank to control*
- > *the price of bank reserves.*

- > *The public, not the government,*
- > *determines how much cash it holds instead of bank deposits.*

Yes. I see. I am not an economist and so, even if I understand something while reading, I will not have it present or won't see how it fits into some general picture.

- >
- > *There may be a limit to (national) government borrowing but we haven't*
- > *found it yet. Obviously the more borrowing, the more government*
- > *securities the private sector holds. Those securities represent net*
- > *financial wealth of the public.*

I understand that.

- > *That financial wealth will increase*
- > *aggregate demand. If you hold a million dollars in T-bills, you are*
- > *likely to feel no different about your spending power than if you are*
- > *holding a million dollars in a checking account.*

yes.

- >
- > *If the demand for consumption due to the wealth effect grows too fast*
- > *relative to national investment and output, the result will be price*
- > *inflation. Thus the ultimate limit on government deficit spending*
- > *should be its effect on inflation.*

I think this is what most people know. and yet these things are not really known. do all economists understand and accept this way of looking at money?

- > *Nevertheless during the period of*
- > *the Reagan and Bush presidencies (1980–1992), the inflation rate*
- > *declined, even as the national debt held by the public quadrupled.*
- > >
- > *>seen like that, what happened in Germany at the end of the war? people*
- > *>had tons of money and could not buy anything with it. would you say*
- > *>that the government had gone beyond the "practical limit"? stated in*
- > *> terms of your hydraulic loop analogy, what went wrong?*
- >
- > *I assume you are referring to the hyperinflation in Germany after*
- > *World War I.*

no. I only know about the collapse after world war II but it would have been similar after the first war.

in the second world war, Germany had two currencies: one for international payments and one to be used only inside. I believe that Hitler's finance man Hjalmar Schacht, was admired for his system. people were paid high salaries, but they could not spend much money. things were rationed: everybody was allowed only so and so many units of basic things. hence the money piled up on savings accounts. after

the war, all this money came tumbling out and there was nothing to buy with it.

- > *What went wrong in financial terms should be clear from*
- > *my article. Quoting: " the government cannot spend without*
- > *borrowing or taxing, and it cannot borrow or tax without spending.*
- > *This balanced reciprocal flow of funds between the government and the*
- > *banking system is key to managing the cost of money to banks, and thus*
- > *to the economy at large."*

I think I am beginning to understand, but only in bits and pieces. it takes time.

- >
- > *The German economy was in shambles after the war, its production*
- > *facilities devastated, and very little income to pay for the huge war*
- > *reparations imposed by the victors. The government could neither*
- > *borrow nor collected taxes to cover its own spending, so it simply*
- > *printed money to spend. The result was an exponential inflation of*
- > *paper money. As noted, the enforcement of tax collection is essential*
- > *in maintaining the public's confidence in what is intrinsically*
- > *worthless fiat money.*