UCLA Economic Letter
Real Estate and the Macroeconomy
UCLA Ziman Center for Real Estate and the UCLA Anderson Economic Forecast

May 2013

Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, Edward E. Leamer, Director, UCLA Anderson Forecast, and Ziman Center economist proposes a novel way to pay the federal deficit.

Let's Privatize the Federal Deficit
Washington Is Incapable, So Taxpayers Should Settle the Deficit Directly

By Edward E. Leamer, Director, UCLA Anderson Forecast

Here is an idea. Don't think of this as a specific policy proposal. It's a teaching document.

The Congress and the President have proven that they are incapable of handling the federal deficit in a sensible way. A wise and permanent solution to this recurring problem would be to turn the decision completely over to the taxpayers. If we did, here is the letter that you would receive after filing your taxes this April:

"Dear Taxpayer, you actually owe 30% more, not just income tax, but Social Security, Medicare and Unemployment Insurance too. If you don't want to settle this obligation now, we offer 10-year loans at a 1.5% interest rate."

Dear Taxpayer,

Thanks for sending in your income taxes in a timely manner in April, but, unfortunately, total tax revenue is not enough to cover Federal spending, and you actually owe 30% more, not just income tax, but Social Security, Medicare and Unemployment Insurance too. If you don't want to settle this obligation now, we offer 10-year loans at a 1.5% interest rate. We encourage you to use this option to borrow if you would otherwise cut your spending. Some economists tell us that overspending right now is good for the economy, though common sense raises some concern with that advice. It's up to you.

Sincerely,
The Internal Revenue Service

This missive from the IRS would be a straightforward private, total, and permanent solution to our ongoing deficit problem. One obvious benefit of this privatization of the deficit is that taxpayers would be up in arms about having to pay 30% more, and they would insist on spending control. To put it another way, the size of government is spending, not taxes, and taxpayers need to be forcefully reminded just how big spending really is.

A more subtle but very important benefit of this proposal is that it properly puts the liability for future taxes explicitly on the taxpayers' balance sheets, unlike the current Enron-style accounting that allows Federal borrowing without creating offsetting future tax liabilities on private balance sheets. Ricardian Equivalence is how economists describe the possibility that taxpayers recognize the future tax liability created by deficit spending. Without Ricardian Equivalence, we are deluded into thinking that someone else will pay our future taxes, and we opt for inappropriately low savings rates.

At the Federal level, privatization of the deficit would create forever balanced budgets, but there would need to be some exceptions that would allow Federal deficits for special circumstances. In time of war or other long-lasting national threat, or faced with expensive long-lasting infrastructure opportunities, it is appropriate that future generations of taxpayers contribute to the effort. This can be accomplished with borrowing that stays on Uncle Sam's balance sheet until those unborn beneficiaries become taxpayers.

Whether a recession is the economic equivalent of war and needs Federal deficit spending remains in doubt, notwithstanding the loudness of Keynesian devotees. But we should remain open to this exception also. However, it is worth remembering that one reason for a Keynesian stimulus is the presence of credit constraints at the individual level that limit intertemporal consumption smoothing, and force inappropriately extreme declines in spending in recessions. The proposed offer to lend from Uncle Sam is completely without credit constraints, and therefore supports the equivalent of Keynesian stimulus but originated at the individual level. Thus, for example, a tax cut in a recession would increase the borrowing opportunities for credit constrained borrowers and thus could stimulate the economy without creating a deficit on the Federal balance sheets.