The Opportunity Cost of Deficits

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The primary policy response of the Federal Government of the United States to the "great recession of 2008" has been an increase in Federal spending financed by the issuance of public debt. The vast majority of this spending has been focused on the purchase of consumption goods and services: much of it government goods and services. A small portion has been spent on the acquisition of capital goods and services: predominately transportation capital. The debt will be repaid by future tax payers, specifically our children. Is this a good deal for our children?

A nation generates income through the successful exchange of goods and services produced by its citizenry. Income can be spent by the individuals who create it, or income can be transferred to someone other than the creator through gifts, loans or taxes. The receiver of the gifts, loans or taxes can then spend the income.

Income represents the monetary accounting of goods and services produced and exchanged. Real income is determined by the amount of actual goods and services exchanged. Nominal income is the monetary accounting value of the actual goods and services exchanged. Nominal income can grow if the number of actual goods and services produced and exchanged increases or if the value of money decreases so that the accounted value of the exchange is higher (we call this inflation). Real income can grow only if the number of actual goods and services exchanged increases.

How does spending income affect real economic growth? In the simplest terms, our labors and capital can be applied to produce two types of goods and services: consumption goods and services and capital goods and services. Consumption goods and services are the things we produce to live and enjoy living: the food we eat, the vacations we take, the concerts we attend, etc. Capital goods and services are the things we produce to create goods and services (both capital and consumption): machine tools, tractors, office buildings, computers, etc. In the real world, there is not always a clean dividing line between consumption and capital goods and services, but for this discussion there is one clear divide between the two: capital goods and services represent the means to produce goods and services; consumption goods and services do not.

Allocating income toward the acquisition of capital goods and services is what we generally call investment. Successful investments create the means to produce goods and services that can be exchanged to generate income.

The pool of income that is available for investment is what we generally call savings. Savings represent the income that individuals set aside for the future. Saved income can be invested by the saver or loaned to someone else. The loan can be direct from saver to borrower or via an intermediary such as a bank, money market fund or other investment organization. Savings can be loaned to someone to acquire capital goods and services or consumption goods and services. When loaned to acquire capital goods and services, the means to repay that loan are acquired with the loaned income. When loaned to acquire consumption goods and services, the means to repay that loan must come from elsewhere: existing capital and labor or future investments.

There is one caveat about capital goods and services: they must eventually be replaced because of wear and tear or obsolescence. This wearing out (and obsolescence) is what we generally refer to as capital consumption, and capital consumption forces a nation to constantly save and invest to maintain its ability to produce goods and services. To grow its ability to produce goods and services, a nation's investment must exceed capital consumption so that capital can accumulate over time. The speed with which an economy grows is controlled by how quickly, or slowly, capital accumulates via investment. Without investment, a nation's capital stock will gradually be consumed and its ability to produce the goods and services that generate income will decline.

In response to the "great recession of 2008" the Federal Government of the United States undertook deficit financed spending to increase the nation's consumption spending. In that, it has succeeded. But the cost of increasing consumption spending has been a decline in investment spending. The Federal Government has borrowed our savings so as to finance its consumption oriented spending, but our savings represent the pool of income our nation has to invest in capital goods and services.

Herein lies the opportunity cost of deficit spending: by allocating our nation's savings toward consumption spending, our government has prevented the nation from increasing the means to produce future goods and services and with that the means to produce future income. We leave our children a debt that must be repaid from their income, but worse, we leave them with fewer means to generate the income to repay that debt.