The Current United States Budget Deficit: An Examination of James Buchanan's and Richard Wagner's *Democracy in Deficit: The Political Legacy of Lord Keynes.*

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Abstract

This paper examines Richard Wagner's and James M. Buchanan's 1977 book, *Democracy in Deficit.* The paper reinforces both authors' claims about political democracies and the inadequacies of John Maynard Keynes's economic theories. Specifically, the paper quantitatively examines the proffered relationship between the United States federal budget deficit and changes in the United States money supply. Buchanan's and Wagner's claims did not derive from data-tested hypotheses. This research examines and supplements their claims by examining the data they report. Furthermore, the paper includes an updated analysis of the United States' budgetary data from 1977 to 2022 to examine Buchanan's and Wagner's claims within the United States' current fiscal environment.

Moreover, the included research uses a panel regression model to begin examining data provided by the Organization for Economic Cooperation and Development to explore possible relationships between other countries' money supply and budget deficits. A basic analysis of OECD data illustrates that with proper fiscal rules, a bloated Federal deficit is not an unavoidable outcome for democratic institutions. Buchanan's and Wagner's analysis of Keynes's economic theories still cause concern, both within the U.S. fiscal environment and, in a broader sense, countries across the globe. Finally, the paper uses the recommendations of Buchanan and Wagner to reaffirm fiscal policy revisions to combat the economic situations perpetuated by Keynes and his ideas.

Introduction

Adam Smith argued his concerns about government spending and debt. He affirmed the importance of government spending and its ability to buoy countries through economic downturns. However, he suspiciously analyzed governments' methods used to fund public spending. As a portion of his analysis, he observed the growth of nations and their budget deficits. To him, these budget deficits emerged as governments spent frivolously without concern for future debt consequences. As Smith asserts in his seminal work, *Wealth of Nations*, "The progress of the enormous debts which at present oppress and will in the long run probably ruin all the great nations of Europe, has been pretty uniform" (Smith, 2012, p. 577). Since 1775, Smith's analysis of countries' proclivity to inflate their debts proves correct in Europe and globally.

James Buchanan's and Richard Wagner's 1977 publication, *Democracy in Deficit: The Political Legacy of Lord Keynes*, deals with the expanding U.S. budget deficit. Explicitly, Buchanan and Wagner attribute the growing U.S. budget to the influence of John Maynard Keynes's economic theories on the United States' fiscal and monetary policy. According to Buchanan and Wagner, the condition of the United States economy, specifically a growing budgetary deficit, could “be 'explained' by the impact of Keynesian influence" (Buchanan & Wagner, 2000, p. 7). Before 1960, Buchanan and Wagner claim, Keynes's theories did not have as profound effects on the United States and its government institutions, educational institutions, and political infrastructures. A departure from "an old-time fiscal religion" of balanced deficits and monetary discipline gradually overcame the United States with an increasing budgetary deficit (Buchanan & Wagner, 2000, p. 16).

Before the mid-1940s, Buchanan and Wagner observe the fiscal discipline of the United States. Buchanan and Wagner claim that the United States' fiscal authorities spent with discipline, apart from periods of emergency. The advent of Keynesianism changed the United States' and its fiscal behaviors. From 1947-1977, Buchanan and Wagner addressed an increasingly strong relationship between Federal Budget deficit increases and the United States' money supply.

The U.S. Federal Budget

When Buchanan and Wagner analyzed the United States’ debt condition, they examined budgetary data from 1947-1974. In 1974, Buchanan and Wagner observed a federal budget deficit of $2.74 billion (FRED, 2022). Their concerns derived from the growing budget deficit and the fiscal policies they observed funding deficits. At the end of fiscal year 2022, the Federal Reserve at St. Louis reported a federal debt of $1.4 trillion. Of course, a country's total debt derives from continual past budget deficits. The problem that Buchanan and Wagner observed did not lessen Rather, it increased exponentially (FRED, 2022). Figures 1 and 2 uses data from the Federal Reserve at St. Louis to visualize Federal account data from 1977 to 2022.

Figure 1 (“Federal Surplus or Deficit [-]”)

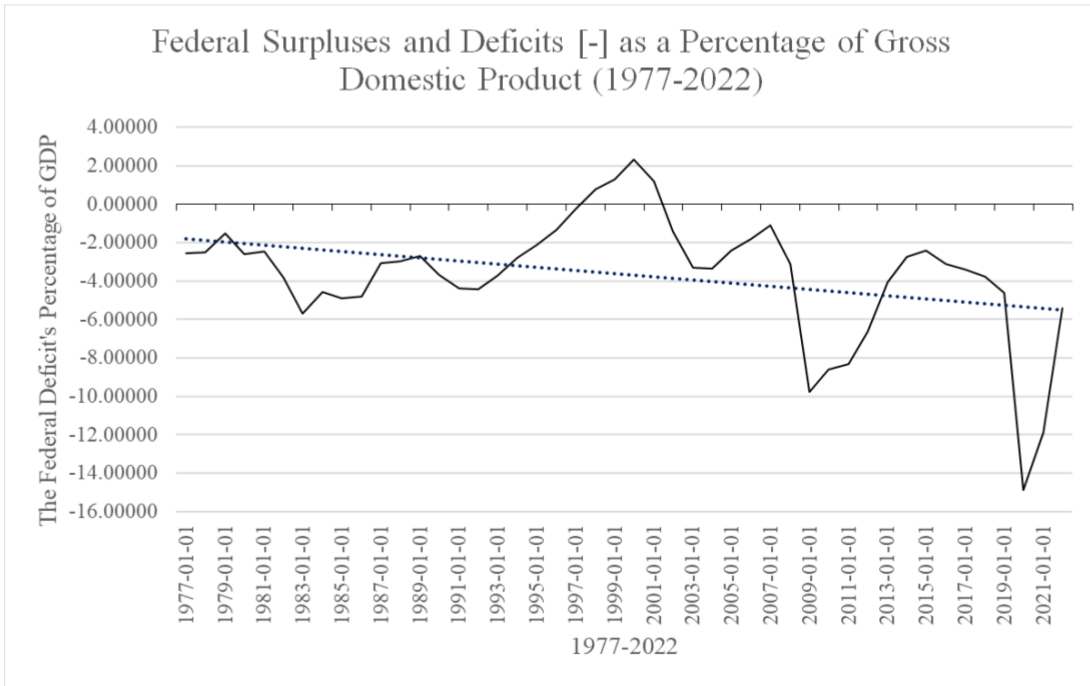
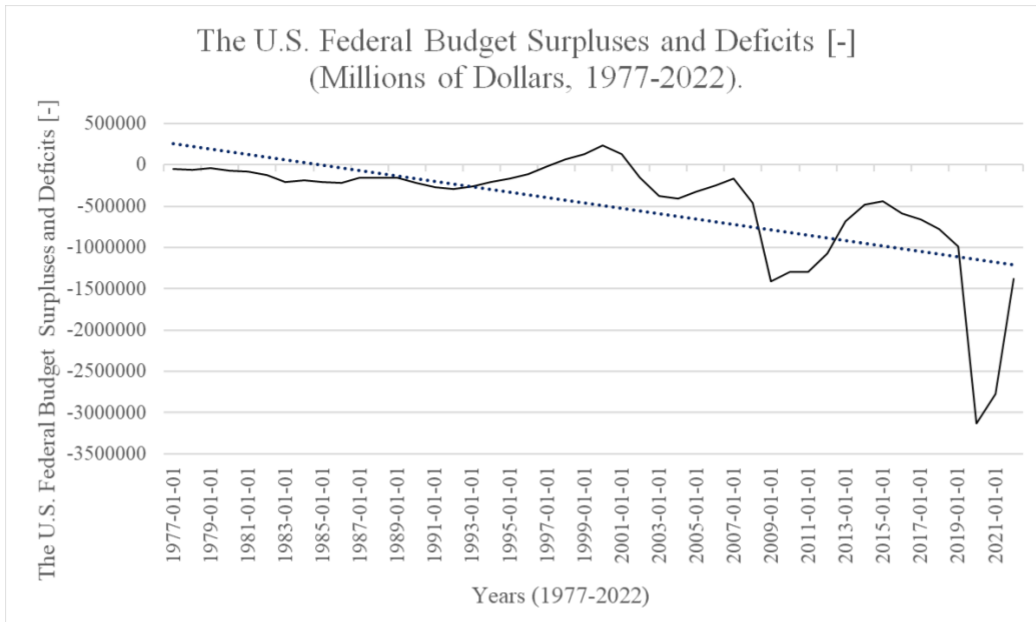


Figure 2 (“Federal Surplus or Deficit [-] as Percent of Gross Domestic Product”)



Keynesianism and Its Assumptions

John Maynard Keynes understood the basic accounting identities of government finance. He understood that when the government does not accrue more revenues than funds outlays, it operates in a deficit. That is, deficits occur when spending exceeds revenue. Nevertheless, he did not anticipate continually growing deficits; he assumed that governments possess the discipline to balance budgets across business cycles.

According to Keynes, when countries experience recessions (decreases in aggregate demand), the government spends more or lowers taxes. During periods of economic growth, the government runs a budgetary surplus and raises taxes. As Buchanan and Wagner explain, during recessionary periods, “the use of the government’s budget” operates as “the primary instrument for ensuring the maintenance of high employment and output” in a Keynesian framework (Buchanan & Wagner, 2000, 96).

Dwight R. Lee reinforces Buchanan’s and Wagner’s claims by arguing that “the basic idea behind Keynesian policy for achieving stable economic growth is straightforward and superficially plausible” (Lee, 2012, p. 473). According to Keynes, governments increase spending, or lower taxes, during a “downturn” and lower spending, or increase taxes, when “aggregate demand exceed[s] the productive capacity of the economy” (Lee, 2012, p. 473). If Keynes’s fundamental theories prove correct, the government balances budgetary deficits by raising taxes and decreasing spending during economic booms. As Buchanan argued in 1978,

> “As developed by the economists who advocated macro-economic engineering, fiscal policy would be devoted to smoothing out cycles in private economic activity. The same principle would guide fiscal policy during both recession and inflation. Deficits would be created during recession and surpluses during inflation to smooth out peaks and troughs. The policy precepts of Keynesian economics were alleged to be wholly symmetrical. In depressed economic conditions, budget deficits would be required to restore full employment and prosperity” (Buchanan, Burton, & Wagner, 1978, p. 33).

After increasing spending, lowering taxes, or a combination of the two, the economy returns to full employment and restores nominal spending growth. Afterward, the government increases taxes and decreases spending to balance the federal budget and lessen, if not eliminate the deficit. Again, as Lee argues, Keynes' theory seems "superficially plausible" in the proper context (Lee, 2012, p. 473). However, as Buchanan and Wagner observe, the growing federal deficit indicates that Keynesian economics operates incongruously within political democracies.

If Keynesian economic theory had successfully helped orchestrate the long-term growth of economies, the federal budget deficit would not have grown exponentially. Surpluses would balance the deficits during recessions and economic booms. Nevertheless, as Buchanan and Wagner argue, Keynes posits his theories within a political environment that differs from the environments of political democracies. Keynes assumes that fiscal authorities possess the integrity, discipline, and incentives to balance budgets throughout business cycles.

The institutional structure of political democracies complicates Keynes' arguments. As Buchanan and Wagner argue, "We might all agree that something has gone wrong. The record of deficits, inflation, and growing government is available for observation…Our central thesis is that the results we see can be traced directly to the conversion of political decision makers and the public at large to the Keynesian theory of economic policy…Elected politicians enjoy spending public monies on projects that yield some demonstrative benefits to their constituents. They do not enjoy imposing on these same constituents" (Buchanan & Wagner, 2000, p. 95).

Buchanan and Wagner correctly observe that the institutional structure of political democracies opposes the implementation of Keynesian policy. Consequently, fiscal authorities do not impose higher taxes or reduce spending during economic booms. Political incentives oppose decreased spending and higher taxes. In political democracies, politicians run for office

and fiscal authorities vie for the favors of U.S. citizens. Politicians understand that citizens do not vote for politicians who plan to raise taxes and cut spending on publicly beneficial projects. In Buchanan's and Wagner's verbiage,

> "Under the assumption that public output enters positively into the utility functions of citizens, the expenditure by itself will secure support for the politician. The taxes, however, will reduce the disposable income of citizens, thereby affecting them negatively and reducing support for the politician. In a plurality electoral system, for given preferences and fixed tax institutions, the budget will be expanded so long as a majority would prefer the public service to the private goods they would have to sacrifice via taxation" (Buchanan & Wagner, 2000, p. 100).

Therefore, according to Buchanan and Wagner, fiscal authorities in the United States do not balance the budget as Keynes suggests; they spend freely without fiscal responsibility. These actions yield the increasing budgetary deficit that Buchanan and Wagner observed in 1977. As Boettke and Newman argue,

> "The consequence of Keynes for economic policy was an elimination of institutional checks and balances and a reversal of the time-tested wisdom of the classical political economists concerning sound money and fiscal responsibility, replacing it with large budget deficits and countercyclical policy. The consequence of Keynes for politics was an unleashing of the natural proclivities of politicians to spend without regard to revenue and perpetually increase the budget deficit without any obvious stopping point in place to curb this behavior…continual increases in the money supply, thereby artificially raising prices and lowering interest rates beyond what is dictated by the natural free market, would engender booms and busts" (Boettke & Newman, 2017, p. 157).

An incompatibility exists between Keynesian economic principles and rule-less political democracies. Due to their interests and concerns, politicians cannot consistently adhere to Keynesian budget-balancing policies. Thus, as loose monetary policy prevails, the government continues to spend.

Funding Deficits Spending

Fundamentally, Federal deficits emerge from the limited ways governments fund spending. Buchanan and Wagner assert that the government possesses three sources of funding.

"Central or national governments, directly or indirectly, possess three means of financing outlays: taxation, borrowing, money creation" (Buchanan & Wagner, 2000, p. 110). The democratic process, as previously discussed, eliminates the possibility that higher taxes fund government spending. Moreover, as Buchanan and Wagner argue, "the first is eliminated by definition if a deficit is to be created" (Buchanan & Wagner, 2000, p. 110). Since a deficit exists in the United States, fiscal authorities have not used higher taxes to eliminate the deficit-generating effects of higher spending during economic booms. For a federal deficit to exist, the amount of money spent must outweigh accrued revenues (taxes).

Moreover, according to Buchanan and Wagner, public borrowing does not help balance the United States' budget. When Buchanan and Wagner reference public borrowing, they refer to the Federal government's manipulations of securities (bills, notes, and bonds) through the United States Treasury. The revenue garnered through the sales of bonds does not lessen the United States federal deficit; the buying and selling of securities, although the issuance temporarily funds deficit spending, does not do so long-term. Of course, the Federal Reserve must pay the principal on the issued bonds. Also, although the interest rates on these bonds are low because the U.S. Treasury guarantees payment (with the "full faith and credit of the United States government"), the U.S. must pay interest on issued securities (U.S. Government Accountability). Consequently, public debt does not fund deficit spending long-term, and public debt also worsens the federal deficit.

Money Creation

Since governments do not fund budgetary deficits in political democracies with higher taxes or public debt, money creation is the only remaining alternative. Buchanan and Wagner argue manipulation of the money supply funded United States budgetary deficits over the period

they consider. As a form of financing, money creation allows the government to spend without raising taxes or borrowing from other sources. Buchanan's and Wagner's arguments do not intend to convince the reader that money-financed deficits, debasement, and inflation. Rather, Buchanan and Wagner address how political democracies often lend themselves to irresponsible fiscal behaviors. As they state, "Here, as at many other points in this book, we feel ourselves to be triturating the obvious. To say that there will be an inflationary bias when governments are allowed to create deficits and to finance these with currency is very elementary common sense" (Buchanan & Wagner, 2000, p. 113). Both economists argue that money-financed deficits are a default method of payment in the U.S. during the period they consider. Buchanan and Wagner support their assertions with qualitative observations regarding federal budget data from 1947 to 1974. Buchanan and Wagner qualitatively observe a noticeable correlation between federal budget deficit increases and money supply increases. Specifically, they note that the date reveals a distinct correlation between changes in the federal budget status and the Federal Reserve's securities holdings. In Buchanan and Wagner's verbiage,

> "An examination of the 1961–1974 period reinforces the thesis that budget deficits are positively related to changes in the stock of money. During this latter period, the average annual increase in the money stock was 4.9 percent, a full three percentage points above the annual average during the preceding interval. A closer examination of this historical record reveals that the Federal Reserve System has responded to budget deficits (surpluses) by increasing (decreasing) its holding of government securities. This pattern obtains for the 1946–1960 and the 1961–1974 periods. The Federal Reserve, in other words, appears to be a major source for financing budget deficits"
> (Buchanan & Wagner, 2000, p. 118).

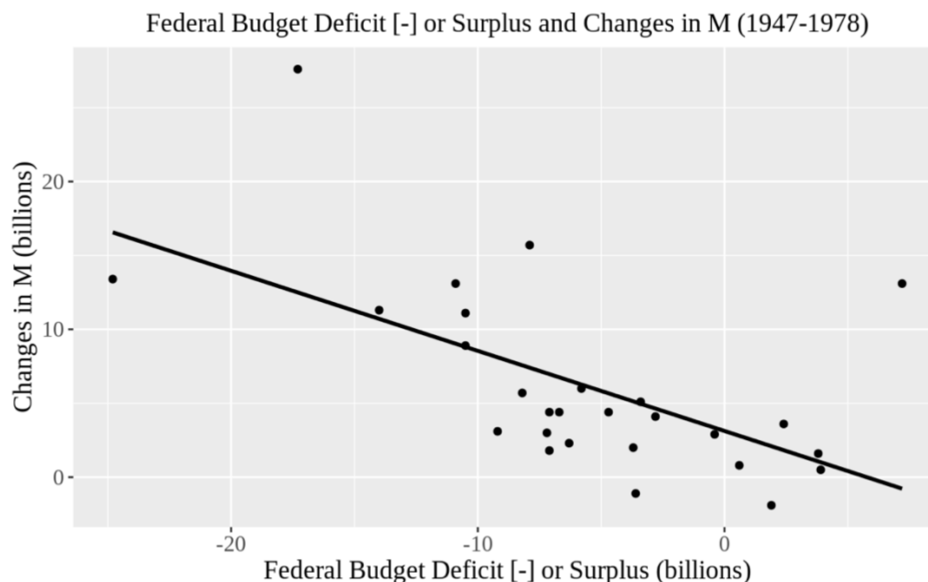
Quantitatively, Buchanan's and Wagner's observations prove correct. Figure 2 reveals the downward trending relationship between the U.S. budget status and changes in the U.S. money supply. Figure 2 demonstrates the relationship between the U.S. budget status and changes in the Federal Reserve's security holdings. Per Buchanan's and Wagner's analysis, budget deficits

during this period relate to “increases in the stock of money” (Buchanan & Wagner, 2000, p. 110). An analysis of the correlation between the federal budget status and changes in the money supply yields a correlation coefficient of -0.5849. Furthermore, A glimpse at Figure 1 illustrates that the relationship that Buchanan and Wagner proffer appears correct, based on the two economists' data. Table 1 lists the data provided in *Democracy in Deficit*.

Table 1 (Buchanan & Wagner, 2000, p. 119).

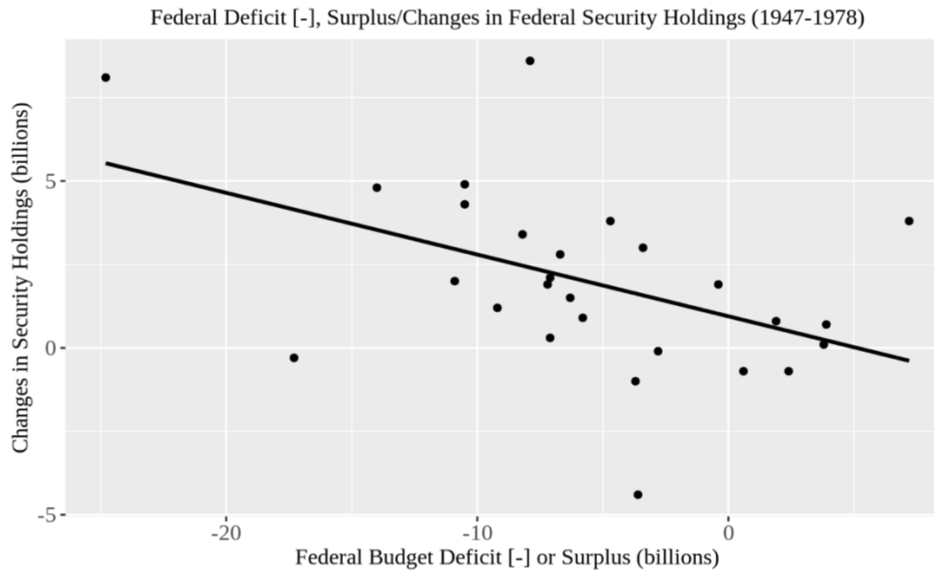
Year	U.S. Federal Budget Surpluses/Deficits (Billions)	Changes in M (Billions)	Changes in the Federal Reserve's Security Holdings (Billions)
1947	2.4	3.6	-0.7
1948	3.9	0.5	0.7
1949	-3.6	-1.1	-4.4
1950	-0.4	2.9	1.9
1951	-3.4	5.1	3
1952	-5.8	6	0.9
1953	-9.2	3.1	1.2
1954	-3.7	2	-1
1955	-2.8	4.1	-0.1
1956	3.8	1.6	0.1
1957	0.6	0.8	-0.7
1958	-7.1	1.8	2.1
1959	-7.1	4.4	0.3
1960	1.9	-1.9	0.8
1961	-6.3	2.3	1.5
1962	-7.2	3	1.9
1963	-6.7	4.4	2.8
1964	-8.2	5.7	3.4
1965	-4.7	4.4	3.8
1967	-14	11.3	4.8
1968	7.2	13.1	3.8
1969	-10.5	8.9	4.3
1970	-10.5	11.1	4.9
1971	-24.8	13.4	8.1
1972	-17.3	27.6	-0.3
1973	-7.9	15.7	8.6
1974	-10.9	13.1	2

Figure 3



Furthermore, Buchanan and Wagner also posit a negatively correlated relationship between the Federal Reserve's security holdings and the money supply. Similarly to the data displayed in Figure 1, Figure 2 displays a relationship between the Federal budget deficits and surpluses and Federal Reserve security holdings, albeit not linear. "A closer examination of this historical record reveals that the Federal Reserve System has responded to budget deficits (surpluses) by increasing (decreasing) its holding of government securities" (Buchanan & Wagner, 2000, p. 118). Again, Buchanan and Wagner target another avenue where governments respond top budget deficits by manipulating the money supply. The correlation statistics do not reveal as strong of a correlation between Federal security holdings and the Federal budget status as the relationship in Figure 1. However, with a correlation coefficient of -0.4615913, the inverse relationship that Buchanan and Wagner posit proves correct. Figure 4 displays this relationship.

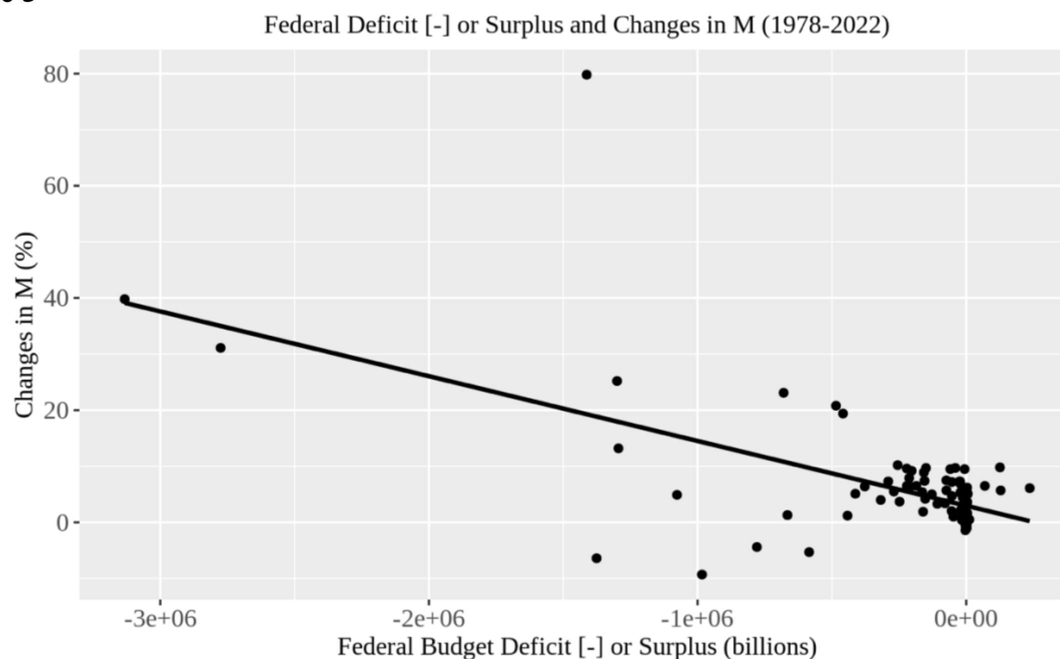
Figure 4



Current United States Data

Buchanan's and Wagner's arguments help understand the current state of the United States' deficit. As previously discussed, the current United States' deficit has worsened over the period spanning from 1974 to the present. If Buchanan's and Wagner's critiques of Keynesianism prove accurate, United States' fiscal data should demonstrate the same relationships that Buchanan and Wagner proffered in 1977. Figure 5 visualizes the relationship between the U.S. Budget Status and changes in the U.S. money supply from 1978 to the end of fiscal year 2022. If Buchanan's and Wagner's arguments prove consistent, data analysis should reveal a relationship between the money supply and the Federal budget deficits following 1977. A statistical data test reveals a correlation coefficient of -0.58. The raw correlation statistics target the similarities between the period Buchanan and Wagner consider (1947-1974) and 1978 to the present.

Figure 5



International Implications

Analysis of U.S. data from 1947-2022 supports Buchanan's and Wagner's claims. Furthermore, if their arguments prove accurate, analysis of international data should support their claims, even if indirectly. Although incomplete, the following data analysis helps explore this hypothesis. The data from countries with similar demo-political structures to the United States should also reveal a relationship between increasing budget deficits and facets of the country's money supply. Conversely, if countries practice fiscal discipline, Buchanan's and Wagner's observed, distressing relationships may not appear as prominently in a respective countries budgetary data. The Organization for Economic Co-operation and Development records budgetary data and money supply data for approximately 30 countries from approximately 1950-2022. A panel data regression for the 30 countries including data from 1975-2019 yields the following results.

Table 2

Coefficents	
Intercept	43.4423
Budget Status	0.64135
Total Sum of Squares	1592700
Residual Sum of Squares	1585500
R-Squared	0.0044784
Adjusted R-Squared	0.0035927
P-Value	0.024728

The statistical output of the panel regression does not indicate a high level of statistical significance. Aggregately, a relationship between each countries money supply and budgetary data does not appear statistically significant. There are a variety of reasons that Buchanan's and Wagner's concerns do not appear strongly in an aggregated data analysis like the above panel regression.

First, the lack of relationship between the money supply and budgetary data for the considered countries may be a product of higher fiscal discipline in OECD countries. Buchanan's and Wagner's contentions with the United States fiscal environment are unfounded in a country that practices fiscal discipline and designates trustworthy institutions bound by clear rules. Secondly, OECD countries that do not face the conflicting incentives of political democracies which ultimately cause bloated deficits and a debased currency. Although more centralized governments present their own series of problems, if the governing entity is bound by fiscal rules, a bloated federal deficit may not factor into a country's challenges. Finally, and perhaps

most importantly, OCED's data sample of countries consists of country's who have already passed OECD's standards of admission and data selection.

Buchanan's and Wagner's claims about Keynes's theories and the relationship between government spending and the money supply prove most accurate in institutional environments most like the United States. To compare country's data best, countries with the most similar political structures must be compared. Properly targeting and analyzing institutional environments most like the United States requires significant data. The V-Dem Institute's Democracy Reports take the most crucial politico-determinate variables and creates profiles of countries to scale each from most to least democratic (Peimstein, et al, 2023). According to this extensive data set, the OECD provides data for some of the most similar countries to the United States and some of the most dissimilar.

In the more democratic countries, controlling for institutions that create fiscal guidelines, data should reveal the relationship that Buchanan and Wagner target in the United States fiscal environment. As previous data revealed, increases in the Federal budget deficit correlate with increases in the money supply in the United States. Table 3 hypothesizes a relationship between the money supply (y) and the Federal budget status (x). The results of the table affirm Buchanan's and Wagner's arguments. The regression posits a statistically significant results between x and y variables. The next step to examine whether Buchanan's and Wagner's arguments extend to an international context involves examining a country comparable to the United States (specifically according to its political institutions).

Table 3

Regression Statistics	
Multiple R	0.3509214
R Square	0.12314583
Adjusted R Square	0.10321733
Standard Error	30.136587
Observations	46

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	5612.2001	5612.2001	6.17938157	0.01679538
Residual	44	39961.4106	908.213878		
Total	45	45573.6107			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*
Intercept	52.9545696	5.91264817	8.95615096	1.7864E-11	41.0384102
GD_P	3.1204818	1.25530468	2.48583619	0.01679538	0.59058146

The V-Dem dataset posits Poland as a comparable political entity (Peimstem, et al, 2023). However, the same regression data for Poland's data contradicts the results of the United States' analysis (p-value: 0.2573). Interestingly, then, even as a comparable political entity, data does not allow statisticians to accept a relationship between Poland's budget deficits and increases in Poland's money supply. OECD targets one of the most viable explanations for the patterns in Poland's data. Despite other economic difficulties, Poland effectively targeted its federal deficit and slowed its growth with a plan implemented in 2011, as described by OECD.

> "The main goal of Poland's medium-term budget strategy is to reduce the general government deficit below 3% of GDP no later than 2013, paving the way for eventual

> adoption of the euro. The government has undertaken a number of new measures to rationalize public expenditures and increase control over public funds. Poland's fiscal framework contains a public debt rule which is anchored in the Constitution (national debt definition) and limits gross debt to 60% of GDP. Recent changes strengthened existing prudential and remedial procedures that are applied if debt exceeds the thresholds of 50%, 55% and 60% of GDP. In addition, an expenditure-based fiscal rule is planned– the aim being to further restore and maintain fiscal stability in Poland by capping discretionary spending growth at 1% per annum. Poland also recently introduced four-year rolling fiscal plans to provide medium term fiscal guidance" (OECD, 2011).

Poland implements clear policies which prevent over-spending and funding policies which harm economic growth. With clear constraints upon politicians, even in a political environment like the United States, Poland prevents a bloated deficit and an increasing money supply, compared to the United States. Poland's solution, although imperfect, involves rules to avoid overspending. Poland's contrast to the United States provides a backdrop for Buchanan's and Wagner's policy arguments.

Buchanan's and Wagner's Policy Prescriptions

Within the Keynesian paradigm, which incentivizes a lack of fiscal responsibility, fiscal authorities create inflation as they increase the money supply to fund the spending which the public desire and affirms in democratic political processes. Rising inflation evokes consequence which include reduced purchasing power, reduced foreign investment, and, eventually, reduce long run output as rising inflation adversely affects an economy's fundamentals and factors of production. The implications of applied Keynesian economics cause political democracies to undergo rising rates of inflation as monetary authorities increase the money supply to fund deficit spending. As this research illustrates, the problems Buchanan and Wagner targeted remain persistent, not only in the United States, but also internationally.

Buchanan and Wagner clearly argue what types of policy reform governments need to implement to combat the inflationary pressures of Keynesian economics in political democracies.

Governments need rules which guided their spending and enforce consistent fiscal responsibility. Buchanan and Wagner argue, first, for “constitutional norms” which ensure that fiscal policies are not "left adrift in the sea of democratic politics” (Buchanan and Wagner 182). The need for structure and rules in fiscal policy cause Buchanan and Wagner to argue for a complete fiscal reform: the implementation of a balanced budget amendment.

The United States needed a balanced budget amendment in 1977, according to the environments that Buchanan and Wagner observed. They environments that they observed and analyzed only worsened between 1977 and the present. Currently as well, to avoid inflation and retain the democratic structure of the United State, the United States must establish policy norms which limit the irresponsible spending of fiscal authorities. Poland’s example, as a comparable political entity, illustrate the importance and effectiveness of constraining rule in democratic systems.

Conclusion

No policy prescription, whether a balanced budget amendment or another derivation, perfectly addresses the complications of spending, balanced budgets, or politicians within a country. Yet, Buchanan and Wagner noted a growing problem that has continued to worsen to the present. The data they examined as well as updated data displayed distressing pattern that emerge from complex political incentives, a lack of rules, and self-interest. The research models that this paper relies upon are a limited way to test causal relationships.

Yet, a close look reveals that, in the U.S., irresponsible, irregulated spending derives funds from increases in the supply of money. OECD data, however, disproves the idea that a comparatively more balanced budget or responsible fiscal behaviors is impossible for a political democracy. With proper rules, as OECD countries illustrates, over time, countries can begin to

eliminate the distressing patterns of spending that Buchanan and Wagner observed in the United States.

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