

GOVERNMENT INTEREST PAYMENTS: THEIR RELATIONSHIP TO ECONOMIC GROWTH AND STABILITY

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Any study which attempts to examine the ways in which the pattern of Government expenditures may contribute to the achievement of the twin goals of economic growth and economic stability must come to grips with the problem of interest payments. The magnitude and variability of interest expenditures have made them a budgetary problem of the first order and have increasingly attracted to them the attention of both public officials and students. In analyzing the interest issue, one must examine the role of the rate of interest, the relationship between the interest expenditures and the Nation's fiscal capacity, and, finally, alternative means of monetary organization which may hold out the possibility of alleviating the burden of the debt. Prior to the investigation of the analytical issues, however, it is desirable to view our present interest problem in the light of history.

Since the onset of the depression, despite a sharp decline in the average rate of interest paid on the public debt, the sums spent by the Federal Government in the servicing of its debt have crept steadily upward. The increased interest expenditures reflect the vast expansion of the public debt which resulted from the emergency expenditures of the thirties and the immense cost of the Second World War. In the past 12 years, the rise in interest charges has also reflected the gradual increase of the interest rate from the lows reached during the period of wartime controls. In table I will be found the basic data relevant to the rise of the public debt and of interest expenditures and, in addition, statistics on budget expenditures and the gross national product. Interest charges during the current fiscal year are anticipated to be \$7.4 billion, more than 10 percent of total budget expenditures. It will be recognized, however, that relative to the total budget, interest charges are now lower than they were in the twenties and even in the period prior to the Korean war. This simply reflects the lower level of total expenditures during these earlier periods. Relative to total output, interest payments are now about 1.8 percent of gross national product—a level 3 times greater than that prevailing in 1929. They have, however, declined from the high point, 2.3 percent of gross national product, which was reached in 1946.

It is useful to view current interest charges in historical perspective, since this helps to dissipate some of the more frenetic attitudes on the subject that have been generated by the continual increase of the absolute amount of interest payments. From the standpoint of history, the present costs of servicing the debt are not unduly heavy relative to our capacity.

Nevertheless, the increased charges should not be viewed with complacency. In national income accounting, Government interest payments are viewed as transfer payments. They add to personal income, but they do not—in contradistinction to other interest—add to national income, since they are not paid for services currently rendered in the productive process. Government interest payments serve no productive function. For the most part, the public debt is a kind of spurious capital. Since it has arisen largely as a result of war expenditures, it has, unlike private debt, little counterpart in real productive assets. National income statisticians make no attempt to impute a return to socially owned capital. The servicing of the debt constitutes a drain on the budget, absorbing funds which might otherwise be used for different purposes. It represents a burden for the taxpayer. What purposes, then, do Government interest payments serve in the maintenance of strong economy?

THE ROLE OF THE RATE OF INTEREST

At the present time, the chief variable influencing the magnitude of Government interest expenditure is the rate of interest. If the money market is not to be disrupted, the rate of return on governments must be consistent with that available on other instruments. Variability of Government interest payments reflects the changes in the rate of interest. The rate of interest on Government obligations cannot be “pegged” without simultaneously stabilizing the rate of interest generally, and, on the other hand, if the general rate of interest is permitted to vary, the rate paid on governments must also vary. In order to understand why the rate of interest must vary and, therefore, in order properly to assess the function of interest payments, we must indulge in a theoretical digression on the question: the role of the rate of interest.

According to the traditional view, the chief function of the rate of interest is to serve as a deterrent to the desire to borrow. In this way it governs the demand for investable funds, thereby limiting aggregate spending from borrowed funds. In recent years it has been recognized that the effective mechanism may be something more than the deterrent effect upon potential borrowers resulting merely from an increase in the cost of borrowing. Borrowers may still wish to borrow, despite the increased cost, but are unable to find lenders. In any event rising rates of interest do imply the cutting off of fringe borrowers.

TABLE I.—Amount of interest-bearing public debt, interest on the public debt, budget expenditures, gross national product, and their relationship, 1929–57

	Interest-bearing debt	Interest on the public debt	Budget expenditures	Interest charge as percent of budget expenditures	Gross national product	Budget expenditures as percent of gross national product
	Millions	Millions	Millions		Millions	
1929.....	\$16,639	\$678	\$3,299	20.6	\$104,436	3.2
1930.....	15,922	659	3,440	19.7	91,105	3.8
1931.....	16,520	612	3,577	17.1	76,271	4.7
1932.....	19,161	599	4,659	12.8	58,466	7.9
1933.....	22,151	689	4,623	14.9	55,964	8.3
1934.....	26,480	757	6,694	11.3	64,975	10.3
1935.....	27,045	821	6,521	12.6	72,502	9.0
1936.....	32,756	749	8,493	8.3	82,743	10.2
1937.....	35,803	866	7,756	11.2	90,780	8.5
1938.....	36,576	926	6,792	13.7	85,277	8.0
1939.....	39,886	941	8,858	10.6	91,095	9.7
1940.....	42,376	1,041	9,062	11.5	100,618	9.0
1941.....	48,387	1,111	13,262	8.4	125,822	10.5
1942.....	71,968	1,260	34,046	3.7	159,133	21.4
1943.....	135,380	1,808	79,407	2.3	192,513	41.4
1944.....	199,543	2,609	95,059	2.7	211,393	45.1
1945.....	256,357	3,617	98,416	3.7	213,558	46.2
1946.....	268,111	4,722	60,448	7.8	209,246	28.9
1947.....	255,113	4,958	39,032	12.7	232,228	16.8
1948.....	250,063	5,211	33,069	15.7	257,325	12.5
1949.....	250,762	5,339	39,507	13.5	257,301	14.9
1950.....	255,209	5,750	39,617	14.5	285,067	13.9
1951.....	252,852	5,613	44,058	12.7	328,232	13.4
1952.....	256,863	5,859	65,408	9.0	345,445	18.9
1953.....	263,946	6,504	74,274	8.8	363,218	20.4
1954.....	268,910	6,382	67,772	9.4	361,167	18.7
1955.....	271,741	6,370	64,570	9.9	391,692	16.3
1956.....	269,883	6,787	66,540	10.2	414,686	16.4

Source: Annual Report of the Secretary of the Treasury on the State of the Finances for the fiscal year ending June 30, 1956. Department of Commerce, Survey of Current Business, July 1957.

The supply of investable funds need not be affected. As a weapon of control, the interest rate does not affect the allocation of resources between investment and consumption activities save insofar as it affects the society's willingness. The interest rate is simply a surface phenomenon—underlying the monetary relationships are the real forces which, in the final analysis, determine the allocation of resources between present and future needs. Of main importance in this respect, during periods of full employment, is the willingness of the citizenry in their individual and corporate capacities to free resources for investment activity by voluntarily refraining from consumption expenditures. In this inclination, they may be abetted by the willingness of the Nation as a whole to save, as reflected by a surplus in the Government budget.

Taken in conjunction with "thrift"—the source of funds—the demand for funds (which is largely a reflection of the expected productivity of capital) tends to determine the rate of interest. If we assume full employment, there is considerable truth in the idea, developed by Knut Wicksell, of a natural rate of interest determined by the real forces of demand and supply. If we are willing to tolerate inflation, the market rate of interest may be held down, and more investment may be carried on through the process of forced savings. It may be assumed, however, that normally, we would wish to avoid inflation. Though serving temporarily to supplement the resources devoted to investment, inflation is undesirable on long-run grounds since it serves to dry up the chief source of investment resources—i. e., voluntary

savings. Inflation causes an inequitable redistribution of income and wealth; it may also, therefore, be considered abhorrent on moral grounds.

In the contemporary economic context, the chief contribution that interest rates may make to economic stability is in controlling the inflationary process. During periods in which there is some danger that resources may fall idle, interest rate should be lowered in order to encourage additional investment activity. But our present-day problem is not one of idle resources. The interest rate must be used as the vehicle for curtailing investment demand within the limits of the available supply of resources. It may be that present inflationary symptoms are due to the upthrust of wages and other costs, but this hardly implies that we should wish to superimpose a demand inflation upon a cost inflation. Use of the rate of interest does imply a rationing of credit through the price mechanism among the various claimants to resources. It may well be that those claimants excluded from access to investable funds are just those individuals and firms that could use capital most productively and would add most to the long-run growth of the economy. To this possibility we must return later.

It is desirable to keep in mind that the interest rate is a two-edged weapon, having side effects which tend to spur, as well as control, inflation. To the extent that prices are administered in accordance with a cost-plus formula rather than being set by competitive forces, a rise in the rate of interest by adding to costs may be reflected directly in a marking up of prices. This is particularly true in a highly oligopolized economy operating under a full-employment guaranty. In addition, it has been pointed out, government interest payments are a part of personal income, but are not a part of national income—they do not constitute payments for services rendered in the turning out of national production. An increase in government interest payments may, therefore, swell demand without swelling output; by thus serving as a feedback to demand they may add to inflationary pressure. From this standpoint, a rise in the interest rate may be viewed as a built-in destabilizer, adding gradually to demand as inflationary pressures rise. Some protection against this destabilizing effect may be obtained by the funding of the Federal debt into long-term issues. Nevertheless, it may be seen that a rising rate of interest has offsetting facets which tend to spur inflation to some extent on both the demand and cost sides.

On balance, it is generally believed, the offsetting facets are of minor importance—the function of the interest rate in the control of investment demand is the crucial one. Interest costs are a minute percentage of the final cost of finished goods. In certain sectors of the economy, a small, once-for-all increase in prices may occur in order to bring about equilibrium in the markets concerned. It may be regarded as the price paid to bring to an end inflation as a continuing process of rising prices. It is desirable to keep in mind the distinction between higher prices and rising prices. On the demand side, some portion (perhaps 30-40 percent) of additional interest payments will be recaptured by the Government in taxes; some will be saved. This is, of course, true of any increase in spending that gives rise to an increase in income. It does suggest, however, that, even if interest payments were to rise by a billion dollars, the net addition to effective demand would be in the

order of perhaps \$500 million—an infinitesimal sum relative to the total demand for final goods and services, which is well over \$400 billion. The curtailment of investment demand is, therefore, of critical importance. Its relative importance should not be lost sight of because it is only one of a complex of influences emanating from a change in the rate of interest, from which no one part can be disassociated.

Though occasionally we may like to fool ourselves on the issue, there is, in reality, no acceptable alternative¹ to flexible interest-rate policies. To approach the problem from another direction may help to cast it in the proper perspective. In the absence of direct controls, which are probably unacceptable to the American people, in a period of rising demand for investable funds, the maintenance of a fixed interest rate would simply imply the abandonment of control over the supply of money and the creation by the banking system of all the additional purchasing power that all potential borrowers might desire. Without direct controls, it is impossible to control both the price and the quantity of any commodity. The implication of a fixed interest rate in the face of rising investment demand is a permanently enlarged money supply with consequential inflationary repercussions. That there is really no issue seems to be confirmed by the recent report of the Subcommittee on Fiscal Policy to the Joint Economic Committee.²

INTEREST PAYMENTS AND THE NATION'S FISCAL CAPACITY

Granted that flexible interest-rate policies are essential in the attempt to stabilize a free-enterprise economy, and that interest payments must, therefore, rise on occasion, one cannot disregard the relationship of the interest burden to the total budget and to national income. On the other hand, before reaching the conclusion that it is always most desirable to cut interest payments, one must keep in mind that there are valuable educational, charitable, and commercial institutions which are, in part, dependent upon interest income for support. Yet, the general presumption must remain that reduction of the interest burden is to be desired since it will alleviate budgetary pressures.

Economists have gotten over their infatuation with the idea that a domestically held public debt is no burden because "we owe it to ourselves." Because a burden is "merely financial," it does not mean that it cannot be burdensome. The element which we term the Nation's fiscal capacity³ is an essential ingredient of a discussion of any major component of the budget. This concept refers to the fact

¹ In theory, fiscal policy could serve as a complete substitute for monetary policy. In principle, the interest rate could be held at a predetermined level by the adoption of appropriate tax and expenditure policies. To the extent that a restrictive fiscal policy is adopted during periods of rising demand, the need for interest-rate variation will be lessened. As an instrument of control, however, fiscal policy is crude in operation and cumbersome in administration. Politically, it is not suitable for quick adjustments. As a practical matter, it cannot cope with the delicate regulation of demand that is required. To imply the contrary is to expect too much of fiscal policy, a "perfectionist" attitude reminiscent of Beveridgeism. A more refined tool is needed. In practice, therefore, it is necessary to use monetary policy.

² Fiscal Policy Implications of the Economic Outlook and Budget Developments, Report of the Joint Economic Committee to the Congress of the United States, June 26, 1957. See, especially, p. 5, on which it is stated " * * * public policies to cope with increases in the price level must take the form of general fiscal and monetary restraints on the expansion of total spending."

that there exist economic limits and even more stringent political limits on the Nation's capacity to tax its citizens. For brief periods, under certain circumstances, this limit may run as high as 40 to 50 percent of gross national product. In the United States, and for extended periods of time, it is likely to be significantly smaller. The existence of a limit on the capacity to tax imposes a limit on (non-inflationary) government spending. The higher interest payments are, therefore, the less will be the funds that are available for other purposes. It is conceivable that, when no consideration is given to the growth of the public debt, an intolerable budgetary situation may develop in which interest payments, in addition to other necessary expenditures, add up to more than the amount supportable by the state's fiscal capacity, with the implication that the debt must perennially grow. Something of this sort did develop in France during the 17th and 18th centuries, and was in no small measure a cause of the revolution. We must remember, however, that the fiscal capacity of a modern state is vastly greater than that of an 18th-century state.

Another related danger which is more germane to the United States is the menace of building in inflation via the public debt. In its ultimate form, the Nation faces the dilemma whether to service the debt by borrowing or to hold down the rate of interest and, therefore, expenditures through its control of the central bank. Rising prices bring about a rise in the natural rate of interest, which tends to increase the burden of servicing the debt. This contingency may be countered by holding down the market rate of interest and thereby stimulating excessive spending, further spurring on the inflation and so on. Happily, we seem to be nowhere near this state of affairs at the present time, though we may have been caught in its toils for a brief period after the Second World War. The rapid fall of the burden of the debt (relative to gross national product) in the last decade has steadily reduced the urgency of this problem.

THE CONTRIBUTION TO STABILITY AND TO GROWTH

In attempting to summarize the relationship of government interest payments to stability and growth, it must be observed at the start that their main direct relevance is the vital role they play in stabilization. In order to contribute to stabilization, interest payments must be accommodated to the natural tendencies of the rate of interest. The obstinate desire to hold down the interest rate on the public debt may simply bring inflationary consequences.

Interest payments are the price of proper debt management. Debt management ought to be designed to relate the liquidity of the debt to the liquidity needs of the economy. Short-term debt or long-term debt with pegged prices is highly liquid; an excess of such instruments adds to the inflationary bias of the economy. To reduce liquidity, a large proportion of the debt must be put into the hands of "firm holders"—preferably on a funded basis. So long as our present monetary arrangements last, adequate interest payments are essential to the achievement of a firm holding of the public debt. If Treasury issues are obliged to compete with private issues for the available funds, the interest rate on government securities must be competitive and must, therefore, reflect market forces. Once again it appears that

there is no alternative to a flexible interest rate, and in this respect, rising interest payments in good times are a *sine qua non* of stabilization policy within our present monetary framework.

In regard to growth, interest payments can contribute little save indirectly. To the extent that destabilization militates against growth, the contribution that interest payments make to stabilization may be essential to growth in the long run. In the short run, however, the rate of growth is largely dependent upon the rate of capital formation—and thus merely reflects the resources made available through nonconsumption of national output. It is sometimes asserted that the capital-rationing process associated with rising interest rates discriminate unduly against the type of investment which in the long run is most productive both industrially and socially—to wit, construction, railroads, public utilities, and borrowing by local school boards. There is certainly some truth in this assertion since these are the segments of the capital market most sensitive to changes in the interest rate. Unless we are willing to accept direct controls for the allocation of capital with all that this implies, there is, however, no alternative. From the economic standpoint, the proper remedy is to increase the rate of saving, by supplementing private savings via a surplus in the Federal budget. The rationing process is implicit in the interest-rate mechanism.

THE QUESTION OF ALTERNATIVES

Since there is little doubt that present interest payments do constitute a drain on the resources available for other governmental activities and a burden on the taxpayer, can anything be done to lower the cost of servicing the debt? Since the interest rate, in itself, ought not to be controlled, are there possibilities for the reformation of our monetary framework which might alleviate the burden of the debt?

Over the long run, it is worthy of note, the growth of Government trust funds promises to promote an attenuation of the problem. The social-security fund is now approximately \$24 billion and, it is hoped, it will continue to grow for the rest of the century. In all, trust funds and other accounts of the Government hold some \$53 billion worth of Federal securities. The Federal Reserve System, which remits 90 percent of its profits to the Treasury, holds an additional \$24 billion. As the holdings grow, increasingly the effect of interest payments is to swell the size of the funds, thus permitting a level of social-security taxes somewhat lower than they might otherwise be (and also, lower insurance deductions for Government employees and others). Payments to the Federal Reserve System are in large measure simply paper expenditures. As the proportion of the public debt in the hands of the trust funds and the Federal Reserve System increases, it implies (a) a lessened net drain on resources, and (b) firmer holding of the public debt, reduced shiftability, and, therefore, lessened danger of a "liquidity time bomb."

Yet, on the other hand, interest rates are rising internationally. This may reflect rising demands for capital, the inflation itself, and, perhaps, some fall in the tendency to save. The Congress, in framing new banking legislation, may wish to keep this problem of alternatives in mind. In a modern economy the money supply in no inconsiderable measure is created through the monetization of public

credit. When the commercial banks monetize public credit, they receive the interest payments; when the Federal Reserve monetizes the public credit, most of the interest payments revert to the Treasury. If the burden of servicing the public debt is regarded as too onerous, the Congress might desire to force a larger portion of the debt into the Federal Reserve System. This could be accomplished by raising reserve requirements and, thereby, reducing the expansion power of the banking system. The Federal Reserve would then find it necessary to supply additional reserves and in the process would acquire additional debt. For example, the required reserves of the member banks are at present about \$18 billion; doubling of the present reserve requirements would imply that the Federal Reserve System would expand its debt holdings by an approximately equal amount.

Such action would imply a retreat from the fractional reserve system. Before embarking on such a course the advantages of the fractional reserve system ought to be weighed. It is more flexible and better adapted to the needs of the economy than, for example, is a 100-percent reserve system relying solely on the monetization of public credit. It has the advantages of the status quo; it is understood; it is institutionalized. Any attempt to change it would be vigorously resisted. Yet, it is true that one way of dealing with the problem of a large interest-bearing public debt is to reduce the burden by moving away from the fractional reserve system. Whether the benefits are equal to the costs is a question of political judgment.

In mentioning this possibility of institutional change, it might be in order to reiterate that short of outright inflation there is no real alternative to permitting variation of the interest rate under our present institutional arrangements. Interest-rate variations, it may be demonstrated, have some inflationary impact in themselves, yet these side effects are negligible when compared to the loss of control over the money supply. Interest-rate variation means changing interest payments, and the latter are indispensable to the maintenance of economic stability. Restraining increases in interest payments by funding the debt, however, may serve to protect the process of economic growth.