There is always a counterpart to the government deficit somewhere in the private sector in the form of a surplus.

There is a simple logical inconsistency in the public’s anger with the government deficit itself and with the continued demands for the return of the era of surpluses.

Contemplate the first chart below. It describes a simple mathematical proposition. One sector’s deficit is another sector’s surplus and vice versa. If you consider for a moment the financial position of the U.S. government vis-à-vis the financial position of the non-government sector (domestic and foreign), it is always the case that the government deficit “goes somewhere”—it is accumulated as a surplus by the private sector. There is no law that can repeal this logic. If the government puts into the economy more than it takes out, the private sector as a whole takes in more than it pays out to the government.

Conversely, when the government runs surpluses, then the non-government sector must run deficits. Contemplate for a moment the Clinton surpluses of the late 90s.

If we want the government to correct its budget stance, then we must necessarily be asking ourselves to correct ours. If we demand that the government runs a
surplus, then we are demanding that we, the private sector run a deficit. If we are demanding of the government to pay off its entire debt, then we must be demanding that every single private portfolio, retirement, or college fund lose its Treasury securities (in this case, the private sector will get dollar reserves in exchange, but chances are that the private sector prefers the interest income the Treasuries pay). The government’s deficit is someone else’s surplus and the government’s debt is someone else’s asset. If you want to wipe out one, you must be asking to wipe out the other.

Recall the Clinton surpluses. What was then considered to be a very ‘prudent’ government stance was in fact only possible because the private sector acted imprudently and ran negative savings for many years. So, take your pick: would you like the private sector be in surplus or the government? You cannot have both. Presumably, we’d prefer the private sector to save and accumulate financial assets, which means that the government must run a deficit and accumulate financial liabilities... Because most people do not think about this basic accounting relationship, they tend to think that a responsible government is one that acts like a household, without recognizing that a ‘responsible’ government is possible only with an ‘irresponsible’ private sector behavior and vice versa.

Now, when I speak of the non-government sector, I put the private domestic and private foreign sectors into one category, which is only useful to drive the point home that one sector’s deficit is another’s surplus—a point which is sadly too often lost in the debate about the government budget. Another way of looking at these balances is to disaggregate the non-government sector into domestic and foreign.
This chart provides more nuances. When the capital account is in surplus, the U.S. is running a trade deficit and foreigners are running trade surpluses vis-à-vis the U.S. So if the private domestic balance was zero (see early 2002), then every dollar of government deficit spending is exactly accounted for by the foreign sector’s surplus. But the private domestic sector normally likes to have positive saving (the blue bar graph is normally above zero). If our trade balance was zero, then in order for the private sector to save, the public sector must dissave an equal amount—to the penny! *But when both the private domestic and private foreign sectors want to run surpluses, the federal government will by definition run deficits equivalent to those surpluses in magnitude (again to the penny).*

So let’s pause for a moment, clear the head from all the political vitriol surrounding government spending and ask ourselves. What must happen if the government budget moves into surplus? Answer: In the presence of a large trade deficit (i.e., foreign sector surplus), there is only one solution—the private domestic sector (that is non-financial, financial firms and households) must move into a large deficit position to make up for the surpluses accumulated by government and foreigners. That is a ‘solution’ of pushing the private sector into more debt. Hardly a prudent solution.

If you want both the US private sector and the government to be in surplus, then the foreign sector must be in deficit vis-à-vis the U.S. That is the U.S. must run trade surpluses. But you can’t force a world that is tripping to sell its products to the U.S. to reverse its trade policy and become a net importer vis-à-vis the U.S. Export led growth is not a global solution for many other reasons, but since the U.S. is expected to runs trade...
deficits for the foreseeable future, how do you propose that the government to move into surplus? By pushing the private sector into deficit and asking it to accumulate more debt?

I think that all of us will agree that it is prudent for the private sector to accumulate savings, so we must be in agreement then that the prudent thing for the government to do is to allow us to be prudent by running deficits. In other words, a truly prudent government is one that does not mimic the behavior of the private sector, but one that offsets it.

Once you recognize the import of this irrefutable relationship, you can justifiably ask three questions.

First, “Will the U.S. government run out of money while it maintains its deficit position?” The answer to the first question is ‘no’—the U.S. government pays all of its obligations in dollars (from veteran benefits to social security to interest payments on debt) and for a nation that controls the issue of its own currency (in our case the dollar), there is no economic rationale that will ever justify default—promising to make payments in dollars, but refusing to do so. Any refusal to pay its obligations will be voluntary and political, not technical and operational. (Note countries like those in the Eurozone can and will default—they do not control their currency.)

The next question would be: “If deficits always go somewhere, where do they go? Whose incomes, cash flows, and balance sheets do they improve? What do we get in exchange for this deficit spending, how many jobs are created and do the deficits foster shared economic prosperity?” If the public does not like the answers to these questions, then the proper electoral response is to demand from the government not to cut programs to ‘fix’ the deficit, but to redirect the deficit to fix the real problems of the economy or the public’s policy priorities.

Once we take care of the economy, the debt and deficits take care of themselves.

And the third important question would be: “Should the government spend willy-nilly on whatever it pleases since it doesn’t face involuntary default?” and the answer to that question is most definitely no. Not all deficits are created equal: some create more inequality and more rentier income, as it seems to be the case in the current crisis. Others can cause inflation. Yet others can directly create jobs, public investments, and productive capacity without generating inflationary pressures. In sovereign currency nations, a truly responsible government spending is one that is measured not by the debt-(or deficit)-to-GDP ratios, but by the real impact of that spending on the economy—job creation, poverty alleviation, stable prices, income distribution, social goods provisioning are all good measures for assessing how responsible government policy has been.

(March 2009, updated 2014)