President Reagan delivered his fiscal 1986 budget to Congress last month with a wide smile and much self congratulation. It was a bitter moment for the Democrats. Reagan reminded them of the sick economy that prevailed when he took office in 1981, and pointed out the gains made in unemployment, inflation, interest rates and industrial output.

The president also referred to four fundamentals in his original economic platform. These were, first, the reduction in the growth of federal spending; second, lower taxes; third, reduced federal regulation; and, fourth, a sound and steady monetary policy to encourage economic growth and bring inflation under control. All these goals, he claims, were accomplished. Only a passing and veiled reference to the budget deficits that are “a far cry from our goal of a balanced budget” hinted that any target has been missed.

What he left unsaid, and what was unassailed by his opponents, was the profound failure of his economic program. As stated at the inception of his term, this program called for lower taxes to balance the budget. This, in turn, was to bring down inflation and stabilize the economy. Not only does the budget remain unbalanced at the end of four years, but the deficits are continuing at the highest pace in history. According to his own projections, by the end of Reagan’s second term, his administration will have presided over total deficits of $1.5 trillion, an amount equal to 1% times as much debt as the government accumulated in its entire history up to Reagan’s first inauguration.

Does the continuing deluge of red ink really matter, considering the ap-

(Updated: This article first appeared in Common Sense Viewpoint Magazine and is re-published with its consent. The author of the article is John A. Pugsley, editor of Common Sense.)
“The entire economic structure in this country is supported by a framework of misplaced confidence . . . at some point—and no one can predict when—it will dawn on savers that they are being duped and their confidence in the future of the American economy will fall.”

Not according to either Reagan or the majority of analysts and experts who are looking ahead. Regardless of the brouhaha over deficit reductions, projections for our economic future are rosier than ever. Here are Reagan’s views of what the next five fiscal years hold, provided all the changes proposed in the budget are enacted by Congress:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal deficit (In billions)</td>
<td>4223.6</td>
<td>-4230.3</td>
<td>-$245.6</td>
<td>$247.8</td>
<td>$232.8</td>
</tr>
</tbody>
</table>

From his projections, we can see that continued massive deficits don’t seem to concern Mr. Reagan as seriously in this term as they did at the beginning of his first one. He is, of course, basing his current view on the experience of his first four years. If the

And if the proposals are not enacted, and spending continues as now mandated under current law, the deficits would be:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal deficit (In billions)</td>
<td>-$222.2</td>
<td>$180.0</td>
<td>-$164.9</td>
<td>-$144.4</td>
<td>-$107.5</td>
</tr>
</tbody>
</table>

Let us discuss the two great anomalies—inconsistencies that must be explained, not swept under the rug. First, official budget projections have always underestimated the eventual economic outcome. Why? Because they are politically engineered to present the case that the incumbent administration wants to make, and because politicians never want to reveal the true depth of the economic problems they are creating. Federal budgets are projected using the cash basis of accounting instead of the accrual basis. This means that all accrual debts being run up each year by government (i.e., the debts that aren’t due this year, but will fall due in future years) are excluded from the budget. If they were included, we would see that the government is not currently running $200+ billion deficits each year, but rather $400+ billion deficits. It is these accrual debts that pile up and must be paid in future years. In other words, the government chooses to use a phony accounting system to camouflage the extent of its spending. The projections are political underestimates. They are nonsense.
The second inconsistency that must be explained is the belief that budget deficits don’t matter. This belief is based on the short-term experience of the past three years in which inflation and interest rates fell, and the economy expanded, in the face of the largest deficits in history. To say these deficits don’t matter is to close one’s eyes to common sense.

If we stop playing games with ourselves, we know that the money is not merely being “borrowed.” The money the government takes in by issuing T-bills and T-bonds is spent and is permanently gone. We are sitting in the middle of a blizzard of irredeemable paper. The inescapable conclusion drawn from this is that someone, sometime, somewhere must take the loss—there is no other possibility. The only question is, how will the loss be felt?

Let’s look at the figures. The government, according to the conservative estimates of the administration, issued $675 billion in IOUs during the first five fiscal years of the 1980s. In the second half, it will issue, by its own estimates (which are unquestionably low), somewhere between $800 billion and $1,100 billion more. Thus, in a decade, it will have issued between $1.5 trillion and $1.8 trillion in IOUs. At this point, gross federal debt is roughly $1,660 billion. Subtract from this the amount the Fed has already monetized ($160 billion) and you have government IOUs amounting to $1.5 trillion in existence.

These are pieces of paper that are intrinsically worthless. By the end of the decade, the total will most likely double to approximately $3 trillion. This is $3 trillion of potential purchasing power—$3 trillion that individuals believe constitutes “wealth” or buying power.

The Emperor Has No Clothes

What are these certificates that people believe constitute “savings,” and which they and their banks carry on the books as “assets?” The certificates are neither wealth nor assets. In reality, they are nothing more than tax receipts — evidence of money taken from someone and consumed by government—and their only value is
“People save only because they believe that it will result in future benefits. When they loan their savings to the government those assets are silently devoured by government, not used productively.”

created in the confused minds of those who buy, hold and trade them.

This is a crazy, lethal game, yet almost everyone is playing it. Truly, it is like the story of the “emperor’s clothes” that didn’t exist, but no one had the courage to admit that the emperor was naked! Federal debt is a fraud, yet intelligent and otherwise rational people continue to stare blankly into the future and claim that deficits don’t matter.

When confronted with the question, What about the deficits?, the standard answer (when one is given at all) is that “they don’t matter as long as people save more.” As savers around the world temporarily pour their savings into Treasury bills, it definitely postpones the effect of massive government deficits. As long as individuals mistakenly perceive that T-bills are really debt securities, and people buy and hold them, it takes the pressure off the Federal Reserve to monetize them, and this holds down money growth.

But any fool should be able to deduce that such a situation must eventually reverse itself. Those worthless certificates cannot be eaten nor converted into clothes or houses or machines. They are not real, but imaginary, wealth.

The entire economic structure in this country is supported by a framework of misplaced confidence. Reagan’s euphoria over the state of the economy, inflation and interest rates will last only as long as the public remains blissfully ignorant of this truth. People save only because they believe that it will result in future benefits. When they loan their savings to the government those assets are silently devoured by government, not used productively.

Budget Projections Are Wishful Thinking

At some point—and no one can predict when—it will dawn on savers that they are being duped and their confidence in the future of the American economy will fall. Once that occurs, there will be an exodus from dollar-denominated securities. T-bills won’t become worthless, at least not immediately, but the symptoms will be a falling dollar, rising inflation and rising interest rates. The last will stall the economy, recession will threaten and the Fed will finally have to monetize the debt—something it has managed to avoid over the past four years.

The Reagan program of supply-side economics failed to produce the single important benefit it claimed — a balanced budget. Reagan may take credit for lower inflation and a robust economy, but this credit is undeserved. The economy has prospered in the face of huge deficits for one reason—individuals have absorbed the debt in a false belief that the IOUs of the U.S. government are true wealth. For this reason, a rational person will look at Reagan’s new budget in a completely different light.

The budget projections which call for lower inflation, lower interest rates and lower unemployment, accompanied by stable GNP growth, are wishful thinking. The deficits will worsen, and the economy will soon recapture the postponed effects of profligate Washington.

Protect Your Investments from Disaster

How should this news affect your investment decisions? Be aware that the current boom will not continue indefinitely. The pronounced economic cycles that characterized the 1970s are still being played out, although with some delay. When domestic and foreign savings stop flowing into our equities markets, the dollar will fall, inflation will soar and interest rates will move to new highs.

For the time being, stocks are still a good bet. Gold and silver remain in the doldrums and commodities are stagnant. But the time is drawing near for a change. Don’t be lulled into complacency. Be ready to move to inflation hedges as soon as the trend reverses.