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U.S. Budget Deficits and Economic Policy

Address by

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I am honored to present the Marsh-McLennan American Enterprise Lecture this year. As you know, part of the objective of this lectureship program is to discuss concerns relating to the private enterprise system.

The subject of my address tonight is the federal budget deficit and its impact on the U.S. economy. I want to talk about the budget deficit and economic policy not only because it is closely related to the theme of this lecture program, but also because I believe the way in which we attempt to deal with this issue is so important to our future. Unfortunately, I believe the budget deficit issue is one of the most misunderstood and confusing issues of recent years.

Accordingly, tonight I would like to, first, explain why I think there is so much confusion surrounding the issue of budget deficits. Second, I would like to suggest what I believe to be the proper goal of fiscal policy. And, finally, I would like to emphasize what I consider to be four key elements of any viable program to deal with the deficit.

Reasons for the Misunderstanding and Confusion Surrounding
Budget Deficits

Let me begin by making an observation that most of you will probably agree with: events in recent years have underscored the view that conventional macroeconomic theory is in disarray. At least part of the reason for this disarray is the way fiscal policy has been portrayed by many economists. And the budget deficit is one of the most misunderstood and confusing elements in these portrayals.

I think there are at least six basic reasons for so much confusion surrounding discussions of the budget deficit. First, there are important disagreements concerning its proper measurement. While the nominal deficit is the most commonly used measurement, many economists contend that a real (price deflated) measure is more meaningful in an economic sense. Others contend that the deficit should be measured as a proportion of GNP or as a percentage of the savings pool. Arguments are also made that off-budget spending should be included or that the budget should be divided into a current and a capital budget. Still others suggest that state and local government deficits or surpluses should be included in the overall measure. It is also common for the deficit to be adjusted for cyclical factors so as to measure a full-employment deficit or surplus. Indeed, researchers at the Board of Governors have devised a measure of fiscal thrust referred to as a fiscal impetus measure. This measure is a weighted difference of discretionary federal

spending and tax changes (in 1982 dollars) scaled by real federal purchases.¹

All of these alternative measures contain an element of truth and different measures may be appropriate for alternative perspectives. Nonetheless, these alternative measures do add to the confusion surrounding public discussions of the deficit. But, in spite of this confusion, these alternative measures do generally suggest that the deficit has declined in recent years and provide a somewhat more sanguine picture than the nominal figure so often mentioned in the popular press.

A second reason for misunderstandings about the budget deficit is that these deficits can be caused by very different factors. For example, they can be caused by changes in economic variables such as slowdowns in business activity; sharp, unanticipated decelerations of inflation; or by sharp increases in interest rates. On the other hand, increases in government spending or decreases in tax revenues unrelated to economic activity can also be fundamental determinants of deficits. Some economists believe that our current budget deficit was caused by tax cuts, whereas others believe it is the result of continued rapid government spending. Still others argue that it was caused by the recession and the sharp unanticipated deceleration of inflation experienced in the early 1980s.

A third reason for confusion surrounding discussions of budget deficits is that the effects of deficits depend importantly on their causes. Recession-caused deficits, for example, are not likely to crowd out private sector activity since decreases in private credit demands during recessions will likely outweigh the effects of increases in government borrowing. On the other hand, deficits caused by increases in government spending unrelated to economic activity will certainly crowd out private activity, particularly if such spending is additional government consumption.

Fourth, the effects of deficits depend in part on the reaction of (or expectations of) the private sector. If the private sector views tax-cut induced deficits as mandating future tax increases (and does not desire a future tax burden for its own generation or the next), then private sector savings behavior may change. In particular, saving may increase so as to finance the deficit without increasing interest rates or crowding out private sector activity.

Fifth, the effects of deficits also depend on the reaction of monetary policy. If the central bank persistently monetizes budget deficits, increased inflation is likely to follow. Such inflation has often occurred in countries that do not have independent central banks. But it can occur whenever any monetary authority attempts to stabilize interest rates at low levels in the face of large

deficits. In such circumstances money creation and inflation become another form of financing budget deficits. But if the central bank is committed to price stability, it will not monetize budget deficits and inflation will not result.

Sixth, the effects of budget deficits also depend in part on the savings pool, not just in the U.S. but in the rest of the world. More specifically, the effect of deficits may depend on saving and borrowing all over the world, not just in the U.S. All borrowers, including the U.S. government, must compete for the limited supply of savings and credit in global markets. Thus, even a deficit that is large relative to GNP or to the domestic savings pool may not crowd out domestic private investment if it is financed internationally. While investment may not be affected in this case, exchange rate adjustments may work so as to affect other sectors of the economy. Consequently, the precise effects of deficits may depend on the exchange rate regime as well as the degree of integration of world credit and capital markets.

The Role of Fiscal Policy

As you can see, there are many very important reasons for misunderstandings about budget deficits. With so much confusion about deficits--and deficits, after all, are the conventional measure of the thrust of fiscal policy

-- there can be little doubt that there is confusion about fiscal policy.

In this regard, let me make one additional point. And this point is a most important one concerning budget deficits and the confusion surrounding conventional analysis of fiscal policy. If the fundamental economic objective underlying fiscal policy is to promote long-term economic growth, then fiscal policy is not an appropriate tool to manage aggregate demand in order to fine-tune or stabilize cyclical economic behavior.

The view that fiscal policy was needed to help in stimulating spending may have been appropriate in the special circumstances of the Great Depression. Aggregate demand, after all, had collapsed in the 1930s because of inappropriate monetary policy, and a restimulation of aggregate demand was desperately needed to foster spending. In this special situation, where financial intermediation no longer adequately functioned to foster monetary expansion through the private sector, fiscal policy could, in effect, be used as a vehicle to enhance the effectiveness of monetary policy and in this way help to bolster aggregate demand. In short, deficits might have served a useful function by working to re-generate the velocity of money.²

But today, the central bank fully understands both its mission and the tools at its disposal. Monetary policy can and will influence aggregate demand so as to promote

price stability. Consequently, a longer-term orientation of fiscal policy is called for.

With this forward-looking role of fiscal policy in mind, it is appropriate to question the common contention that in recent years the U.S. has adopted the wrong policy mix. More specifically, it is commonly asserted that the combination of "expansionary" fiscal policy and restrictive monetary policy is inappropriate. Advocates of this position view the goal and purpose of fiscal policy to be the management of aggregate demand. They view monetary policy and fiscal policy as substitute tools for this objective. If the proper role of fiscal policy is interpreted to be the promotion of long-term economic growth, however, this characterization of "easy" fiscal policy and tight monetary policy is misplaced. If fiscal policy is primarily a tool for expanding economic potential, monetary policy and fiscal policy are complements in an overall macroeconomic strategy for price stability and growth. And a strategy of cuts in marginal tax rates, along with commitments to both contain spending and pursue a price-stabilizing monetary policy, is certainly not an inappropriate policy mix.

Key Elements in Any Solution to the Budget Deficit

Where does all this leave us with regard to a strategy for solving our current deficit problem? I believe we must keep four key points in mind.

First, it is undoubtedly true that large and continuous deficits potentially can be disruptive and therefore should be reduced. Such deficits, after all, absorb saving that could otherwise be employed in financing more productive private sector activity and additional economic growth.

Second, any deficit reduction strategy should keep the longer-term fiscal policy goal of fostering economic potential as a primary objective.

Third, if this longer-term objective of potential growth is the primary goal of fiscal policy, then restraint in government spending is clearly the best way to pursue this goal. More specifically, given a price-stabilizing monetary policy, government spending must be financed either by borrowing or taxation. But both government borrowing and taxation have adverse effects on economic growth. Borrowing absorbs savings that could otherwise be used for productive private investment, and taxation adversely affects incentives to work, save, invest, and innovate. Yet there is little evidence indicating that reductions of government spending have lasting adverse effects on overall economic growth. Indeed, it is most likely that it is the amount government spends, not the particular form of finance, that is the real burden imposed upon the public. Accordingly, it is likely the case that reductions in government spending,

especially in its most wasteful forms, actually work to increase long-term economic growth. And empirical evidence supports this view.³

It should be recognized that reductions in government spending do not necessarily mean that particular goods or services no longer are available. When government spending as a proportion of GNP becomes large--as is now the case--it is likely that many services provided by government can be provided more efficiently in the private sector. This is the message of the privatization literature and the unambiguous empirical evidence that supports it. It is this more efficient provision of services and thus more efficient utilization of resources that ultimately brings about more rapid economic growth and higher living standards.

Fourth, as suggested above, tax increases to reduce the deficit are inappropriate for a number of reasons. If potential growth is an important goal for fiscal policy, increases in taxes will most likely conflict with such objectives. This conflict is due to the adverse effects higher tax rates have on incentives to work, save, invest, and innovate. Tax increases likely will not work to reduce the deficit significantly, if growth is adversely affected. And if tax increases work to promote additional government spending, as some economists argue, then they almost certainly will not reduce the deficit. In any case, it is not clear that taxation is superior to borrowing as a

form of financing government spending, especially when the deficit is declining as a percent of GNP. It may well be the case that increased taxation is as costly or crowds out private sector activity just as much as borrowing.

Lessons for Resolving the Budget Deficit Dilemma:

In conclusion, there are important lessons to be learned from the federal budget experience of recent years. Reorienting budget strategy to promote longer-term economic growth appears to be a most sensible goal of fiscal policy. I do not believe that it is just a coincidence that two of the longest, most vigorous noninflationary economic expansions of this century occurred after major tax rate reductions and during periods of relatively restrained monetary policy. But there can be no doubt that this is what happened following the Kennedy tax cuts of the 1960's and the Reagan tax cuts of the 1980's. One could argue that it was the excessive spending habits of the federal government in the second half of the 1960's that ultimately led to the disruption of the prosperity of that period. Hopefully, it will not be our failure to effectively restrain government spending in the 1980's and early 1990's that finally derails the current expansion.

Footnotes

- 1/ See, for example, Darrel Cohen, "Models and Measures of Fiscal Policy," Working Paper Series, Board of Governors of the Federal Reserve System, No. 70, March 1987.
- 2/ In some interpretations of the period, the collapse of the U.S. money stock had promoted a loss of confidence and made a proper functioning of monetary policy very difficult. In the U.K., Keynes' writing reflected the fact that British monetary policy had been severely constrained by the return to the gold standard at its pre-World War I par value. Consequently, monetary policy was rendered ineffectual in both countries and, in these special circumstances, possible temporary alternative roles for fiscal policy were proposed.
- 3/ See, for example, Landau, Daniel, "Government Expenditure and Economic Growth: A Cross Section Study," Southern Economic Journal, January 1983; Landau, Daniel, "Government Expenditures and Economic Growth in the Developed Countries, 1952-1976," Public Choice, 47, 1985; Plosser, Charles, "Government Financing Decisions and Asset Returns," Journal of Monetary Economics, Vol 9, 1982; Marlow, Michael, "Private Sector Shrinkage and the Growth of Industrialized Economies," Public Choice, Vol. 49, 1986; Saunders, Peter, "Public Expenditure and Economic Performance in OECD countries," Journal of Public Policy, Vol. 5, Part 1, February 1985; U.S Treasury Department, Office of the Assistant Secretary for Economic Policy, "The Effect of Deficits on Prices of Financial Assets: Theory and Evidence," U.S. Government Printing Office, Washington, D.C. 1984.