"TRUE FACTS AND FALSE PERCEPTIONS ABOUT FEDERAL DEFICITS"

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During the decade of the 1980s, the U.S. has enjoyed spectacular success in reducing inflation and unemployment, two problems that seemed almost insurmountable at the start of the decade. In 1982, the nation's unemployment rate was nearly 11 percent; currently, it is just above 5 percent. The inflation rate was running above 10 percent in early 1981; today, it's less than half that. In 1981, the prime rate was about 20 percent and corporate bonds were yielding over 15 percent; currently, the prime rate is 11 percent, and corporate bonds yields are down around 9 5/8 percent.

Unfortunately, at the same time that we have achieved some success in solving our inflation and unemployment problems, another problem has emerged. This problem, as you all know, is our much-lamented federal budget deficit. It seems to be as intractable now as our inflation and unemployment problems appeared to be at the start of this decade. I should confess that I don't have any sure-fire solutions to this problem. However, there are better and also worse ways that we might go about solving it.

How can we recognize the less costly, better solutions and avoid the more costly, worse ones? Only by making sure that our decisions are based solely on the "true facts" about federal deficits, and not on the commonly-held false perceptions that show up so frequently in public discussions of this problem. This afternoon, I would like to identify some of these false perceptions and review some of the important true facts about federal deficits. Let's first consider the more wide-spread false perceptions.

The first false perception about the deficit is that it is somehow "too big" for us to manage and certainly "too big" to persist for much longer. Given that our federal deficits have been running in the $150-$200 billion range for the past several years, it is not surprising that people are concerned about the size of the deficit. However, focusing simply on the absolute size of the deficit alone doesn't really tell us much about whether it is dangerously large or not. A much more useful way to look at the magnitude of the deficit is to compare it to the nation's income, for example, our gross national product. This year, the federal deficit-to-income ratio is about 3 percent, not too much above the deficit-to-income ratios that we ran in 1980 and 1981. Moreover, this proportion has fallen steadily and considerably since it hit 5.2 percent in 1983. Thus, when we look at the size and direction of movement of federal deficits relative to the size of the economy, we can see that the federal deficit is a much smaller problem than it is frequently made out to be.

The next false impression is that deficits cause interest rates to rise and inflation to accelerate. The reasoning behind this impression is straightforward: more government borrowing produces greater demands for credit and goods. Surely, if this is the case, interest rates and prices must rise. Well, while this logic may seem impeccable, it "just ain't so;" all evidence points the other way. For example, what has happened to interest rates and inflation rates since the federal deficits exploded upwards in 1982? As I noted at the start of this talk, they've been cut in half. Moreover, a host of studies over the past decade have failed to find any significant impact of federal deficits on interest rates or inflation.

The apparent contrary reaction of interest rates to government deficits has been documented in studies of other countries as well. For example, in six other major countries during the 1980's, lower deficits did not appear to produce lower interest rates. Thus, while one or two economists can always be wrong, or perhaps confused, studies by scores of economists tell us that our general impression about how deficits affect interest rates is simply false.

As for inflation, it is now generally accepted that inflation is caused chiefly by monetary pressures that affect all prices and, occasionally, by temporary influences that affect specific prices. The impact of OPEC on oil prices in the mid- and late-1970s and the recent drought's effect on food prices are examples of these temporary influences. Government deficits have never played a major role in inflation, at least as far as detailed studies have determined.

The third false impression is that the federal deficits represent a huge burden that we are somehow dumping on future generations, that is, on our own children. It is certainly true that, if the federal debt is paid off in future years through increased taxes, future taxpayers will bear this burden. But, it is just as true that the people who own the bonds at that time will receive these funds. Consequently, for the most part, the deficit does not impose a burden on future generations *per se*; it merely tells us that, eventually, there will be some future redistribution of income from one group of our children to another group of our children.

Well, so much for false impressions. What are the true facts about federal deficits ... the ones that we should consider carefully when we are looking for solutions to the deficit problem?

The first, and perhaps most important, true fact about federal deficits is that they use up our savings. What is so important about that? The only way that our economy can continue to grow, the only way that we can continue to produce more goods and services and jobs, is if we continue to provide for growth in the economy's productive capacity. This means that we must invest more and more in our nation's capital stock. If we fail to do so, our standard of living will inevitably erode over time.

Where does our investment come from? From someone's savings--either our own or from those of foreigners. Now, if we were world-class savers, then our own domestic savings could well support both our private investment demands and the federal deficit as well. Unfortunately, as a nation, we have not been among the best of savers in the 1980s. For example, since 1982 we, as individuals have saved, on average, slightly more than 3 1/2 percent of our income each year. This rate is abysmally low when compared to savings rates that have run as high as 17 percent in Japan and 20 percent in England in recent years. As a result, because federal deficits have used up a sizeable portion of our own savings, some of our investment funds have come from abroad. That is, we have had to borrow and borrow and borrow from foreign savers in order to fund both our federal deficits and our private capital investment projects.

Now, why should we worry about borrowing from foreigners? After all, if they are willing to lend us their savings, what's the problem? Actually, there are two reasons why relying heavily on foreign savings should concern us. The first reason is obvious. When we have to repay these loans, we will not simply be transferring income from one group of U.S. citizens to another group of U.S. citizens; instead, we will be transferring income--that is, goods and services--from U.S. citizens to foreigners. This "external drain" is the true burden or cost to us from borrowing abroad. Of course, if we had put these foreign savings to good use by profitable investment in domestic capital, then this burden could be easily paid out of our increased production down the road.

Unfortunately, not all foreign savings is used for private capital projects; some of it has been used to fund the federal deficit. Again, this "external" funding of our deficit is a measure of the deficit burden actually imposed on future generations. Fortunately, so far at least, it is rather small; at the present time, only about 13 percent of our total federal government debt outstanding is held by foreigners.

Reliance on foreign savings creates a second problem, however; one that has become acute at times over the last two years. The problem is financial market concern about foreign savers becoming increasingly reluctant to place more of their savings in the U.S.; indeed, there might even be fears that foreigners would decide to pull their previous savings out of the U.S. as well. If this were to take place, especially over a fairly short time period, there is likely to be significant turmoil in U.S financial markets and world foreign exchange markets. The net result could be substantially higher U.S. interest rates and greatly increased volatility and risk in our financial markets.

This problem is compounded because financial market participants, both in the U.S. and abroad, are uncertain about how U.S. policymakers might respond if they feel that such circumstances are likely. For example, there could be increasing concern that the Federal Reserve would attempt to drive up U.S. interest rates so that foreigners will continue to ship their savings off to the U.S. The "bottom line" from such a policy could well be almost the same result as if the foreigners had actually withdrawn their savings. Moreover, when the Federal Reserve has tightened too much in the past, a major slowdown in the economy has generally occurred. It's no wonder that financial markets might become concerned about potential policy actions designed to retain foreign savings in the U.S.

Thus, one true fact that stands out clearly is that, because of our abysmal savings behavior, the large federal deficits have helped to produce an influx of foreign savings. This result imposes a potential burden both on future generations and on present financial market participants and policymakers. This result alone tells us that we should take some action to reduce our federal deficits. But which, of the many possible actions currently being considered, should we take?

There is a second true fact about budget deficits that provides some help in pointing out the better alternatives to use for deficit reduction. Budget deficits, by definition, arise because government receipts fall short of government expenditures. Numerically, they can be reduced or eliminated by virtually any combination of increased government receipts and reduced government expenditures. However, our earlier discussion of the uses of savings and the need for greater productive private investment suggests that the better way to reduce federal deficits is to reduce government expenditures, not to raise government receipts.

I noted earlier that our budget deficit currently makes up only about 3 percent of our gross national product, not too much different from what it was at the start of this decade. An interesting question to ponder when considering what to do about the deficit is the following: How did the deficit actually arise? I'll bet that the popular answer to this question is that, during the 1980s, government expenditures were somewhat restricted, while government receipts fell because of the various tax reductions. People who believe this answer would argue that, since reductions in tax receipts "caused" the deficit, taxes should be increased to reduce the deficit.

While this view is widely held, it is factually wrong. Since 1979, government spending has risen about 2 percentage points per year faster than this nation's income, while government receipts have risen at just about the same rate as our GNP. Over the prior decade, just for comparison, government expenditures rose only slightly faster than our nation's income while government receipts actually rose somewhat slower than our GNP. To put it another way, at the present time, government expenditures are running about 23 percent of our gross national product, up sharply from about 21 percent back in 1979. Government receipts, on the other hand, equal about 20 percent of our gross national product now, just about the same proportion as in 1979.

What does this tell us about how to go about reducing the budget deficit? Simply that the "drag" that federal government activity imposes on the economy can be measured best by the size of government spending relative to total income. This tells us something about the extent of redistribution of resources within the economy from private uses, including private investment activity, to government. If we want to reduce the inefficiencies associated with removing resources from private uses, we should take actions that reduce the amount of government spending in the economy. If we look to see why deficits have risen so high in the 1980s, it is chiefly due to a major increase in the amount of government spending relative to private spending. Reducing government spending would reduce both the deficit problem and increase the efficiency with which our resources are used.

On the other hand, there seems to be little to recommend reducing deficits by increasing government receipts. Not only would this do nothing to rein in the size of government relative to the private sector, it would impose additional costs on the economy. As I mentioned earlier, one of our biggest problems, one that carried over from the 1970s, is the low level of savings in this country. If we could increase our savings rate sufficiently, the relatively low level of our government deficits would not pose an external problem--we could fund both our own government deficits and provide for satisfactory domestic investment as well. However, we can't do this at our current savings levels. Increasing government receipts by higher taxes, however, would, at least initially, reduce the level of domestic savings. Do we really want to do this?

In addition, higher taxes are likely to reduce the net incomes and, consequently, the investment demands of private business firms. It is difficult to see how reducing the extent of private investment in this country, even temporarily, would enhance our well-being.

Well, what have we learned from this tour through the federal deficit countryside? Simply that there are many false perceptions about the costs associated with federal budget deficits. These false perceptions have led people to argue that we have to reduce our federal deficits and that any way we do so would be an improvement over our current situation. Examination of a few true facts about the deficit tells us that this view is wrong. If we are truly concerned with the future of this country, we must be extremely careful about how we go about reducing federal deficits. In fact, we should consider seriously only those solutions that promise both to reduce the size of government in the economy and to encourage greater savings and capital investment. Any purported solution that does not guarantee to produce these results should be, and hopefully will be, rejected.