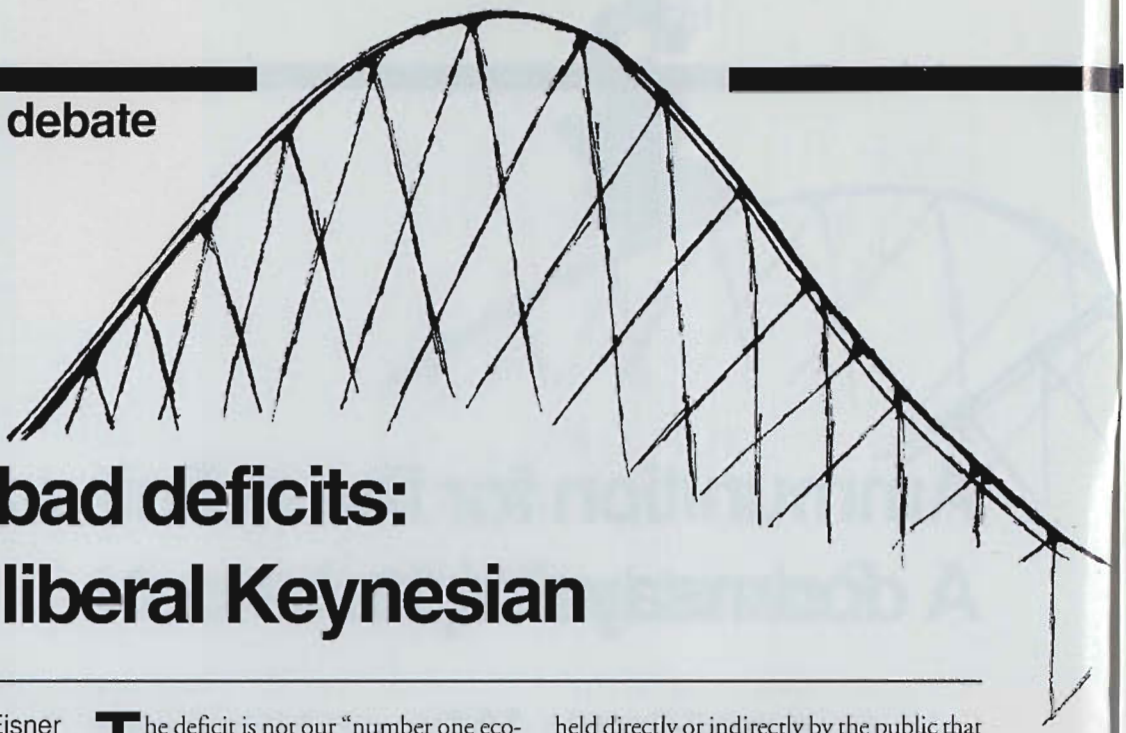
The great deficit debate



Good and bad deficits: Views of a liberal Keynesian

by Robert Eisner

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Our real problems are our need to move the economy to full employment now and invest for long-term growth in the future.

The fact is that a deficit can be too small as well as too large. You cannot tell which, unless you measure it correctly and relate it to the current economic situation.

Federal accounting should send chills down the spine of any business executive. If large American corporations followed federal rules, many of the most prosperous would have profit and loss statements in the red. Simply enough, the federal government, unlike private business—and state and local governments for that matter—has no separate capital accounts. All expenditures, whether real investment or acquisition of financial assets, contribute to the deficit. If federal accounts followed business practice, they would include depreciation charges instead of investment expenditures—estimated at over $200 billion by the Office of Management and Budget—and knock some $70 billion off the 1992 deficit figure of $290 billion.

What is more, deficits have economic significance largely because they add to debt. That means not only that the government owes more, but that the holders of that debt, still overwhelmingly the American public, own more. However, inflation eats away at the real value of this debt. Even a modest inflation of 3 percent yields an "inflation tax" on the $3,000 billion of federal debt held directly or indirectly by the public that amounts to $90 billion. The recession and slow economy of the past three years are responsible for another $100 billion of annual deficit. The inflation-adjusted, cyclically-adjusted, or structural current expenditure budget is thus in virtual balance.

An appropriate measure of overall balance might well be one in which the federal debt grows at the same rate as the national income, thus keeping the debt-income ratio constant. But one must understand—as few seem to remember—that the growth in the debt is precisely what we call the deficit. A rate of growth of 7 percent in the national income, surely attainable, with the federal debt held by the public at $3,000 billion, would thus imply that a "deficit" of $210 billion would be balance. And recession aside, that is just about where we are now. So the first response to the question of what to do about the deficit should be another question; "What deficit?"

If we measured deficits correctly, what could we say about them? The most important thing is that they contribute to more spending. In the first instance, since they mean that the government is giving more to the private sector than it is taking away in taxes, they give people and business greater net income out of which to spend. Another way of looking at this is to recognize that the bigger the government deficit, the more the public is adding to its wealth in the form of its holdings of treasury bills, notes, bonds, and cash. And if the public sees itself as

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excessive concern about the deficit will con-

increased persistently as a share of GNP.

ing transfers, would avoid persistent deficits.

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wealthier it will spend more.

But in our economy, where firms produce not by orders of a commissar but on the basis of what they can sell, more spending means greater production and greater employment. Simple charts and more rigorous statistical analysis make clear that over the past third of a century, greater real, properly calculated deficits were associated with greater subsequent growth in real gross national product and reductions in unemployment. Lesser deficits, or surpluses, were associated with lesser real GNP growth or actual decline, and with increases in unemployment.

This historical verdict has now been dramatically confirmed. Our really huge recent deficits, from 1982 to 1986, were a major factor in a sustained recovery from deep recession, a recovery that saw the official unemployment rate cut in half in six years. But what has happened to the relevant, inflation-adjusted, cyclically-adjusted deficit since then? Calculated from the Bureau of Economic Analysis high employment (6 percent unemployment) budget, that deficit *fell*, from 1986 to 1991, from 3.4 percent to 0.8 percent of GNP. This loss of fiscal stimulus may well explain the recession, surge in unemployment, and slow economy that came along in 1990, contributing to major public dissatisfaction and the change in administration in Washington.

Deficits can be too large if they cause spending to rise faster than our capacity to produce. They then contribute to inflation. They can also be too large if they somehow reduce investment, in this way and in this way only putting a burden on the future.

But deficits can also be too small. Unemployment is now 2 percentage points above the close to 5 percent level maintained from 1988 to 1990. It is some 4 percentage points above the rate of a quarter century ago. There is no ground for the gloom and doom that says we cannot do that well again. There are resources to produce more. There is room for more growth without inflation. It is an unfortunate set of values that would argue for deficit reduction now to depress the economy, because of the *possibility* that there might otherwise be more inflation or that in the "long-run" this is necessary to free additional funds for investment.

Lower structural deficits have in fact been associated with *less* subsequent private investment. And greater deficits have been associated with more investment, and for good reason. Increases in spending and output generated increased need for more productive capital, and the profits to finance it. Reductions in consumer spending are more likely to reduce than increase private investment.

But most critical to our future is the vast amount of public investment in infrastructure, to maintain and improve our roads, bridges, and airports and our resources of land, air, and water, and in research and in the health and education of our people. The real burden we are in danger of bequeathing to our future is a generation of semiliterate and illiterate school dropouts and countless more falling behind in the skills and training necessary to cope in a technologically advanced world. Deficit reduction that curbs our investment in human capital is the greatest folly of all.

What we can and should do now is ease our monetary constraints. A more liberal Federal Reserve policy would allow interest rates and the dollar to fall, thus stimulating domestic investment and exports and reducing our dependence on foreign investment. There would be a direct effect in reducing the deficit as each percentage point drop in interest rates would reduce Treasury interest payments by some $20 billion. A switch in Treasury financing to lower-rate, short-term securities would help in this decrease in the nominal deficit. The more prosperous economy would reduce the deficit further.

And then, most important, we should tackle our real deficits. We should offer whatever increases in government spending and tax incentives are needed to bring about full and speedy economic recovery. And we should place top priority on public and private investing in our children, our grandchildren, and ourselves.

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