

## Why Balance the Budget?

Remarks Before the  
Rotary Club of Grand Rapids  
Grand Rapids, Michigan  
October 30, 1997

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“Peter Pan” was at one time the longest running show in Washington, D.C. When asked why she thought that was the case, the star of the show, Sandy Duncan, said, “Maybe it’s because people inside the Beltway relate so well to fantasy.” That certainly seems to be the case when it comes to the federal budget deficit. But it is not just those inside the Beltway who believe in fiscal fairy tales.

The budget deficit has been public enemy number one on and off for about two decades. Jimmy Carter successfully campaigned for president in 1976, promising a balanced budget. Presidents Reagan, Bush, and Clinton later jousted at that same windmill, often at the expense of good policy. Today, we find ourselves magically transported to the shore of the Promised Land of balanced budgets. It is time to ask whether we really have arrived, and if so, what the promise is worth.

I question the assumption that the deficit is, by itself, bad. And I question whether balance is necessarily better. My intent is not to change your mind on the issue in the next fifteen minutes, if we happen to disagree, but rather to offer a different perspective for thinking about the deficit. I am not an apologist for undisciplined federal borrowing. A chronic budget deficit probably does have some negative effects on the economy, perhaps large ones – although there is no consensus among the experts. The Mother of Bad Consequences of a big, persistent budget deficit is that it obscures far more serious problems. Furthermore, these problems will not automatically go away when the budget is balanced. And, depending on how the budget is balanced, they can get worse.

### A Little History

Let’s start with a little history. Back in 1976, the national debt – which is all of the deficits and surpluses in the history of the country added up – stood at \$269 billion. The dirge of deficits since then raised the debt to \$5.4 trillion by last June. That was a big increase in a relatively short time, but these are merely numbers. They have meaning only in relation to the size of the economy. On that basis, the deficits from 1977 to 1997 still raised the national debt substantially, from 36% of gross domestic product (GDP) to about 69% today. The annual deficits responsible for this run-up in debt have been blamed for all manner of catastrophes.

- Deficits supposedly raise the threat that the government will create inflation to reduce the real burden of the debt.

- Deficits, it is widely believed, raise interest rates by increasing the demand for credit.
- Budget deficits have been blamed for the trade deficit, too. Higher interest rates, according to this line, increase the foreign exchange value of the dollar, which decreases our exports by making them more expensive overseas and increases imports by making them less expensive to Americans.
- The accumulation by foreigners of U.S. government securities is believed to make our economy dependent on the mood of foreign creditors and vulnerable to geopolitical blackmail.
- And lastly, deficits bankrupt our children and grandchildren by saddling them with heavy interest payments.

At least the situation appears to be looking up. After hitting a record \$290 billion in 1992, the deficit has steadily decreased. In the fiscal year just ended, the deficit was about \$30 billion – only one-quarter of a percent of GDP and the smallest in both percentage and dollar terms since 1974. What is more, Congress and the president agreed this past summer to balance the budget by 2002. Indeed, no sooner was the ink dry than some people started to call for running a surplus to pay off the national debt. Presumably the objective is to reduce and eventually eliminate the corresponding interest payments.

This idea reminds me of the story about the prisoners of war who used cans of sardines as money, passing them from hand to hand in exchange for other goods. One day, a prisoner detected a terrible stench wafting from a corner of the barracks. He went over to investigate and found that a fellow prisoner had gotten hungry and opened one of the cans. “You fool,” he said, “those are *trading* sardines, not *eating* sardines.” We might find the economic consequences of paying down the national debt – instead of just trading it back and forth – as unappetizing as those stinky fish, but that’s a different kettle.

### Defending the Deficit

More to the point, the negative effects of a budget deficit are overblown.

- First, the long string of budget deficits has been associated with falling, not rising inflation. Consumer prices increased at an annual rate of 7% in 1970s, when the budget deficit averaged 2% of GDP. In the 1980s, inflation slowed to 5½% in the 1980s, while the deficit doubled. Now, there is a risk that the Federal Reserve could come under pressure to lend directly to the Treasury, which would create inflationary growth in the money supply. Yet the conditions have been right for this for more than a decade, and it has not happened. The Federal Reserve is among the most politically independent central banks in the world, and thereby extremely unlikely to be co-opted into debasing the currency.
- Second, the budget deficits have coexisted with falling, not rising interest rates. The yield on the government’s 30-year bond hit 15% in 1981, when the national debt was one-third of gross domestic product. After 16 years of budget deficits that pushed the debt ratio up to two-thirds of GDP, the bond yield is down close to 6% today. The

reason that government borrowing has not raised interest rates is that even a few hundred billion dollars is small change in the multi-trillion dollar global capital market.

- Third, there is no direct connection between the budget deficit and the trade deficit. In 1987, the \$150 billion budget deficit was almost exactly matched by the \$142 billion trade deficit. By 1992, the budget deficit had swelled to \$290 billion and the trade deficit had shrunk to only \$30 billion. Since then, the budget and trade deficits have gone in opposite directions again. The budget deficit has decreased to about \$30 billion and the trade deficit has increased to about \$150 billion. If you were to draw any conclusions from the relationships between the deficit and inflation, interest rates, and foreign trade, they would be just the opposite of conventional wisdom.
- Fourth, the share of the national debt held by foreigners has increased significantly, from less than one-twentieth in the 1950s to one-sixth in the 1980s to one-third today. But this is more of a blessing than a menace. The tremendous inflow of foreign capital during the last fifteen years has enabled us to invest more than our meager savings would have permitted. This investment will make possible faster economic growth than we otherwise would have been able to enjoy. Regarding the risk of foreign manipulation, the Prime Minister of Japan made an idle threat last June to sell large chunks of U.S. Treasury bonds. But foreign investors could not disrupt our markets by dumping securities without inflicting significant financial pain on themselves. It comes down to the fact that where we keep our assets is more important than where we park our liabilities. We would be in a much more precarious position had we *lent* a trillion dollars overseas than we are in, having *borrowed* it.
- Lastly, what about mortgaging the future? My initial response is that the interest payments are among the least destructive expenditures made by the federal government. They do not interfere with the functioning of the market-place, finance wasteful or counterproductive ventures, or deprive anyone of their lawful possessions. More broadly, though, this is exactly the point; it's just that the deficit is not the issue.

### What's the Problem?

The reason is that our standard of living depends heavily on how well we use our resources – land, labor, and capital. It's like the story about the man who passed a newsstand every morning on the way to work and left a quarter, but never picked up a newspaper. One day, the owner of the newsstand finally stopped him. "I know what you're thinking," said the man, "You're going to ask me why I've been paying for a paper and never taking one." The vendor replied, "Not really. I just wanted to tell you – they've raised the price to 35 cents." The problem is not that government spending has been financed so heavily by borrowing, it is that the spending has purchased so little and the cost just keeps climbing. Although, we might take comfort from Will Rogers, who said, "Just be glad you're not getting all the government you're paying for."

Put another way, how the government spends money is a lot more important than where the money comes from. Take the case of two identical young men, each with \$100,000. Suppose the first young man uses the money to buy a fast sports car and make

frequent trips to Club Med. And suppose the second uses the money to get an education or finance a new business. Who is likely to be more prosperous thirty years later, the young man who consumed the money or the young man who invested it? Does the source of the money affect the outcome? Even if the first young man has the advantage of a fat bank account and the second young man has to borrow the money, the results would be the same. Similarly, how the government deploys the resources under its control has a far greater bearing on the economy than does the mix of taxing and borrowing that finances those resources.

At the risk of putting too fine of a point on it, the problem is not that the government *borrow*s too much money, the problem is that government *waste*s too much money. The public sector produces less than the private sector with the same amount of resources, because it is not disciplined by the competitive forces of the market-place that breed success and flush failure. As a result, the more resources that are allocated to the public sector, the lower will be the overall level of economic activity.

Now, there are a number of legitimate functions for the federal government – things that the private sector would not execute well, such as providing for the national defense. But the problem is that government has expanded beyond these core functions into areas that are better left to private enterprise or left alone. The federal government spent more in the last twelve months than it spent cumulatively from 1800 to 1940, after adjustment for inflation. Social programs account for two-thirds of the budget, and never before has defense spending been a smaller component of the budget than it is today. The stretch by government wastes scarce resources and undermines its ability to perform legitimate duties. Like Arthur Godfrey said, “I’m proud to be a tax-paying American, but I could be just as proud for half the taxes.”

What it comes down to is that the level of government spending has a greater influence on the economy than how that spending is financed – the mix of taxing and borrowing. [300-0-600] Balance is good in general, but achieving the right balance between the public and private sectors would be better for the economy than achieving a balance between federal revenues and expenditures.

In addition, government tax, spending, and regulatory policies interfere with private decisions in ways that cause us to consume more and save less, which also restrains economic growth. The United States has an embarrassingly low saving rate, compared with other major industrial nations, in large part because we tax income used for consumption only once and income that is saved two or three times.

For example, under the income tax, wages, salaries, dividends, interest and capital gains are all taxed as personal income. If we spend that money on a new car there is no further tax liability on the car or on the return or value we get from driving the car. On the other hand, if we take those same after-tax dollars and save them or invest them in a business, then the return or value received from those savings is taxed again when the business distributes the profits back to the investors in the form of dividends or capital gains. This system penalizes saving and investing and thus encourages consumption.

## Sweet Dreams

Let me end by describing a cartoon I saw recently in *Barron's*. A young boy is drifting off to sleep, as his father sits by his bed reading, "... So the Congress balanced the budget in seven years, reduced taxes, increased Medicare and we all lived happily ever after." That is a fairy tale that will not come true. The issue is economic growth, not deficit spending. Balancing the budget will not improve the nation's growth prospects, and it could be done in a way that inhibits growth. Just as in "Peter Pan," the answer lies in our willingness to stop being children.