

DO DEFICITS MATTER?

by

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The federal budget deficit for fiscal year 1989 was \$152 billion. In December, the 1990 deficit was supposedly reduced enough (with the help of a small sequester under the Gramm-Rudman-Hollings (GRH) procedure) to meet the target of \$100 billion. Then, the President's budget for 1991 said the deficit will drop next year to \$63 billion, again meeting the GRH target. It sounds as if we are making progress--an improvement of almost \$100 billion from 1989 to 1991. And 1991 looks good compared to 1986, when the deficit was over \$220 billion.

But the Congressional Budget Office (CBO) tells us things are not so rosy. In January, CBO estimated that the deficit for 1990, instead of meeting the GRH target, was more likely to be \$135 to 140 billion. And the baseline deficit for 1991 was in the same range, \$75 billion above the target.

In March, the picture worsened because of rising estimates of the cash required for the savings and loan debacle. CBO's new estimate of the deficit for 1990 rose to \$159 billion and its baseline for 1991 was pegged at \$161 billion, almost \$100 billion above the target.

The reality is even more discouraging. In my framework, we have not made a nickel's worth of progress on the core problem, a huge deficit in the general fund. All we have done is hide it.

Today you have asked us whether or not any of this makes a difference. Do deficits matter? My answer is an emphatic "yes." They matter because they rob the future.

To explain that answer, I need to explain how I look at the budget. There are two primary parts, programs financed from general revenues (primarily individual and corporate income taxes) and those financed from earmarked revenues (primarily payroll taxes).

The earmarked accounts are dominated by the Social Security, Civil Service Retirement, and Military Retirement trust funds. In the 1970s, they ran modest surpluses, averaging just under \$10 billion per year. In the 1980s, those surpluses ballooned, reaching \$125 billion in 1989 and still climbing as we began funding the liability for military retirement and raised the Social Security payroll tax.

In the rest of the budget--the general fund--the picture is the opposite. In the early 1970s, we ran deficits, averaging less than \$25 billion per year. In the late 1970s, they jumped up to an average of about \$65 billion. That seemed bad, but was nothing compared to the 1980s, when they started at \$83 billion and reached \$283 billion in 1986. After dipping briefly in 1987 and 1988, the general fund deficit was again back up around \$275 billion in 1989, almost exactly where it was when we started the GRH process four years ago. Over the past seven years, general fund deficits have averaged \$250 billion.

These numbers may seem unfamiliar; nobody talks about them. Occasionally the reality comes out, as when Treasury needs a debt limit increase reflecting the general fund deficit. Most of the time, people talk about the combined deficit, in which trust fund surpluses merge with general fund deficits to show a declining deficit. But it is declining only because of the rapidly growing trust fund surpluses, especially Social Security; we have not begun to deal with the huge deficits in the general fund.

The payroll tax increase was sold to the public to build reserves for the Baby Boom retirement in 2010 and beyond. That is wise if it helps the economy carry the weight of the retirements. But this requires that the resources be channelled now into productive capital investments, leading to more rapid economic growth.

Government could invest in roads, bridges, research, education, health, etc. Or we could pay off some debt and free up resources for investment by the private sector in factories, machines, and homes. But neither is happening today. Instead, the trust fund surpluses are financing the general fund deficit. And the general fund mostly goes for defense and interest.

The payroll tax isn't being invested for economic growth, it is simply financing current consumption. That is how we rob the future, by squandering the opportunity to build a more rapidly growing economy that could support a larger retired population while still providing rising living standards for everyone else.

But why is the general fund so far out of balance? In 1989, general fund outlays totaled about \$890 billion. More than a quarter of this was for interest on the debt. We had general fund revenues of \$614 billion, mostly from the individual income tax. By the time we finished paying interest, we only had \$374 billion left to cover everything else. It fell a long way short, so we borrowed the difference, \$53 billion from Social Security, \$71 billion from other trust funds, and \$152 billion from U.S. and foreign investors.

The problem stems from two 1981 policy decisions--to accelerate the defense build-up and to cut taxes--coupled with the failure of the President and Congress to agree on offsetting

budget cuts or revenue increases elsewhere. The resulting deficit caused the public debt to rise from \$900 billion in 1980 to \$3 trillion now, on its way to \$4 trillion and beyond. To finance that debt, general fund interest costs rose dramatically, adding that much more to the annual deficit.

For most of the last decade, we have been in a budgetary impasse which slowed the growth of spending in many parts of government. But these savings, and more, were simply eaten up by rising interest costs.

We are stuck with a structural imbalance in the general fund of close to \$300 billion. It doesn't go away just because we finance it with trust fund revenues. And solving it will require very large increases in revenue or very dramatic cuts in popular defense and domestic programs, or both.

Some will ask if it is necessary. We have been running huge deficits for a decade. Why not just go on as we are?

To answer that question, we must talk about managing the economy in three dimensions: short term economic stability, international economic relations, and long term growth.

Policymakers and the public are not yet accustomed to this three-dimensional framework. All too often, the public debate--such as it is--is framed as inflation versus unemployment, choices that relate to only one dimension of policy--short term stabilization.

Trade deficits are blamed on unfair competitors, shortsighted businessmen, or lazy workers, depending on who is casting the blame. Those matters are important. Inefficiency reduces the profits of our businesses and the incomes of our workers; trade barriers impose costs on both us and our trading partners. But they do not cause the trade deficit. That, almost entirely, reflects macroeconomic forces, primarily low private savings and huge budget deficits.

Those same budget deficits, by draining savings from the economy, also threaten our future growth. But this third dimension of economic policy is largely ignored in the public debate.

Economic growth and the trade problem demand a tighter fiscal policy and an easier monetary policy. If the switch is handled carefully, more investment, higher export demand, and slackening imports will keep domestic employment up as the budget stimulus declines. Meanwhile, higher national savings and investment should lay the foundation for rising productivity and more rapid growth. Internationally, foreign capital inflows should slow (perhaps even reverse) and the current account deficit should close. After all, as the wealthiest nation in the world, we should be an exporter of capital. Only the budget deficit

combined with our low personal savings rate puts us in the bizarre position of being the world's largest capital importer.

The transition will not be easy. With our economic policies so far out of balance, change carries significant risks. We will need luck as well as skill to avoid those risks. But waiting will not make the risks go away, so we ought to get on with the job before the current policies do even greater damage.

Our budget policy should focus on long term economic growth and seek an acceptable level of savings and investment. In 1986 and 1987, our net national saving was less than 2 percent of Net National Product. In 1988 and 1989 it was a little higher, around 3 percent, but still far below historic norms. (In the 1950s and 1960s, for example, the rate was 8 to 9 percent.) Only by importing capital accumulated by foreign savers (the other side of the coin of our huge trade deficit) have we been able to sustain a modest pace of domestic investment. And because that investment was financed abroad, much or all of the income it earns will be paid to foreign investors, in the form of dividends and interest payments.

Clearly, we need more savings. Some have suggested tax incentives, but there is little evidence that they would have the desired effect. Even if they did, the incentives would increase the total supply of savings only if they increased private savings more than they worsened the budget deficit by reducing revenue.

While I doubt government's ability to stimulate personal savings, it is still possible to increase the total supply of savings. The answer lies in the budget. A budget deficit consumes savings; a budget surplus adds to savings.

To reach a net savings rate of 8-9 percent of NNP, all other things being equal, the federal government should be running an overall surplus of \$100 billion or more, instead of the deficit of \$150 billion that we had in 1989. That is where we would have been if the general fund budget had been in balance while the trust fund surpluses were allowed to accumulate.

But if we moved from deficit to surplus, would other things be equal? I have noted the risks involved in the transition. Those risks are very real, and for an economy in recession (or with accelerating inflation) other things are certainly not equal. That is why the transition needs to be managed carefully.

Taking those risks is warranted if it leaves the economy, after the transition, with a higher level of savings. But some believe this would not happen. Based on the Ricardian Equivalence theory, they argue that changes in the deficit are simply offset by equal and opposite changes in private savings.

The theory is that higher deficits today mean higher taxes in the future. People anticipate those higher future taxes and



compensate by saving more today. Thus, as deficits go up (or down), private savings will move in the opposite direction.

Maybe there are people who actually behave this way, but I'm not one of them and I don't know anyone who is. I wouldn't even know how to figure out what my "share" of the deficit is, much less my share of whatever future tax increase may be needed to finance it.

In addition to the theory's reliance on an implausible assumption about human behavior, it flies in the face of the experience of the 1980s, when the enormous growth of the deficit was accompanied by relatively stable business savings and a continued decline of personal savings. Thus I reject the Ricardian Equivalence theory. I remain convinced that moving the general fund toward approximate balance and moving the combined budget into surplus would leave the economy, after the transition, with a substantially increased supply of savings.

But is it plausible to talk about such a change in policy? Is closing the general fund deficit a realistic possibility? I doubt that we can do it by concentrating exclusively on the spending side of the budget. But spending restraint certainly must be part of the solution, so let's consider the possibilities.

We should start where the big money is. That means defense, a third of the general fund. But don't count on the "peace dividend" to solve the problem. As events in Eastern Europe and the USSR unfold, we can cut the cost of defense substantially. But it will take time to rationalize the structure of our defense establishment to fit the new era. And we're facing a structural imbalance as big as the entire defense budget. No one has suggested that we could cut defense by more than a fraction of that amount.

Next comes interest costs, which depend on the amount of debt and the level of interest rates. But the debt is the sum of past deficits. And interest rates reflect conditions in world capital markets.

Between them, defense and interest represent about 60 percent of general fund spending. The other 40 percent covers a lot of different programs, most of which--in the context of a \$250 billion problem--are relatively small.

Health programs, the largest and most rapidly growing of these, are about 9 percent of general fund spending, mostly for Medicaid and the federal subsidy for Medicare. (Medicare itself is financed through a trust fund.) Past efforts to control health costs have largely failed, as those in this room can undoubtedly attest. I suspect we will need to restructure the way we deliver and pay for health care if we are to control costs that are rising at twice the rate of inflation. But accomplishing that structural

reform will be a Herculean task, so don't count on large, quick savings.

Where else can we look? Income security represents another 9 percent or so of general fund spending for programs such as AFDC, Food Stamps, and housing subsidies. But spending in this area was squeezed pretty hard in the 1980s and actually declined when adjusted for inflation. Big savings seem unlikely when poverty rates are rising, especially among children.

The rest of the general fund budget is spread among even smaller programs. Candidly, some are of dubious merit. But cutting them is not easy, as our experience with the price support program for honey demonstrates. It is a small program, serving only a few thousand beekeepers. A few years ago we at GAO examined the program, found no justification for continuing it, and recommended its termination. The program is still in place.

Elsewhere, spending may rise, adding to the problem, rather than helping solve it. Environmental programs are an obvious example. Here the challenge will be to keep costs under control and assure that the money is used effectively. The cost of farm programs, on the other hand, has declined since peaking in the mid-1980s. The trick will be to keep them from exploding again in the next cycle of world commodity prices. And then there is the savings and loan disaster, where the cost to the taxpayer grows by leaps and bounds.

Expenditure reductions--or at least constraints on growth--are clearly possible and desirable. But capturing those savings will take time, effort, and--above all--political leadership.

In the meantime, there are demands that government address a long list of potentially costly unmet needs. Some of these, such as education, drugs, crime, AIDS, and homelessness, are seen as crises, not just by politicians but by citizens across the country. Others, such as the problems of our decrepit nuclear weapons complex, simply cannot be deferred much longer without unacceptable risks to public health and safety, to say nothing of the need to restore some capacity to produce nuclear weapons. And then there are dilapidated highways and overcrowded airways, where inefficiencies exact a growing toll from our economy.

If this assessment is correct, we will not solve the budget problem until our political leaders are ready to negotiate a broad-ranging solution involving both sides of the budget, revenues as well as spending. The solution will have to involve a package which is accepted as fair in total, even though individual pieces--such as the elimination of marginal programs--are thought unfair by those affected. My personal view is that substantial increases in taxes will have to be part of the package. Nobody wants to pay higher taxes. But we have partied on borrowed money for a decade; it is time to pay the piper for the dance.

Here we run into another issue. Some say the effort is futile; any savings or increased revenue will just be spent for something else. And the deficit is the only restraint on spending. To control government, you must starve it of revenue.

I find it difficult to reconcile these arguments either with experience or with the other arguments that the same groups often make. For example, if they believe (because of Ricardian Equivalence or otherwise) that deficits don't matter, why would the deficit be a constraint on spending? As former CBO director Rudy Penner has pointed out, if deficits don't matter, surely we should have bigger ones.

Beyond this, I think the history of the last 40 years or so makes it abundantly clear that the political process does not automatically spend all the growth in revenue that comes along. For several decades, as revenue grew because of inflationary bracket creep, the political process responded by cutting taxes every few years. This doesn't sound to me like a bunch of greedy politicians looking for ways to capture and spend any revenue they can find.

Concern about these matters--the stalemate over the budget and its implications for our future--has caused us at GAO to examine the structure of the budget and the budget process. These are the issues that my colleague, Don Chapin, will be discussing. For my own part, I will conclude by simply reasserting that deficits do matter. We can--we must--deal with them.

By acting--or failing to act--on the structural deficit in the general fund we are choosing the economy we will bequeath to future generations of Americans.

If we continue on our present course, we risk leaving them a second rate economy, able to support only a second-rate standard of living, and a second-rate place in world affairs. Our only excuse will be that it was more comfortable to consume than to save and pay taxes.

But we can choose a different path. It is not easy, but the challenge is modest compared to what faces the leaders of Eastern Europe, trying to build stable democracies and functioning economies out of the ashes of authoritarian regimes. With only modest discomfort, we can put our fiscal house in order, bequeathing a vibrant, growing economy to our heirs, one that provides ever greater capacity to solve our other problems while also playing a proper role in the world's affairs.