Up From Deficit Reduction

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Executive Summary

The continuing political emphasis on deficit reduction is harming the nation's economic prospects in three ways. First, it enforces a fiscal policy that will be overly contractionary, and thus employment. family income. personal saving, and business investment will be needlessly depressed. Second, it is blocking expansion of public investment-in infrastructure. education and training. environmental protection, and defense conversion-that was the programmatic heart of Bill Clinton's electoral victory in 1992. Third, the demand for further deficit reduction is threatening the nation's most important income support programs-Social Security, Medicare, and aid to the poor.

The only serious argument for deficit reduction-that it will increase private investment and augment the nation's capital stock-is not supported by evidence. Other arguments seem designed to confuse the public. This report challenges the case for deficit reduction.

The only serious argument for deficit reduction-that it will increase private investment and augment the nation's capital stock-is not supported by evidence.

The deficit need never, as a routine matter, be zero or close to zero, and under certain circumstances increases in deficits are necessary and appropriate. Stabilizing the ratio of public debt to gross domestic product provides a regime of fiscal discipline that is responsible, noncontractionary, politically feasible, and hospitable to expanded public investment. Such a commitment requires less than the amount of deficit reduction currently in store and leaves sufficient slack in the budget to expand public investment and to stimulate the economy if unemployment is judged to be too high.

Deficits, now falling, are projected to begin growing again at the end of the 1990s. This growth can be attributed entirely to just two programs in the federal budget-Medicare and Medicaid. (Social Security adds to the problem in 25 years.) If we accept such projections, it is indeed the case that, left unattended, these programs-and these programs alone--will eventually destabilize the federal budget. We cannot resolve the problem by attacking other areas of the budget.

At the same time, these programs perform the most essential missions in our public policy-insuring the vast majority of Americans against destitution in sickness and old age. Moreover, the health programs are deeply intertwined with the nation's entire health care system. For both reasons, any deficit reduction measures must support the missions of these programs,

and reform must be structural, as opposed to fiscal; the latter sort of reform-through such devices as entitlement caps, spending freezes, and sequesters-only postpones and complicates any serious reckoning.

The case for rapid deficit reduction rests more on political designs than economic arguments. A powerful coalition of wealthy interests benefits from the dominance of deficit reduction in the public policy debate. This coalition consists chiefly of parties who are more interested in small government than in small deficits, but it includes financial interests who are more interested in weak inflation than in strong economic growth. The political power of these interests is based on votes cast with dollars, and for this reason is vulnerable to votes counted at polling places.

Preface

On June 22, 1994, the *Washington Post* reported that the deficit for FY 1995 was expected to decrease by $55 billion, or $28 billion more than forecast just six months before. Over three years, the accumulated savings could amount to $44 billion. The news failed to cause a politica! ripple in the nation's capital. The following day, there was no sign in the nation's newspapers that President Clinton or any other Democratic leader thought the windfall should be applied to the nation's urgent investment needs in education, infrastructure, welfare reform, environmental protection. or conversion of the defense sector. Not did any Republican suggest that the savings be applied to stimulate investment or job creation through tax cuts. The destination of the dividend was preordained: it would reduce the federal budget deficit.

The ideology underlying the fiscal doctrine of unlimited, unending deficit reduction is not aimed at stable prices, full employment, and greater private investment.

This Congressional Budget Office estimate was the second downward adjustment of deficit projections since the budget agreement of August 1993. The first, in January 1994, was equally unheralded. The unquestioning acceptance of lower deficits on both occasions amounted to the adoption of a more contractionary and austere fiscal policy without benefit of (discussion or vote in the budget committees of the U.S. Congress. The price for setting America's economic course on this automatic pilot is an escalating neglect of the nation's public investment needs and feeble economic growth.

The ideology underlying the fiscal doctrine of unlimited, unending deficit reduction is not aimed at stable prices, full employment, and greater private investment. Rather, the motivations are to reduce the size of government, to disassemble the U.S. system of social insurance, and to maintain unyielding downward pressure on the price level. The implied economic policy is one of stagnation: a disproportionate weight is put on low inflation to the detriment of employment, investment, and general economic growth. The policy is also counter-redistributive: it favors wealth-holders at the expense of wage-earners, the elderly, and the poor. If stated outright, these goals would be manifestly unpopular, so the sales pitch for extreme deficit reduction has to focus elsewhere-on creating and perpetuating misconceptions or downright superstitions about the federal budget and the public debt.

Certainly a well-intentioned concern for the effects of deficits on sav-

ing and investment has played an important role in the fiscal policy debate, but the evidence for such a linkage is lacking. Ideology, not economic theory, supplies a greater degree of political pressure for fiscal austerity.

Much of the objection to brute-force deficit reduction has been narrow and reactive. Activists are reduced to defending at-risk programs after conceding the necessity of extreme deficit reduction. This report offers a critical analysis of a wide range of arguments for rapid deficit reduction, and shows how activist policies can be fiscally responsible.

Past measures to reduce deficits ha we been misconceived and have harmed our economic prospects.

In this report we find that current fiscal policy for the remainder of the 1990s is contractionary and incapable of improving the prospects for long-term economic growth. Past measures to reduce deficits have been misconceived and have harmed our economic prospects. Too much deficit reduction is now in store. All that is needed is enough to stabilize the level of public debt relative to gross domestic product. Deficits need to be controlled, but success of a lasting and responsible nature will depend almost entirely on reform of the nation's health care system.

The alternative defended here is not merely sensible in terms of fiscal discipline and benign in its implications for economic equity; it is founded principally on what is required to secure full employment and economic growth. The sentiment that brought in a new administration-to invest in the nation's workers and infrastructure and to fight unemployment along the way-is the touchstone for this report. Although the message of the voters has since been neglected in Washington, it may be possible for the mandate of '92 to resume its place at the top of the nation's agenda.

"If I do too little investment,
then some other candidate won the election, not me."
-President Bill Clinton, February 7, 1993[1]

Introduction

For the past decade new initiatives in economic and social policy have taken a back seat to the unproductive debate over the federal budget deficit. Not only has domestic policy been paralyzed, but vast sums that could improve the prospects for employment and lasting economic growth have been squandered. Our longstanding neglect of full employment for the sake of deficit control has robbed income from millions and probably contributed to the breakup of families and other social ills (Wilson 1987; Merva and Fowles 1994).

One tipoff to the specious character of the case for rapid deficit reduction is the fact that, despite the rechanneling of billions of dollars to meet the fiscal goals of the deficit hawks, the deficit continues to confound us.

Debt and deficits continue to distract us, but deficit reduction is neither as important nor as urgent as the attention it commands, particularly in light of recent, substantial changes in the deficit outlook. One tipoff to the specious character of the case for rapid deficit reduction is the fact that, despite the rechanneling of billions of dollars to meet the fiscal goals of the deficit hawks, the deficit continues to confound us.

Presently, most members of Congress swear allegiance to the goal of eliminating deficits altogether within the next six to 10 years and doing so almost exclusively through spending cuts rather than tax increases. Many of President Clinton's initiatives to promote investment for economic growth have fallen victim to this misplaced priority. In the fall of 1993, a package of over $100 billion in budget cuts was barely beaten back, and such initiatives reappear continually. One of the worst ideas periodically brought up for consideration is a balanced budget amendment to the U.S. Constitution. Another dubious gambit was the formation of a commission, headed by Senators Robert Kerrey and John Danforth, charged with determining how best to reduce entitlement spending.[2]

The predominant sentiment in Congress, the stance of the journalistic elite, and the well-financed agitation organized by Ross Perot, the Concord Coalition, and others all take for granted the necessity of eliminating deficits within five to seven years. So far, many who have grave reservations

about this “zero option” have failed to put forward substantive, specific alternatives (beyond general counsels of moderation). Most opponents of austerity policies think that deficits are undesirable and should be eliminated as soon as possible by humane means. Even those who have doubts about the merits of deficit reduction find it difficult to buck what seems to be overwhelming public dissatisfaction with government’s inability to do what it claims is necessary--eliminate deficits.

The truth is that the deficit never has to be zero, and the national debt never has to be reduced from its present level.

The truth is that the deficit *never* has to be zero, the national debt *never* has to be reduced from its present level, and there will inevitably be times when it will be beneficial to cause deficits to increase. In general, deficits and debt need to be controlled, and this paper explains how. We describe our approach as “sustainable deficit reduction.” We call for enforcement of the deficit levels currently projected over the next six years, during which time policies should be developed and implemented to further reduce the long-term burden of the public debt in fiscal year 2001 and beyond.

In this paper, the burden of public debt is defined as the cost of servicing federal debt held by the public (the government’s annual interest payments) relative to the federal government’s fiscal capacity (national income subject to taxation). It is measured as the ratio of federal debt held by the public to the gross domestic product.’

Sustainable deficit reduction, as advocated in this paper, entails the following specific measures:

- Addressing the long-term deficit problem through structural reform of Medicare and Medicaid, with spending cuts to begin taking effect in FY2000;
- Using the savings in health care to reduce the debt/GDP ratio by approximately one-half percent of GDP annually;
- Interrupting deficit reduction during recessions through the use of strengthened “automatic stabilizers” in the tax system and spending programs;
- Expanding public investment in a capital-budgeting framework.

This paper attempts to show that the zero option--eliminating deficits entirely within five to seven years-is fed by misinformation and illogic

and would cause the nation far more harm than good. Sustainable deficit reduction, in contrast. is conducive to both economic growth and fiscal discipline. The study provides evidence for the following propositions:

- There is no economic rationale for the principle that the federal budget deficit should always or usually be zero or close to zero;
- In light of the most recent budget agreement (the Omnibus Budget Reconciliation Act of 1993, or OBRA93), there is no short-term deficit problem. In fact, we probably have too much deficit reduction scheduled in the short term;
- Rapid deficit reduction or budget-balancing measures typified by the zero option cannot make good on their most important promise: to increase business investment, economic growth, and family incomes;
- High deficits and rising national debt are not reliable indicators of diminished economic well-being; far more important are employment, wages, profits, and labor productivity;
- The economic burden of public debt is best reflected in the ratio of debt to gross domestic product, not by the dollar size of deficits:
- Deficits cannot be eliminated with balanced budget amendments. entitlement caps, spending freezes, defense cuts, tax increases. or any similar package of austerity measures. The solution lies in reform of the U.S. health care system, and nowhere *else;*
- We should begin planning now for further deficit reduction through health care cost containment, but under present circumstances a sustainable deficit reduction program need not begin to take effect until the end of this decade.

High deficits and rising national debt are not reliable indicators of diminished economic well-being.

The study that follows has three parts. First, we analyze the arguments generally put forth on behalf of the zero deficit option. Second, in the section titled "Looking Ahead," we look at the shape of the federal budget and elaborate the benefits of the sustainable option. The final section touches on the political circumstances surrounding deficit reduction.

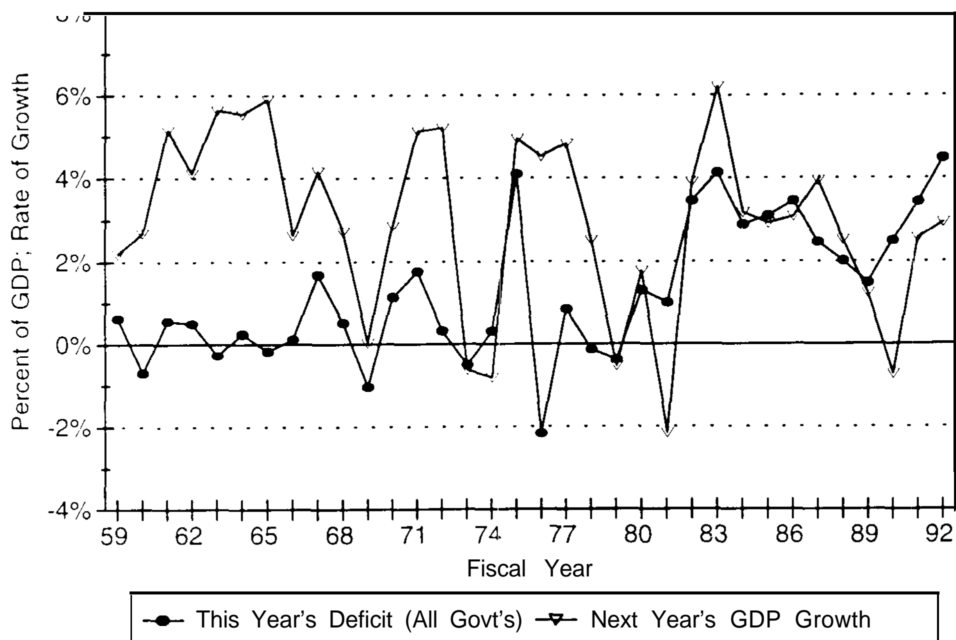
Dreading Deficits: Why Worry?

A great illusion about deficits that drives prescriptions for precipitous spending cuts holds public borrowing to be synonymous with economic stagnation and fiscal ill health. However, it has usually been the case that deficit increases (or decreases in budget surpluses) have been followed by *more, rather than less,* economic growth.

Figure 1 shows the trends in public sector (federal, state, and local) deficits and economic growth over the past 30 years. (Since borrowing by state and local governments should affect the economy in the same way as federal borrowing, we have included it here.) The deficits are expressed as a proportion of gross domestic product, and the growth rate is adjusted for inflation. Although there are a number of exceptions (particularly 1959-67). the change in real economic output often echoed the change in the size of the previous year's deficit (as a proportion of GDP); that is, an increase in the size of the deficit relative to the economy as a whole was followed by an increase in the rate of real economic growth. These data do not constitute a theory of what determines economic growth, but they do debunk

It has usually been the case that deficit increases (or decreases in budget surpluses) have been followed by more, rather than less, economic growth.

Figure 1
Economic Growth Often Follows Deficits



the simple claim that higher deficits inevitably or even frequently discourage economic growth in the short term.'

The long-term effects of deficits are a different matter. There are basically two sets of concerns. The one of most interest to economists is the effect of deficits on investment, saving, interest rates, and economic growth. By nature this problem is subtle and imperceptible, though ultimately very important-what some have likened to "termites in the basement." Of more interest to the public and to politicians, however, is the danger of an explosion of debt 30 years hence that compromises the Social Security system. pushes taxes to confiscatory levels, causes hyperinflation. and ultimately bankrupts the national government. Advocates of the zero deficit option routinely invoke all of these potential dangers in support of their position, but the various problems and their remedies are quite different.

The investment consequences of deficit reduction are small, especially in comparison to the employment effects.

This section tries to show that the "termite" problem is unfounded, which is fortunate because its solution would be very difficult. In contrast, the danger of an "explosion" is real, but its likelihood is grossly exaggerated and easily nullified. The sustainable deficit reduction option proposed here is aimed primarily at averting explosion, although it does provide for some insurance against the possibility that a few termites might be chewing on the economic woodwork.

The zero deficit option is motivated by the premise that the rapid' elimination of deficits over the next seven years is essential for the near- and long-term health of the economy and to the solvency of the federal government. It rests on the presumption that the benefits of deficit reduction for investment are large and immediate, while the costs in terms of unemployment are negligible and bearable.

Sustainable deficit reduction is based on the idea that the economic burden of the debt consists of its long-term effects on capital formation (public and private) and of the federal government's capacity to perform its functions and meet its commitments. A sufficient condition for satisfaction of these goals is more or less continuous reduction of the debt/GDP ratio. Underlying this approach is the premise that the investment consequences of deficit reduction are small, especially in comparison to the employment effects.

What follows is a critical survey of the major concerns, some of them more substantive than others, driving popular and political support for the

zero option. The quotations heading each section reflect the concern under scrutiny.

"We have to cut the budget deficit...as a means to increase national investment in productive assets."
(Schultze 1992)

Domestic business investment should rank higher in our national priorities than saving.

In popular discourse, the implication drawn from this concern is that deficit reductions translate automatically into higher investment.[6] Lower deficits imply greater government saving (because "dissaving" has decreased). It is a truism of income accounting that, at the end of the day, saving equals investment. But in practice the *uses* of saving simultaneously determine the level of investment; there is a feedback process to consider, as Schultze, for one, readily acknowledges. The uses of saving depend on many millions of interdependent decisions by individuals and business firms. Saving is not a fixed quantity, and it can be employed for a number of purposes that provide no boost to economic growth.

Investment in plant and equipment located in the United States provides jobs for American workers and most of the income received by their families. It is this same income "produced" in the United States that is the primary source of tax revenues. In contrast. income saved by Americans but invested in foreign countries provides no benefits for domestic employment and relatively little relevance for taxes or for the well-being of the vast majority of the population. Domestic business investment should thus rank higher in our national priorities than saving.

The two major determinants of investment spending are aggregate income and the price of investment goods. For a given level of gross domestic product (income), a decrease in the price of investment is required for the level of investment to increase. Weighing against any improvement in the cost of investment attributable to deficit reduction are potential slowdowns in income growth, and therefore in consumption spending. Business firms would be indifferent to lower investment costs if they did not expect success in selling to the public. One of Keynes' basic insights was that if factors that have a strong effect on investment, such as income, fluctuate sufficiently, they will swamp the influence of factors that have a weak effect on investment, such as interest rates or other factors in the cost of investment.'

The key factor in the cost of investment for the purpose.4 of this discussion is the rate of interest, and empirical research has not shown that deficit reduction plays a strong or a consistent role in reducing interest rates. On this question, a recent review of the literature reports:

> [E]conomists seem to be no closer to agreement than was the case six years ago.. . .There was not then and there is not now a clear consensus on whether there is a statistically and economically significant relationship between deficits and interest rates.. . .One cannot say with complete confidence that budget deficits raise interest rates and reduce savings and capital formation. (Barth et al. 199 1)[8]

Empirical research has not shown that deficit reduction plays a strong or a consistent role in reducing interest rates.

The same skepticism is not uncommon among conservative economists. For instance, Friedman (1984) has written:

> Of the several relevant statistical studies that I know of. none has found that deficits systematically raise interest rates for given levels of government spending and inflation.. ..[D]eficits are bad-but not because they necessarily raise interest rates.

A similar view reflecting the uncertainty among economists is provided by Alan Meltzer (1992) of the American Enterprise Institute:

> Considerable empirical work has been done in past years to test the effects of deficits on interest rates and saving. The results are mixed....Political concern for the effect of the deficit on interest rates may be misplaced, but belief in the effect of the deficit on the economy may not be. (Emphasis added.)

Even if deficit reduction reduces interest rates, such a decrease would not be sufficient to raise investment. Business investment patterns betray little sensitivity to changes in interest rates. In theory the effect of lower interest rates on business investment is positive, but research has shown that the magnitude of this effect is very small or nil for most firms in the economy, including the fastest-growing firms (Fazzari 1993). and therefore insufficient justification for a headlong rush to balanced budgets and national debt reduction.

Explanations for the evident breaks in the theoretical chain of causality from deficit reduction to interest rate drops to increased business invest-

ment in the United States include the following:

- Saving can be and is used for investment outside the United States. Americans lend to foreigners. Capital moves across national borders in pursuit of higher rates of return. The whole world is thirsty for capital, and U.S. business firms must compete for it by paying world-market rates of interest. Furthermore, U.S. firms need not invest in America, even though they might borrow more in the wake of deficit reduction.

The Federal Reserve may exploit a reduction in the deficit for the sake of reducing inflation.

- Another use of saving that preempts investment is consumer borrowing to purchase homes or automobiles or to otherwise run up credit card balances. In effect, consumers bid up interest rates in competition with business borrowers. Such purchases can increase national income in much the same way as consumption spending in general or federal deficit spending. There is no basic difference in terms of the effect on business investment and labor productivity. The composition of consumer spending or government spending might have some bearing on business investment and productivity, but this would be a secondary matter. For example, borrowing by families or governments to finance higher education is more relevant to productivity growth than borrowing to pay medical bills.

- Business firms might borrow more, but not necessarily to buy new plant and equipment. Rather, they could borrow funds for mergers and acquisitions-in other words, to acquire each other. Hardly any of the surge in business borrowing in the 1980s found its way into investment in plant and equipment (Pollin 1992).

- The Federal Reserve may exploit a reduction in the deficit for the sake of reducing inflation. When the federal government reduces the deficit, it reduces aggregate demand (consumption, investment, and government spending) in the economy as a whole, thereby reducing employment and the price level, among other effects. To avert the employment loss, the monetary authorities could offset this drag on demand by increasing the rate of growth in the money supply, which could increase business investment, jobs, and income, albeit at the risk of increasing the price level. But if the Fed loves lower

> inflation more than increased employment. it can abstain from any action to offset the government's reduced borrowing. By so doing, it will preclude any pickup in business investment or growth.

Implementation of the Clinton deficit reduction program produced precisely this reaction from the Fed. On the basis of good news about economic growth for the fourth quarter of 1993, and without any evidence of inflation, the Fed began to signal monetary restraint by increasing short-term interest rates. An immediate jump in long-term interest rates followed. Evidently, the Fed's action produced a result diametrically opposed to its purported intention. Interest rates include a real component and an inflation premium (the latter is the amount the lender needs to guarantee a real return; it reflects expectations of future inflation). Since there is no economic fundamental to which to attribute any change in the real rate of interest, it is hard to escape the conclusion that the Fed's peculiar maneuvers increased expected inflation.

The Administration's entire economic strategy rests on falling interest rates.

The Council of Economic Advisers (1994) had previously considered long-term rates to be above their appropriate levels. Indeed, the Administration's entire economic strategy rests on falling interest rates. The rise in rates precludes the improvement in the cost of business investment, which is supposed to motivate deficit reduction. Moreover, the higher rates will increase the deficit because the government's cost of borrowing and its interest payments will rise. In this way, hard-won progress in deficit reduction is hijacked by the Fed for the sake of putting downward pressure on prices (Galbraith 1994).

Pointing to current investment levels and recent bright spots in the economic picture as evidence of the beneficial effect of low interest rates (Council of Economic Advisers 1994) is opportunistic and unconvincing. One could claim that economic conditions would be much better if the Administration had undertaken an entirely different policy. It could still prove to be the case that Administration policy has no more than a limited and temporary effect. Interest rates could have fallen in anticipation of slow growth, rather than because of muscular deficit reduction. Alternatively, deficit-based drops in interest rates might produce a smashing quarter or two followed by several more years of economic doldrums.

The best evidence in such debates can be obtained by reference to ex-

tended periods or to historical developments in other countries-in other words, by looking at broad experience rather than what could be a short-lived coincidence. It is too soon for the Clinton Administration to declare victory over recession by virtue of its deficit reduction program.

"The economy is now dangerously close to full employment."
Martin Feldstein [9]

Recent rates of employment growth have been low in comparison to business expansions in previous recoveries.

Deficits are alleged to overheat the economy and aggravate inflation. But the only time to worry about overstimulation is when two conditions take hold: the economy is operating near capacity, and the deficit is increasing in proportion to the size of the economy. No such milestone is in sight, so on this account there is no short-term deficit problem. While the latest unemployment figure of 6% compares well with recent experience, with the right fiscal policy it could well recede to 5% or 4% without setting off worrisome inflation. Furthermore, recent rates of employment growth have been low in comparison to business expansions in previous recoveries (Baker 1993). Moreover, over the next five years the deficit is not projected to increase faster than the economy. There is also widespread agreement among forecasters that little inflation is expected this year (Merrill Lynch 1994). One challenge for those worried about price increases is to explain why the record deficits set off by the Reagan Administration were not associated with inflation.

When there is slack in the economy, part of the deficit provides stimulation in the elliptical sense that, without it, the economy would be at a lower ebb. Certain public spending, such as unemployment compensation and public assistance benefits, automatically increases when the economy slows down; at the same time, tax revenues are lower than they would otherwise be. When the economy is expanding, the opposite pattern prevails. Thus, the deficit automatically increases or decreases as the economy contracts or grows, respectively. If the budget failed to accommodate the economy in this way, we would expect an aggravation of booms and busts in the business cycle. Recessions would be deeper, and booms would be more inflationary.

In the most recent recession, about $100 billion of the annual deficit was attributable to lower tax revenues and to higher spending on such pro-

grams as unemployment insurance and public assistance (Congressional Budget Office 1993b). We refer to this as the "cyclical" component of the deficit, as opposed to the remaining "structural" component. The cyclical portion of the deficit cannot reduce observed unemployment-its virtue is in forestalling potential growth in unemployment. In this sense. it would be erroneous to gauge the effects of deficits on employment by reference to the cyclical component.

To stimulate employment beyond observed levels, it is necessary to *increase* that portion of the deficit that is immune to an upturn in the business cycle-the "structural deficit." A proper test of the restorative power of deficits would compare changes in structural deficits with employment and other indicators of economic recovery.

To stimulate employment beyond observed levels, it is necessary to increase that portion of the deficit that is immune to an upturn in the business cycle.

There is strong evidence that increases in the structural deficit can increase employment, income, and investment (Eisner 1986. 1993. 1'994). Such an effect is standard in models of the total economy used by academics, business forecasters, and federal agencies, and underlies the pattern observed in Figure 1. In the same vein, the danger of "overstimulation" hinges on the future path of structural deficits, not of the official deficit. Relative to the size of the economy, both structural deficits and official deficits are now projected to decrease through FY 1998 (CBO 1994).

Because the unemployment problem may resurface, the option of fiscal stimulus (increasing the structural deficit) should be kept close at hand. The rule of thumb for the size of a prudent but effective annual stimulus is 1% of GDP, currently about $65 billion (Tobin 1993).

"The other plausible scenario is death by hyperinjlation.. .. It is the reason Warren Rudman said, 'Our money will be worthless by 1997.' We could succumb to hyperinjlation instead of panic if, instead of selling all those securities to other investors, the treasury sells its securities to the Federal Reserve. "
(Figge and Swanson 1993)

For some the link between deficits and inflation is founded. on a fear that the government will monetize the debt. In other words, the outstanding public debt could be paid off by increasing the money supply, a practice popularly understood (with some imprecision) as "printing money."

In actuality the way debt monetization could occur is that the federal government could sell bonds to the Federal Reserve Bank and use the proceeds to pay its creditors. Whenever the Federal Reserve buys government securities, it increases the money supply. Because such a policy would be extremely controversial, only a desperate government would attempt to meet its financial obligations in this way. The fear is that the huge increase in the money supply required to liquidate a large national debt would be likely to cause a wave of hyperinflation that would wreck the economy.

A* constant or falling *debt/GDP ratio should reduce* pressures *for monetization.

Although our argument in this paper in no way contemplates debt monetization as a realistic policy option, fears of it may be overdrawn. One determinant of one's assessment of the threat posed by debt monetization would be how close the economy is to full employment, a subject that is always subject to some dispute. If the unemployment rate is 6.5%, for instance, and you believe that 6% is "full employment," then you should be more worried about debt monetization than if you thought that a noninflationary rate of 4% unemployment were possible. Another consideration is the uses to which the proceeds of debt repayment would be put by holders of government bonds.

Debt becomes unbearable to a government when the cost of making interest payments, along with the government's other expenditure needs, exceeds its ability to raise tax revenue and borrow. The question is, how much is too much? If it is acknowledged that the burden of the debt depends on its size in relation to the economy as a whole, a constant or falling debt/GDP ratio should reduce pressures for monetization. As we will see, such a process does not require zero deficits, or even very low deficits. It only requires that what is called the primary deficit be eliminated or. at most. that modest primary surpiuses be achieved. The primary deficit is defined as the net amount of government borrowing (borrowing minus repayments of principal) minus net interest payments (interest paid minus interest received). A primary surplus is achieved if the government borrows less than what it pays out for interest on its outstanding debt.

The rnost important guard against debt monetization is the Federal Reserve Bank, which controls monetary policy. The federal government cannot force the Federal Reserve to buy its bonds. We should admit that, from our standpoint. the Fed's so-called independence is very much a mixed blessing for economic growth.[10] But given the Fed's anti-inflationary zeal, there

is little reason to believe that its bias will not remain as it has nearly always been: toward excessive restraint of money creation (Greider 1987).

As noted above, recent experience bears out this expectation of Fed behavior: scarcely had the good news of growth in the fourth quarter of 1993 settled in when the Fed announced an increase in the discount rate. The public was assured that this would help keep long-term interest rates from increasing, and that it might even decrease them. Unfortunately. long-term rates increased immediately. We are left with the unverifiable consolation that long-term rates might otherwise have increased to even greater levels.

Despite the hysteria of some writers, investors do not seem to be afraid to buy public debt. If the best judges of the value of government bonds are those who regularly trade in them and own vast amounts, the willingness of these persons to continue this enterprise should provide some confidence that these assets will retain their value. Nobody would lend the government money at 5% if he or she expected inflation to wipe out the real value of the returns, much less the principal.

Despite the hysteria of some writers, investors do not seem to be afraid to buy public debt.

"[O]ur deficit-intoxicated government keeps handing out consumption promises.. .. The sum total of these federal liabilities is staggering.. .. This mind-numbing bill-equivalent to $150,000 per household-is supposed to be paid by our kids."

(Peterson 1993)

Some have polemicized against deficits by reciting figures of the "per capita national debt" or of the burden of future federal spending on younger generations. Images of bawling infants born into crushing debt have been presented in television commercials.

The Bush Administration counted about $16,000 in government liabilities per capita for 1992[11] (Office of Management and Budget 1993). Of course, it is equally true that there are $16,000 of assets per capita in the form of claims on the federal government, since most of these commitments have been made to Americans. We put this point aside for the moment.

Peterson (1993) and others have moved this argument a step further by offering a tabulation of future federal expenditures, including Social Security, Medicare, government employee pensions, etc., that give rise to his $150,000 figure.[12]

To do a thorough accounting treatrnent of federal debt (the $16,000 per capita), we should also consider the value of government assets, including public capital and land, mineral rights, and the gold in Fort Knox. Remaining liabilities (or assets, depending on how you look at it) are then reduced to about 98,000 per person. But we would not be finished.

What is really at issue here is the stock of real, productive assets-the total national wealth, both public and private. The taxing power of the federal government makes the returns to such wealth available to meet public sector obligations. The Bush Administration estimated national wealth at ***$189,200 per*** *capita* for 1992, after deducting wealth in the United States owned by foreigners. The latter amounted to half a trillion dollars out of a total of $48.7 trillion, or a little more than 1% (OMB 1993).[13]

The simplistic public-debt-per-capita figure typifies the hysteria of some advocates of the zero option.

But we're not done yet. The government's financial capacity goes beyond the value of specific assets under its direct ownership. It consists primarily of its power to tax, and this is grossly understated by the extent of wealth or capital. Most GDP and tax revenue in the future will be derived from the value added by labor, whereas the national wealth is defined as the stock of nonhuman capital and does not include the present discounted value of future labor earnings. Since labor compensation is easily twice the income derived from capital, the present value of future GDP is at least three times the $189,000 figure in the Bush Administration's last budget report.

The simplistic public-debt-per-capita. figure typifies the hysteria of some advocates of the zero option. Peterson's figures stir things up even more. First of all. they are premised on soaring Medicare and Medicaid costs, which all agree are unsustainable and must be reduced. Second, they presume an extraordinary clairvoyance about the distant future.‘” Third, they presume a profound grasp of the secrets of economic growth, since they purport to predict the parallel accumulation of the nation's ability to pay for future public expenditures.

More generally, any such figure—even if accurate-is intrinsically misleading because it reflects a detraction from national wealth. What is actually in question is some commitment of future tax revenues to future government transfer payments received by American taxpayers. As with the public debt. the capacity of taxpayers to bear these responsibilities in the future will depend on the rate of economic growth. What we do now is generallv acknowledged to have a bearing on future growth, but there is

great dispute about the best direction for policy. We have shown above that the evidence for deficit reduction as the basis for economic growth is insufficient to justify either past budget deals and expenditure limitation measures or new forced marches to zero deficits.

'Debt can be expected to snowball, and interest payments to take an increasing share of federal revenue. The federal government is caught in its own version of Ponzi finance.... America's debt is now self-propelled."
(Calleo ***1992)***

Interest payments have indeed grown relative to the budget and to GDP. Taking 1977 as a reference point, by FY 1992 net interest grew as a share of budget outlays and of GDP by, respectively, 7.1 and 1.8 percentage points. As shares, each had roughly doubled (i.e., from 7.3% to 14.4% of outlays and from 1.6% to 3.4% of GDP). Obviously these trends cannot be allowed to continue, and their direction has already been changed as a result of the Clinton budget. Projecting such trends forward leads to extreme consequences that tend to shift the debate toward more dramatic but less workable remedies. The relevant policy issue is what all this means for the choice between zero deficits or sustainable deficit reduction.

While recent levels of interest outlays ($180 billion for FY 1993) are large, they do not threaten a $1.5 trillion federal budget or a $6 trillion economy.

An important aspect of interest outlays is how they differ from government expenditures for things like payroll or paperclips. Interest payments do not consume real *economic* resources: they are transfers from one group of citizens to another.[15] In contrast, the government's purchases of goods and services reallocate real resources among sectors of the economy. The only actual loss of resources to the U.S. economy from interest expenses is through payments to foreigners, which in 1991 were about 0.7% of GDP and 2.8% of federal outlays (CBO 1993a).

While recent levels of interest outlays ($180 billion for FY 1993) are large, they do not threaten a $1.5 trillion federal budget or a $6 trillion economy. In fact, given the current slack in the economy, these outlays actually increased total GDP by raising the deficit.

What about higher levels of interest payments in the future'? There is some point at which rising interest payments make the burden of debt onerous, and it is mathematically possible for compounding interest on rising

debt to expand total public spending to unbearable levels. Determining whether we are in real danger from this economic nightmare is not difficult.

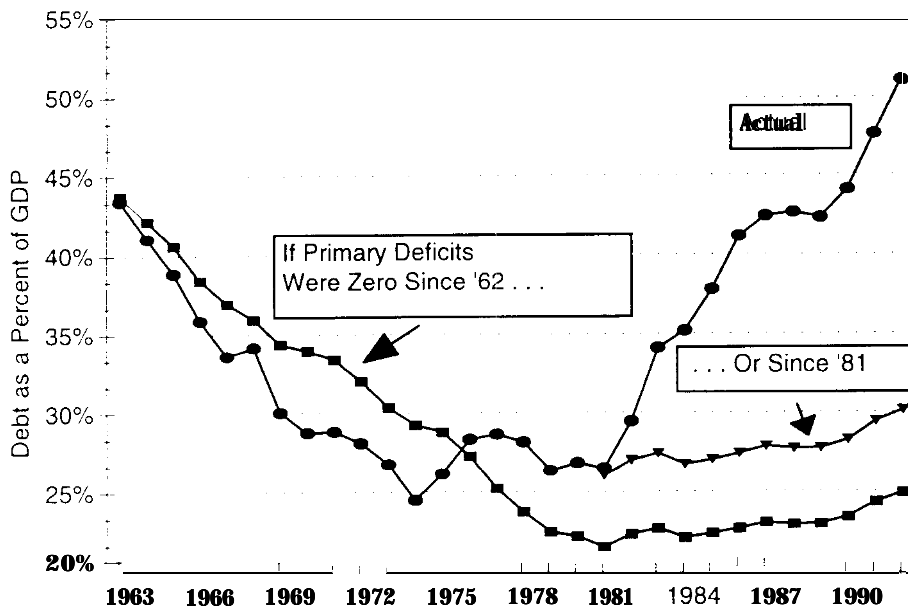
The central point of reference is the ratio of debt to GDP,[16] a useful proxy for the debt burden. A concern about interest obligations is really a concern about the burden of the public debt. The capacity to carry debt—meeting interest payments without drawing down saving or consuming capi-tal-depends on the net income of a family (personal income), business firm (profits), or nation (GDP[17]).

The central point of reference is the ratio of debt to GDP.

As the "Actual" line in **Figure 2** shows, the ratio of debt held by the public to GDP has indeed risen over the past 12 years, from ***29%*** to 52%. Presently this ratio remains far below its 1945 wartime high of 114%. Current levels cannot foretell our doom because we have been there before.[18] Because we know that current or even 'higher levels are bearable, efforts to reduce unemployment at the expense of short-lived increases in the ratio ought not to be rejected (Tobin 1993).

Another simple comparison is the level of U.S. public debt relative to that of our counterparts in Europe and Asia-advanced industrial nations with whom we must compete in international trade. For every year from 1984 to the present, the ratio of U.S. public debt to GDP was below the average (weighted by GDP) for the principal nations of the Organization

Figure 2
Debt and GDP, Actual and Hypthetical



for Economic Cooperation and Development (OECD), and usually well below the average (OECD 1993, 141; Dornbush and Poterba 1990).[19]

The faster the economy grows, the lighter is the burden of the debt; this would be signaled by a falling ratio of debt to GDP. One way of tracking the ratio is by reference to the primary deficit, defined above as net federal borrowing less net interest outlays. The rationale for separating out interest expenditures is that their effect on the debt/GDP ratio is largely offset by GDP growth. In other words, while higher interest rates increase the government's costs of borrowing and its debt burden, they also tend to be associated with faster GDP growth. Since these opposing effects tend to cancel each other out, the remaining source of change in the debt/GDP ratio is the primary deficit.

History bears out our claim that rises and falls in interest rates tend not to alter the ratio of debt to GDP.

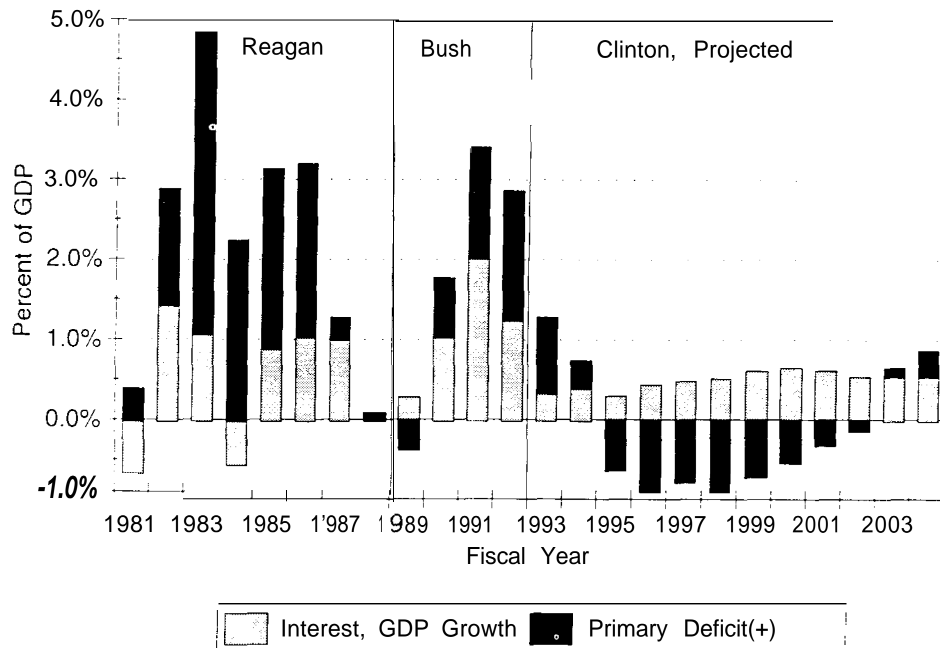
History bears out our claim that rises and falls in interest rates tend not to alter the ratio of debt to GDP. (If this claim pans out, the usefulness of the primary deficit as a tool for understanding the impact of fiscal policy is affirmed.) Figure 2 depicts the historic trend in the debt/GDP ratio under the assumption that primary deficits are held at zero. The simulated decrease stays close to the actual historic path through 1979, and the precipitous rise in the 1980s is avoided almost entirely.[20]

It is easy to calculate the specific contributions of interest cost, GDP growth, and primary deficits to the ratio.?' These are depicted in **Figure 3** for the years 198 1 to 2004. From 1945 to 198 1 (not shown), the ratio dropped continuously (except in 1976). Vertical bars above the horizontal axis reflect additions to the ratio, and bars below the axis reflect subtractions. The effects of net interest costs and GDP growth are combined in the gray regions. In some years, the combined interest-GDP effect reduced the ratio (1981 and 1984). Usually it increased the ratio, but in most cases by less than did primary deficits. Overall, the pattern illustrates that the primary deficit has mattered much more than the official deficit for the increase in the burden of public debt, and suggests that it is possible to borrow most of what is necessary to pay interest on the public debt indefinitely" if net borrowing for all other purposes is prohibited.

Some have been moved to describe the case where the combined growth in GDP and reduction in the primary deficit fail to offset the effect of the interest rate (thereby raising the debt/GDP ratio) as "unstable" because, by extrapolation, the public sector would eventually go bankrupt. Yet such "in-

A policy of achieving modest primary surpluses is far more feasible than the zero option.

Figure 3
Sources of Change in the Burden of Public Debt



stability" has waxed and waned in the past, and in any case elimination of primary deficits would eliminate the instability.

This perspective points up the limitations of the official deficit measure and commends a change in emphasis toward reducing primary deficits whenever unemployment is not prohibitively high. The concept of the primary deficit is an efficient device for getting at the effect of deficits on the burden of the debt. Pushing primary deficits below zero will shrink a public debt of any size relative to GDP. Figure 3 shows this in the projections for 1995-99.

A constraining factor for this policy is the level of interest rates relative to GDP growth. If the interest rate paid by the government exceeds the rate of GDP growth, some primary surplus will be necessary. The higher are interest rates relative to GDP. the bigger a primary surplus is required to prevent the debt burden from growing. Realistically, the primary surplus required to prevent an increase in the debt/GDP ratio will usually allow an official deficit well above zero.

A policy of achieving modest primary surpluses is far more feasible than the zero option. For instance, by FY2004 net interest outlays are pro-

jected at $334 billion and GDP at almost $11 trillion. A primary surplus of one-half percent of GDP ($55 billion) would permit an overall deficit of about $280 billion. The actual deficit for that year is projected at $365 billion, so our sustainable deficit reduction approach requires budget savings (spending cuts and/or tax increases) of about $85 billion, rather than all $365 billion demanded by the zero option. Sustainable deficit reduction is not quite painless, but it is a much more realistic goal than zero deficits.

Financing interest payments with borrowing may seem unpalatable. The average family faces interest rates in the range of 10% to 20% for unsecured loans such as credit cards. Since most families' incomes do not increase at double-digit rates, borrowing to pay interest would quickly lead to bankruptcy. The government's situation is quite different, for three reasons: (1) it can borrow at lower rates than any private person or business; (2) unlike the typical family, the government's fiscal capacity--the gross domestic product, roughly speaking--compounds yearly; and (3) unlike any wage earner, the government's fiscal capacity extends into perpetuity—the government can borrow to finance interest payments indefinitely. Our debt burden will not increase as long as our basis of support for carrying debt—GDP-grows more rapidly than debt. Looked at another way, the deficit's share of GDP should not exceed the rate of GDP growth.

Because the fundamental burden of the debt depends entirely on the nation's economic prospects, the focus should be on what can be done to boost economic growth.

By this route, we come to the core issue for the future burden of any given debt: the size of GDP. In other words, how rich and productive can the nation become? This will chiefly depend on the extent of private and public capital, the enhancement of technology, and the capabilities of the labor force. Increases in labor productivity will put downward pressure on the debt/GDP ratio.

Because the fundamental burden of the debt depends entirely on the nation's economic prospects, the focus should be on what can be done to boost economic growth. The correct recipe for growth is, of course, one of the most basic, endless controversies in economics and politics. We do not pretend to have the answer, but we do insist that the answer is *nor* the rapid elimination of deficits. One might not know how to get to the moon while knowing that it can't be done by building an enormous staircase.

Reducing the problem of economic growth to the question of the size of the federal budget deficit has been a great disservice to the public debate. The protestations of its advocates notwithstanding, rapid (deficit re-

duction makes antirecession stimulus, public investment, or any other major reform requiring fiscal flexibility practically impossible. By obliging ourselves to put all of our eggs into the zero option basket, we preclude from consideration all other measures to improve the economy. Such a state of affairs is one of the signal political triumphs of the Reagan Administration and the conservative movement. Today, a fair number of Democrats, and even some liberals,[23] continue to press such a policy upon the nation.

The notion that interest payments crowd out other public spending does not follow.

"Net interest payments grew from 8.9% to 14.7% of ***federal income. In the end relatively fewer resources were available for all federal functions.. .."***
(Calleo 1992)

"Cumulative public debt is now adding an extra $200 billion to the budget each year-just to pay net interest!... If there is a real line item in the budget we could label 'waste, fraud, and abuse, ' that's it... ."
(Peterson 1993)

The notion that interest payments crowd out other public spending (Calleo 1992; Peterson 1993; Shapiro[24] 199 1) does not follow, and the contention that they are "waste" harkens back to medieval dogma. If the government is paying, say, 5% interest, then a dollar of interest paid yearly in perpetuity made possible $20 in spending. Conversely, $20 in deficit reduction today provides a dollar per year in subsequent interest savings, forever. It is obvious that higher pre-existing debt claims more of the debtor's current resources, but, by the same token, higher interest payments in the present are making possible the past's higher spending. It may or may not be desirable to spend $20 today and a dollar less in every subsequent year (or vice versa), but one can only conclude that higher outlays for net interest payments reduce spending if one ignores the initial outlay made possible by borrowing.

The interest savings made possible by deficit reduction are not impressive. For instance. at 5% interest, saving $10 billion in annual interest payments would require reducing a year's deficit by $200 billion. As pointed out above, insofar as the Fed exploits deficit reduction for the sake of inflation fighting, there will be less interest savings.

A more enlightened line of criticism of interest payment:, is that the runup in public debt in the 1980s did not finance projects that would produce future benefits. While it is true that more investment should increase GDP and reduce the debt burden in the future, this is a question of the best use of public funds. not of whether borrowing and interest payments make it possible to spend more or less.

One could justify borrowing for purposes of consumption if the benefits of spending in the present compare favorably with the costs picked up later. An obvious example is a life-saving medical expense. One would ordinarily prefer to survive and carry a heavier debt burden than to die with good credit. Deficits in the 1980s did not provide such unambiguous benefits, so it could be said that deficits make possible tax cuts or less worthwhile spending (since the costs are deferred), but not less spending overall.

There is no getting around the fact that reducing future interest payments would require drastic cuts in current spending.

From the standpoint of spending capacity, the ability to borrow is an unquestionable advantage, regardless of the extent of prior debt. Anyone free of constraints on borrowing (such as a balanced budget amendment) could not fail to be better off. Avoiding excessive debt is important. but that is a different issue than whether interest obligations per sc reduce spending capacity or well-being.

Some exhortations against borrowing seem to assume that tax revenues are near their upper limit, and that rising interest payments will therefore squeeze out other spending. Yet, as we have noted above, interest payments need not be financed with tax revenues. Moreover, there is little doubt that tax revenue could be increased. The United States currently has one of the lowest levels of taxation in the industrialized world.

There is much wasteful spending to regret from the 1980s, but there is no undoing the past, and there is no getting around the fact that reducing future interest payments would require drastic cuts in current spending. At 5% interest, if $20 of current spending can be found that is less valuable than a dollar of alternative annual spending (or tax cuts) in the future. then we should eliminate the spending. But on this account we would not be spending more or less; we would be spending at different points in time and buying a different bundle of goods and services.

The thesis criticized here is particularly suspect as a brief for increased domestic spending of any type. Under rapid deficit reduction the prospects for new public spending could not be dimmer.

"[T]he large, permanent deficits of the 1980s, and, so far, the 1990s, do not have progressive effects. Moreover, as deficits have grown, so has the tax burden on working families. Together, these developments point progressives in a new direction: restrain the growth of federal spending."
(Shapiro 1991)

Public borrowing in and of itself does not redistribute what is called 'post-fisc' income.

Deficits are said to exacerbate economic inequality because ordinary peoples' taxes are used to pay interest to wealthy holders of government bonds. Tax dollars (and new borrowing) are indeed employed for this purpose. Without doubt, deficits in the early 1980s helped to bring about tax cuts for the rich and increased defense spending. Nevertheless, public borrowing in and of itself does not redistribute what is called "post-fisc" income (that is. income net of taxes and gross of the benefits of government programs). A different president might have used deficits to finance tax cuts as well as new spending benefiting the poor.

The real sources of change in income distribution that are brought about by government budget policy are taxes and spending, not deficits.[25] At the "front end" (when the deficit is incurred), the benefits (tax cuts or spending increases) financed by new borrowing can in principle benefit any income class, depending on the policy being implemented. But what about the ensuing period, when a higher public debt requires increased outlays for interest payments?

A budget may accommodate a rise in interest payments in three ways: with an increase in revenues, a cut in noninterest spending, or an increase in borrowing. In principle, a tax increase or spending cut could be focused on higher-income persons, so the "payback" need not reduce equality. In practice it can be difficult to make "progressive" cuts in public spending, since this spending disproportionately benefits middle- and lower-income persons in the first place. Although raising; taxes is not necessarily an easier remedy, tax increases are more likely to adversely affect the better off.

There is a larger consideration that mitigates the danger of *anyone* bearing the full costs of the payback. The *principal* of the debt need never be repaid; only the interest payments are mandatory. Debt can always be "rolled over" ("refunded" is the formal term) indefinitely; as old bonds are redeemed. new ones are issued. A debt principal of $20 at 5% is fully ser-

viced by an annual payment of one dollar, forever. But nobody lives forever, so everybody can escape some portion of the cost of a perpetual debt.

One way to finance interest payments is with new borrowing. As noted above, this is unwise for a family and probably for most businesses. but under certain circumstances it is quite feasible for the U.S. government. As long as borrowing does not exceed interest outlays, the ratio of debt to GDP will remain approximately the same. To be perfectly safe, we could prohibit the federal government from borrowing as much as 100% of its interest outlays indefinitely. As noted above, we only need to run a modest primary budget surplus to prevent the debt/GDP ratio from rising.

The distribution of noninterest public expenditure is more progressive than the distribution of the tax burden.

All this may seem to signal a trend of burgeoning interest payments by government and consequently a change in the distribution of income. While government bonds are indeed likely to be purchased disproportionately by persons with relatively high incomes or wealth, in order to receive such payments these persons had to forego the purchase of something else. The most likely effect of public borrowing is not on the level of personal saving, but on its composition. For most investors, the purchase of government bonds was an alternative to some other financial asset. In general these investors would be just as wealthy if they had purchased fewer government bonds and more, say, corporate debt. In this light, interest payments are additions to income that would have come about in any case. There is no necessary implication for the distribution of post-fist income.

In general the distribution of noninterest public expenditure is more progressive than the distribution of the tax burden. Therefore, from the standpoint of income equality, the benefits of spending increases can be expected to offset the costs of tax increases necessary to meet the higher interest payments. Similarly, spending cuts will usually be more regressive than the taxes used to finance interest payments. *It is not the practice of borrowing that detracts from equality. What mutters is the distribution of the tax burden and expenditure benefits. The nature of the public sector militates strongly in favor of higher deficits favoring the less well-off.* One should be wary of those who seize on inequality in taxation as a device for attacking public spending, but who steer clear of measures that could directly render the tax system or public expenditure more progressive.

It is entirely possible that fiscal policy from 1980 to the present worsened the distribution of income, but this would not be due to deficits in and

of themselves. Rather, it would stem from changes in the tax code and in the composition of public spending. One might argue that deficits made it easier to "lock in" regressive changes in taxes and spending in the early 1980s. We had income tax cuts in 198 1 that disproportionately benefited the wealthy and payroll tax increases in 1983. But the distributional effects of tax reforms in 198 1 and 1983 were partially offset by major tax increases from 1982 to the present (Stein 1989). A sharp rise in defense spending through 1986, which benefited a lot of manufacturing workers (among others), was followed by a sharp fall in defense as a share of the budget and GDP. We had significant increases in Medicare and Medicaid spending, which overwhelmingly benefit lower-income persons. In the Bush Administration we had some modest but real increases in domestic discretionary spending (Moore 1992). It is possible., although not obvious, that the net effect of these and other policies was a worsening of equality, but such a finding would not rest on a deficit being incurred and net interest payments subsequently rising.

Deficit mania is the most important drag on public efforts to reduce poverty and inequality.

The current reality of federal budgeting is that spending cuts and tax increases falling predominantly on the wealthy are less likely than other measures. If a program for the zero option were implemented, it would probably be financed predominantly by cuts in programs that provide income support and health care to the poor and elderly. (Many current proposals, summarized in the appendix, do just that.) Deficit mania is the most important drag on public efforts to reduce poverty and inequality.

A simple "equality litmus test" for any member of Congress distressed about the use of payroll taxes to pay interest on the debt is to adopt Senator Daniel Moynihan's proposal to cut the payroll tax so that the Social Security and Medicare trust funds are placed on a strict pay-as-you-go basis. To prevent increases in the deficit, the same tax bill should provide for the replacement of all lost revenues by means of an increase in income taxes for the wealthiest 20% of American families.

"[T]he heavy dependence on overseas 'capital in the 1980s has resulted in increasingly conspicuous foreign control of our real assets." (Calleo ***1992)***

Foreign ownership of public debt or assets in general is said to threaten

the nation's political and economic security. Presumably foreigners could undertake transactions that would not be in the interests of the nation, or they could exploit their ownership of U.S. government bonds or other assets for nefarious political purposes.

If we grant that all holders of public debt are motivated by profit and investment portfolio safety, rather than patriotism, it follows that there is no reason why foreign lenders should feel any differently about the quality of U.S. public debt than do U.S. citizens.

The United States, of course, is not like other borrowers. It is one thing for a large country to bully a Third World nation for whom foreign credit is a lifeline to basic civil order, but quite another for any nation to attempt to intimidate the world's only superpower.

Pulling out of the United States would have such grave consequences for foreign investors that the possibility can be discounted altogether.

Pulling out of the United States would have such grave consequences for foreign investors that the possibility can be discounted altogether. If foreigners hold a "fire sale" of a large quantity of U.S. assets in a short space of time, the prices of these assets would be depressed. When these same foreigners exchanged their dollar proceeds from the sale for foreign currencies, the value of the dollar itself would fall. Both types of price changes would impose severe capital losses on foreign sellers.

This implausible "pullout" scenario means foreigners as a group sell their U.S. assets to Americans and exchange their dollars with Americans for foreign currencies. Each nation's currency is a claim on its own assets, so a currency exchange is analogous to an exchange of real assets like land, buildings, corporations, bonds, stocks, etc. In a pullout foreigners basically trade assets they own in the United States for assets that Americans own outside the United States. Since foreigners own more here than Americans own abroad (hence the recent designation of the United States as a "debtor nation"), foreigners must buy U.S. exports to fill the gap. The ultimate effect is that the United States would export more than it imports, and our trade deficit would turn into a trade surplus. All of this is quite unlikely.

About 19%[26] of federal debt is owned by foreigners. Increased foreign ownership of U.S. public debt is typically associated with greater foreign ownership of U.S. assets in general. As noted above, at present foreigners own more U.S. assets and dollars than Americans own of foreign assets and currencies. How this came about is beyond the scope of this paper, although it may be noted that remedies that would provide collateral benefits for deficit

reduction and the economy in general are available (Blecker 1992). So how ought we to regard this increased foreign ownership of U.S. assets?

Assets in the United States provide jobs for American workers. The larger the capital stock, the better the labor-market opportunities should be in the long run. It is not obvious why workers should care whether their company is owned by Americans or foreigners. Ownership is little protection against the mobility of the capital in place, since American companies can move their facilities and export their jobs as easily as can foreigners.

It is not obvious why workers should care whether their company is owned by Americans or foreigners.

A relevant question is whether the national origin of a firm's owner determines where the best jobs are located. There is some evidence that headquarters and high value-added jobs stay in the firm's country of origin. If this is so, it would amplify the national interest in saving and in domestic ownership of capital, but here: we are in a realm of uncertainty and theoretical dispute about a tangential problem that cannot begin to justify such major policies as the zero option.

Another dimension of the foreign ownership issue is that it implies an increased outflow of income from U.S. production to foreign recipients. There are two major interpretations of this prospect: the increased outflow of capital income could affect either the *share* or the level of GDP received by Americans.

Concern about the share is commonly linked to fears of a compromise to U.S. political sovereignty. Since this does not lend itself to economic analysis, we can only refer to the comments above about the debatable economic perils of borrowing from foreigners.

Political paranoia aside, the matter of the American "share" of ownership is only logical as a problem of the absolute level of American-owned assets. Why should we care where such assets are located? Suppose manna from heaven fell in equal bounty on the United States and Japan, but the Creator decreed that all manna landing in the United States was owned by the Japanese and all of it in Japan owned by the United States. In each nation. the share of foreign ownership would have increased. Would either nation be worse off?

Concern about the wealth owned by Americans stems from the regret that the outflow of capital income might instead be received by Americans. This feeling goes back to the truism that if we save more we will be richer in the future. As with the "savings pool" metaphor. this hypothesis tries, to

make economic theory out of accounting definitions. As discussed above. economic growth is not contingent on the zero deficit option

"[T]he big upward adjustments [such as] treasury borrowing of our retirement trust fund 'surpluses' push the deficit back up.. .."
(Peterson 1993)

Is the "real" deficit larger than we are told because of trust fund surpluses? Trust funds are special accounts used by the federal government to administer certain programs such as Social Security, Medicare, and unemployment insurance.[27] They are kept separate from the remainder of federal programs, which are treated in what are called "federal funds."

Why don't the federal funds pay the trust funds with 'real money' from taxes or borrowing from the public, rather than IOUs?

Although we use the conventional term "federal funds," the reality is that the federal funds have no funds, so to speak. They collect a large volume of receipts and administer a larger volume of expenditures. but at the end of the fiscal year their balances are negative-they are in debt to the trust funds.

In FY 1992, the combined surplus of all trust funds was $96 billion, meaning that the "in-go" of revenues and interest earned on the fund balances exceeded by $96 billion the "outgo" of expenditures. A fair amount of the total receipts of the trust funds-$198 billion-was due to transfers from federal funds. These transfers take three forms: money collected from the public through taxes and fees, money borrowed from the public, and IOUs. Revenues and money borrowed from the public by federal funds are used by the trust funds for payments to the public for program benefits and administration. The IOUs are new debts owed by the federal funds to the trust funds. As noted above, the federal funds maintain negative balances because they are in debt to the trust funds. Of the $198 billion transfer, $102 billion ($198 - 96) was used for payments to the public that required federal revenues and money borrowed from the public. The $96 billion remaining in the transferred amount consisted of loans by trust funds to federal funds.

Why don't the federal funds pay the trust funds with "real money" from taxes or borrowing from the public, rather than IOUs? To the extent the transfers from federal funds are not needed by the trust funds in the year in question, the only thing the trust funds could do with any surplus is bank it-which means lending it to the public. Why, then, should the federal funds

increase taxes or borrow from the public so that the trust funds can turn around and lend the money out again? There would be no effect on national saving or anything else if the trust fund surpluses were handled in this way.[28] If the extra debt to the public taken on by federal funds is added to the official deficit, then for the sake of consistency we should count the additional assets held by the trust funds. Consolidating these transactions for the entire federal government returns us to square one: there would be no change in net borrowing from the public, and no effect on national saving or investment.

The reality of the trust fund surplus is that it has no effect whatsoever on the budget or the economy.

The reality of the trust fund surplus is that it has *no effect whatsoever* on the budget or the economy. It is not borrowed from the public. Only the $290 billion-the "federal borrowing requirement"-is borrowed from the public under the auspices of federal funds, and only this amount could have some kind of fiscal or economic effect.

The remaining $102 billion of transfers from federal funds to trust funds was used for payments to the public or for government purchases of goods and services to run the trust fund programs, so it was necessary to finance this amount through taxes and borrowing from the public. Total trust fund resources could not have been used to "hide" some part of the deficit because the trust funds draw more from general revenue and borrowing then they contribute with their own revenues. In other words, the combined trust funds contribute to the deficit.

An exception to this pattern can be found in the trust fund for Social Security, which consists of Old Age and Survivors' Insurance (OASI) and Disability Insurance (DI). What is different about Social Security is that it collects more in actual payments from the public in the form of payroll taxes than it spends on administration and benefits. For instance, in 1992 OASI ran a $51 billion surplus, while the excess of receipts from the public over administration and benefits was $20 billion (OMB 1993). The other $31 billion came from interest credited to the OASI trust fund by the federal funds. Like the other trust funds, OASI loans its surplus of $51 billion to the federal funds. Unlike the other trust funds, $20 billion of this surplus is money collected from the public that is spent on programs administered through the federal funds. This means that to this extent the OASI program *reduced* the amount the federal government had to borrow from the public. In other words. it reduced the official deficit; it did not "hide" it.

No matter how you slice these figures, the OASI program did not force the government to undertake some covert borrowing that contributed to some hidden deficit. The deficit is what the federal government borrows from the public, and OASI allowed the federal funds to borrow less. Insofar as federal borrowing from the public is bad for the economy, borrowing from the trust funds alleviated such harm.

This conclusion follows with greater force if we look beyond a single year. Even though trust fund balances derived from earmarked revenues are not backed by tradable financial assets, these balances. including the interest accrued, imply reduced federal debt held by the public. If a trust fund collects one dollar more than it needs to pay in program benefits. and this dollar is lent to federal funds for purposes of general expenditure. then this transfer, as noted above, precludes the need to borrow that dollar from the public. Moreover, the interest in the trust fund "earned" by that same dollar reflects the foregone interest payments on the dollar not borrowed.

Reducing program benefits for the purpose of deficit reduction would increase borrowing by federal funds of trust fund receipts.

Critics of deficits often declare that the intragovernmental loans from trust funds to federal funds are a scandal and should be counted as an addition to the national debt. But reducing program benefits for the purpose of deficit reduction, as proposed by the Concord Coalition (1993) and others. would *increase* borrowing by federal funds of trust fund receipts from the public, which amounts to "stealing" even more of the surplus (by the popular reckoning alluded to above). Reducing benefits would reduce to some extent the liabilities of federal funds to trust funds, meaning fewer interfund IOUs but also greater borrowing of dedicated receipts by the federal funds for the purpose of general expenditure-also known as deficit reduction.

"When retiring baby boomers look for their Social Security benefits 20 years from now, all they'll find is a bunch of paper IOUs from the federal government. When retiring postal workers, military personnel, civil servants, and railroad employees look to their government-run pension funds for monthly checks, the money supposedly set aside to pay those checks won't be there...."
(Figge and Swanson 1993)

Will the national debt impede the government's ability to meet its commitments in the future? From an accounting standpoint, the trust funds will

be solvent for varying lengths of time, depending on the fund (CBO 1993b). Dedicated revenues are automatically credited to the funds, so the extent of deficits cannot affect the fund balances. The same is true of interest accruing within the funds; these are also automatic receipts, consisting of IOUs from federal funds. The critics' point is that nothing in these funds can be used to make payments to the public in the future. But this does not mean the government will not be able to keep its promises. The only way to finance future benefits is borrowing from or taxing the public, and, as noted elsewhere in this paper, the feasibility of these devices is entirely a matter of the health of the economy. It has nothing to do with whether a particular fund is in surplus or deficit, and little to do with overall budget deficits.

Social Security produces no adverse effect whatsoever on deficits for the next 20 years.

Beyond 2030, Social Security expenditures for benefits and administration begin to fall behind trust fund income (Steuerle and Bakija 1994). Moreover, the gap widens markedly after 2050. In this event, some combination of tax increases and benefit reductions would be required to repair the system.

An immediate increase in the payroll tax of about 2.1 percentage points would keep the trust fund in the black for the next 75 years. Alternatively, we could do nothing for 20 years, then raise the rate by about 2.5 percentage points immediately and by another 2.5 points (relative to current rates) gradually until 2030 (Board of Trustees 1994). These increases are not trivial, and they are not proposed here as ideal policies. Rather, they are meant to show that the scale of necessary reform in Social Security is manageable. The policy implications of the long-range problem in OASDI are discussed below.

Until 20 15, cash paid out by Social Security will be less than receipts. In this sense, *Social Security **produces** no adverse effect whatsoever on deficits for the next 20 years.*

In contrast, the federal retirement systems for civil servants and military personnel are now close to their peak in terms of the number of retirees relative to the number of current federal employees (OMB 1991). The costs of retirement benefits should roughly keep pace with federal payroll, both of which do not grow any more rapidly than receipts. In other words, no increasing deficit pressure can be attributed to these retirement systems, and there would be little payoff to them for the sake of averting any future "blow-up" of the deficit.

Summary: Let Us Now Praise Deficit Reduction

The dominant influence deficits have enjoyed in policy debates, as well as the public revenues that have been offered in tribute to the war on deficits, are unjustifiable. The case for the zero option-rapid deficit reduction-does not stand up to scrutiny. Deficits do not reflect the changes in the nation's economic well-being that have been imputed to them, nor do they threaten the ability of the federal government to meet future commitments to the elderly and others. As a routine matter there is no reason why the deficit should be zero or nearly so. The result of these mutually compounding errors has been a tragic rejection of fiscal policies that could reduce unemployment and promote long-term growth.

But the principle that lower deficits and debt, judiciously brought about, are preferable from the standpoint of investment and growth is not rejected here. If the federal government borrowed $1 trillion a year for the next 15 years, the economic outlook would not improve. More realistically. and assuming the Federal Reserve committed itself to growth, deficit reduction in periods of economic health could have worthwhile effects on irtvestment and a more tolerable cost in employment. The maxim that deficits that finance public consumption detract from capital formation is true enough to justify a policy of sustainable deficit reduction. This is a different view from one that calls for automatic, large deficit reductions without regard to employment. We need more realistic expectations for deficit reduction.

The principle that lower deficits and debt, judiciously brought about, are preferable from the standpoint of investment and growth is not rejected here.

The preferred standard for evaluating deficits is the change in the ratio of debt to GDP over an extended period. Deficits that are routinely well above zero, and deficit increases for purposes of fiscal stimulus. are consistent with a decline in the debt/GDP ratio and advances in capital formation. From this standpoint, sustainable deficit reduction entails:

- Structural reform of the U.S. health care system, the unique solution to the long-term burden of the public debt;
- Consistent reduction of the debt/GDP ratio when unemployment is low;
- Fiscal stimulus to relieve high unemployment;
- Expanded public investment in a capital budgeting framework

Some will object that postponing action on the deficit is merely a means to evade the problem. Yet, to the contrary, this proposal calls for health care cost containment efforts to proceed immediately, since significant savings in health care spending will take time to bring about. The real political problem is that such efforts entail painful choices that politicians would prefer to avoid for the sake of measures that are dramatic on their face but that do not compel difficult decisions or real action any time soon, if ever.

Looking Ahead

In this section, we discuss the current (summer 1994) outlook for the federal budget deficit and the ways in which the budget has evolved to reach this point. Finally, we consider policy options in the broader context of putting the nation on a path to full employment and long-term growth.

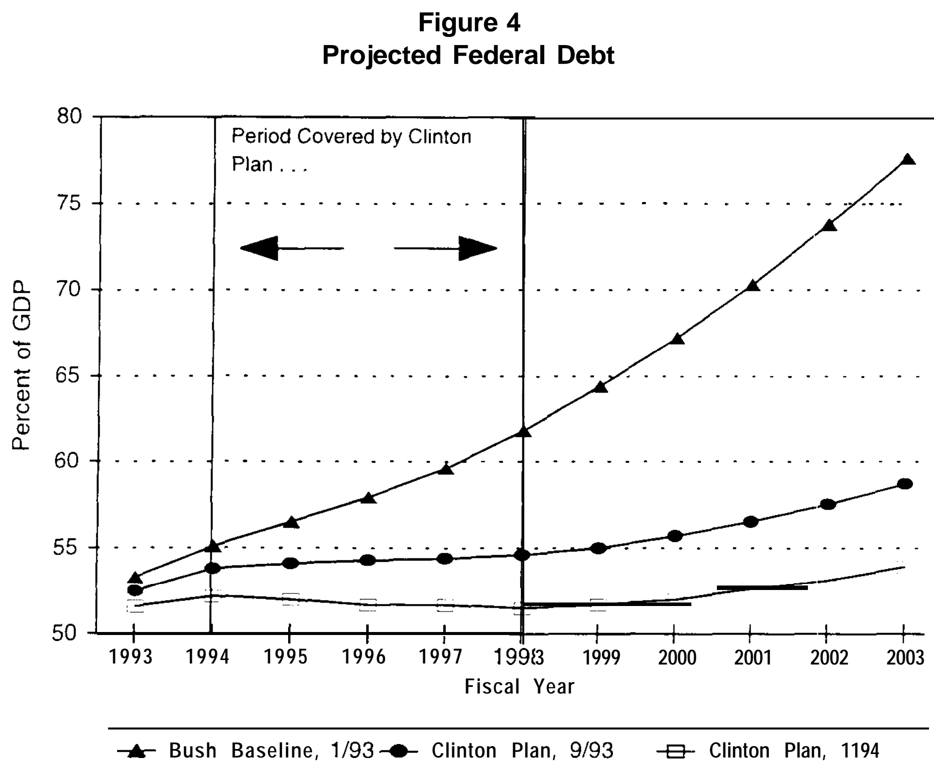
At the outset, the data need to be put in the proper context. Alarmists eschew appropriate gauges of debt and deficits in favor of dramatic numbers derived from absolute dollar amounts. The fallacies of such rhetoric should be clear. Federal debt held by the public is close to $3.3 trillion, compared with $242 billion in 1946. But if we translate the 1946 level in terms of its size relative to GDP, it would be more than $7 trillion. Conversely, if we translated the present debt to 1945 terms, it would total $ 1 14 billion. A debt of $10 trillion, given our current experience. is colossal, but next to a GDP of $40 trillion, it would be comparable to our debt burden in 1970. It is the relative size that matters, and the obvious standard of comparison is the entire economy as measured by GDP.

Alarmists eschew appropriate gauges of debt and deficits in favor of dramatic numbers derived from absolute dollar amounts.

Where We Stand With the Federal Budget

Figure 4 shows recent changes in the IO-year outlook for the ratio of

Figure 4
Projected Federal Debt



debt to GDP (CBO 1993b,1993c, 1994). The top line reflects the baseline that stood when Bill Clinton was inaugurated last year. Such projections helped to stampede the Administration into a budget agreement that was heavy on deficit reduction and light on measures to foster economic growth and social justice.

The underlying data are shown in **Table 1.** The first line of the first panel, under the heading *"As of January* **2993,"** shows deficits in current dollars. The fifth line shows the ratio of debt to GDP and is the top line in Figure 4. In January 1993, the deficit in year 2003 was projected to reach $6.53 billion, and debt held by the public was projected at $7.5 trillion, or 78% of GDP.[29]

Such deficit projections helped to stampede the Administration into a budget agreement that was heavy on deficit reduction and light on measures to foster economic growth and social justice.

These numbers might be scary, but how reliable are they? Their authors said:

> "[E]normous uncertainty surrounds such long-range extrapolations. The economy's performance is a big question mark.. . .The economy is bound to deviate from these assumptions in ways that cannot be anticipated. And other major uncertainties abound, most notably about the continued spiraling of health care spending and about other open-ended commitments, such as those for deposit insurance." (CBO 1993b)

Is disaster upon us? Only if nothing is done, but nobody expects such an outcome. In fact, as we discuss shortly, plenty has already been done. Nor should we forget that unanticipated events can bring the deficit down as well as push it up. In particular, since health care spending is large and is expected to grow rapidly, the projections are sensitive to small deviations in the rate of growth of that sector. A downward fluctuation in this growth would bring about a significant change in the deficit for the year in question, along with compounded effects (due to a lower baseline and lower debt-service costs) in subsequent years.[30]

In January 1993 the federal deficit for FY 1993 was projected by President Bush's Office of Management and Budget at $327 billion. The actual amount turned out to be $255 billion, more than 22% off the mark. Only a few years ago, deficit hysteria was enlarged by the savings and loan bailout. We were told that costs could exceed half a trillion dollars (Figge and Swanson 1993. 53). It turns out that the actual figure is about $150 billion (CBO 1993b). Such results underline the fragility of the case for panic and

Table 1
The Budget Outlook Through 2003

	Billions, Fiscal Year										
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
As of January 1993											
Cash-Flow Deficit	310	291	284	287	319	357	404	455	513	579	653
Net interest	198	211	231	250	270	292	314	339	368	400	437
Primary Deficit	112	80	53	37	49	65	90	116	145	179	216
Debt Held by the Public	3,290	3,585	3,874	4,169	4,496	4,863	5,275	5,739	6,261	6,850	7,512
As a % of GDP	53.3	55.1	56.5	57.9	59.6	61.8	64.4	67.2	70.3	73.8	77.6
As of September 1993											
Cash-Flow Deficit	266	253	196	190	198	200	223	251	282	320	359
Net interest	198	203	217	230	242	253	265	278	292	311	327
Primary Deficit	68	50	(21)	(40)	(44)	(53)	(42)	(27)	(10)	9	32
Debt Held by the Public	3,249	3,507	3,713	3,919	4,137	4,357	4,601	4,873	5,176	5,517	5,896
As a % of GDP	52.5	53.8	54.1	54.3	54.4	54.6	55.0	55.7	56.5	57.5	58.7
As of January 1994											
Cash-Flow Deficit	255	223	171	166	182	180	204	226	256	288	324
Net interest	199	201	212	228	239	249	261	270	283	298	315
Primary Deficit	56	22	(41)	(62)	(57)	(69)	(57)	(44)	(27)	(10)	9
Debt Held by the Public	3,247	3,462	3,642	3,822	4,021	4,218	4,441	4,686	4,961	5,268	5,611
As a % of GDP	51.6	52.2	52.0	51.7	51.7	51.5	51.7	52.0	52.6	53.1	53.9
After $120 ***Billion Stimulus***											
Stimulus (Deficit Increas	60	60	0	0	0	0	0	0	0	0	0
New Net Interest	198	206	224	238	250	262	274	287	302	321	338
New Cash Flow Deficit	326	316	203	198	206	209	232	260	292	330	370
New Primary Deficit	128	110	(21)	(40)	(44)	(53)	(42)	(27)	(10)	9	32
New Debt Held by Public	3,309	3,630	3,844	4,057	4,283	4,512	4,765	5,046	5,359	5,710	6,100
As a % of GDP	53.5	55.7	56.0	56.2	56.3	56.5	57.0	57.7	58.5	59.5	60.7

Sources: Data from Congressional Budget Office, EPI calculations.

precipitous action, based as it is on predictions of events 30 years *away*. Errors in projections compound over time; the further ahead in time, the greater will be the discrepancy between actual and predicted values. Readers are invited to form their own conclusions about the degree of justifiable confidence in projections of budget outcomes for the year FY2003.

Errors in projections compound over time; the further ahead in time, the greater will be the discrepancy between actual and predicted values.

How did the Clinton plan alter the picture described above? The second line in Figure 4 is the projected debt/GDP ratio after passage of the Budget Act of 1993. The period explicitly covered by the plan is FY 1994-98 inclusive, but the effects of the plan persist. Within the window of the plan itself, growth in debt/GDP is halted. Beyond the term of the plan, the ratio begins to grow once more, though not nearly as quickly or as much as under the previous baseline.

Table 2 compares the five-year outlook before and after the budget passed in 1993. Before passage, debt held by the public was projected to rise from $3,290 billion in 1993 to $4,863 billion in 1998, or 7.82% per year, even though receipts were projected to grow more rapidly than outlays by almost half a percentage point (5.19% as opposed to 4.7 1%). At the same time, GDP was projected to grow at less than 5% annually, so the debt/GDP ratio was projected to rise to 62% by 1998.

The Clinton plan raised the growth rate of receipts from 5.19% to 5.99%, and lowered it for outlays from 4.7 1% to 4.19%. At the end of the period total debt was projected to be $4,218 billion, $645 billion less than under the Bush baseline.

Developments between September 1993 and January 1994 required upward revisions in the GDP growth rate from 4.87% to 5.17%. Expected growth in health care spending also faded somewhat, at least temporarily. The result was an additional reduction from the Bush baseline in the projected ratio of debt to GDP to 52% By the year 2004 debt held by the public as a percent of GDP is projected at 55%.

The Clinton plan reduces the increase in debt held by the public by nearly $2.4 trillion over the Bush budget baseline for the IO-year period. Critics of the Administration made much of the residual debt accumulation and ignored the distance covered by the plan. The extent of deficit reduction reflected in the CBO projections may be overstated if the fiscal drag arising from the deficit cuts reduces economic growth below expectations. but by any reasonable standard the contrast with the Bush baseline is striking.

Table 2
The Economic and Budget Outlook Through 2004, Before and After Congress Passed the Clinton Budget
(Billions, Current Dollars, By Fiscal Year)

	Before				After					Out Years		
Fiscal Year	1993	1998	5-Year Growth	Annual Growth Rate	1993	1998	5-Year Growth	Annual Growth Rate	The Clinton Difference	2004	6-Year Growth	Annual Growth Rate
Gross Domestic Product	6,178	7,883	1,705	4.87%	6,295	8,185	1,890	5.25%	0.38%	10,920	2,735	4.80%
Revenues	1,143	1,482	339	5.19%	1,153	1,556	403	5.99%	0.80%	2,054	498	4.63%
Outlays	1,453	1,839	386	4.71%	1,408	1,736	328	4.19%	-0.52%	2,419	683	5.53%
Unified Budget Deficit	310	357	47	2.82%	255	180	(75)	-6.96%	-9.78%	365	185	11.78%
Debt Held by the Public	3,290	4,863	1,573	7.82%	3,247	4,218	971	5.23%	-2.58%	5,995	1,777	5.86%
As a Percent of GDP	53%	62%	8.44%	2.94%	52%	52%	-0.05%	-0.02%	-2.96%	55%	3%	1.05%
Exhibits:												
Discretionary Outlays	547	584	37	1.31%	543	547	4	0.13%	-1.18%	658	111	3.08%
Mandatory Outlays:												
Social Security	302	385	83	4.86%	302	388	86	5.01%	0.16%	523	135	4.98%
Medicare	146	259	113	11.46%	143	238	95	10.16%	-1.30%	435	197	10.05%
Medicaid	80	146	66	12.03%	76	135	59	11.54%	-0.49%	250	115	10.27%
Civil Service and Military Retirement	61	79	18	5.17%	69	73	4	1.21%	-3.96%	96	23	4 56%
Other	180	182	2	0.22%	172	191	20	2.15%	1.93%	232	41	3.24%
Deposit insurance	3	(10)	(13)	NA	(28)	(4)	24	NA	NA	(2)	2	-11.55%
Net interest	198	292	94	7.77%	199	249	50	4.49%	-3.28%	334	85	4.89%
Offsetting receipts	(65)	(78)	(13)	3.65%	(67)	(83)	(16)	4.25%	0.61%	(106)	(23)	4.08%

Sources: Congressional Budget Office, Economic and Budget Outlook: FY1994-98, January 1993; Update, September 1993; Congressional Budget Office, Economic and Budget Outlook: FY1995-99, January 1994.

On the spending side, reductions in projected outlays are for the most part spread throughout the budget." The growth rate of Medicare is reduced significantly, if temporarily, and modest reductions are achieved in federal employee retirement and user fees ("Offsetting Receipts"). The big loser is discretionary outlays, which are fixed at $547 billion. There is no boost to aggregate nonmilitary public investment in this plan.

The updated deficit projections (CBO 1994) do not change the basic maxim that growth fails to eliminate deficits. As we will see in the next section, the reason in this case is that a significant piece of the budget—health care-will once again grow more quickly than receipts or GDP.

Borrowing restricted to financing net interest outlays generally does not add to the debt burden.

Figure 4 is suggestive of the policy direction embodied in sustainable deficit reduction. The ratio of debt to GDP is substantially flattened out through approximately FY2000. During that period, the nation has the opportunity to develop sustainable, comprehensive reforms to contain the costs of health care. Successful implementation of such reforms would make it possible to continuously "grow our way" to lower debt-GDP ratios, as the nation did steadily for 30 years after 'World War II.

How We Got Here

As shown in Figure 2, the debt/GDP ratio, after mostly declining through the 1970s. began a steep upward climb in 198 l. It is reasonable to search for factors underlying the runup in the ratio since then, since these would seem to be at the root of our present situation.

The primary deficit remains our focus, since, as discussed above, borrowing restricted to financing net interest outlays generally does not add to the debt burden. It is true that in order to reduce the ratio of debt to GDP, it is usually necessary to run *primary budget surpluses:* that is, one must borrow fess than the amount of net interest outlays.

Table 3 shows budget trends over the years that the debt/GDP ratio was increasing-from FY 1982 to 1992. The data are expressed in terms of annual rates of growth; GDP growth is included for purposes of comparison.??

In terms of receipts, the effect of the 198 1 tax cuts in FY 1982 and 1983 are obvious. Against a decade (FY 1982-1992) average of 5.5% a year, receipts grew only 3.1% in 1982 and *fell* 2.8% in 1983 (not shown in the table). Increases thereafter can be attributed to the economic recovery, but

Table 3
Federal Budget Dynamics in the 1980s

	1980	1982	1984	1986	1988	1990	1992	Average Growth Rate, 1982-92	Percent of Total Outlays 1992	Absolute Increase, FY 1992
Annual Rates *of Growth*										
Gross Domestic Product	8.8%	5.3%	11.4%	6.3%	8.0%	5.7%	4.2%	6.2%	NA	
Total Receipts	11.6%	3.1%	11.0%	4.8%	6.4%	4.1%	3.5%	5.5%	79.0%	37.4
Total Expenditure	17.4%	10.0%	5.4%	4.6%	6.0%	9.6%	4.4%	6.5%	100.0%	58.0
Net Interest	23.2%	23.5%	23.7%	5.0%	9.4%	8.8%	2.5%	9.7%	14.4%	4.9
Medicaid	12.9%	3.6%	5.8%	10.1%	11.3%	18.8%	29.1%	12.7%	4.9%	15.3
Medicare	21.6%	19.5%	9.4%	6.7%	4.8%	15.8%	13.9%	10.2%	8.4%	14.2
Social Security (OASDI)	14.1%	11.6%	4.5%	5.4%	5.7%	7.0%	6.9%	6.6%	20.6%	18.3
Deposit Insurance	-76.5%	50.0%	-33.3%	-168.2%	222.6%	164.1%	-96.1%	NA	0.2%	(63.7)
All Other Mandatory	22.2%	8.9%	-14.0%	-4.6%	1.3%	9.4%	65.2%	4.3%	12.8%	69.6
Defense/International	17.1%	15.9%	9.3%	7.8%	3.0%	-0.4%	-5.6%	5.7%	23.2%	(18.9)
Domestic Discretionary	13.3%	-6.6%	4.2%	1.3%	7.5%	8.0%	9.3%	4.1%	15.5%	18.1
As Share of GDP										
Federal Deficit	2.8%	4.1%	5.0%	5.2%	3.2%	4.0%	4.9%			
Federal Debt Held by Public	26.8%	29.4%	35.2%	41.2%	42.6%	44.1%	5 1 1%			
Primary Deficit	0.8%	1.4%	2.0%	2.0%	0 1%	0.7%	1.5%			
Net of Deposit Insurance	0.8%	1.4%	2.0%	2.0%	-0.1%	-0.4%	1.5%			
Assuming Primary Deficits Were Zero Since '62:										
Cash-Flow Deficit	1.5%	1.9%	1.7%	1.6%	1.6%	1.7%	1.6%			
Federal Debt Held by Public	22.2%	22.3%	22.1%	22.7%	22.9%	23.4%	24.9%			
Assuming Primary Deficits Were Zero Since '81:										
Cash-Flow Deficit		2.3%	2.1%	2.0%	1.9%	2.0%	1.9%			
Federal Debt Held by Public		27.0%	26.7%	27.4%	27.7%	28.3%	30.1%			

also to legislated tax increases in 1982, 1983, 1984, 1986, 1987, and 1990 approved by Presidents Reagan and Bush (Stein 1989).

Growth in expenditures outpaced GDP. On average, no more than a gap of one percentage point between receipts and expenditures was sufficient to yield the deficits we have come to regret. It is worth noting that expenditure growth exceeded GDP by much less (0.3%) than receipts fell short (0.7%), so by the GDP standard we co-uld say that the shortfall in receipts was responsible for 70% of our deficits'. There is no real objective reckoning in this regard-one could argue just as easily that receipts should have kept up with expenditures or that expenditures should not have outstripped receipts.

What matters in deficits are categories of expenditure that are both large and fast-growing.

Our main purpose here is to look more closely at the expenditure side. As noted above, what matters in deficits are categories of expenditure that are both large and fast-growing. A small item that grows rapidly is of little importance in a $1.5 trillion budget, whereas a large item that fails to increase dwindles in significance next to the perennial expansion of the tax base.

The two major causes of spending growth, aside from interest payments, are the two largest health care programs in the federal budget-Medicaid and Medicare. Both grew annually at double-digit rates, about twice as quickly as receipts or GDP.[33]

The other major entitlement program-Social Security's insurance for old age and disability-was well behind the health programs in rate of growth. The average for 1982-92 was 6.6%, slightly more than GDP. As explained above, the collection of dedicated payroll tax revenues for OASI and DI will have *reduced* the need for federal borrowing from 1984 to 20 15 (Board of Trustees 1994).

Separating out deposit insurance[34] shows what happened to other, more routine mandatory expenditures, including all entitlements other than Social Security, Medicare, and Medicaid. This category includes all means-tested "welfare" programs. What emerges from Table 3 runs strongly against the conventional wisdom: *total mandatory spending (aside from Medicare, Medicaid, Social Security, and deposit insurance) grew more slowly than total receipts.* The thesis of so-called runaway entitlement spending is specious. In the case of Medicare and Social Security, moreover, the existence of trust fund balances for both programs in the 1980s supports the argu-

ment that neither of these programs should be assigned retrospective responsibility for deficits in the 1980s. Revenues collected under their auspices actually reduced the need for federal borrowing.

Prospectively the situation is somewhat different. The Social Security trust funds will have positive balances until 2030.[35] The Medicare trust fund is not nearly so well off; it is projected to go into debt in the year 2000 (GAO 1992). The anticipated, if debatable, rate of growth in Medicare and Medicaid spending is roughly double that for GDP and federal receipts. Such growth is not sustainable indefinitely, so some kind of cost containment will be required in less than 10 years. *Nothing else* in the federal budget presents this problem of rapid growth.

The slowdown in domes tic and, belatedly, defense discretionary spending is the single, dubious achievement of the Gramm-Rudman regimes.

Growth in defense spending outstripped that of receipts in every year but one from 1980 to 1986, but since then the reverse has been the case. Just as cuts in mandatory spending (outside of health care) cannot fix the deficit, neither can cuts in defense. No program that fails to justify its costs should be held immune from cuts, but no illusions should be harbored that defense budget cuts have much to do with long-term deficit reduction.

The category of nondefense discretionary spending includes the costs of most government administration (outside of defense and international). including employee payroll and other purchases of goods and services. and all public investment in civilian infrastructure, education, and training. Here the bottom line is that such spending grew more slowly—4.1 %--than everything else noted so far. It had the least by far to do with the deficit. In fact, the slowdown in domestic and, belatedly, defense discretionary spending is the single, dubious achievement of the Gramm-Rudman regimes. Such measures did not reduce the deficit because they failed to reckon with health care; instead, given the importance of civilian public investment to economic growth, they probably cost the nation more (including lost deficit reduction) than they gained.

The discretionary categories-both defense and domestic-are the infamous repositories of pork-barrel spending. While the extent of waste in the budget cannot be known with any precision, there is little reason to believe that waste has increased in relative terms. If we acknowledge that, then the slow growth of discretionary spending implies the diminution of government waste. It also attests to the forbearance of the much-maligned Congress. While such self-denial may have been bad economic policy, the

U.S. Congress should at least be credited with acting effectively in the face of what it perceived to be a deficit problem by restraining (after 1986, in the case of defense) that part of spending that was most amenable to limitation.

"Reinventing government," like Idiscretionary spending, is mostly irrelevant to the deficit problem. While the search for efficiency improvements is commendable, such spending is no cause of deficits (Diulio et al. 1993).[36]

'Reinventing government,' like discretionary spending, is mostly irrelevant to the deficit problem.

In general, if we designed deficit reduction according to how deficits arose-if we "sent the bill to those who went to the party"-we could point to the 1981 tax cuts and to spending on defense and health care. Alternatively, if we are interested in controlling the forces holding up deficits in the near future (defined here as the next 40 years), the proper focus narrows exclusively to health care. The reason is that any cut in a program that grows as slowly as GDP (which means everything except Medicaid and Medicare) and any tax increase that also grows at the same rate as GDP will fail to hold the line on any expenditure that grows more rapidly than GDP.

One alternative route to deficit reduction is annual tax increases to cover burgeoning health care costs. Absent a sea change in public opinion about taxes and government, no such scenario is politically plausible.[37] In fact, there is no tax reform that permanently shields the deficit from the growth of Medicare, Medicaid, and health-derived tax expenditures, because no fixed set of tax rates, brackets, deductions, etc. provides receipts that grow more rapidly than GDP.[38]

To say a path is unsustainable over the long run does not imply that some dramatic action must be undertaken immediately. We have some way to go before the unsustainable becomes the insupportable. What is most important is setting in place a reliable process of health expenditure control that gathers steam over time.

What Should Be Done Now

How much further deficit reduction is in order now, and how soon must it come about? Returning to our basic principle, we focus on the debt/GDP ratio and the primary deficit. The bottom line in Figure 4 depicts the latest projections from the CBO (1994). (The third panel of Table 1 shows the same data.)

One year ago, primary deficits were foreseen for the entire decade. Pas-

sage of the Clinton budget moved the budget to primary *surpluses* for 1995 to 2002, inclusive, but rising primary deficits are projected for FY 2003 and after. CBO projects no growth in the debt/GDP ratio until 1999, followed by increases totaling 3.4 percentage points through FY2004.

Does the rise in debt/GDP under Clinton's budget justify large spending cuts and tax increases? The previous section argued that the answer to this question is no and advocated sustainable deficit reduction as an alternative. We have also pointed out the irrelevance of most expenditure categories to long-term deficit reduction. The implications of this position are offered next.

Budgeting for Economic Growth

Given the prevailing potential for unemployment problems. economic stimulus via deficit increases should be kept under consideration. A group of prominent economists, including Nobel laureates James Tobin and Robert Solow, proposed a $60 billion annual stimulus for 1993 (Tobin1992).[39] While such a policy may be less pressing now, we would like to illustrate its feasibility in the context of long-term deficit reduction. For this purpose, we modify the CBO projections of the Clinton plan (provided in the second panel of Table 1) with the assumption that such a program was undertaken in 1993 and 1994. (We do not use the most recent projections in the third panel because we want to illustrate the effect of a stimulus in a period in which deficits are already thought to be too high and in which the debt burden is increasing at a moderate pace.)

Given the prevailing potential for unemployment problems, economic stimulus via deficit increases should be kept under consideration.

The result is shown in the bottom panel of Table 1. A two-year program of $120 billion stimulus increases the FY 1993 debt/GDP ratio by 2.5 percentage points over two years. As the table shows, however, the subsequent effects are small-the debt-service costs are no more than $1 1 billion annually by FY2003, and the debt/GDP rate is only two percentage points higher-60.7% instead of 58.7%.[40] Economic stimulus, then, does negligible harm to the long-term debt outlook.

To defend against the charge that stimulus would be undertaken carelessly, the Congress should consider two sorts of criteria for implementing such a measure: (1) the extent of economic sluggishness that would trigger a stimulus; and (2) the rules for a regime of fiscal discipline.

Economic stimulus primarily addresses short-term employme-nt prob-

lems, but it also bears on long-term growth because drops in GDP are likely to be associated with declines in investment and capital formation in the private sector. In the same vein, public investment is often the first casualty of fiscal distress in state and local governments. We have emphasized that the long-term fiscal health of the national government depends on economic growth, not on the absolute level of the national debt, interest payments, deficits, or trust-fund surpluses. While year-to-year changes in deficits are unimportant in this context, an appropriately specified regime of fiscal discipline focused on the management of the debt/GDP ratio is essential. The nature of this regime is elaborated in the next section.

A more reliable way for government to guarantee new investment is to undertake it directly by expanding public-sector capital.

A focus on long-term economic growth cannot be limited to the pursuit of capital formation in the private sector. Private capital is but one of a number of factors in economic growth, and not the greatest by any means."

A more reliable way for government to guarantee new investment is to undertake it directly by expanding public-sector capital. Unfortunately, the political emphasis on deficit reduction since the early 1980s has depleted the resources available for public investment (Democratic Study Group 1990) in facilities that would improve the profit margins and productivity of firms.

A thriving literature has developed on the benefits of public investment for economic growth (Aschauer 199 1; Kuttner 1992), and this issue served Clinton well in his campaign. The evidence turned up by this research is also an indirect testament to the ability of Congress to direct resources at real needs, as opposed to pork-barrel projects.

We can also use public investment to help the workforce augment its education and technical skills (Rasell and Appelbaum 1992) and to reverse the underutilization of our cities (Persky, Sclar, and Wiewel 1992; Cisneros 1993). Protests about spending excess notwithstanding, the budget passed by Congress in 1993 provides for *no meaningful increases* in resources devoted to such ends; resources are instead commandeered for deficit reduction (Schafer 1993; Democratic Study (Group 1994).

Democratic spending advocates have been known to muddy the investment issue by using the "investment" label to garnish any projects they favor. The current budget process takes little account of the differences between investment and consumption, yet such a distinction would be helpful. Investments that improve the economy's long-term prospects will ease

the burden of whatever level of public debt prevails in the future.[42] In FY1992 the government's net borrowing was $290 billion, but net public investment (gross investment minus depreciation of the public capital stock) was $50 billion.[43] The difference-$240 billion-is a better guide to fiscal policy's immediate implications for total (public and private) capital formation.[44]

An increase in the primary deficit that finances public investment will, we expect, lift future GDP. Therefore, primary deficits that finance capital investment should be considered; they would not change the burden of public debt in the long run.

Improvements in the economic forecast since passage of the 1993 Omnibus Budget Reconciliation Act promise even lower deficits, adding up to a savings of $105 billion during 1994-98. Yet if current policy continues, every cent will be devoted to additional deficit reduction. In his 1992 campaign, President Clinton promised to scale back his plans for public investment if tax increases were required to implement them. Upon taking office, he surprised the nation with proposals for significant tax increases earmarked almost entirely for deficit reduction. Now that additional funds are available for new spending without the need for additional taxes, there is a precious opportunity to fulfill a campaign pledge that was the core of the Democrats' strategy for boosting economic growth.

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A Liberal Dose of Fiscal Discipline

What is an appropriate regime for deficit reduction? We agree that it is necessary to somehow control federal borrowing and indebtedness, and there are two basic tasks in this regard. One is to periodically change the structural deficit to stabilize the business cycle, as discussed above. The second is managing the public debt over the long term.

By one school of thought, a constant debt/GDP ratio should be maintained indefinitely (Eisner 1994).[45] A yet more cautious approach would reduce the ratio gradually, as the nation did for almost 30 years after World War II. This qualification of Eisner's rule is founded on expectations of some limited benefits for private investment arising from a downward drift in the debt/GDP ratio (assuming a cooperative, pro-growth Federal Reserve Board). In addition, a general aversion to risk motivates our preference for a declining burden of public debt.[46]

Since the President's latest budget halts the rate of growth of debt/GDP for a considerable period, as a next step it is necessary only to force the ratio to fall, not to eliminate deficits altogether. This can be accomplished by using savings in health care spending to maintain modest primary budget surpluses, in the neighborhood of 0.5% of GDP. In other words, if the federal government pays $283 billion in net interest in FY2001, a cash-flow deficit in the neighborhood of $233 billion would yield a primary surplus of $50 billion, enough to reduce the debt/GDP ratio.

Because the near-term outlook for deficits is so good, there is no compelling reason for further short-term deficit reduction.

As suggested above, new reductions could begin at the point where the primary surpluses begin to dwindle; as shown in Table 1, third panel, this occurs around the year 2000. As emphasized above, the principal obstacle to "growing out of the deficit" is health care spending. If the rate of growth of Medicare and Medicaid can be arrested, the long-term instability of the debt-GDP ratio can be eliminated. If it cannot, there is no end to budget problems.

Because the near-term outlook for deficits is so good, there is no compelling reason for further short-term deficit reduction. In June 1994, published reports said that the CBO's estimate of anticipated deficits had fallen again. For the sake of sustaining the. recovery and promoting economic growth. such unanticipated resources would best be used to speed up public investment outlays already authorized by Congress. Yet the caps on outlays in discretionary programs are withholding this essential ingredient of the nation's prosperity.

Institution of a capital budget does not necessarily have negative connotations for the long-run path of the debt/GDP ratio. Capital accounting spreads the cost of a capital project over its useful life; implicit in this procedure is the premise that the cost of a project is not fully borne at its inception. Just as a business firm amortizes the cost of its equipment, the federal government should allocate the costs of its own investments. Incorporation of capital budgeting would reduce the official deficit by the amount of net public investment (although it would not change the actual amount of borrowing from the public) and the resulting number would be a good guide to the effect of the budget on capital formation. A different figure—the primary deficit-would be the proper guide to the effect of the budget on the debt/GDP ratio. The measurement of public debt and debt/GDP would not change at all

There are two principles that justify borrowing for capital expenditures and amortizing the loan over the life of whatever is purchased. One was described above-net borrowing minus net public investment is a more informative number than the official deficit in weighing the budget's effects on investment and growth.

The other principle speaks to equity: those who benefit in the future from public investment undertaken in the present should bear their fair share of the cost, just as renters defray their landlord's mortgage payments with the monthly rent. In this "pay-as-you-use" principle, payments for the expenditure are contemporaneous with the benefits generated. An unfortunate consequence of this equity-based rule is that expenditures classified as capital would enjoy a political advantage in budget battles over other types of public spending, since the capital could be financed by borrowing whereas noncapital expenditures would have to be financed with current revenues.

The ideal deficit level has nothing to do with the proper amount of public investment.

The rule that capital expenditures should be financed with debt is superseded by a larger consideration-the promotion of full employment with stable prices. In years of particularly high unemployment, borrowing may exceed capital expenditures, while in the good times when inflation is a threat some capital expenditures should be financed with current receipts. The ideal deficit level has nothing to do with the proper amount of public investment: the correct level of public investment entails a comparison of future benefits and costs, which has little to do with the business cycle or current economic conditions.

In the same vein, the repayment of loans that finance capital expenditures over the life of the assets is an unnecessarily restrictive fiscal rule. If we adhere to the debt/GDP standard, there is no need to repay the principal of any loan over any specified period. At most, there would be an interest in causing debt to grow more slowly than GDP (in other words, running primary budget surpluses). Insofar as public investment increases the rate of GDP growth, there is even less call for deficit reduction, much less debt reduction.

The long-range Social Security problem has little relevance to fiscal policy or deficits. Additional deficit reduction scheduled for the 1990s will not improve the future condition of the trust funds; as argued above, lower deficits could slow down economic growth and have a negative impact on trust fund solvency in the future.

Restoring the long-term balance of the trust funds through an immediate payroll tax increase or benefit cut would provide additional deficit reduction not presently required from a general economic standpoint. Conversely, whatever the correct deficit is for FY 1995, it has no relationship to the deficit reduction implied by any given reform of Social Security. Social Security reform should be considered in an environment that is free from deficit mania, although it is true that Social Security reforms are more easily and effectively accomplished in advance of the actual onset of trust fund deficiencies, however defined.

This approach has the virtue of providing for an effective attack on the root causes of the long-term debt burden: runa way health care spending, inadequate public investment, and weak counter-cyclical policy.

To summarize, this proposal for fiscal discipline boils down to the following principles:

- Address the long-term deficit problem through structural reform of Medicare and Medicaid, with spending cuts to begin taking effect in FY2000;
- Reduce the debt/GDP ratio by running annual primary surpluses of approximately 0.5% of GDP;
- Interrupt debt/GDP reduction during recessions; enact legislation that automatically triggers increases in the structural deficit when, by agreed-upon standards, unemployment is judged to be excessive;[47]
- Adopt a capital-budgeting framework to facilitate the expansion of public investment spending.

This approach has the virtue of providing for an effective attack on the root causes of the long-term debt burden: runaway health care spending, inadequate public investment, and weak counter-cyclical policy. It does not try to advance private capital formation on the backs of working families, the poor, or the elderly, nor does it attempt to control deficits through counterproductive and politically obnoxious budgetary practices. For this reason. we feel justified in describing our approach as sustainable deficit reduction.

Conclusion: In Whose Interest?

Since 1982, two budget policies inspired by fear of federal deficits have imposed significant economic costs on the nation. One was restraint of federal spending outside of the health care and defense areas. The second was a series of deficit reduction packages enacted without regard to the level of employment. Both fiscal blind spots persist in the vision of policy makers today.

Deficit reduction could be interpreted as a gigantic government program devised to induce investment in plant and equipment by the private sector. We could say that this program was "reauthorized" by means of President Bush's budget deal in 1990 and President Clinton's first budget plan in 1993, at a cost of about $500 billion each time. These reauthorizations were financed to a lesser extent by taxes, and predominantly by foregone discretionary spending (particularly nondefense spending). What did we get for this outlay? In light of the lack of evidence of a connection between deficit reduction and investment, the answer would be very little. In particular, a dispassionate comparison of investment in the 1980s with prior decades would fail to show anything special.

Deficit reduction could be interpreted as a gigantic government program devised to induce investment in plant and equipment by the private sector.

If deficit reduction were a real program aimed at boosting private investment, it would never, given its track record and the extent of uncertainty about its value, have established its hold on the federal budget. It is not the merits of the case that promote the highly risky use of enormous sums for deficit reduction-it is politics.

Although the prevailing spirit of deficit cutting risks great harm to the nation, and particularly to its most economically vulnerable families, it also promises great benefits to narrow, self-seeking interests. Not everyone promoting deficit reduction is self-serving; many are genuinely concerned and honestly engaged. But the political partisanship of narrow interests #distorts the deficit debate considerably, helping to infuse it with economic moonshine and detracting from the consideration of serious concerns. Thus, this study concludes by mapping out the powerful "distributional coalition" fueling the drive for the zero deficit option.

One component of this coalition consists of those seeking to reduce the size of government. Chief among them was President Reagan, notwithstanding the fact that he bore a considerable share of responsibility for creating

deficits in the first place. Reagan explicitly proposed that federal receipts be curtailed so that the resulting deficits would force Congress to reduce spending and by extension the size of government. As Reagan put it in an address to the nation on February 5, 1981 (White and Wildavsky 1989):

> Over the past decades we've talked of curtailing government so that we can then lower the tax burden. Sometimes we've even taken a run at doing that. But there were always those who told us that taxes could not be cut until spending was reduced. Well, you know we can lecture our children about extravagance until we run out of voice and breath. Or we can cure their extravagance simply by reducing their allowance.

Well-placed observers have described the onset of deficits at the beginning of the 1980s as a deliberate strategy to reduce the size of government.

Well-placed observers have described the onset of deficits at the beginning of the 1980s as a deliberate strategy to reduce the size of government. Senator Daniel Moynihan said (1988):

> By the close of 1983, I *knew* the early Reagan deficits had been deliberate, that there had been a hidden agenda. How did I know? The people who did it told me: now, that is, that the plan was not working.

Moynihan alludes to the realization of guilt by some Reagan Administration officials by quoting budget director David Stockman:

> The 1983 deficit...had already come in at $208 billion. The case for a major tax increase was overwhelming, unassailable, inescapable, and self-evident. Not to raise taxes when all other avenues were closed was a willful act of ignorance and grotesque irresponsibility. In the entire 20th century fiscal history of the nation, there has been nothing to rival it.

After the budget-busting tax cuts and defense spending increases had been accomplished, conservative economist Milton Friedman wrote in the December 14, 1988 *Wall Street Journal:*

> [B]udget deficits and trade deficits can be disastrous under some circumstances… .But they can also be beneficial under other circumstances. And I submit that those "other circumstances" prevail in the United States today, and have prevailed for some years.. . .We believe the deficit has been the only effective restraint on congressional spending.

Deficit reduction via spending cuts is the logical device for those determined to shrink the public sector; tax increases are rejected. This game has spread to the state level. Proposals for tax cuts have been introduced and passed before the means for revenue replacement are worked out. thus generating pressure to reduce spending.

Another element of the coalition consists of those who benefit from reductions in the price level or in its rate of growth, a group that might be called the "deflation lobby." This could include anybody receiving fixed interest payments on loans, and therefore all owners of public and private bonds (one of the largest quantities of which is owned by H. Ross Perot). The average person is probably unaware that the bond market is much larger than the stock market in terms of the volume of transactions. trading fees, and capital. Not all bondholders are wealthy, of course: many recipients of interest income, such as fixed-income pensioners or workers whose pension funds hold bonds, have relatively low incomes.

Another element of the coalition consists of those who benefit from reductions in the price level or in its rate of growth, a group that might be called the 'deflation lobby.'

Any decrease in inflation or interest rates provides a capital gain to all such lenders. Insofar as deficit reduction pushes down interest rates. bondholders benefit. The same is true for *reductions* in economic growth. Lower growth means lower inflation, and less inflation is just as beneficial in raising the value of bonds and increasing the wealth of bondholders as a decline in real interest rates. By the same token, inflation that hurts holders of public debt helps debtor governments-the value of claims against the public sector is reduced.

Popular myth has it that inflation is the "cruelest tax." In fact it is one of the most benign. Its chief victims are those same lenders, whereas its chief beneficiaries are all who have borrowed at fixed rates. Lenders' incomes are high relative to borrowers (although there are exceptions. as noted above). While the stagnation of real wages has become notorious, it could be argued that wage stagnation has been due not to price increases but to changes in the nation's industrial makeup and labor relations. On these grounds, inflation is not taxing to wage earners: the forces putting upward pressure on prices do likewise to money wages. Social Security benefits are indexed to inflation, so the elderly are shielded from price increases in this respect.

The major victims of inflation among the non-rich include recipients of public assistance and fixed-income pensioners. While these are indeed among

the most vulnerable persons in society, it would not be difficult to shield them from any policy that accepted a modest rate of increase in the price level for the sake of full employment (Blank and Blinder 1986). Welfare benefits could be indexed in the same: way as Social Security benefits, and the personal income tax could provide relief to low-income pensioners. While workers whose pension funds held bonds would suffer some losses from an increase in the price level, these workers would gain much more because higher wages would be expected in labor markets that were "tightened" by a successful full-employment policy. A commitment to full employment, at the cost of a marginally higher level of inflation, benefits most of the poor and the middle class.

A commitment to full employment, at the cost of a marginally higher level of inflation, benefits most of the poor and the middle class.

In contrast, there is evidence that inflation can reduce stockholders' income derived from dividends and capital gains (Dombusch and Fischer 1990). One explanation is that an increase in expected inflation increases nominal interest rates. Shareholders compare their dividends to the returns available from bonds. If bond yields go up, people move out of stocks and into bonds, depressing share prices and to some extent limiting the erosion in bond prices occasioned by the inflation.

While inflation used to cause everyone's real federal tax burden (taxes adjusted for inflation) to rise, in 1985 the system was reformed to prevent "bracket creep." All in all, because inflation is a reduction in the value of money and the prices of many assets, a modest increase in the price level has the same effect, very roughly speaking, as a tax on wealth.

Two of the great political achievements of the deflationists have been to characterize their intellectual opposition as lovers of inflation and to stigmatize their political critics as paranoids. Apparently it is possible to have a welfare lobby, a criminals' lobby, a labor lobby, or a civil rights lobby, but the notion that wealthy people who benefit from disinflation would seek political influence is beyond the pale of respectable commentary.[48]

Another part of the coalition that benefits from the obsession with deficit reduction are the enemies of social insurance and aid to the poor. Only the two major health programs underlie the general upward pressure on deficits, but critics of government spending have succeeded in putting across the myth that all entitlement programs are out of control.

Finally, there are those who are milking the connection made between deficits and national saving to advance an agenda for a national consump-

tion tax. We regard the saving/investment problem as the only serious argument for the zero option, and thus made it the first object of our criticism in Section II. Much less well-founded is the use of this issue as a springboard for advocacy of consumption taxation. Such arguments begin by making the standard connection between deficits, saving, and investment, then shift into different arguments about the disincentive effects of capital income (rent, interest, and dividends) taxation or the disincentives of high marginal tax rates. This leads to the presumption that transformation of the progressive income tax into a consumption tax will advance saving and investment.[49]

Critics of the public sector, of social insurance, and of the progressive income tax have been with us for a long time. What is new is their practice of cloaking such outlooks in proposals for deficit reduction and embellishing their arguments with liberal rhetoric about the merits of a fair distribution of income.

The most powerful force in operation is not a squadron of errant economists but a fundamental failure of democracy to give voice to the interests of the vast majority of its citizens.

Less familiar to the public are the deflationists. Their apologists are among the wealthiest members of society; they inhabit the highest positions in large corporations, law firms, investment banks, accounting firms, and financial brokerages. They are the lobby that is above lobbying and political partisanship. The Clinton Administration, like its predecessors, is well-salted with these devotees of deflation.

It is possible to have honest differences of opinion about the deficit. But anyone seeking to move the debate beyond the present hysteria and confusion should realize that the most powerful force in operation is not a squadron of errant economists but a fundamental failure of democracy to give voice to the interests of the vast majority of its citizens. A political regime based on the primacy of deficit reduction shackles the nation—particularly working people, the elderly, and the poor-to retrograde ideology and economic stagnation. The next step toward progress in economic and social policy must cross this threshold. We can only advance if we come up from deficit reduction.

Appendix: Some Unhelpful Proposals

The achievements and costs of the Clinton deficit reduction program have not stifled a chorus of complaints in the U.S. Congress that the plan does not go far enough. The critics' objections ought to be judged in light of their suggested alternatives. This section reviews current proposals to deal with deficits.

The General Accounting Office

A very deep economic abyss was foreseen by the General Accounting Office (1992) in a report invoked at balanced budget amendment hearings in fall 1993 by Senator Paul Simon. The GAO projected deficits and economic growth over the next 30 years under three alternative scenarios. The first was the continuation of current policy, the second was the maintenance of deficits at the constant rate of 3% of GNP, and the third was the elimination of the deficit and the achievement of budget surpluses within 10 years. The GAO tilted clearly toward the latter policy. which is a radical step beyond the zero option.

Under the continuation of pre-Clinton policy, the federal deficit was projected to grow to over 20% of GNP by the year 2020, and per capita GNP was projected to move hardly at all in real terms. The causes of deficit growth in the model are health care, Social Security, and net interest payments. Inherent in the model is slower growth of GDP due to higher deficits and interest rates, a premise that we criticized in this report.

Under the scenario described as "muddling through"-deficits kept at 3% of GDP-real per capita GNP increases by about $6,500. and total GNP is over 20% higher than under current policy. Under the most radical scenario of moving to budget surplus, per capita GNP increases by almost $9,500.

The advocates of the zero option fail to absorb some important points made in this report:

- Under the extreme deficit-cutting scenarios, per capita consumption *declines in comparison to the "muddling through" scenario until the year 2013* (which GAO describes as "the near term"). The consumption decrease alluded to here applies to all personal consumption, not just to benefits from the government's transfer programs. In other words. the GAO findings are consistent with the arguments in this paper about the immediate economic costs of deficit reduction.

- The GAO acknowledges that "individuals and groups whose living standards are declining for other reasons could, however, suffer additional setbacks because of the deficit reduction program" (1992, 69). In other words, their living standards would decrease altogether, not merely increase by some less-than-expected amount. They would be made de-

cidedly worse off under rapid deficit reduction.

- The difference in per capita GNP growth when comparing the "muddling through" and "surplus" scenarios-$6,500 versus $9,500—is less than half the difference between "muddling" and doing nothing. In this light, "muddling through" is not quite as bad.

- The causes of public spending growth in the model are health care, Social Security, and net interest payments. Thus, cuts elsewhere in the budget don't solve the deficit problem. A balanced budget amendment, Gramm-Rudman,[50] and other expenditure limitation measures correspond precisely to the methods of deficit control in the "muddling through" model presented by GAO (1992, 88). Neglect of the sources of spending growth in the "muddling through" scenario brings ever increasing deficit reduction requirements in the remainder of the budget-to the tune of $500 billion annually by 2020. The perverse outcome is that the growth items-Social Security, interest, and health care-tend to push everything else out of the budget.

- The GAO points out that the policies leading to their disaster scenario are "unsustainable," which means the outcome can never actually come to pass.

- The GAO asserts that public investment will stimulate private sector productivity, and it proposes to alter the budget presentation to reflect the economic distinction between capital and operating expenditures. A balanced budget amendment and similar expenditure limitations measures would outlaw any such procedure.

The GAO report was not met without criticism. The most obvious has been discussed in this paper: projections of unsustainable conditions are treated as predictions when in fact the authors admit they cannot happen. In this respect, the GAO analysis swallows its tail: it produces projections that are simultaneously held to be unrealizable but that compel radical action.

A second problem with the report is that the linkages between deficits, interest rates, investment. and growth in the model used are vulnerable to the arguments presented in Section III.

Cutting Social Security benefits without cutting payroll taxes would be a political debacle, and rightly so. The spurned "muddling through" scenario is premised on a bizarre expenditure-control policy the results of which are exploited to attack the notion of moderation in deficit reduction. In this policy, fast-growing parts of the budget are left alone, spending cuts are imposed on the remainder of the budget, and taxes are not increased to make up the difference. In this subtle but crucial respect, there is a demagogic cast to the GAO report.

Penny and Kasich

This year's campaign in the House of Representatives to cut spending by legislative means is being fronted by conservative Democrats under the leadership of retiring Rep. Tim Penny. The "Penny pinchers" propose to add $108 billion in spending cuts over the next five years. Penny's Republican counterpart in this effort is Rep. Tim Kasich, minority leader of the Budget Committee.

With one important exception, addressing the merits of specific cuts is beyond the scope of this paper. The exception lies in the fact that the Penny package leans to a significant degree on savings in Medicare and Medicaid. As we stressed above. this is the right place to focus spending discipline. Unfortunately, the Penny/Kasich proposal to use such savings for deficit reduction sabotages health care reform.

The flat elimination of benefits and programs proposed by Penny and company violates public commitments made in the interests of social justice. Sotne of them-such as the termination of the Neighborhood Legal Services Corporation (saving $370 million per year)-reflect nothing but ideological spite. As noted previously, such cuts do not address the deficit problem. Furthermore, they are made without regard to employment levels.

The Concord Coalition

A private group of businessmen and politicians has put forward its own version of the zero option: a comprehensive plan to eliminate the deficit. generate budget surpluses of over $40 billion, and reform the federal income tax. Like other "zero" plans, it promotes high unemployment and unravels our major social insurance programs. Less obvious is its implied, massive shift in the distribution of income from lower- to higher-income families.

The Concord group favors means-testing for all entitlements. including Social Security (but rejects reduction in the payroll tax that finances Social Security). It also advances the Social Security retirement age, increases Medicare premiums, cuts veterans' health services, reduces federal spending on public investment, and includes a gasoiine tax increase of 50 cents per gallon and other revenue measures. Finally, it advocates a balanced budget amendment to lock in the deficit reduction accomplished by the end of the plan.

Some features of the Concord plan are well-taken; many specific provisions are supported with substantive arguments. The problem here is with the forest, not the trees:

- The proposal for means testing entitlements runs the danger of transforming these programs from social insurance to welfare. The consequence will be reduced protection for the poor and elderly. Furthermore, such measures would not necessarily reduce deficits."

- The squeeze on public investment will impede productivity growth and business investment.

- The plan projects a blanket hostility to the importance of fiscal policy to support full employment.

- The plan includes a major provision that has no effect whatsoever on the deficit: the transformation of the federal income tax to a consumption tax. This could easily result in a significant redistribution of income from the bottom 80% of taxpayers to the top 20%. More generally, the tax proposal is a tipoff to the covert agenda of the coalition-to advance discredited supply-side economic doctrine under cover of deficit reduction.

The Bipartisan Commission on Entitlement Reform

In return for his vote for the Clinton budget in 1993, Senator Robert Kerrey (D-Neb.) obtained an Administration commitment to create a commission to review entitlements and tax policy. The Bipartisan Commission on Entitlement Reform was constituted early in 1994. It consists of 12 senators and 10 representatives (half from each party) and 10 private citizens. Senators Kerrey and John Danforth (R-Mo.) are the chairmen.

The commission is founded on untenable premises:

- The chairmen claim that "identifying the problems is no longer the issue. They have been confirmed by study upon study." The problems in question are productivity growth, saving, and investment. In fact, there is considerable controversy about the importance of saving as opposed to investment, as discussed above.

- Although the importance of productivity, economic growth, and investment are not in question. the means by which the chairmen expect to advance these goals-reducing the growth in mandatory outlays and reforming the tax system-are highly debatable cures.

- The chairmen claim that mandatory spending is increasing "at a rate far exceeding economic growth." As shown in this paper, as a general statement this is not true. The exceptions are Medicare and Medicaid. Only if we go out to 2036 does an additional problem—Social Security-arise.

As noted above with respect to Penny and Kasich, austerity measures aimed at Medicare and Medicaid sabotage health care reform. Even so, neither by intention nor construction is the commission a body capable of leading health care reform. The Social Security program has no part in deficits for the nest 40 years. In this case, moreover, there already exists a body-the Advisory

Council on Social Security-whose mission is to propose solutions to future difficulties in Social Security; there was no need to reinvent this component of the federal government. Finally. linking tax reform to the deficit question is an enormous stretch, and the commission is venturing into distant territory with inadequate resources. In intellectual or policy terms, it is overreaching.

The proportion of the commission consisting of Republicans and conservative Democrats (which includes both chairmen) is disproportionate to the political makeup of Congress. Of the private citizens, only two-Richard Trumka of the United Mine Workers Union and Robert Greenstein of the Center for Budget and Policy Priorities-are not corporate executives or attorneys doing corporate work. The commission is an antidemocratic device aimed at circumventing the electorate, which means it is guilty of political overreaching as well.

Simon's Folly: The Balanced Budget Amendment

A perennial threat to the economy and to social welfare is the misnamed balanced budget amendment promoted by Senator Paul Simon and others. In reality it is an expenditure limitation bill, since its provisions make more difficult the reduction of deficits by tax increases than by spending cuts. But this qualification does not begin to plumb the depths of harm such a bill would cause (Sawicky 1993, 1994).

Given current projections for the deficit, a balanced budget requirement would cause a recession the likes of which the nation has not seen for 60 years, and this downturn could persist indefinitely. Full employment would become unattainable because the use of deficit spending for economic stimulus would be blocked. If the nation is to aid the poor and unemployed during recessions, offsetting cuts would be necessary in other programs. Worst of all, the use of fiscal policy to moderate recessions would be all but outlawed.

Budget balancing would enforce the current failure to distinguish capital from operating expenditures. The current inadequacy of public investment commitments would be exacerbated.

Some conservatives, such as Jack Kemp, likely contender for the 1996 GOP presidential nomination, and former federal judge Robert Bork, are apprehensive about this amendment. The *Wall Street Journal's* editorialists have declared their opposition. What ought to worry them is that, insofar as the amendment really does compel the Congress to act, the result could be a very large tax increase. Previous budget showdowns have resulted in tax increases in the range of $30 billion to $50 billion annually; if the deficit to be closed is $220 billion, the tax bite could be considerably larger. In the same vein, a magnification of the pressure that has already killed high-tech projects and military spending beloved by conservatives could wipe out many more programs.

All of these consequences follow if the amendment is successful in its own terms. If it proves unenforceable (it has no enforcement provisions), if Congress is able to evade its provisions by gimmickry, if it leads to a morass of litigation, or if it brings about total gridlock in Washington,

its only accomplishment will be to reduce the credibility of our democratic institutions.

Ross Perot's Plan(s)

One of the loudest critics of deficit spending has been 1992 presidential candidate H. Ross Perot. In his campaign, he presented a deficit-elimination plan (Perot 1992) that included the elimination of "unnecessary or outdated programs" (although none were specified), defense cuts, elimination of farm subsidies and tax breaks, means-testing of entitlements, increases in the payroll tax for Medicare, reduction of the cost-of-living adjustments in public employee pensions, and various tax increases. Total tax increases in the plan over a five-year period were almost $400 billion, and total deficit reduction approached $800 billion. As noted above, the Clinton and Bush plans were in the neighborhood of $500 billion.

A striking feature of the Perot plan, in light of Perot's subsequent behavior, was its similarity to what came to be the Clinton plan. Common features include cuts in discretionary spending (and public investment), increases in the Medicare component of the payroll tax, increases in the gas tax, increases in the collection of corporate income taxes from foreign firms, and reductions in the pension benefits of public employees. An important difference is that Perot's plan was much larger and much less specific. For instance, Perot proposed to cut health care spending by $14 1 billion, but offered no details on how this might be accomplished.

Perot describes the U.S. economy as "perched on the edge of a cliff' and implies that the runup of public debt is chiefly to blame. His book reflects the frustration and suspicions of many Americans. Unless public understanding of these problems improves, we remain at risk of proposals that can do considerable damage both to the economy and to social justice.

The Progressive Policy Institute

Robert Shapiro, vice president of PPI,[52] proposes that federal spending be allowed to increase no faster than per capita income (1991). He also proposes to divide the budget into operating and capital segments.[53]

The basic idea underlying the proposal is that federal spending should keep pace with the ability of families to pay taxes, and therefore with average income. This idea has serious deficiencies:

- If successful, the rule incurs all the criticism cited in this paper of the federal government's failure to stimulate the economy and increase employment. Indeed, one rationale Shapiro advances for deficit reduction is the value of running deficits to reduce unemployment (Shapiro 199 1, 2). He argues that when deficits are high, it is not feasible to increase them for purposes of fiscal stimulus. Elsewhere, however, he says that such measures are un-

likely to be effective in any case because of the openness of the U.S. economy (Shapiro 1991, 6).

- Shapiro admits that it would be "witless" to set any arbitrary level for public spending, but to restrain spending growth according to per capita income growth is equally arbitrary. If it is witless to set a fixed level for public spending as a share of GNP, it is also witless to set next year's level at this year's plus an increment based on per capita income growth. Public preferences might dictate that it should be more or less.

- If the criterion is ability to pay, then it is taxes that should be geared to total income, not spending. Shapiro's rule closes the deficit gap precisely because it fails to limit the growth of tax revenues relative to spending. In other words, it forces taxes to grow more rapidly than spending or per capita income. More specifically, Shapiro stipulates that the entirety of consumption spending in the budget must be financed on a current basis by taxes and user fees. The implied tax policy is an immediate upward jolt to taxes in the neighborhood of $200 billion annually (the reviled Bush and Clinton budgets raised annual taxes by much less than $100 billion), followed by a rate of revenue growth below that of the economy as a whole.

- To gear ***total*** public spending to ***per capita*** income is to stipulate that total public spending as a share of total income should ***decline*** to the extent that population increases. If the numerator (income) and denominator (population) of a fraction (per capita income) are both increasing, the fraction must increase more slowly than its denominator, as Shapiro notes (1991, 13). So what begins as a "progressive" campaign against deficits ends as a conservative strategy to reduce the size of government.

- It is not unreasonable to say that the ability to pay taxes declines as population increases, other things being equal; that is why exemptions are provided in our personal income tax. However, there is likely to be a great difference between, say, a married couple taking an extra exemption upon the birth of its first child and a reduction in its tax liability of 33%. By Shapiro's logic, a population increase of X% requires a reduction in public spending of X/[100+X]. Furthermore, he does not allow for the possibility that newborns or immigrants might impose special burdens on the public sector, as opposed to family budgets.

- Shapiro's so-called "capital budget" would limit deficits to the extent of investment spending in the budget, and investment spending would be subject to the overall limits on total spending. This would prevent the government from taking steps to reduce unemployment with fiscal policy and would establish a mandatory tradeoff within arbitrary levels between in-

vestment spending and consumption. As noted in this paper, the correct deficit level has nothing at all to do with the correct level of public investment spending.

- Like the balanced budget amendment, Gramm-Rudman, and other expenditure limitation measures, there is nothing in this proposal that forces or encourages the government to make the choices necessary to solve the health care problem. Shapiro himself proposes cuts in spending on entitlements in general (through the implementation of means testing, among other devices) and in federal employment. Therefore, his approach could be characterized as a radical version of the GAO's "muddling through" scenario, in which the limitations on total spending fail to alleviate the pressure of health care spending on the entire budget.

The goals of Shapiro's plan for deficit reduction are indistinguishable from those of Ronald Reagan, the Concord Coalition. and the Republican Party in general. Can such a program be described as "progressive"?

Endnotes

1. Quoted in Woodward 1994.

2. These and other proposals are discussed in some detail in the appendix.

3. The numerator of the ratio is debt rather than interest payments because interest rates fluctuate constantly. At any particular point in time the debt is composed of bonds paying a variety of interest rates. The denominator is GDP rather than national income, as defined by income accounting theory, because the two principal discrepancies between GDP and national income-indirect business taxes and capital consumption-are, in the case of IBTs, available for taxation and, in the case of capital consumption, subject to large measurement error. These qualifications are appropriate and standard among economists, because their interest in the debt burden is chiefly an interest in its trend over time, not in its level or in year-to-year changes.

4. This relationship is stronger if we focus on what is called the structural deficit. rather than the official, cash-flow deficit (Eisner and Pieper 1984; Eisner 1986, 1994).

5. We characterize the elimination of deficits within seven years as "rapid" in light of the difficulty experienced to date, and because such schemes are promoted without regard to the prevailing level of unemployment.

6. For instance: "Our deficits, after all, are just negative public savings. By soaking up our already shallow pool of private savings, deficits crowd productive investments **out** of private capital markets." (Peterson 1993)

7. I am indebted to Robert Eisner for this point, among others. He should not. of course, be held responsible for any errors in this paper.

8. The authors go on to affirm the need for deficit reduction because "the costs of being wrong.. .involve a serious risk to future generations." Their paper does not address the question of whether the zero option is the necessary goal. We share their fear, but to a more limited extent.

9. Quoted in Pearlstein 1994.

10. Establishment of more formal, reliable guarantees of fiscal discipline might be a necessary precondition for the democratization of monetary policy.

11. The Bush Administration's definition of liabilities was defined broadly to include implicit liabilities for pension guarantees, deposit insurance, federal pensions. and the like.

12. Such figures are taken from economists' research on so-called "generational accounts" (Kotlikoff 1992; Office of Management and Budget 1994) and are founded on projections of interest rates, taxes, and other intriguing economic milestones over the next 100 years. For a skeptical view of the policy value of this work, see Aaron (1991) and Haveman (1991).

13. The tally of national wealth for 1993 was $51 trillion, or $196,000 per capita net of wealth owned by foreigners (OMB 1994).

14. For instance, Peterson's calculation would entail an estimate in present-value terms of the payroll taxes an infant will pay over his or her lifetime. So if a newborn is presumed to pay $1,500 in taxes in year 2030—never mind how-that figure must be discounted according to interest rates

which prevail from now until then to get the present value. If the rate of interest is 6% every year, the present value of the tax payment is $184. But if the rate is 8%, the amount is $94, almost a 50% difference.

15. The only real resource cost is the inefficiency associated with the extent of taxes collected to service the debt. but this would follow irrespective of the use of the tax dollars.

16. Federal debt held by the public (including the Federal Reserve System) in 1992 was close to $3 trillion, not the $4 trillion bandied about by politicians and pundits. The latter figure includes debt owed by the federal government to itself. The burden of debt from the standpoint of the taxpayer and the private sector consists solely of debt held by the public, not in debt that requires the government to pay interest to itself. The financial burden on the federal government implied by balances in the trust funds has nothing to do with the size of the balances. It depends on the amount of future federal spending required to run the program in question, such as Social Security. The economic burden of these programs depends on the nation's future wealth, which is the basis for financing all such programs.

17. Properly we should speak of net domestic product, rather than gross, to factor out capital consumption. In terms of the trend in the ratio of debt to either GDP or NDP, rather than the absolute levels, there is not much difference. For the sake of familiarity, we use GDP in the text.

18. In any given year. the deficit incurred adds to the outstanding public debt from the end of the previous year. If GDP grows by, say, 3% and debt grows by 3% or less, then the ratio of debt to GDP cannot increase. It follows that if the deficit is larger as a share of GDP than the rate of GDP growth, then the ratio of debt to GDP will rise. Another way of gauging this relationship is by comparing the deficit to the net interest paid on the debt. The ratio of net interest paid to net debt outstanding is the average rate of interest paid by the government. At the same time, the interest rate is taken by economists as a rough proxy for the rate of growth of total output, or GDP. A deficit no larger than net interest payments thus increases the deficit no faster than the rate of growth of the economy as a whole. Therefore, with respect to increases in the burden of the public debt, the only amount that matters is the excess of borrowing over interest payments, which is called the "primary deficit." (Eisner 1986, 39-40; Penner 1988)

19. This comparison is based on the ratio of gross public debt to GDP for the entire public sector ("general government"). The OECD also calculates a net debt ratio founded on estimates of public sector assets. By this measure, the United States is slightly above the OECD average. While this is a better theoretical approach. comparisons across nations are problematic because they entail imputations of the value of nontraded assets and because certain industries that are public in some nations are private in others.

20. This admittedly simplistic calculation is based on assumptions of historic values of GDP and average interest costs to the federal government (in terms of net interest outlays to debt held by the public). Insofar as lower total deficits are good for GDP growth and lower interest rates, these results overstate the debt/GDP ratio. To the extent that primary deficits have been helpful in alleviating recession, they understate the ratio. Because it tends to be based on the former premises, broadly speaking. the argument against this result is self-invalidating. If we are correct about the benign character of deficits. then we can content ourselves with chipping away at the primary deficit when unemployment is very tow.

21. The algebraic expression for this relationship is:

$$\Delta d = d\,(i - n) - x$$

Delta d is the change in the ratio of debt to GDP. d is the ratio itself. i is the interest cost to the federal government, n is the rate of growth of GDP, and.\- is the primary budget surplus (hence. when x is negative we have a primary deficit). This expression shows how the effect of an increase in the primary deficit on the debt/GDP ratio (d) can be nullified by a sufficiently high rate of growth of GDP(n). Conversely, the benefit of a decrease in the primary deficit could be negated by sufficiently high interest costs. For a derivation, see Dornbusch and Fischer 1990, 628; Penner 1988.

22. Insofar as economic growth fails to match or exceed the average interest rate faced by the government, primary surpluses are required to stabilize or reduce the debt/GDP ratio. This is a far cry from eliminating the deficit altogether. By 1992, for instance, a primary surplus of $50 billion would have been consistent with an official deficit of about $ 140 billion.

23. For example, sponsors of the balanced budget amendment include Senators Paul Simon and Carol Moseley-Braun of Illinois.

24. The reader is referred to the Shapiro quote heading the next subsection.

25. Nonfiscal actions by governments, such as regulation, can also improve or worsen the distribution of income.

26. The figure is 13% if we consider foreigners' share of the gross public debt, which includes the intragovernmental debt held by trust funds. Elsewhere in this paper we have discounted the significance of the gross debt level.

27. The other major trust funds serve the following purposes: federal civil service retirement, military retirement, railroad retirement, highways, airports, and deposit insurance.

28. An alternative is that the federal funds could borrow money (or increase taxes) for transfer and the trust funds could buy stocks and bonds. The indebtedness of federal funds would increase just as much as in the preceding example, while the federal government. through the guise of the trust funds, would come to own an enormous share of the U.S. private sector.

29. A similar analysis by the General Accounting Office is discussed in the appendix.

30. The Wharton Econometric Forecasting Group recently projected much slower growth in health care spending (Karl and Bachman 1994). To the extent this forecast holds up, the long-term deficit problem diminishes considerably.

31. Exceptions include Social Security, Medicaid, and deposit insurance.

32. There is no need to take account of inflation in this context because we are comparing changes among different items over the same time period; the same inflationary component would be built into all items.

33. The revenue loss associated with the nontaxable status of employer-paid health insurance also grew rapidly in the 1980s.

34. Deposit insurance spending fluctuated sharply over the decade, so its yearly growth rates are not meaningful. Federal outlays for the savings-and-loan bailout are negative (more is being collected than disbursed) through 1999.

35. There is an imminent problem with disability insurance. The DI trust fund is now in deficit, and its reserves will be gone by 1995 (Steuerle and Bakija 1994). The shortfall is not sufficient to put the entirety of Social Security in the red, but reform of the DI program belongs on the agenda in the 1990s.

36. See Diulio et al.'s discussion of the "budget fallacy."

37. William Baumol (1967) has advanced the theory that public services and personal services in general are afflicted with a "cost disease" that causes their relative prices to increase more rapidly than inflation. The reason, briefly, is that increasing productivity and wages in the manufacturing sector increase the cost of labor in the service sector beyond its rate of productivity growth, since service workers of comparable skills must be paid the same as manufacturing workers. While this is logical. it remains to be validated by empirical testing. It could be true of some services but not of others. If it were found to be true for health care, it would suggest that families could maintain their standard of living because the added costs of some services would be offset by the reduced costs of some goods (consider, for example, the reduction in price and improvement in quality of television sets over the past 40 years). The wrinkle here is that in order to maintain their standard of living in this scenario, families must consent to continuous increases in the share of income taken by taxes.

38. A partial exception would be the repeal of indexation in the income tax. With sufficient inflation, real tax revenues could increase more rapidly than the size of the economy as a whole. Of course, as we saw in 1980, voters could prove once more to be intolerant of such a tax system.

39. In remarks before the National Economic Club, Prof. Tobin (1993) indicated that, in his view, $60 billion was a conservative estimate of the amount of stirnulus from which the economy could have profited.

40. The calculation presented here is admittedly very simple and has some obvious biases. Most of the biases, however, militate against the argument being advanced here. An exception is that the implied deficits are low insofar as the stimulus increases the federal government's net interest payments due to higher interest rates. On the other hand, the deficits are overstated to the extent that the stimulus causes GDP to increase in FY 1994 and thereafter. They are also overstated because the implied interest cost is on the high side. given prevailing interest rates paid by the government for new debt. Finally, this calculation is purely classical, so to speak, in that it assumes the stimulus program fails to increase GDP.

41. Research on the contribution of private capital to economic growth places its share at less than 20% (Denison 1985). The average rate of real economic growth in the United States from 1929 to 1982 is estimated at 2.9%, so 0.58 percentage points could be attributed to private capital formation in this calculation. In contrast, labor's contribution is about 65% of the total, whereas public capital and technological progress, among other things, are thought to account for the remaining 15%. More private capital does not imply more technology-the latter has to do with the *quality*, as opposed to the quantity, of capital (public and private) and labor. Technological progress depends on the extent of resources devoted to research and development. There is a broad consensus among economists that research and development ought to be subsidized by the public sector (Aaron 1990).

42. There is no implication here that investment spending is intrinsically "good" and other spending is not. Investments can fail to pan out and consumption can be essential. All the distinction points to is the general propriety of financing investment with borrowing and operating

expenditures with current revenues. As this paper aims to explain, however, there are many qualifying considerations.

43. The GAO estimated that net public investment in FY 1992 was $52.9 billion (OMB 1993).

44. A formal capital budget could improve the conduct of fiscal policy. but from the standpoint of investment needs it would be incomplete in some important respects. For instance, traditional capital budgeting is limited to expenditures on infrastructure facilities-"things" that are owned by business firms or governments. But there is widespread agreement that improvements in such areas as education, training, research and development, and even public health can augment economic growth. Methods of incorporating these kinds of expenditures into a capital budgeting scheme have yet to be refined, so under present circumstances a capital budget might be biased against commitments the nation ought to be making.

45. This seems arbitrary. If the current ratio happens to be 48%, why is that the proper percentage for all future years?

46. We suggested in the previous section that the deficit targets in OBRA93 were sufficient for the near term. Note in Figure 4 that for the next five years under these targets (the middle line) the debt burden barely rises. Unfortunately, there is at present little political support for this position. One reason is the unfounded euphoria over the economy's performance in the fourth quarter of 1993.

47. An analysis of the precise triggering conditions is beyond the scope of this paper. This point is motivated by our belief that existing "built-in stabilizers" ought to be strengthened.

48. The realization seems to have reached the White House. As Woodward (1994) wrote in *The Agenda:*

> ...Clinton's face turned red with anger and disbelief. "You mean to tell me that the success of the program and my reelection depends on the Federal Reserve and a bunch of f——ing bond traders?" he responded in a whisper.
>
> Nods from his end of the table. Not a dissent

49. This view is explicit in the proposals of the Concord Coalition; in the tax proposals of David Boren (D-Okla.), John Danforth (R-Mo.), Sam Nunn (D-Ga), and Pete Domenici (R-N.M.): and in the goals of the Bipartisan Commission on Entitlements. See the appendix for further discussion.

50. With respect to federal discretionary spending, Gramm-Rudman was a howling success. The problem for deficit reduction is that all such savings are offset by increases in health care spending.

5 1. Aaron and Ball article in *Washington Post,* November 14, 1993.

52. PPI is an official arm of the Democratic Leadership Council, an organization of primarily conservative Democrats.

53. Shapiro shares the view advanced in this paper that deficit reduction has little relevance for investment and growth (1991, 7). His own rationales for deficit reduction include the premises discussed in the section titled "Dreading Deficits: Why Worry?" The latter justifications hold much less water for most economists than the preeminent concerns for capital formation and inflation, so by conceding this point Shapiro surrenders most of the ground available to him at the outset.

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