

## COMPETITIVENESS AND BALANCED BUDGETS

by **Jeff Faux**  
President  
Economic Policy Institute

The negative macroeconomic consequences of a constitutional amendment, or similarly rigid requirements, to balance the federal budget each year are well known. Nobel Prize winning economist James Tobin summed up the dangers in 1985:

Outlawing deficits would increase economic instability. Ill-timed expenditure cuts or tax increases would make recessions worse. The natural swings of federal expenditures and tax revenues dampen business fluctuations; it is perverse policy to eliminate them. These automatic stabilizers, reinforced by discretionary counter-cyclical fiscal measures, are a major reason why cycles have been much less severe since the World War II than before. Since November 1982 tax cuts and increased outlays, mostly for defense, have fueled a brisk recovery; without those stimuli our economy might be as anemic as those of Britain, Germany, and other European countries, whose governments practice, like Herbert Hoover, fiscal austerity in hard times.'

Some policymakers, however, still harbor the misperception that budget deficits so impede a nation's competitiveness that draconian measures to achieve zero deficits are justified. The specific fiscal policies of the recent past clearly have placed a heavy burden on the U.S. economy. As a result of this particular pattern of deficit spending, the U.S. has become the world's leading debtor nation and therefore increasingly vulnerable to economic forces beyond its borders. But deciding on policies to work our way out of the present dilemma requires us first to separate fiscal myth from fiscal reality.

It is worth remembering, for example, that two of the most widely accepted assertions about the economic effects of recent federal deficits have proven wrong. First, it was widely believed that the deficits of the Carter years, which averaged \$57 billion per year, were responsible for the

inflation that racked the economy in the late 1970s and early 1980s. Yet, the federal deficit has jumped to an average of \$172 billion under Ronald Reagan while inflation has all but disappeared.

It was also widely assumed in the early 1980's that federal deficits would "crowd out" private investment, thus denying business the capital needed for new plants and equipment. But despite record fiscal deficits there has been no indication that business is starved for capital.

Inflation and "crowding out" have been replaced with a more accurate charge against the deficit: that the necessity of financing the deficit with foreign capital led to the high interest rates and the overvalued dollar that devastated the U.S. balance of trade. But the connection between the fiscal and trade deficits is not nearly as tight as many would have it. For example, the dollar began to fall in February 1985 as the federal deficit was still rising; the dollar had dropped 22 percent against foreign currencies by 1986 while the deficit rose to \$220 billion. Clearly, the key factors in the dollar's fall were the intervention of the world's major central banks in currency markets and the increasing unwillingness of foreigners to hold dollars, not any action on the U.S. fiscal deficit.

Yet the myth persists. As economist Peter Bernstein put it:

We were told that the dollar rose because the budget deficit was so big. Now we are told that the dollar can go into free-fall because the budget deficit is so big.

We were told the budget deficit made interest rates go up and thus made the dollar go up. If we could cut the budget, interest rates would fall and the dollar would fall. Now we are told that the weaker dollar is making interest rates **rise**.<sup>2</sup>

In terms of competitiveness, the central problem is not in the deficit itself. *The central problem is that **the funds** that we are borrowing -- largely now from overseas -- are not being invested in future growth which *would allow us to pay back our international debt.**

For the federal government to borrow money, **in and of itself, is not** irresponsible. Credit is the lifeblood of a modern economy in the public as well as in the private sector. Just as businesses borrow to invest in plant and equipment and individuals borrow to invest in homes and education, governments properly borrow to make public investments that can generate a return to the nation. Neither does the fact that we are borrowing from overseas, in itself, pose a threat to economic stability. Indeed, the U.S. became an industrial nation in the 19th Century largely with foreign capital.

The table below shows the recent behavior of deficits, economic growth and manufacturing productivity in the U.S. and its two leading commercial rivals -- Japan and West Germany. It is obvious that the size of the fiscal deficit, by itself, is not the crucial determinant of an economy's performance.

DEFICITS, GROWTH & PRODUCTIVITY

	79	80	81	82	83	84	85	86
<u>U.S.</u>								
Deficit	0.6	-1.2	-1.0	-3.5	-3.8	-2.7	-3.4	-3.3
GNP	3.2	-0.2	3.4	-2.1	3.7	6.4	2.7	2.5
Productivity	-.6	-1.2	2.2	.6	8.3	5.6	4.3	3.8
<u>Japan</u>								
Deficit	-4.8	-4.5	-3.8	-3.6	-3.7	-2.1	-0.8	-0.9
GNP	5.2	4.8	4.1	3.3	3.4	5.1	4.7	2.5
Productivity	7.4	6.9	3.0	5.8	6.0	8.5	6.7	2.0
<u>Germany</u>								
Deficit	-2.6	-2.9	-3.7	-3.3	-2.4	-1.9	-1.1	-1.2
GNP	4.4	2.0	-0.1	-1.0	1.5	3.0	2.5	2.4
Productivity	4.2	-.6	.8	1.3	5.5	3.7	3.7	.1

Sources: Deficits: (as a percent of GNP) Organization for Economic Cooperation and Development (OECD), OECD Economic Outlook, Dec. 1985 and June 1987.

GNP: (annual percent change per year) 82-86: OECD, OECD Economic Outlook, Dec. 1985 and June 1987; 79-81: World Bank, World Development Report 1986.

Productivity: (annual percent change in manufacturing productivity) Bureau of Labor Statistics, "International Comparisons of Manufacturing Productivity and Labor Cost Trends 1986," June 15, 1987.

The case of Japan is illustrative. Over the last twenty years Japan rose to become the second most powerful -- and by some dimensions, the most powerful -- economy in the world. Its rise has been accompanied by persistent budget deficits. But Japan's deficits have reflected a much higher rate of public investment in its capacity for economic growth than have America's deficits. Between 1975 and 1984, while total national government spending as a percentage of Gross Domestic Product (GDP) rose in both the U.S. and Japan, non-defense outlays of government as a percent of GDP rose from 27 to 32 percent in Japan and dropped from 30 to 29 percent in the U.S.. Over the last two decades government spending for capital investment as a percent of GDP rose twice as fast in Japan as in the U.S. (and 67 percent faster in West Germany).<sup>3</sup>

With countries, as with businesses and individuals, taking on more debt makes economic sense when it can generate future streams of income. In a largely private market economy, income-generating government investments are largely those that increase the productive capacity of the private sector (e.g. highways, education, basic research) which then return to the public sector in the form of higher revenues from increased economic growth. Clearly, the budget deficits of the last decade in the U.S. have not been aimed at generating new income streams, but rather have been diverted to military spending and to private consumption through tax reduction.

The public investment in human and physical capital necessary to support private growth has been neglected. The result is a huge backlog of public needs that will have to be addressed if we are to maintain competitiveness. These include:

- retraining displaced workers
- training the economically disadvantaged in basic skills
- expanding vocational education
- language, math and science instruction
- basic industrial research and development
- promotion of technology commercialization
- investment in roads, water and sewer systems and other physical infrastructure

Outlawing deficits thus poses a threat to efforts to raise U.S. competitiveness. By requiring, in effect, that all new revenues be dedicated to reducing the deficit to zero, such proposals would effectively deny funds for the financing of needed public investments in human and physical capital, which in turn help generate faster growth and new revenue streams. Without new revenue streams the burden of our debt will grow (already, interest payments to foreigners are expected to reach \$60 billion per year by 1989) and will increasingly have to be paid off with a lower standard of living.<sup>4</sup>

The more sensible policy is to shift budgetary priorities to investments that can support higher long term growth rates. At the same time we can continue to reduce the overall federal deficit gradually through a mixture of tax revenues and a paring back of unnecessary military spending. A reasonable goal is to aim for a deficit that over the next several years diminishes to one or two percent of *GNP*. At that point, depending on the state of the economy, we may want to reduce it further, or to increase it. An unreasonable goal is a deficit of zero -- which would restrict us from the prudent use of credit to invest in our future.

July 1987

### **Endnotes**

1. James **Tobin**, "Against the Balanced Budget and Tax Limitation Amendment," paper presented at hearing, Connecticut Senate, March 18, 1985.
2. "A Case of Mistaken Identity", *Wall Street Journal*, April 17, 1987.
3. Lucy Gorham, *No **Longer** Leading: A Scorecard on U.S. Economic Performance And the **Role** of the Public Sector*, Washington, D.C.: Economic Policy Institute, 1986.
4. Lester Thurow, "The 20's and 30's Can Happen Again," *New York Times*, January 22. 1986.