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Closing the Deficit

by Allan H. Meltzer

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Are deficits a problem? A year ago, the dominant view of Wall Street economists, the media and prominent politicians was that deficits would produce rising inflation, slow growth and a hesitant recovery in 1983. Interest rates could not decline, we were told, in the face of projected Treasury borrowing. Virtually every blip in interest rates was attributed by commentators to changing views about the possibility of financing a \$200 billion deficit. A member of the Council of Economic Advisers who suggested, at one point, that there was no accurate or reliable evidence relating deficits to interest rates was made humble for his apostasy.

Now that many of these forecasts have been shown to be wrong the rhetoric has changed. Tub-thumping about the deficit continues, but most financial market forecasters do not predict a prompt return to high inflation, recession, stagnation or a rise in interest rates to the levels of 1981. The locus of concern about deficits and their effect on interest rates and inflation has changed markedly. Now, it is the administration, or parts of it, that expresses concern about the effects of the deficit on interest rates, the trade balance the level of investment and the continuation of the recovery into 1985.

These are important concerns. In view of the claims and counter-claims, it may be useful to set down some of what is known about the relation of deficits to inflation, interest rates and economic activity.

Four Propositions

Four propositions summarize some principal findings about deficits based on experience here and abroad.

First, there is no reliable evidence that the size of the budget deficit has any effect on interest rates, and there is no reason to expect to find evidence of an effect. Interest rates

are determined by spending decisions on one side and by decisions about asset portfolios on the other. The size of the deficit, interest rates, income and other variables are determined simultaneously for given tax rates, fiscal rules, monetary policy, anticipations and the like. Studies that fail to show a relation between deficits and interest rates – and there are now many such studies – simply confirm this implication of economic theory. There is no reason to be surprised by these findings. But, they should not be misread. People who look for a relation between the size of the budget deficit and the level of interest rates are looking in the wrong place.

Second, the way a deficit is financed affects interest rates, prices, exchange rates, exports and imports. If the deficit is financed by issuing money, prices rise. Sustained high rates of money growth permit real incomes to rise more rapidly for a time, but this effect terminates relatively quickly and is replaced by a more lasting effect on inflation. Interest rates rise with sustained high money growth and inflation. The dollar depreciates on the exchange market if the domestic rate of money growth exceeds rates of money growth abroad.

In the twelve months ending June 1983, the Federal Reserve purchased 7% of the increase in public debt held outside Treasury trust accounts. This rate of purchase required the Federal Reserve to increase its holdings of debt by 11%. If the Federal Reserve finances projected deficits of \$200 billion per year to the same extent, money growth will remain high, inflation will return to double digits, and market interest rates will rise.

Current deficits do not require the Federal Reserve to inflate. To prevent inflation, the Federal Reserve must finance a smaller share of the deficit. More must be financed by selling bonds to the domestic public or to foreigners. These sales of debt on the market raise real interest rates. Capital flows in from abroad, attracted by the rise in real rates. The dollar appreciates. The offset to the capital inflow is a current account deficit; exports are lower, and imports are higher. Domestic industries that export or compete with imports have lower sales. We buy foreign goods and services and export our bonds.

The rise in real rates does not require a rise in market rates of interest. If money growth and inflation remain low, a decline in inflation premiums can more than offset the effect of the debt sales on real rates. It is the rise in real rates, however, that causes the current account to remain in deficit.

There are not many reliable estimates of the effect of debt on real rates of interest. Some of my own work suggests that each one percent rise in the amount of debt held by the

public raises short-term interest rates by nine basis points. Using this estimate implies that the approximately 25% increase in the stock of privately held public debt raised short-term real rates by more than two percentage points in the year ending June 1983.

Third, high real interest rates raises costs for all borrowers. The Federal government, as a major debtor, cannot avoid these costs. If after-tax real interest rates remain high relative to the growth of real income, the real interest cost of servicing the debt can rise faster than tax revenues; the debt can rise without limit relative to income.

A fiscal policy that requires the debt to grow without limit cannot continue. A policy of this kind is infeasible. If the government fails to act, the public can act on its own. Experience in countries like Chile under Allende or Argentina in the mid-seventies suggests that when the public becomes convinced that government lacks the determination to end the fiscal crisis, by reducing spending or raising taxes, there is a flight from money and other nominal assets. Tax payments are delayed, the deficit widens, interest rates and inflation rise rapidly. In Mexico, Brazil and Argentina, we have seen a similar process operate with respect to foreign debt.

Real interest rates cannot be measured precisely but, on reasonable measures, current after tax real interest rates are high enough relative to the prospective growth of real income to suggest that projected growth rates of government spending and taxes may produce a crisis. We know that interest payments have increased relative to nominal budget receipts and outlays for several years. Gross interest payments, in current dollars, have doubled in the last four fiscal years.

Currently, there is no sign of a flight from the dollar or other indication that we are on the edge of a crisis. We should not take too much comfort from that. Several other countries have similar problems, so concerned investors may be uncertain about who will and who will not solve the fiscal problem. There should be no doubt that our problem is serious. In the three most recent years ending in June, private ownership of public debt rose by 13%, 15% and 25% respectively. In contrast, for the four years ending in 1980, the average growth of debt, measured in current dollars, is 10%. Since inflation was 10% or more in the past, the real debt did not increase, or increased slowly. Now inflation is lower, so the growth of real debt is much greater relative to the past.

Fourth, current fiscal policy shifts spending from investment to current consumption. Much of the government's spending, including defense spending, is used to maintain or increase consumption spending.

Deficit finance is not the issue here. A central issue that Congress and the administration must decide when they choose fiscal policy is how much they want to favor current consumption at the expense of investment and future consumption. This decision is not made by setting taxes alone. Deficits financed by inflation are a tax on wealth. In our tax system this tax has fallen heavily on saving and productive capital. Deficits financed by issuing debt allocate domestic and foreign saving to current consumption if, as is true in our system, Congress and the administration choose to spend mainly for consumption.

A major problem with popular versions of supply side economics is the neglect of government spending. The proposition that taxes affect the allocation of spending is a half truth. It is true that taxes can shift the balance between consumption and saving. We cannot neglect the other half of that truth – that the allocation between consumption and investment is not much affected if the government reduces taxes and borrows the additional saving to finance consumption.

What Should Be Done?

Concern about fiscal policy should not focus on the narrow issue of the deficit. Closing the deficit by increasing taxes substitutes tax revenues for bond finance. The taxes crowd out private spending to maintain government spending. The main effect on government outlays comes from the reduction in interest payments resulting from the reduction in the projected size of the debt and the fall in interest rates induced by the reduction of debt. Any positive effect on private investment depends on the type of taxes and on the relative effects of lower interest rates and higher taxes.

Changes in fiscal policy should be undertaken with a clear understanding of their effects on resource allocation. Current fiscal policy encourages consumption. If the public, Congress and the administration are content with an economic expansion in which investment spending for plant and equipment remains relatively low, debt finance can continue as long as the debt does not rise so fast relative to output as to make the policy infeasible. If a higher rate of investment and lower inflation is desired, Congress and the administration must reduce spending.

Most reductions in spending must come from health, pensions, social security and defense. The relative size of these programs makes them the obvious targets if reductions in

the aggregate are to reach \$50 or \$100 billion. These are not the only place for budget reductions, however. Spending on agricultural programs has nearly doubled in the last two fiscal years. Reducing the appropriation for agriculture to the level of fiscal 1981 would reduce spending by \$20 billion or more.

There are other opportunities that have not been exploited. The Treasury Department has refused to consider indexation of long-term debt. As a result, they are now paying billions of dollars of interest that could have been avoided. Between June 1981 and December 1982, the Treasury issued \$170 billion in debt with more than three years to maturity at an average interest yield in the neighborhood of 13%. Inflation in 1983 is at least 4 or 5% below the rates of inflation anticipated at the time much of this debt was issued. A saving in gross interest cost of \$7 to \$8 billion would have been achieved in 1983 if these issues had been indexed. And, if inflation remains low or falls, additional savings of the same, or greater, magnitude would be achieved annually.

The computation overstates the true saving by neglecting taxes on interest, by using gross rather than net interest cost and by assuming that the entire \$170 billion would have been sold as indexed debt. But the computation also underestimates potential interest reductions that the Treasury could have achieved.

The Treasury had the opportunity to offer holders of outstanding high coupon bonds the opportunity to exchange their bonds for indexed debt when inflation was high. If this offer had been made in 1981, when fears of continued inflation remained strong, it is not unreasonable to believe that the taxpayers would now pay billions less for interest expense.

The British government introduced indexed bonds in 1981, on a limited scale, and later opened their offers to all market participants. Currently, ten per cent of the British debt is held as indexed bonds, so taxpayers as a group benefit from the fall in inflation by spending less for interest on new and older debt issues.

A further, substantial reduction in interest cost could be achieved by reducing the variability of monetary policy. Estimates prepared for the Treasury suggest that the increased variability of unanticipated changes in money growth raised short-term rates in 1979 to 1982 by three percentage points. Variability had declined recently, so the risk premium in short term rates is somewhat lower.

If improvement in monetary control reduced variability of money growth to the average levels of the 1970s, short-term interest rates would fall approximately two percentage

points below current levels. Currently, there is more than \$370 billion of privately held debt due within one year. A two percentage point reduction in interest cost saves approximately \$7.5 billion of interest payments annually. Additional savings would be available on longer-term debt.

These examples are taken from one part of the government budget, the part I know best. They suggest that opportunities for cost saving budget reductions are available if the Congress and the administration are willing to make desirable reforms. The Grace Commission presented a long list of additional savings. Many of their proposals also require desirable changes in administrative practices and established ways of conducting public affairs. These opportunities should be taken if the proposal reforms are considered desirable.

Democratic governments face the challenge of returning to price stability within an environment in which private firms provide high employment and use savings to finance investment, growth and rising standards of living. I believe it is a mistake to see this challenge as a problem of closing the deficit. It is a mistake to believe that these objectives are best achieved by raising taxes. It is a mistake to believe that our current fiscal problems can be solved once and for all.

The central fiscal problem in democratic societies results from the increase in the share of our output taken by governments. This share has increased from decade to decade in all developed, democratic countries. The challenge is to cut back that share or keep it from rising. To do so, the public must be willing to tolerate and the Congress and the administration must offer reductions in spending for defense and social services as the main elements in a program to shift resources from consumption to investment.