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Debt and Deficits: Some Measurement, Economic and Political Issues

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Few topics have received as much attention as the continuing U.S. budget deficit. Its causes and consequences, its politics and economics are the subject of an enormous literature that ranges from abstract treatise to popular commentary. Yet, there is hardly any agreement about the most basic issues.

For the past decade, the academic and policy communities have been divided between two extremes. On one side are those who predict dire consequences for the U.S. economy from continuing budget deficits and, on the other, those who claim that the deficit is irrelevant. Almost everything that has happened or even been feared has been blamed on the budget deficit from high interest rates and low investment to America's permanent decline as a great nation.

Despite the large literature and commentary, consensus has been reached on very few issues. Such basic issues as the appropriate measure of the government's fiscal stance or whether the budget is in surplus or deficit are in doubt. No single paper can hope to resolve all outstanding issues or even summarize the many controversies. I have restricted attention to a few principal issues of the measurement, economic effect, and the political process including the current policy discussion.

Measurement

Most discussions of the budget deficit take the numbers produced by OMB and CBO, and labelled federal budget deficit, at
face value. This is surely misleading and probably a mistake. Misinterpretation is encouraged by these agencies. For example the August 1991 report by CBO opens with the following alarmist statement: "The Congressional Budget Office (CBO) projects that the federal deficit will grow to record levels in 1991 and 1992 before beginning to subside. The total deficit will rise from last year's $220 billion to an estimated $279 billion in 1991 ... Excluding ... temporary factors, the underlying deficit is projected to stabilize in the range of $170 to $190 billion over the next several years ... [S]uch deficits are no better than those of the late 1980s and considerably worse than the average of the 1960s and 1970s." CBO, 1991, p. xi.

Both the degree of certitude about the magnitudes and the implication that we should be concerned about the particular magnitudes are unwarranted. Among the few things about budgets and deficits on which economists agree, two are relevant here. First, if any measure of the budget deficit is relevant for the economy, it is the primary budget deficit -- the deficit net of interest payments. The reason for the exclusion is that interest payments are a pure transfer without economic effect. Second, the principal long-term effects of the deficit on the economy depend on the ratio of debt to GNP.

For fiscal years 1990 and 1991, CBO (1991, p. 72) shows that net interest payments of the federal government exceed $180 billion for 1990 and $200 billion for 1991. Hence, neglecting temporary payments (principally for deposit insurance costs), the budget as measured is in surplus. This has been true for several years. Using this measure of the primary deficit, the government has had a continuing surplus for several years and, after a small deficit reflecting the 1991 recession in fiscal 1992, the budget surplus is expected to return.

Interest payments and payments for the losses on the deposit insurance fund are excluded from the primary deficit, but they may be financed by selling debt. Debt may rise relative to GNP. A
persistent increase in this ratio is a signal that the economy is not growing fast enough in nominal terms to service the debt; unless policy is changed, the debt will grow without limit and interest payments to service the debt will be unbounded also. CBO (1991, p. 10) projects that this will not happen under current projections; the ratio of debt to GNP levels off at about 48%.

These conclusions seem reassuring. The primary budget is in surplus, and the debt to GNP ratio is projected to be stable. If these were the only measurement issues, we could be confident that the budget posed no long-term threat to stability and could go on to discuss other possible effects, for example the effect on capital spending, consumption and the use of resources or on intergenerational transfers.

Unfortunately, there are other measurement problems to consider. These concern what should be included in spending, revenues and the primary budget deficit and what should be counted as debt. How should the social security fund be treated? What should be done about liabilities for government credit agencies and government guarantees? Should the surplus of state and local governments be subtracted from the federal deficit when considering economic effects? Should the government’s assets be subtracted from its liabilities to get a measure of net worth? How should assets like the national parks and military equipment be valued? Answers to several of these questions are in dispute.

The standard measure of the deficit is a cash flow measure of the amount that the government has to finance currently. It is relevant only, if at all, for concerns about budgetary finance such as whether the public debt crowds out private capital. But even as a measure of financing this measure is incomplete since government credit agencies that issue debt are excluded and, as recent experience shows, guarantees may involve large future outlays. In addition, the government accepts obligations for pensions that are as much a government obligation as a formal debt contract. Why should a debt contract have a different financing
process should include improvements in accounting to give taxpayers more than the information in the current cash flow deficit.

Many proposals for reform urge the adoption of a capital budget to distinguish between a deficit on current spending and the financing of long-term assets with long-term debt. Publication of a government balance sheet and the change in net worth is a step in that direction. A balance sheet would show new investments in highways, schools, and other infrastructure for comparison with the amount of new debt issued. A balance sheet would be less likely to include as public investment government spending on health, welfare or education of the citizens. Spending for buildings would be counted as assets; spending for current programs that raised the level or quality of human capital would not.

The most widely cited numbers for federal spending and the budget deficit include changes in so-called baseline spending. These changes reflect current spending increases mandated by past federal decisions. This measure is useful for some purposes; it recognizes that much government spending is committed in advance.

Those who are knowledgeable about the budget process recognize that changes in baseline budgets include increases in spending. Much of the public is misled by this procedure. Members of Congressional committees or the administration talk about spending reductions or increases as if they were changes in the level of spending, in the case of reductions, reductions from the previous year. In fact, they have in mind reductions from the baseline -- reductions in the amount by which spending increases. The result is confusion when actual increases are described as reductions in spending.

The simple solution is that the President and OMB should present a budget showing changes in taxes and spending from last year's levels with discretionary and mandated changes labelled as such. Congress and CBO should adopt similar language -- language that does not describe increases as reductions. An example, one of many possible, comes from a recent CBO report. The report
debt as a part of net wealth. Deficit finance affected net wealth by changing the stocks of debt and money, thereby changing consumption and saving. In Brunner and Meltzer (1972) the influence of debt finance on wealth is shown to be small both absolutely and relative to the effect on the price of existing capital relative to the price of new production. The substitution effect on the relative prices of capital, or claims to capital, and bonds dominate the wealth effects.

Barro (1974) challenged the existence of a wealth effect for government debt. He pointed out that treatment of debt as a part of wealth neglects the future taxes required to service the debt. Forward looking individuals will not be fooled into thinking that they are wealthier because the government has printed bonds instead of money; they will anticipate that taxes will have to be paid in the future equal to the value of the debt. In his analysis, deficits have no effect on relative prices, real wealth or economic activity.

Barro’s proposition does not claim that government spending is irrelevant or without effect. And it does not claim that the way in which tax revenues are raised has no effect. Barro considers only lump sum taxes to abstract from the distortions resulting from different types of taxation and the effects of these distortions on output, its composition, wealth and utility. Barro’s proposition claims only that the present value of all current and future taxes is not affected by a reduction in current taxes financed by current debt and, therefore, by future taxes.

The mechanism that removes the effect of debt is intergenerational transfer. An increase in debt today to finance tax reduction is offset by higher saving. The current generation leaves to its progeny both more debt and more wealth with which to service or pay the debt. The net effect is zero on both current and future generations. Negative saving caused by increasing the government budget is fully offset by higher private saving and conversely, so total saving remains unchanged.
Barro’s analysis raises a puzzling issue. Why would a rational government finance tax reduction by issuing debt if the action had no effect? If deficits are identical to deferred taxes, why does the U.S. government have a large net debt and a negative net worth on its balance sheet?

Two main answers have been suggested in the literature. Alesina and Tabellini (1990) show that an incumbent government can affect future spending by its successor by reducing tax rates to produce a large budget deficit today. The successor government is deterred from spending by public concern about the size of the deficit. Deficits matter because people believe they matter. Cukierman and Meltzer (1989) use a framework identical to Barro’s with one exception. Some individuals are bequest constrained. They do not choose to leave positive bequests to their progeny. Knowing that future generations will be wealthier in a growing economy, they would like to tax future wealth by consuming more today and leaving debts to be paid by their heirs. The law does not require private net debts to be honored by succeeding generations, so the transfer to the present generation from the future cannot be made privately. But public debt can be left. Cukierman and Meltzer show that government deficits and debt can arise through this process of inter-generational redistribution. The presence of bequest constrained individuals reverses the main implications of Barro’s analysis. Debt and deficits affect real interest rates and capital accumulation.

Considerable empirical work has been done in past years to test the effects of deficits on interest rates and saving. The results are mixed. A relatively comprehensive survey by the Congressional Budget Office of econometric evidence of the effect of the deficit on short- and long-term interest rates concluded that “the results overall are too dispersed to be decisive” (CBO, 1989, p. 2). Moreover, many of the estimates were not significantly different from zero by the usual statistical tests.

**Economic Effects of the Budget**

In the early analysis of spending and deficits, government spending or taxes acted directly on aggregate spending and through the multiplier process changed aggregate output by a multiple of the initial change. Deficits were expansive and surpluses contractive.

Critics of this familiar textbook analysis pointed out that changes in interest rates, stocks of debt, anticipations, and intertemporal substitution between debt and taxes modified this result. The analysis of deficit finance eventually reflected some of these criticisms. By the 1970s most discussions of deficit finance recognized that the response of the economy to deficit finance depends on the way in which the deficit is financed. In the analysis of that time, monetary financing of the deficit augmented the effect of deficit spending.

Christ (1968), Brunner and Meltzer (1972), and others introduced the government's budget equation, and thus financing of the deficit, explicitly. A principal implication of their analyses is that the initial effect of spending or taxes on output and prices is small relative to the effect of the absorption of additional stocks of money or government debt into portfolios. The reason is that the change in spending (or tax rates) is a one-time change in the flow of spending, while the financing of the deficit continues to change asset stocks until the budget is balanced. Additions to stocks of money and debt must be absorbed in portfolios, so there are continuing effects on relative prices, the absolute price level and the level of output. These changes in relative prices

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1Part of this section follows Brunner (1986).
induce changes in spending and output that continue after the
direct effects of government spending die out.

In this analysis, deficit finance affects the economy mainly
by inducing changes in relative prices. The magnitude of the
effect on output is smaller for debt finance than for monetary
finance. Monetary finance lowers interest rates temporarily and
raises asset prices. Debt is assumed to be a closer substitute for
real capital than for money, so increases in debt to finance
deficits raise real interest rates and the relative price of
capital. The induced rise in interest rates opens the prospect
that bond financed deficits crowd out real capital thereby lowering
the level of long-run expected income (or normal output). In
this case the short-term effect of debt financed deficits is
expansionary; the long-term effect may be contractionary for output
and standards of living. An exception would be a deficit to
finance government capital spending financed by issuing debt. If
the government capital is as productive as private capital, normal
output would be unaffected.

Bailey (1971) analyzed differences between government spend-
ing on consumption (or transfers that increase private consump-
tion) and spending for investment. His analysis recognizes that
the allocative effects of the government’s spending (or tax rate
changes) are important for understanding the response to govern-
ment spending (or taxes). These effects are independent of the
method by which they are financed, but the means of financing
alters the total effect.

The implication of the analysis to this point is that both
the type of government spending and the method of financing the
deficit affect the size of the response and the long-run conse-
quences for the economy. The analysis assumes that debt and
capital are substitutes but not perfect substitutes; government
debt is part of net wealth of the private sector.

Analysis of fiscal actions within the standard framework used
in the 1960s and 1970s (IS-LM), assigned importance to government
Barro's work stimulated a large number of studies of the effect of deficits and anticipated deficits on saving and interest rates. Again, the results are mixed. Studies of the relation of budget deficits to aggregate saving or consumption, interest rates and bequests show that Barro's hypothesis is not easily rejected based on aggregate data. Budget deficits do not appear to have had important effects on U.S. aggregates.

Studies using micro data give a more negative result. For example, a study by Boskin and Kotlikoff (1985) tested a main implication of Barro's hypothesis: consumption spending is independent of the age distribution of the population. This hypothesis is rejected in their test. A study by Bernheim, Shleifer and Summers (1985) also rejects some main implications of Barro's hypothesis about bequests.

A study of consumption spending by Darby, Gillingham and Greenlees (1991) compares two models. Both explain consumer spending in the postwar period and both forecast U.S. consumer spending during the 1980s based on equations estimated up to the end of the 1970s. The results are inconclusive about the effects of deficits on consumer spending or saving. The statistical tests do not support a choice between the models. The main point of agreement about deficits in this work is that the effect of debt finance on consumption is not equivalent to an equal increase in disposable income.

Less formal evidence from countries with high inflation provides some possible evidence on the effects of deficit finance. In conditions of high inflation, budget deficits are financed by money growth, and observed real interest rates are relatively high. The high real interest rates may reflect a risk premium in real rates reflecting the inability of government to reduce spending or raise taxes.

Brunner (1986) suggests that the risk pattern in interest rates reflects the presence of a fiscal regime rather than the fiscal actions investigated in many of the tests of the economic
irrelevance of debt finance. Different fiscal regimes give rise to different risk premiums that persist in real interest rates and thus affect saving and investment. These patterns are not much altered by current fiscal actions unless these actions persist long enough to change beliefs about the fiscal regime. Earlier, Mascaro and Meltzer (1983) found support for the relation between government regime and risk premiums in interest rates in a different context.

This work is at an early stage. It does not establish that deficits have significant effects on economic variables. The most accurate assessment of the current state is that the issue is in doubt.

Open world capital markets provide one plausible explanation of the failure to find an effect of deficits on interest rates. A country’s deficit is financed in the world capital market. If world capital markets are integrated, risk adjusted, after-tax real rates of return are equalized between countries. If the deficits are small relative to world saving, the effect on interest rates may be hard to detect.

The deficit may affect the exchange rate in this case. An increase in the deficit causes an appreciation of the exchange rate as capital flows toward the country with the budget deficit. Foreigners acquire (net) domestic securities, claims to real capital, and rights to receive interest and dividend payments. The increase in the capital inflow is balanced by a trade deficit; imports rise relative to exports.

This combination of budget deficit, trade deficit, and capital inflow is shown by United States data for the 1980s. A problem in interpretation arises however because tax reduction in 1981 also changed the real after tax return to capital. Tax reduction was not a change in lump sum taxes, as in Barro’s model. Although the trade deficit began to decline in the late 1980s, as the measured budget deficit fell, the decline followed the 1986 chang-
es in tax rates that raised the cost of capital and lowered the effective real return to capital.

To estimate effects of debt or deficits on the real interest rate and real exchange rate, I used a standard model in which the real interest rate or the real exchange rate depends on real money balances \( M_1 \), real income, the real value of the deficit, and in some cases, I held constant the real value of change in net foreign assets. The real interest rate is the long-term government bond minus the current rate of inflation, the latter based on the GNP deflator. The change in real net foreign assets is measured by the deflated current account deficit or surplus.

Table 1 shows the results for three measures of the deficit. DRNW and DRND are changes in the real value of net worth and the real net debt of the federal government using Bohn's (1992) measures deflated by the GNP deflator. DRFD is the change in the real value of the federal debt, a more traditional measure of debt finance.

(Insert Table 1)

The results in Table 1, based on annual data for 1962-89, suggest that the broader measures of the budget have statistically more reliable effects on the real exchange rate than the more conventional measure. A $1 billion dollar increment to real net worth or the real net debt appreciates the Federal Reserve's trade weighted real exchange rate index by 2.5 points on average. The negative coefficient on the change in real net worth and the positive coefficient on the change in real net debt tell the same story. The difference in sign reflects measurement; net worth is recorded as a negative number, and net debt is recorded positively.

Efforts to replicate the results with the real short- and long-term interest rate as dependent variable produce less stable and less reliable results. My findings are not reported for they are much like the results in the literature.
Table 1

Effects of Debt Finance on the Real Exchange Rate* 
Dependent Variable is the Change in the Real Exchange Rate 
1962-1989

<table>
<thead>
<tr>
<th>DRNW</th>
<th>DRND</th>
<th>DRFD</th>
<th>DM/p</th>
<th>Dy</th>
<th>RCA</th>
<th>ρ</th>
<th>Constant</th>
<th>R²/DW</th>
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<td></td>
<td></td>
<td>2.81</td>
<td></td>
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<td></td>
<td></td>
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<td>(1.80)</td>
<td>(2.63)</td>
<td>(1.22)</td>
<td>(2.90)</td>
<td>(1.89)</td>
<td>(2.07)</td>
<td>(2.29)</td>
<td>(1.27)</td>
<td>(3.45)</td>
</tr>
<tr>
<td>-10.15</td>
<td>.016</td>
<td>.023</td>
<td>.050</td>
<td>.58</td>
<td>-3.40</td>
<td>.34</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2.51)</td>
<td>(1.67)</td>
<td>(1.78)</td>
<td>(2.14)</td>
<td>(2.07)</td>
<td>(2.10)</td>
<td>(3.07)</td>
<td>(1.60)</td>
<td>(1.67)</td>
</tr>
<tr>
<td>1.12</td>
<td></td>
<td></td>
<td>3.34</td>
<td></td>
<td></td>
<td>2.06</td>
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<td></td>
</tr>
<tr>
<td>(.57)</td>
<td>(.47)</td>
<td>(.89)</td>
<td>(1.75)</td>
<td>(1.42)</td>
<td>(1.47)</td>
<td>(2.37)</td>
<td>(1.75)</td>
<td>(1.42)</td>
</tr>
</tbody>
</table>

* t values in parentheses.
The preliminary evidence tentatively supports two conclusions. First, broader measures of the government's fiscal position appear to give more information about the fiscal position. Second, the data are consistent with an open capital market and a relatively elastic supply of foreign capital so that principal effects are on the exchange rate and not on the domestic interest rate.

No discussion about the effects of continued budget deficits on the economy would be complete if it ignored the effect on inflation. Sustained budget deficits in many countries have been financed by monetary expansion thereby generating sustained inflation. Recent U.S. experience shows that a budget deficit is not a necessary condition for inflation; inflation has been reduced. This experience differs from the experience in Latin America where budget deficits have been financed by money growth and sustained budget deficits have often given rise to anticipations of inflation, a flight from money holding and rising velocity of money.

Some Political Aspects

Despite the indecisive conclusions about the macroeconomic response to budget deficits and the proper measurement of a deficit, there is considerable evidence that budget deficits have political implications. Rhetoric about "the deficit" is a standard political theme. Politicians act as if constituents are concerned about the size of deficits; they remonstrate against deficit spending with great frequency. Yet the deficit continues if we take either the standard measure or the broader measures of net worth or net debt as measures of U.S. fiscal position.

If we use a narrow measure, the primary budget deficit in the national income and product accounts (NIPA), characterization of

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2At a previous AEI forum in the early 1980s a member of the President's Council of Economic Advisers, William Niskanen, minimized the significance of the budget deficit. The resulting political flap ended only after he made the proper incantations to appease the local deities.
the fiscal stance changes. Instead of the "unbroken string of ever increasing deficits" we find for the years 1948-89, 26 years of NIPA primary budget surpluses and 16 years of deficits. The last two years, 1988 and 1989, are years of surplus. The largest deficit is in the Reagan years $81.8 billion in 1983, but when the data are deflated by the deflator for government purchases, the record primary deficit shifts back to 1975.

Once again, measurement matters. Using a broad measure, Bohn's (1992) change in net worth of the government sector gives a picture that is closer to the rhetoric, although there are important differences. Positive changes in net worth (surpluses) occurred in 13 years, negative changes in 29 years, but seven of the positive changes were in the 1950s. From 1982 to 1989, all the changes in net worth are negative. The cumulative nominal reduction in government net worth for these years is $1.67 trillion. Bohn (1992, Table A1) shows total government net worth at $-1.68 trillion, so for 1948-81 positive and negative changes were offsetting. This cumulative measure of deficits was near zero at the end of the 1970s in part because the change in net worth includes appreciation of government assets, especially the value of its oil and gas properties in the 1970s.

Putting measurement aside and accepting that the U.S. government has a tendency to run deficits raises the issue of why this is so. It has not been true throughout U.S. history; there are periods of sustained surpluses in the late 19th century and in the 1920s. Also, all countries do not run persistent deficits. Among the 21 countries that the World Bank classified as high income countries, 14 reported budget deficits in 1989 (World Bank, 1991). In 1972, the same data show 23 high income countries with 13 in deficit. These data suggest important differences among countries. Italy, Ireland, Belgium and the United States report persistent deficits and Italy and Belgium have ratios of debt to GNP of about 100%. Switzerland and Singapore typically report a
budget surplus. Germany and France report relatively low ratios of government debt to GNP.

Within these data, there are large differences in the composition of spending. Some countries invest more while others spend for consumption. Some spend relatively heavily for defense. Typically, 25 to 30% of U.S. federal expenditure is for defense, while 5 to 6% is more typical for Western Europe and 2 to 3% is customary in countries like Austria or Ireland. A case can be made for spreading defense costs over future generations, by debt finance, particularly if such expenditures are expected to decline relative to wealth or income in the future. A similar case can be made for investments in highways, airports, hospitals, and other infrastructure. As Eisner (1986) has emphasized, this is why measures of net worth may be more informative about the government’s fiscal position than conventional measures of the deficit or the NIPA primary deficit. The latter measures do not distinguish between asset acquisition and current consumption.

There are two broad classes of political explanation of the size of government and its fiscal policies. One emphasizes structural aspects of the budget process such as the committee structure of Congress, the relation of agencies and departments to committees and staffs, or the segmented nature of the budget process with division between the House and Senate and between various committees. The second type of explanation treats the budget process in a modern, developed economy as a redistributive process. Much of the spending is for redistribution. All of the redistribution is not from higher to lower incomes, but given the distribution of federal tax payments, much of the net transfer is.

People with incomes or wealth above median income preponderantly favor lower tax rates and less redistribution; people with incomes (or wealth) below the median favor more redistribution financed by higher taxes on those above the median. In the United States, both groups get some of what they want. Until recently, postwar federal tax rates have remained in a narrow range at about
18 to 20% of GNP. Spending has increased from decade to decade, and most of the increase has been for redistribution -- either intergenerational redistribution for health care and payments to the retired or spending for welfare, education and middle class subsidies.

The most intriguing evidence for the structural explanation of spending is in Cogan (1988). Cogan argues that the growth of federal spending is more rapid when appropriations are decentralized -- decided by individual committees -- and slower when appropriations are centralized, decided by a single committee. Cogan shows that Congress shifted several times between centralized and decentralized decisionmaking. Prior to 1870, decisionmaking was highly centralized; spending rose slowly except in wartime. Between 1880 and 1920, decisions were decentralized, growth of spending (in non-war years) increased. Centralization returned in the 1920s; aggregate federal spending was about the same in 1929 as in 1922. Decentralization returned in the 1930s, and spending rose both during the 1930s depression and in the postwar years.

Three major problems confront structural explanations. First, growth of government spending is not unique to the United States. Nutter (1978) showed that government spending increased relative to GNP in all developed countries during the thirty years after World War II. These countries differ markedly in political structure. Some have parliamentary government with ministerial responsibility. Some have weak or undeveloped committee systems. Some have coalitions all or part of the time. Structuralist explanations run the risk of mistaking process for cause.

Second, growth of spending does not explain budget deficits. The current measured deficit persists because Congress and the Administration are unwilling to either raise tax rates or reduce growth of spending. The deficit reflects the political decision to reduce tax rates without reducing the growth of spending commensurately. The growth of spending has not increased, and growth of non-defense spending decreased in the 1980s. To explain why
deficits occur, a structural explanation must explain both taxes and spending.

Third, the growth rate of non-defense spending is not uniformly higher under the decentralized system. Non-defense spending increased more rapidly from the mid-1960s to the 1980s than in earlier or later periods. Cogan’s structuralist explanation does not account for these changes.

The redistributive hypothesis explains budget deficits as a decision to tax future generations. Cukierman and Meltzer (1989) show that, in a growing economy, those who would like to leave negative bequests combine with rentiers, who benefit from higher interest rates, to vote for deficits. A majority does not always prefer deficits. The number who favor deficit spending rises with the spread of the distribution of income, the variability of income and other factors.

The redistributive explanation views the growth of government spending and deficits as the result of demand. A majority demands spending for social security, health care and other major programs that redistribute income. This coalition elects the members of Congress and sustains a majority that votes for spending. A (possibly different) majority has also elected presidents on a program to not increase tax rates or to reduce rates. Prior to 1981, deficits were held down by inflation. The inflation tax and tax "bracket creep" raised tax collections and held down the deficit or, on some measures, produced surpluses. The relatively high inflation of the 1970s eroded support for this system mainly by making more of the public aware of the mechanism. Vestiges of this form of taxation remained; for example capital depreciation is not indexed. But lower inflation and elimination of bracket creep reduced this source of revenue without reducing the growth of spending.

Recent discussions about tax rates are almost tailor made for the redistributive hypothesis. Democrats urge tax credits or temporary tax reduction for the middle class and, less often, tax
rate increases for the upper class. They emphasize equity and fairness -- politically more attractive names for redistribution. Republicans emphasize the benefits of lower tax rates for growth and productivity. They favor lower tax rates for capital or capital gains. The Democrats denounce these as benefits for the rich.

Tax credits or temporary tax reduction cannot help the middle class, at least not much. Despite the recession, the economy is not far below measured productive capacity because manufacturing output has been sustained by export growth more than in past recessions. Unemployment cannot be reduced permanently by much more than 1% without structural changes. The shortfall in output from a 2-1/2% growth rate in the past three years is in the neighborhood of 5 percentage points.

The lagging growth of the middle and lower income working population is not primarily the result of tax changes in the 1980s. It reflects slow productivity growth since about 1970 and, as Kosters (1991) has emphasized, increased returns to education or schooling that raised the incomes of the educated and professional groups relative to those with less schooling. Tax reduction in the 1980s may have accelerated these changes by increasing the incentives for high income earners to work.³ To the extent this is true it is a social benefit, not a cause for concern.

To raise the relative and absolute incomes of the middle income groups requires measures that increase their productivity. These include improvements in education and skills and increases in investment that give productive workers better tools. Increases in current demand will have little lasting effects on productivity.

³It may also have encouraged them to take more of their income as taxable income.
What Can Be Done?

If the deficit arises from the structure of the Congressional appropriation process or the structure of the political process, changes in structure could change budgetary finance or the growth of spending. Cogan’s argument implies that centralizing the appropriation process would lower the growth of spending.

The present system diffuses responsibility. The President can claim that Congress is to blame for the deficit, the growth of spending, or the composition of spending. The Congress blames the President. Congress diffuses responsibilities among many committees. There is no effective enforcement mechanism for agreements, no penalty for failing to keep agreements or follow rules to reduce the deficit. Experience with Gramm-Rudman-Hollings and the 1990 Omnibus Budget Reconciliation Act shows that these mechanisms lack enforcement. They may provide a short-term change in the growth of spending, but they are not carried through to completion. As Levy (1991) notes, these agreements lack credibility. They are becoming like debt-ceiling legislation that has been in place for decades; each time the constraint binds, it is replaced with a new looser constraint.

The obvious lesson is that there must be enforcement and responsibility. Assigning all appropriations to a single committee would concentrate authority and responsibility, so it may be a useful step. Since much of the budget is now in interest payments and so-called entitlements, major changes in spending are unlikely unless the public is willing to have government reduce the growth rate of retirement, health care and other redistributive programs. Demographic factors alone suggest that not much will be done. But, centering responsibility could slow the growth of new programs if structure rather than public demand is a main reason for growth of spending.

Other proposals include term limitation for members of Congress. Term limitation has been suggested as a means of making Congress more responsive to the public’s demands. Hence it would
slow spending only if this last conjecture is correct and if a majority desires a reduction in aggregate spending. There is room for doubt about both conjectures. There is not much evidence that the public wants the deficit or aggregate spending reduced if the programs that benefit them are reduced as part of the change. Shorter terms for Congress would increase the relative importance of staff. If many of the hypotheses about the role of Committee staff are correct, this reform could increase spending.

Another proposed reform is the line item veto. A president who is committed to budget or deficit reduction as a major goal could use this power to reduce spending. Whether spending limitation would persist is less clear. A line item veto would give a president a strong bargaining tool for getting votes on bills that he wants. This would alter the current balance of power between the executive and legislature. It is hard to see why this change in relative position would lower spending and the deficit. It is not unknown for a president to offer support for spending or tax programs to gain votes on some part of his program.

Finally, there is a long-standing proposal for constitutional spending limitation or proposals to require a super majority to increase spending or tax rates. These proposals do not depend on whether a structural or redistributive explanation of spending and deficits is correct. They introduce a change in structure to limit spending, but they also change the public’s demand for spending.

Any spending limitation agreement that is credible and enforceable creates a public good. Each group that demands more spending learns that there is a limit on the total. An effective agreement establishes a consensus that limits an individual’s demands on government in exchange for limitation of all other demands. Unless agreement on limitation is recognized as binding on all others, it will not be credible or enforceable.

In earlier periods, consensus on limitation of deficits was achieved by sustained public support for the gold standard and a
fixed exchange rate. This consensus was destroyed in the 1930s and no other has taken its place. Sustained efforts to establish a new consensus based on fear of the consequences of continuous deficit spending have not succeeded. Perhaps, as in the discussion of measurement, we have not had deficits, although I think this is not true. Or, perhaps, as in the discussion of macroeconomic effects, deficits have major consequences only if they are financed by inflation or if they are perceived as part of a shift in fiscal regime from rectitude toward profligacy. Or, perhaps any harmful effects in the United States, such as crowding out capital, depend much less on the deficit than on the fact that government shifts the composition of spending away from investment and toward consumption. These effects occur slowly through slower growth of capital, productivity and standards of living relative to countries that may have budget deficits but also have higher rates of investment, as in Italy or a reunified Germany. Recent deficits may have attracted foreign capital to finance investment, appreciating the real exchange rate in the process but sustaining higher investment.

The last conjecture seems to have a basis in both fact and theory. The evidence summarized in Table 1 above suggests that measurement matters and the deficit matters. When the deficit is measured as the change in the net worth of the federal government, I find that increased deficits appreciate the real exchange rate and increased surpluses depreciate the exchange rate. Deficits act qualitatively like dissaving and surpluses like saving according to these results. 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.
Bibliography


