The Deficit: A Monetarist's Perspective

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There is no "monetarist position" on the budget deficit. Monetarism is mainly about the effects of money on inflation. Deficits have an effect on inflation—defined as the maintained rate of price change—only if they are financed by issuing money. Argentina, Bolivia, and Brazil are recent examples of inflations financed by money issued to pay for government spending. In these or other countries with budget deficits equal to 15 per cent of GNP or more, people observe that the government is unwilling to raise taxes or reduce spending; they expect inflation, so they resist holding domestic money. There is a flight from money, rapid money growth, and rising inflation. When the budget deficit was reduced Argentina and Bolivia were able to reduce money growth and inflation.

Some economists argue that deficits must sooner or later increase money growth and produce inflation. Experience in most developed countries does not support this claim. An example is Italy, which managed in the 1980s to reduce inflation from 15 or 20 per cent a year to 5 per cent or less while budget deficits have remained at 10 per cent of GNP or more. At the Italian share of GNP, the U.S. budget deficit would be $600 billion. And while Italy is an extreme example, it is not a unique example of a country with a persistent budget deficit and a declining rate of inflation. Our own country and Japan are other examples. Inflation here has fallen from 10 per cent to about 3 per cent despite the budget deficits of the 1980s and 90s. Inflation in Japan was reduced to about zero at a time when the government budget deficits remained equal to 3 per cent of GNP or more.

The lesson to be learned is that a country with a deficit can avoid inflation by borrowing to finance the deficit while slowing money growth. Should we, however, be concerned that, as in Mexico, Brazil, or Argentina, continued borrowing will pile up debts that we will have difficulty servicing? Will foreigners refuse to lend, forcing a rise
in interest rates and an economic day of reckoning? Adam Smith warned that there is much ruin in a nation. Is it all about to come due?

Continuing clamor about the deficit obscures what should be the central issue. Borrowing, hence the budget deficit, can be useful if we use the borrowed resources productively. If the return on our investments, or the value we place on consumption, exceeds what we pay on the debt, we are made better off by borrowing to finance expenditures. Because our borrowing is in dollars and the dollar is not rigidly pegged, we do not face problems arising from a mismanaged foreign-exchange system as Brazil, Argentina, Mexico, and other large debtors did.

Some argue that the problem is that, as a nation, we are consuming not investing. Hence, we must pay future income for what is usually described as a consumption binge. We should not accept this argument at face value. There is reason to be suspicious of the published data and to question the accuracy of the reported measures of net investment. A larger issue is whether we should accept the argument at all. Consumption is not evil. There is no reason to see calamity if the public willingly chooses to consume more today and repay tomorrow. Indeed, most of us do just that when we buy a house and take out a mortgage. As a society, however, we should be concerned about biases in the tax system, in laws, in regulations, and in government spending that tilt total spending toward consumption and against investment. If there are such biases, we should correct them in the interests of efficiency. The gain from increased efficiency is worth having whether the budget is in deficit or surplus.

There probably is a bias against investment. Government can reduce the bias. The largest part of government spending consists of consumption spending and transfer payments that mainly finance private consumption spending. The fastest growing part of government spending is for health care, mainly consumption. Government can reduce this spending. Tax changes in the 1986 act ended some inefficient special preferences but shifted taxes from households to corporations. A larger part of current taxes is now borne by owners of capital. This discourages investment and favors consumption. Government can shift taxes from investment to
consumption by substituting a broad-based consumption tax for the personal and corporate income taxes.

The fact that there are many different, strongly held professional views about the effects of the budget deficit should tell us that convincing evidence of major effects is lacking for the United States. The deficit can be the source of a problem if it is financed by inflation, if it rises continuously relative to income, if it absorbs saving into wasteful spending. Currently, the major problem is that excessive concern about the deficit will convince the public that we must have higher taxes. Closing the deficit by tax increases does not improve the use of resources and may make it worse by encouraging more government spending for consumption.

Much of the postwar fiscal history of the Federal government can be written in three sentences: Taxes have remained below 20 per cent of GNP. Government spending has increased persistently as a share of GNP. Large reported budget deficits are the result.

The problem is to change the incentives that have produced these results. Raising tax rates is neither the best nor the only way. A constitutional limitation on spending would restrict government’s use of resources to a maximum share of GNP in peacetime. If we are willing to pay no more than 20 per cent in taxes, a 20 per cent share for government spending, including transfers, would avoid persistent deficits.