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Michigan **COMMENTARY**

Playing Chicken with America's Future

by Robert Kleine, Vice President and Senior Economist

The U.S. Senate is now debating President Clinton's deficit reduction plan, and it is not a pretty picture. The Democrats are fighting with each other. The Republicans, ignored by the White House, now sit back, stubbornly united in opposition to any policy initiated by Clinton; they seem to be under the mistaken impression that the American people will be grateful to them for preventing higher taxes, most of which fall on higher income taxpayers, even if that means there is no deficit reduction. Particularly disturbing is the role of special interests who are holding the country hostage.

My sense is that most people want Congress to reduce the deficit, even if it means higher taxes, and will be outraged if gridlock continues. Washington politics are as changeable as the Michigan weather, and in the end some agreement is likely, but the process doesn't have to be this difficult. The question is who is looking out for the interests of the American people? The president needs to play this role more effectively or we all lose.

One of the problems with the debate in Congress is that much of it is based on myths, and this adds to the confusion of the voters. Let's examine some of these myths.

MYTH: The deficit is not so bad, and it will shrink if nothing is done.

This is the position of a few apologists on the left and right who do not want, on the one hand, to cut spending, and on the other, to increase taxes. The fact is that the Congressional Budget Office (CBO) estimates the deficit (now about $300 billion annually) will rise to $663 billion by 2003, and the General Accounting Office has projected that the deficit could reach 20 percent of gross domestic product (GDP) by 2020; it is currently about 5 percent of GDP.

In an editorial several months ago the *Wall Street Journal* claimed that we grew out of the huge deficits after World War II and we could do it again. This argument is extremely misleading. In 1945 the federal deficit was $45 billion, and government outlays were $95 billion, $82 billion of which was for defense. By 1947 federal outlays were $37 billion ($13 billion for defense), and the budget had a surplus of $6.6 billion. I do not think you can call this growing your way out of the deficit. The deficit was eliminated because of an 80 percent reduction in defense expenditures. Today, not even an 80 percent reduction in defense expenditures would balance the federal budget.

Can we grow our way out of the deficit? Not likely. I have calculated what it would take to balance the budget by 2003 using the CBO projected deficit of $663 billion for that year, which is probably optimistic given its tendency to underestimate the deficit. If one assumes that the economy will grow as fast as during the 1983–86 period (real GDP growth of 3.6 percent financed by borrowing nearly $1 trillion and not paying it back), revenues would be about $200 billion higher in 2003, but the deficit would still be $450 billion.

MYTH: All we need to do is cut federal spending.

It is unrealistic to expect that the problem can be solved entirely on the spending side. Cutting spending can hurt the economy as much as reducing expenditures. Spending should be reduced, but consider these figures: According to the CBO, federal outlays are expected to increase by about $1 trillion from 1993 to 2003. Of this amount, only $120 billion is in discretionary spending. Of the increase, $863 billion is in Social Security, Medicare, Medicaid, and interest on the debt. Cuts must be made in entitlement programs, but is

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the effect of reducing Social Security or Medicare benefits any different from that of raising taxes? I think not. In fact, it is worse because it places the entire burden on one segment of the population rather than requiring everyone to share the burden.

To balance the budget would require reducing federal spending from the current level of 23.5 percent of GDP to 19.4 percent, a level we have not seen since 1974. If spending were reduced to 22.1 percent of GDP, the lowest level in the 1980s, the deficit would still be $278 billion in 2003. This figure may not sound too bad, but the problem is that the deficit begins to increase rapidly beginning several years later when the more than 80 million baby boomers begin to retire.

The only feasible solution is a *combination* of tax increases and spending reductions. Everyone will benefit from a lower federal budget deficit, and everyone should be willing to sacrifice for the long-term good of the nation.

MYTH: It is impossible to balance the federal budget.

The federal government generally ran balanced budgets from 1950 to 1970, although federal outlays increased at an annual rate of almost 8 percent, much faster than today. At the same time, government receipts as a share of GDP rose from 14.4 percent in 1950 (the last year federal outlays were below the 1945 level) to 19.8 percent in 1970. The economy also grew faster in this period, in large part because saving and investment increased and real interest rates were lower because the federal government was not draining savings from the economy.

The federal government did not begin to run large deficits until 1982, after the Reagan tax cut. The deficit that year was $109 billion, 2.8 percent of GDP. Up until that time, the largest post-World War II deficit was $65 billion in 1975, 2 percent of GNP. Fiscal policy in the 1980s was irresponsible. Taxes should not be reduced without reducing expenditures. There is plenty of blame to go around, but to be honest we should blame ourselves.

MYTH: The 1990 budget agreement did not reduce the deficit.

One of the favorite arguments of conservatives is that the 1990 budget agreement raised taxes, which resulted in more spending and a weaker economy, and did not reduce the deficit. Let us look at the facts. According to the CBO: "If the changes in spending and taxes agreed to in 1990 had never happened, the deficits in 1991 through 1995 would be close to $500 billion higher than current estimates." The 1993 deficit would be $89 billion higher, the 1994 deficit $131 billion higher, and the 1995 deficit $160 billion higher.

What has happened to increase the deficits above the 1990 projections, from $29 billion to $284 billion in 1995, is that factors beyond the control of the president and the Congress have reduced revenues and increased spending for entitlements and other programs. For example, in 1995 outlays are projected to be about $116 billion higher and revenues about $136 billion lower ($102 billion due to slower economic growth) than assumed in the 1990 agreement. The spending increases are mainly for Medicaid and Medicare ($60 billion) and deposit insurance ($37 billion).

Conservatives would attribute the decline in revenues to the tax increases in the budget agreement, but remember the recession started in July 1990 and the budget agreement occurred in October 1990, with most of the tax increases taking place in 1991. Higher taxes may have delayed the recovery, but it is unlikely that more than $30–40 billion of the decline in revenue can be attributed to higher taxes. That means that without the 1990 budget agreement the 1995 budget deficit would be at least $120–130 billion higher than currently projected. Congress cannot seem to deal with a $300 billion deficit. How would they deal with a $400 billion plus deficit? Although he disavowed it, the 1990 budget agreement was one of President's Bush major achievements. Unfortunately, being right doesn't always win you votes.

MYTH: Reducing the deficit will not reduce interest rates.

A major reason for reducing to deficit is to lower interest rates, thereby encouraging more investment by businesses and large ticket purchases, including homes, by consumers. Some "analysts" who are opposed to tax increases base their arguments on the flimsy ground that reducing the deficit will not reduce interest rates. This is an absurd argument. Both the theory and the evidence are clear. The deficit puts upward pressure on interest rates in two ways. First, the government must borrow billions of dollars to finance the deficit. This increases the demand for money, which bids up the price, or interest rate. The effect on interest rates has been softened somewhat by an increase in the supply of investment capital, in the form of foreign inflows. This source has started to dry up, however, which means that future deficits will put more upward pressure on interest rates. Second, over the long-term, high deficits year after year can result in inflation (which pushes up interest rates) by (1) overstimulating the economy during recovery periods and (2) contributing to lower productivity because the deficits soak up savings, thereby reducing investment.

Apologists point to the decline in interest rates in the early 1980s, when deficits were large. Of course interest rates fell in the early 1980s; they did so because inflation dropped from double- digit rates to under 4 percent. Interest rates adjusted for inflation tell the real story. In the 1950s Aaa corporate bond rates, adjusted for inflation, averaged 1.2 percent; in the 1960s the average was 2.3 percent; in the 1970s it was 0.4 percent. In those three decades the federal deficit was quite small. In the 1980s, however, the real interest rate averaged 7.12 percent, and in the last three years the real rate has averaged about 4.5 percent. Every economist knows that it is *real* interest rates that are the crucial factor in investment decisions.

If you think the federal deficit doe not affect interest rates, watch what happens if Congress fails to pass a credible deficit reduction plan. The recent decline in long-term rates will be reversed, and rates will rise at least one percentage point.

MYTH: The energy tax is bad for the economy.

The country has been sold a bill of goods by the oil industry and their lobbyists. Consider the following quote from *The Economist* magazine (June 12–18, 1993).

> The nonenvironment arguments mustered against the American energy tax have been as meager as the environmental support. The tax, grumble energy users, will make some American industries (they mean their own) less competitive. It will cost jobs and output. That is all true in narrow terms but also wildly exaggerated and meaningless: The uncut budget deficit will have all these effects and more.
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> To look at the effects of the tax in isolation misses the point: Any measure to reduce the deficit will cost jobs and exports in some parts of the economy but improve the prospects for the economy overall. A well-designed energy tax would bring bigger gains at smaller costs than many other revenue-raising schemes. Other lobbyists complain that the energy tax would hurt household incomes, and especially those of the poor. Yet if the federal government is to borrow less, some households will have to pay higher taxes at the same time public spending is cut. Other schemes to plug the deficit, such as cuts in welfare, could hurt the poor more than the energy tax.

What the Senate Finance Committee has done is shift much of the burden from energy companies to senior citizens, many of whom have low incomes, by proposing deeper cuts for Medicaid. The energy tax makes sense and was a centerpiece of the president's plan. It should not be dropped.

CONCLUSION

It is time to stop apologizing for the deficit and holding on to pipe dreams that we can grow our way out of the problem. The pain from the Clinton economic program will pale in comparison to the economic pain we will endure if we wait much longer. We need courageous leaders with vision if we are to make any progress, not people like David Boren who are willing to sell out their party to help a few oil companies. Unfortunately, we will continue to suffer shortsighted leadership as long as we reward those politicians who vote for narrow interests and penalize those who pursue the public interest. If we do not reduce the deficit in the next few years, people may turn to a third party or a leader like Ross Perot to save them from the special interests and the politicians.