

ECONOMICS USA

PROGRAM #24

FEDERAL DEFICITS:
CAN WE LIVE WITH THEM?

AUDIO PROGRAM TRANSCRIPT

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DEFICITS: CAN WE LIVE WITH THEM?

(MUSIC PLAYS)

Announcer: Funding for this program was provided by Annenberg Learner.

FRANK STASIO: This program was originally recorded in 1985. Though times have changed, the basic economic principles presented here remain as relevant today as they were when the series was produced. Also, please note that individuals interviewed on this program may no longer hold the same titles they held when this program was recorded.

(MUSIC PLAYS)

FRANK STASIO: Economics USA. One of a series of programs designed to explore twentieth-century micro and macroeconomic principles. The subject of this edition is Deficits. Our guest is Alice Rivlin, Director of Economic Studies at the Brookings Institution, and former head of the Congressional Budget Office. I'm Frank Stasio.

RONALD REAGAN: "Strong economic growth will keep deficits coming down, and, make no mistake, the deficit *is* coming down. And it would come down even faster if the Congress would give us a Constitutional amendment, mandating government spend no more than government takes in.

GEORGE MCGOVERN: "This...this deficit is not bad. It's obscene and destroys long-term hopes for the future of our nation and for long-term economic growth. It must be dealt with, and they refuse to even discuss it."

FRANK STASIO: What happens when a country runs a deficit? Does a nation face the same consequences as a family that falls behind in its payments? For much of our

history, economists and policymakers believed that it was irresponsible for the government to end the year in the red. Even Franklin Roosevelt, who was thought to have embraced deficit spending, recoiled at the thought early in his Presidency.

FRANKLIN D. ROOSEVELT: “And I should like to take this opportunity to say, loud enough to be heard in Washington, that, even in hard times, it is possible to have a balanced budget.”

FRANK STASIO: There was always a fear that, if the government did not balance the budget, people would lose confidence in the economy, creating greater hardships down the road. But, as Roosevelt learned during the depths of the Great Depression, the warnings about the evils of deficits were overblown, and the only thing to fear was fear itself.

FRANKLIN D. ROOSEVELT: “I am saying, over and over, that I believe that we can restore prosperity throughout the nation by re-establishing the purchasing power of half of the people of the nation. This nation is asking for action, and action, now. Our greatest primary task is to put people to work. Let me assert my firm belief that the only thing we have to fear is fear itself.”

ALICE RIVLIN: “Some kinds of deficits are really quite useful.”

FRANK STASIO: Alice Rivlin is the Director of Economic Studies at the Brookings Institution, and the former Director of the Congressional Budget Office.

ALICE RIVLIN: “If the economy is sliding into an unexpected recession, for example, then, the federal budget will go into deficit automatically. That’s because fewer people are working. They aren’t paying taxes. And the revenues fall off, and some kinds of expenditures go up, like unemployment compensation. So, there’s an automatic deficit, and that’s good. It helps offset the effects of the recession. It puts more money into the economy. If we were to try to stop that sort of deficit, by raising taxes, or cutting the expenditures, we’d make the recession worse.”

FRANK STASIO: The Great Depression was a perfect example of an appropriate time to run a deficit. Robert Nathan is an economist who worked in the Roosevelt Administration.

ROBERT NATHAN: “It was quite clear by...by ’32...’33, that something had to be done. And this was, I think, the changes in the New Deal, that, for the first time in history, there was a decision that the government had to take a part and move in, not to take over industry, not to own and operate, not to socialize the economy, but take fiscal measures and monetary measures, and even work measures—Works Projects Administration, public works, and the like— to turn the economy around. And...and the Keynesian principles that, in times of recession government deficits could be a very stimulating factor, certainly proved to be true.”

FRANK STASIO: But what was true for the 1930s may not be true for future generations. Alice Rivlin, speaking 1985, says the huge budget deficit run up in the nineteen eighties seemed inappropriate.

ALICE RIVLIN: “We have an economy which has been growing for the last couple of years. It’s recovered well from the last recession, so that the deficit in the federal budget is not caused by a recession. It’s what economists call ‘a structural deficit.’ It’s there, despite the fact that the economy is growing quite well. Now, that kind of deficit, whatever its size, and this one is big, can have bad effects.”

FRANK STASIO: Rivlin says it’s not the size of the deficit that determines its appropriateness, but rather, the economic conditions at the time of the deficit. In the mid-’80s, the economy had just recovered from a severe recession. Inflation was low, and unemployment, while by some interpretations, relatively high, was stable. In good times, as the economy approaches full capacity, economists usually recommend that the government run a surplus. In other words, take in more than it spends, as a way of cooling off the economy, and heading off inflation. Many economists fear running a deficit in good times because they tend to absorb money that might otherwise be used in private investment. But Rivlin points out that the situation in the 1980s was unique. The deficit did not crowd out investment.

ALICE RIVLIN: “The deficit is a use of national savings, and we are using a large portion of our national savings to run the federal government, to pay for the deficit rather than using it for investment and more productive things. That means, in order to have a high level of investment, we have to get additional savings from somewhere else. We have to get somebody else’s savings, for example. And that’s the way we’re solving that problem right now— we’re having a big inflow of capital from abroad. But that has its problems, too.”

FRANK STACIO: Does it make a difference if we’re borrowing from ourselves, or if we’re borrowing from foreigners?

ALICE RIVLIN: “Yes, it does make a difference. Borrowing from foreigners has several problems. One is that it means that the value of our currency, the dollar, tends to be very high. Those foreigners are demanding dollars to, uh, pay, to invest in the United States. And, uh, that bids up the price of dollars in terms of pounds, or yen or...or deutsche marks, or whatever. And the effect of that is that it is very expensive, then, for foreigners to buy our goods because our currency is so high. And it’s very cheap for us to buy from them. So that, our export industries and our industries that compete with imports suffer. And that is one of the things that’s happening right now, particularly in manufacturing. We’re having a very hard time exporting, and a very easy time importing. And that makes for imbalances in the economy. The other problem is that, in the long run, all...all debts have to be paid back. And it...it’s no different if you’re a...a nation than if you’re a person. We will be paying back, over a long period, these funds that we have borrowed from foreigners. Now, that’s not necessarily bad, but it means that we’ll have less left over for ourselves. The, whatever we produce, part of it will go overseas to pay the interest, and the dividends, and the repayment of these debts.”

FRANK STACIO: Americans have never been completely comfortable with the idea of deficit spending. Even Franklin Roosevelt, whose budget was in the red for most of his Presidency, tried to cut government spending in 1937, before the deficits of earlier years could bring about a complete recovery. The cry for a balanced budget rose sharply in the early nineteen eighties because of ever-increasing deficits posted through the period.

There was a serious attempt to call a Constitutional convention to consider an amendment to the constitution that would mandate a balanced federal budget. Backers of the Constitutional amendment wanted to bring the budget into balance by the end of each fiscal year.”

ALICE RIVLIN: “I think it would be very difficult, probably bad for the economy, to force the U.S. Government to balance its budget every year. And the reason for that is that it could not, then, offset recessions with its budget deficits. You really do want the federal government to be able to run a deficit when the economy’s in a recession, or, to run a surplus, perhaps, when there is a high inflation and the economy is fully employed.”

FRANK STASIO: But there are some experts who say the budget should be balanced over the period of the business cycle. Economists point out that a deficit is good for the economy in a recession and harmful when the economy is near full capacity. They argue that the budget should reflect the cyclical swings in economic activity. Many economists argue that there is no need to balance the budget over any specific time period.

ALICE RIVLIN: “It wouldn’t matter if the federal government ran somewhat larger deficits, even if they ran a small deficit every year. As a matter of fact, over the period from about, uh, the end of World War II to the early, till about 1980, we were running deficits in the federal budget almost every year. They were larger in recessions and smaller in good times. But the budget was rarely exactly balanced.”

FRANK STASIO: It is sometimes helpful, in understanding the full impact of deficits and surpluses, to project what the budget would look like at full employment. The so-called full-employment budget has been adopted by recent administrations as a way of gauging the real effect of a budget deficit.

ALICE RIVLIN: A full-employment budget is just a way of measuring the federal budget deficit. If one is in a recession, the federal government budget goes automatically into deficit. And one can say, well, that’s just caused by the recession. If we re-compute this deficit, and say how much it would be at full employment, then, we will get a lower

number, and a measure of what, in the sense the real deficit is, not just the deficit caused by temporary recession in the economy.

FRANK STASIO: And why is that? How does it work? What is the value of viewing the deficit from a full-employment point of view?

ALICE RIVLIN: “It’s useful to dev... to view the deficit from a full-employment point of view, uh, just really to get an idea of what the net effect of the deficit is, how much of it is simply an automatic effect of the recession, and how much is something extra that the federal government is doing, over and above the natural result of an... of recession.”

FRANK STASIO: The use of a full-employment budget has important policy implications. Remember, deficit spending creates a multiplier effect, which stimulates the economy and helps reverse unemployment during a recession. Policymakers will be misled if they don’t make the distinction between a full-employment budget and the actual budget. So, it appeared in 1958, for instance, that the Eisenhower Administration was running a ten-billion dollar deficit. But economists argued that the deficit was actually caused by the recession. Unemployment was at seven percent. Output was down sharply. An economist calculated that, if the economy had been at full employment, the budget would have been in a surplus. Government spending in nineteen fifty-eight did help ease the recession, but Eisenhower was uncomfortable with that seemingly huge deficit of ten billion dollars. Later, when Ike was about to leave office, he didn’t want to walk away with a budget deficit. So, against the counsel of his advisors, he ran a surplus in nineteen sixty. Economist Herbert Stein.

HERBERT STEIN: “1960, he was leaving office. He was not running again. The pains of the recession did not ... that we were having in 1960 were not so evident to him as the pains of the 1954 recession had been. They were pretty evident to Mister Nixon.”

FRANK STASIO: I was gonna say, it was... he was running.

HERBERT STEIN: “Who was...who was running, and he was very unhappy about the situation.”

FRANK STASIO: Vice President Richard Nixon was running for President. He was one of those urging Ike to continue to run a deficit and complete the recovery. But the President stayed with his program, and left the government in the black. The surplus in 1960 stalled the recovery and may well have cost Nixon the election. When Richard Nixon finally captured the presidency eight years later, he became the first president to regularly use the full-employment budget. Deficits can have varying effects on the economy, depending on how they are financed. One way to finance the deficit is to borrow from individuals in businesses. When this happens, the government absorbs savings, which would have been invested in other ways. This can cancel the stimulative effect of a deficit.

ALICE RIVLIN: “We’re not a high-saving country. Japan, for example, saves a much higher proportion of its gross national product than we do. Net national saving in the United States, over the period 1950 to 1984, was about seven point two percent at, on average, of the gross national product. So, if we’re using, say, four percent of that to finance the government, it means we’re in considerable trouble. We’re going to have to get the rest of our saving from somewhere else.”

FRANK STACIO: “If I go into debt and borrow from, essentially, from within my economy, in the domestic economy, and then pay it back, is that less a burden to future generations than having to pay...pay back that loan to foreign investors?”

ALICE RIVLIN: “Well, it is, in a sense. It’s a little bit like borrowing from your brother. It keeps it in the family. And, from the point of view, of the family as a whole, it’s just a transfer when...when, one member paying to another. On the other hand, it still does create a problem. The U.S. Government, even when it borrows from U.S. citizens. does have to budget the amount necessary to pay the interest, and it means that the federal government has less flexibility, in the sense it has to pay that interest first, and then think about what else are we going to buy. If foreigners for some reason just suddenly decided not to lend us any more money, then we would be in much deeper trouble. Our interest rates would rise very rapidly unless the Federal Reserve was willing to create a lot more money. I don’t think they would be. And then our investment rates

would...would drop, because it would be very expensive for firms that wanted to put up new factories, for instance, to...to borrow money.”

FRANK STASIO: The other way the government may finance a deficit is to create new money. It does this by having the Federal Reserve System buy up the government’s debt. This does not absorb savings and, consequently, will have a greater expansionary effect on the economy than borrowing from the public. But this process increases the money supply, and tends to lead to inflation. How do policymakers decide whether to run a deficit and how high the national debt should be allowed to climb? The budget process itself is complicated, and fraught with competing, and, often, conflicting goals.

ALICE RIVLIN: “Well, the federal budget starts really in the executive branch of the federal government, with the various agencies, the Defense Department and Health and Human Services, and the others, trying to figure out what they need for their programs in the next year. Those needs are transmitted to the president, or, really, to the Office of Management and Budget. They always exceed the available funds. Everybody thinks they need more for their program, and the job of the Office of Management and Budget is to put these competing claims together, and to make sure that, uh, the budget that the President sends up to the Congress reflects the Administration’s views of priorities, and reflects the, whatever the Administration thinks is the appropriate balance between spending and revenues, which may be a surplus, or it may be a deficit. Most of the time, in recent years, it’s been a deficit. So, the Office of Management and Budget works hard on this document and, uh, with the President, sends it up to the Congress in February. But that’s just the beginning. The Congress then gets to work on the budget and what it thinks the government should be spending, and for what, and how this should be paid for. The first action is in the Budget Committees, and they take the President’s proposals, they take the views of experts that they call as witnesses, and the estimated needs from the various committees of Congress that deal with these agencies. And they put this all together in what is called a budget resolution, which is a general framework for the budget. It doesn’t give specific amounts of, how much for tanks, or how much for guns, and so forth, but it has a number for defense, and a number for health, and a number for income security, and a number for revenues. And that budget resolution is voted on by

the Congress. That's been a very difficult process in the last few years. Sometimes, the House and Senate vote for very different budgets and have to iron out the differences in conference. Sometimes, the president gets into the act. But, in principle, by May, and, usually, by a little later in the summer, the Congress has completed its budget resolution or its overall framework. Again, that's not the end. Then, once they have this overall framework, they have to do the specific Appropriations bills that fit in that framework, and the specific tax bills, and wrap that all up by the time the fiscal year begins, on the first of October."

FRANK STASIO: "To what extent is this whole process coordinated so that, if there was a fiscal policy that you wanted to pursue, it could be...it could be, it could stay on target?"

ALICE RIVLIN: "Well, that really is the point of the congressional budget process. The President expresses his fiscal policy as well as his budget priorities in his budget, and then the Congress debates that, and may agree with it or disagree with it, but expresses its philosophy or its fiscal policy in the budget resolution. And, then, the rest of the Appropriations acts are brought into line with that. It is a process designed to get a fiscal policy and have it expressed in the budget resolution, and carried out in the other Acts. In that sense, the difficulty is getting the fiscal policy. It hasn't been so much, carrying it out, once you have it."

FRANK STACIO: "But isn't, there's a twofold, there are really two things going on. While on the one hand you have a fiscal policy that you'd like to pursue, on the other hand you have a social agenda that...that needs to be covered in these various agencies, so that you need so much for defense that, or so much for social programs. And you may make that decision without considering its effect on the economy in general. So, don't those two agendas... can't they come in conflict?"

ALICE RIVLIN: Well, a budget is conflict. A budget is a process of putting together conflicting claims, and desires, and fitting those into the total that the government wants to spend, which is consistent with its fiscal policy. A budget is always a process of adjudicating conflicting claims.

FRANK STASIO: As Director of the Congressional Budget Office from 1975 to 1983, Alice Rivlin was an important player in the budget process.

ALICE RIVLIN: The Congressional Budget Office is an... independent analytical arm of the Congress. They produce estimates of what's likely to happen to the economy, estimates of what the budget will look like if the Congress goes on doing what it's doing, how big the deficit will be in the future if policy isn't changed, and that sort of thing, analysis of the impact of alternative changes, or alternative legislation on the budget. The Congressional Budget Office is, essentially, the keepers of...of the numbers of, for the Congress. They do for the Congress what the Office of Management and Budget and the Council of Economic Advisors do for the President.

FRANK STASIO: Rivlin says the budget-making process has changed a great deal over the last sixty-five years.

ALICE RIVLIN: "For much of the U.S. Government's early history, budget-making was fairly casual, and the President, himself, did not have very strong control over the federal budget. Individual agencies tended, uh, at different times of the year to go to the Congress and say, 'we need more money for this or that.' And presidents, understandably, felt that they wanted to get control of the government budget. The...the main step in presidential control took place in 1920 with the Budget Act that created the Bureau of the Budget, as it was then called, now called the Office of Management and Budget. And that gave the president a central mechanism for making a government budget, and he insisted that the agencies come to him, to his office, and say what they needed. And he would make the decisions about what was going to happen in terms of what Congress would be asked to spend, for what, and what the taxes would be. Over quite a long period the...the President's offices worked hard to improve the process of making the President's own budget proposal. And making, uh, taking steps to get more information about what programs actually did to evaluate them. But, meanwhile, the process in the Congress was just as chaotic and fragmented as ever. In the...the early 1970s, for instance, even after the president had gone through all this effort to make a budget that reflected his priorities, when it got to Capitol Hill, it was almost, literally,

shredded apart and considered, in pieces, by different committees. There was no overall process for looking at the federal budget. Spending bills were voted on, one at a time, on different days, and nobody had the ability to say, are we spending too much on defense, and not enough on health, or vice versa, because those were considered on different days, and the question never came up. And taxes were considered on different days, so nobody ever asked the question. They asked it, but they didn't answer it: 'Do we have enough revenues to pay for this expenditure?' So, this was all pretty chaotic. and it probably led to higher spending because, if you are voting on an appropriation bill, and you don't have to vote at the same time for the revenues, you may tend to vote for...for higher spending. It was all of that that led to the creation, in 1974, of a new budget process on the Hill. The Budget Reform Act of 1974 created a process by which the Congress could look at the budget as a whole. It created two new budget committees which had not existed before, whose job was to put the conflicting claims on the budget together, and to consider the President's budget as a whole, and alternatives to it. and bring a budget resolution to the floor that reflected an overall budget policy, not just the conflicting claims. That process has worked quite well, I think. Its main objective was to focus the attention of the Congress on the budget as a whole and make them vote on it. And they now do that. They have also discovered how hard that is, and the difficulty of making a budget and getting a budget resolution has been extraordinary in the last few years. But the process has worked, I think, reasonably well in forcing the Congress to come to grips with the issue."

FRANK STASIO: Let's review some of the main points in this discussion about deficits. Budget deficits occur when the government spends more than it takes in. Deficits can help the economy out of a recession by increasing aggregate demand. However, if the economy is operating near full-capacity, deficits can lead to inflation. The prevailing view about government spending before the Great Depression was that the government should balance its books at the end of each fiscal year. There are still some today who argue for that approach. And, in fact, there was a movement to call a Constitutional convention to mandate a balanced federal budget. Alternatively, some economists and policymakers feel that the budget should be balanced over the course of the business cycle. And some experts believe there is no need to balance the budget. Rather, they

argue that the budget should be used to counter the business cycle so that the government could operate with a deficit during a recession, and a surplus near full-capacity. Many deficits are caused by a slowdown in the economy. Recessions lower tax revenues and increase federal spending on relief programs. One way to adjust for the effects of a recession on the budget is to formulate a full-employment budget. A full-employment budget shows how revenues and expenditures would balance if the economy were operating at full employment. There are two ways to finance the deficit. The government can borrow from firms and individuals. This tends to absorb savings and raise interest rates, which can offset the expansionary effect of a deficit. The other way to finance the deficit is to borrow from the Federal Reserve, that, in effect, print money. This adds new money to the economy, and is more expansionary, but is also more inflationary than borrowing from private sources. The process for devising the national budget is long and complex and tries to reconcile many competing and conflicting priorities. There have been a number of reforms, in both the executive and legislative Branches, that have attempted to consolidate the process. so the budget can be considered as a whole. Deficit spending was a bitter pill for policymakers during the Depression, but when it cured chronic unemployment, the experts were convinced that government spending was good medicine. However, with deficits in the mid-'80s running over two hundred billion dollars, threatening to reduce productivity, the new lesson may be that medicine should be taken only as directed, and only when needed.

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FRANK STASIO: You've been listening to Economics USA, one of a series of programs on micro and macroeconomic principles. Our guest has been Alice Rivlin, Director of Economic Studies at the Brookings Institution, and former head of the Congressional Budget Office. Economics USA has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

(MUSIC ENDS)

Announcer: Funding for this program was provided by Annenberg Learner.