IRET Congressional Advisory

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MIXED SIGNALS FROM CHAIRMAN GREENSPAN

Federal Reserve Board Chairman Alan Greenspan has urged Congress to meet President Clinton's goal of reducing the deficit by $500 billion over 5 years, and to regard the budget reconciliation package as just the first step in a longer term effort that will be needed to eliminate Federal budget deficits. Failure to do so, in the Chairman's view, would drive up interest rates and hurt the economy. Greenspan's remarks were given on July 20th in testimony before the House Banking Committee Subcommittee on Economic Growth and Credit Formation.

***How** one cuts the deficit is more important than how **much** one cuts it.*

Administration spokesmen have pointed to the Chairman's remarks as an endorsement of their budget package. However, Greenspan clearly favors spending restraint over tax increases in achieving deficit reduction. He stated that slowing the growth of federal spending — not rearranging federal taxes — is critical to reducing the deficit, which sounds nothing like the budget package that was hammered out in conference.

The emphasis the Chairman placed on reducing the growth of Federal spending as a means of controlling the deficit is welcome and valuable advice. However, Greenspan confuses the issue, and weakens his own case, by focusing too much on the size of the deficit reduction and by repeating conventional platitudes about the pain of government spending cuts and a link between deficits and interest rates. Contrary to the tone of the Greenspan testimony, the economy and the financial markets would do much better with a deficit reduction package of $400 billion, all from spending restraint, than with a $500 billion package with $250-plus billion in tax increases.

Doctor, doctor, will it hurt?

Greenspan says that cutting spending is a hard choice because it reduces GDP, at least in the short run, but that the economy is strong enough to handle it. He says that in the long run the economy is better off with the resources shifted to more productive use in the private sector. On the latter point, Greenspan is correct. However, he makes too much of the near term pain, for two reasons.

First, spending restraint does not hurt the economy as a whole, and need not inconvenience any portion of it to any significant degree for any significant time. The massive conversion from war production to peacetime output after World War II shows how fast the private sector can shift gears.

If the economy were growing rapidly and creating new jobs at a fast clip — as it might be if the tax increases were left out of the budget package, and if a modicum of tax relief were provided to labor and capital — the transition from working or producing for the government to working or producing for the private sector would be rapid and relatively painless. A smaller government sector would quickly mean a larger private sector and a larger, more useful, and more satisfying total GDP. Faster private sector growth,

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in turn, would painlessly reduce government spending on welfare and unemployment.

The notion that spending cuts hurt output is a hang-over from the Keynesian era. If you define GDP as including government spending, no matter how useless (e.g. Keynes's notion that you could fight recession by hiring people to dig holes and fill them in again), then any cut in government spending is considered to be a cut in GDP.

In reality, it is a good thing for the government to release its grasp on real resources — manpower, steel, computer chips, land, oil, office space, etc. — which could and would be better employed in the private sector. In the private sector, the resources would be used to produce things people want to spend their money on; in the public sector, the resources are used to produce things that politicians want to spend other people's money on, things that no consumer would buy if given a free choice.

Spending restraint may be hard on a Member of Congress who would have less bacon to bring home, and it may annoy federal employees and special interest beneficiaries of the lost federal largesse, but it is not a hard choice for the taxpayer, the private sector employee and his boss, or the consumer of private sector output.

In any event, the issue of whether spending cuts hurt the economy is moot; spending will not really be cut under the budget agreement. The baseline budget assumes huge spending increases, which would merely be trimmed back. Defense and saving on interest on the debt would be the only areas of real reduction. Domestic programs would feel no pain.

Taking credit where credit is not due.

Administration spokesmen have hummed ad nauseam the mantra that interest rates have come down by 100 basis points since the election of President Clinton because of the prospect of meaningful deficit reduction. That is nonsense. Interest rates have come down because slow money growth and fear that the budget plan will further depress the sluggish economy have dampened concern about inflation and reduced businesses' demands for saving.

The Chairman gives support to the Administration chant by asserting that failure to reduce the deficit by the promised $500 billion would make the markets nervous and drive rates higher. The historical record does not support that contention. Interest rates are driven by inflation, taxes, and uncertainty, not by deficits. Since 1981, interest rates have tumbled in line with falling inflation and falling marginal income tax rates. They have fallen regardless of swings in the deficit or changes in the deficit outlook.

Deficit reduction, per se, does not lower interest rates. Indeed, deficit reduction by means of higher marginal tax rates should be expected to send interest rates higher by raising the tax premium built into the interest rates. It is obvious that taxable bonds carry a higher interest rate than tax exempt bonds. It should be equally obvious that the interest rates on taxable bonds will rise if tax rates are increased.

The House (and Senate piggy-) Bank is no place to save.

Greenspan suggests that deficit reduction would raise national saving, and that budget surpluses would be even better. He is mistaken. Deficit reduction, per se, does not increase national saving and investment; the effect of deficit reduction on saving and investment depends on how the deficit is cut. Spending cuts would increase national saving and investment. Tax increases would reduce national saving and investment.

A cut in government spending would leave more private saving to pay for investment, and, more importantly, would release real resources to the private sector to produce the investment goods — plant, equipment, and structures. A tax hike would reduce private saving by at least as much as the tax revenue increased. Business saving would

fall dollar for dollar with a corporate tax rate hike or a reduction in depreciation allowances, and the incentive to invest would fall as well. Individuals have always responded to a cut in after-tax income by slashing saving, especially when a tax increase has been anti-saving (as with marginal rate hikes and IRA or pension restrictions). True, the government may borrow less after a tax hike, if the economy does not stumble too badly. However, the matching drop in private saving would mean no net increase in saving to finance investment. Furthermore, with no cut in government spending, the government would continue to divert labor and capital from production of plant, equipment, and structures for the private sector to production for government.

Nor is there any sense in the idea that a government surplus would be good for national saving and growth. Government does not save, nor would raising taxes to redeem government debt add to the incentive to save and invest by the private sector. If the objective of fiscal policy is to promote saving and investment, it would be far better to aim for a balanced budget, with any revenue surplus used to reduce tax rates on labor and capital to lower the cost of production and raise private saving, investment and employment in the United States.

The objective is private sector growth.

Deficit reduction must not be the sole objective of fiscal policy. How one cuts the deficit is more important than how much one cuts it. To make a strong case against the tax-and-spend crowd, one must explain that the real budget problem is the excessive absorption and misdirection of real economic resources by government spending, i.e., we need a smaller government. One must also explain that spending cuts increase GDP while tax increases reduce it. One must point out that taxes and budget surpluses are not "saving", that true saving is done by the private sector and involves investment to expand the production of market-tested goods and services over time, and that tax increases discourage saving and investment. Judged on that basis, the budget reconciliation package is a disaster, regardless of its purported effect on the deficit. It should be defeated.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.