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THE CLINTON ADMINISTRATION'S PRO-DEFICIT POLICY

Congress's House and Senate Budget Committees have developed detailed, explicit plans for bringing the federal government's budget into balance by the year 2002. Instead of responding with an alternative deficit-cutting plan of their own, Administration officials, notably National Economic Council Chair Laura D'Andrea Tyson and White House Chief of Staff Leon Panetta, have reacted by disparaging the Congressional blueprints on macroeconomic grounds. According to the Administration officials, large-scale deficit reduction is economically dangerous and, in any case, not particularly useful. The Administration's budget, which was presented in February, projects $200 billion annual deficits from now through the year 2000.

Ms. Tyson states the Administration's case succinctly, "[A]ny effort to reduce government spending takes a dollar out of the economy. And when it takes a dollar out of the economy that dollar means a dollar of reduction in demand in the economy. So it increases the contractionary risks on the economy."

This is a throwback to the type of Keynesian analysis so popular — and so mistaken — a generation ago. The essence of the Keynesian analysis is that the economy is driven by total (or aggregate) demand, that the private component of demand is not stable or dependable, that the government can add or subtract demand from the economy at will by means of fiscal and monetary policies, and that the government should use its control over demand to fine-tune the level of economic activity.

At a practical level, the Keynesian model lost favor in the United States in the 1970s when it proved unable to address accelerating inflation. It incurred an even worse setback in the 1980s when inflation collapsed while the economy enjoyed its longest peacetime recovery, contrary to the predictions of many prominent Keynesian economists that the Reagan Administration's policies would lead to either runaway inflation or a collapsing economy.

The theory underlying the Keynesian model suffers from numerous defects. The flaw that bears most directly on what Ms. Tyson said is the failure to ask where the government gets the resources that it spends. The government does not create wealth. When the government spends a dollar, it must obtain that dollar by taxing or borrowing it from the private sector, both of which reduce private demand by a dollar, or by printing the dollar, which invites inflation. High government spending, instead of being invigorating as Ms. Tyson suggests, tends to weaken the economy because in order for the government to obtain resources for government-determined uses, it must take the resources from typically more productive private uses.

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More broadly, the Keynesian analysis consigns supply factors -- including productivity, the capital stock, people's work efforts, and people's savings behavior -- to the background. It ignores the often detrimental effects of steep taxes and large government spending programs on those factors.

Ms. Tyson compounds the errors of the normal Keynesian analysis by assuming that more government spending is always macroeconomically better than less. The traditional Keynesian model calls for restraint in a healthy economy, and Administration officials insist the economy is now booming. Nevertheless, Ms. Tyson warns that spending growth should not be reined in over a multi-year period because a recession could develop while the deficit-reduction effort is underway, and the spending limitations would supposedly make the recession worse. "[W]hen the economy is slowing down, as this economy does slow down occasionally...what the federal government is doing [by deficit reduction accomplished through lower spending] is adding additional contractionary risk, downside risk." If Ms. Tyson's blanket assertions are accepted, government spending should never be cut significantly.

In reality, by allowing more resources to remain under the control of workers and savers, where the resources can be responsive to market forces, a spending-restraint program increases the economy's underlying strength and flexibility. That will tend to make any recession that does develop milder and shorter and will improve the economy's long-term growth prospects. If Ms. Tyson's analysis were correct, the countries with the most vibrant economies would be those with the largest government sectors and the biggest budget deficits (in Ms. Tyson's terminology, little "downside risk") and the countries with the weakest economies would be those with the smallest government sectors and government budgets in balance or surplus (much "downside risk"). That is, governments could deficit spend their nations into affluence. The accumulating evidence from around the world, of course, is the opposite. The countries with the largest and most intrusive government sectors tend to be the worst performers.

The Administration also criticizes the Budget Committees' timetables as arbitrary. According to Leon Panetta, "[T]o pick a date out of the air ... to say 2002 is somehow a magic year to do this does not make economic or investment sense in terms of this country." Ms. Tyson echoes this, "[W]e have said pretty clearly that we think the effort to achieve balance by an arbitrary date is a campaign promise."

Leaving aside the suggestion in these criticisms that campaign promises ought to be discarded following elections, the Administration is correct that 2002 is arbitrary. The goal could be to balance the budget by 2000, or the target year could be 2005. Any particular year is arbitrary, but the use of a specific deficit-reduction timetable makes excellent sense. If no zero-deficit year is ever specified on the ground that the year chosen must be arbitrary, the budget will never be balanced. Specifying a target year for balancing the budget is certainly better than saying we shall balance the budget someday.

Mr. Panetta, after rejecting the objective of "strict [budget] balance," does say, "If we could get [the deficit] to less than one percent of GDP and move on a path that would get us there, I think that's the kind of rational path on deficit reduction that makes sense." But by rebuffing the Budget Committees' timetables while refusing to offer any deficit-reduction plan from the Administration, Mr. Panetta strips his statement of operational significance.

Congressional Republicans are animated by a sense that government has become too large and expensive and that among the benefits of downsizing government would be smaller budget deficits. The Clinton Administration plainly disagrees. Behind its macroeconomic objections may be the recognition that the Budget Committees' resolutions would severely constrain the ability of the Administration and the Congress to maintain

existing federal programs on their current growth paths, let alone enact new spending initiatives. On the Administration's priority list, deficit reduction comes after protecting most existing federal programs and maybe adding some new ones.

Labor Secretary Robert Reich, for example, talks about "two deficits -- one is a budget deficit that does have to be brought down... But there is a second deficit, and it's a deficit in terms of investing in our people... We cannot abandon one for the sake of the other." Given how much the Administration includes in what it calls "government investment" and its characterization of current "government investment" as deficient, that would preclude any meaningful slowing in the growth rate of government spending.

As the Administration demonstrated with its health care proposal, which would have placed one-seventh of the U.S. economy under federal control, its idea of budget prudence is to increase taxes and expand government spending. Somehow Administration officials, who are so concerned about whether the economy can adjust to lower deficits, are not concerned about the difficulties people would face in adjusting to huge new government programs financed by huge tax increases.

To shield government spending from major reductions relative to its baseline, the Administration has advanced arguments that shrinking the deficit is neither pressing nor very important. It has also put forward a Keynesian sort of theory that significant deficit reduction is macroeconomically extremely dangerous. The logic behind the Administration's deficit arguments is grievously flawed. Lower deficits achieved through spending restraint would help the economy, not hurt it.

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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.