IRET Institute For Research On The Economics Of Taxation

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FEDERAL DEFICIT REDUCTION: SOME POLITICAL ECONOMIC OBSERVATIONS

Statement by
Norman B. Ture
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Presented to
The Joint Economic Committee
May 26, 1994

SUMMARY

- Deficit reduction involves important political as well as economic concerns. These political concerns focus on how acceptance of budget deficits affects policy makers' decision about the scope and magnitude of the public sector.

- The Keynesian analysis casts up a conflict between short-run economic stabilization objectives that often appear to call for incurring or increasing budget deficits and long-term growth objectives that call for minimizing deficits' preemption of saving.

- The neoclassical analysis argues that both the near-term and long-run effects of deficit reduction depend on how, not on how much, the deficit is reduced.

- Reducing the deficit by cutting spending is likely to be stimulative in the short run. By releasing saving for private investment and other productivity-enhancing private uses, reducing deficits by cutting spending will contribute to the economy's achieving a higher long-run growth path.

- Tax increases to reduce budget deficits adversely affect the economy's performance in both the short and long terms.

- Deficit reduction goals should be set by reference to the extent to which the nation is willing to trade higher levels of output in the future for the government activity financed

by borrowing. The less the benefits that are thought to be obtained by the government activity, the stronger is the case for deficit reduction achieved by curtailing those activities.

- Deficit reduction need not and should not be constrained by monetary policy or foreign economic developments. Monetary policy should focus on price level stabilization, not on fine-tuning short-term economic outcomes.

- Spending cuts to reduce the deficit should not be deterred by efforts to help other nations deal with their economic difficulties. Government-to-government aid in the form of grants and loans has not been successful. Economic assistance should instead take the form of reducing barriers to American businesses' investing and creating new business ventures in the country needing assistance.

- Practical considerations may present obstacles to reducing government spending and budget deficits, but although these obstacles may slow the pace at which spending and deficit reductions can be attained, they should not deter deficit reduction efforts.

- Borrowing to finance budget deficits hides the cost of government activities from the public. The result is more of those activities than if people were better informed about what they are and how much they cost. Tolerating budget deficits implicitly underwrites an expanding public sector.

- Determination of the scope and magnitude of government spending is not subject to the economizing constraint that enters into all private spending decision making.

- The lack of this economizing constraint exacerbates the problems created by the absence of any bright line separating policy makers' judgments about what government should and should not do.

- The scope and magnitude of government activities have become so great that few, if any, people know the content of even a handful of government spending programs. As a result our votes are neither endorsements nor rejections of specific government activities or of the full set of them

- Policy makers are subject to little pressure from their constituents to economize effectively in government spending decision making. On the contrary, policy makers are under pressure from constituents to create new programs or expand existing ones from which one or another constituent group obtains rewards not available to them in the market place.

- To simulate that bright line's effect, the following rules would be helpful.

    - Government spending should be tied very tightly to government revenues.

- Government revenues should be obtained from taxes that are highly visible and that are paid by the largest possible number of real people. This would establish a closer and more constructive nexus than now exists between policy makers and their constituents. Spending decisions would be more effectively limited by people's willingness to pay the bill.

■ Budget process reform is also needed to intensify pressure for setting spending priorities. The process should be simplified, and statutory rules should be enacted to make spending authorizations binding on actual outlays.

■ Without changes of this sort, there is little prospect for effectively curbing the growth of government over the long run. By the same token, there is not much likelihood that budget deficits will be eliminated or even reduced over time.

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The Joint Economic Committee is to be commended for holding this hearing concerning the considerations that should govern deficit reduction efforts. Attention to the magnitude and direction of change in the federal budget deficit appears to have waned in recent months, in part, I am sure, because of the more immediate interest in health care reform and other important domestic policy initiatives, as well as events and developments abroad. In some part, as well, the seeming decline in concern in the public policy forum and the media about the deficit may be attributable to OMB and CBO projections of decreases in the deficit over the next few years. This waning of attention is unfortunate, because the occasion for concern, I believe, is not primarily by how many hundreds of billions of dollars government budget outlays exceed budget receipts nor whether that amount is estimated to increase or decrease over the next four or five years. Much more fundamental political and economic issues of public policy are involved.

The economic issues are encompassed by the questions the Committee has posed to the witnesses. The political issues concern the effects of acceptance of budget deficits on public policy makers' decisions concerning the volume and composition of government activity; in turn, this involves fundamental issues concerning the responsibilities properly assumed by government in a free society. With the Committee's indulgence, I want to address my observations to the latter issues after responding to the specific questions addressed to the witnesses in the letter of invitation.

Economic Concerns

The stated purpose of this hearing is to examine how much further the budget deficit can be reduced without harming the economy. The implied concern is that deficit reduction per se may have adverse economic effects or that there is some amount of deficit reduction, undertaken in some stipulated period of time, that would harm the economy.

The idea of "too much" or "too fast" deficit reduction is an artifact of the Keynesian model of the interaction between the fisc and aggregate levels of economic performance. It relies on a presumption that government budget results and changes therein have so-called first order income effects, that is, directly affect disposable income, hence aggregate demand, which in turn determines levels of employment, output, and income.

In the Keynesian context, government spending is perceived to add to disposable income, hence to increase the economy's aggregate demand for products and services, while taxes are deemed to reduce disposable income, thereby reducing consumption and aggregate demand. These changes in aggregate demand are identified as the principal determinants, in the short run, of the volume of total output, hence the amount of employment and of total income. Deficit reduction necessarily implies either an increase in taxes, a reduction in government spending, or some combination of the two that must have the effect of reducing aggregate demand, hence reducing or curbing the increase in total output, income, and employment.

In this model, the perceived danger is that there is some additional amount of deficit reduction that might overwhelm the economy's current expansionary thrust. I believe that concern is warranted only if the deficit reduction is sought by increasing taxes, in which case virtually any amount of deficit reduction would pose some threat to the economy's effective performance.

In its early formulations and public policy applications, the Keynesian analysis was little concerned with questions concerning the growth of the economy's production capability. The influence of public policies, including tax and spending policies, on the conditions of supply were given little attention. Public policies were deemed to have little influence on the conditions of supply of labor services; saving was generally perceived as a leakage from aggregate demand, hence as exerting a contractionary influence on economic activity. In more recent years, however, the importance of saving and capital formation and of other nonconsumption uses of income and production capacity as determinants of the level and slope of the economy's growth path has been universally recognized. At the same time, it has been recognized that government budget deficits preempt saving, hence impede economic growth. The Keynesian model, therefore, creates a tension between short-term economic stabilization objectives, which appear often to dictate budget deficits, and long-term growth objectives, which call for minimizing budget deficits' preemption of saving.

I infer that this is the context of the Committee's concern about how much more the deficit can be safely reduced.

This tension between growth and stabilization objectives is not generated in the neoclassical framework of analysis. In the neoclassical analysis, the first-order effects of fiscal variables are identified in terms of their impact on the relatives prices and relative costs confronting private sector decision makers. Fiscal aggregates per se do not determine levels of real aggregate demand, output, employment, and income in the short run. The effects of taxes and government spending are derived instead from their influences on the relative prices and costs confronting household and business decision makers. These influences affect the conditions of supply of labor services and the allocation of income between consumption and saving and other uses; changes in factor supply conditions result in changes in output, hence in income, hence in aggregate demand for products and services.

In this framework, government spending, instead of adding to disposable income, tends to raise the costs of production inputs to households and businesses, reducing the amount of these inputs in private uses. Thus, increases in government spending tend to displace, not add to, private sector employment, output, and income; indeed, except in those cases in which government uses of production inputs are more productive than the displaced private uses, total output, employment, and income are reduced by government spending. Increases in government spending, whether or not they increase budget deficits (or reduce budget surpluses) exert a contractionary, not an expansionary, influence on the economy.

In the same vein, taxes raise the cost of the taxed activity relative to other costs, tending to reduce the amount of such activity that is undertaken by households or businesses. Income taxes of the present configuration, as well as payroll taxes, raise the cost of market-directed uses of one's time, energy, and resources, relative to so-called "leisure" uses. Income taxes also increase the cost of saving relative to current consumption uses of income. Insofar as market-directed effort or saving decreases in response to tax-induced increases in their relative costs, output and income must also fall.

In this neoclassical model, the near-term effects of deficit reduction depend on the manner, not the amount, of deficit reduction. Reducing government outlays, or curbing their growth, will tend to have a stimulative effect on levels of economic activity. Most tax increases, on the other hand, will exert a depressing influence on production, employment, and income.

It is a matter of national income accounting arithmetic that government borrowing to finance budget deficits takes up saving, reducing its availability for private sector, growth-generating uses. By releasing saving for growth-generating uses, cutting government spending to reduce the budget deficit will contribute to achieving a higher long-run growth path for the economy. Most tax increases enacted to achieve deficit reduction, on the other hand, will exert a depressing incentive effect on growth-generating activities that may well outweigh the favorable effects of whatever cutback in government borrowing is achieved.[1]

It must be acknowledged that government spending reductions may have disruptive effects in the short run. These spending cuts, by their very nature, release production resources from government uses or change the opportunity costs of their alternative private sector uses.

Reallocation of production inputs ordinarily is not costless, but merely averting those reallocation costs is not sufficient reason to forgo spending and deficit reduction opportunities. Moreover, the frictions of reallocation will be less the more efficiently the market mechanism operates; market efficiency generally is enhanced by reducing government claims on production capability.

What should determine deficit reduction goals?

The principal economic consideration that should determine deficit reduction goals is the extent to which the nation is prepared to accept lower levels of output than would otherwise be attainable in the future in order to undertake more government activities in the present. Government borrowing to pay for the difference between outlays and receipts necessarily preempts saving by households and businesses that would otherwise be used to add to the stock of tangible and intangible capital. Such saving and capital additions reflect savers' willingness to forgo current consumption in favor of greater production capability, hence higher levels of income in the future than would otherwise be available. If the government spending financed by borrowing is to be justified, it must afford gains that exceed its opportunity cost — the forgone additions to the society's income-generating capacity.[2]

Government finances should not be permitted to exert a preemptive claim on the saving that households and businesses undertake. When government borrows, it finances the deficit at the cost of lowering the economy's growth path through time, compared to the level it would otherwise attain. Government deficits, particularly if they are more than transitory, represent public policy makers' willingness, perhaps unwitting, to sacrifice higher living standards in the future for whatever gains are sought by government spending in the near term. One should not categorically assert that there can never be circumstances in which such a trade- off would afford a net gain for society, but history encourages a healthy skepticism on this score.

Should deficit reduction goals depend on the kind of budget changes made to lower the deficit?

Insofar as releasing government's hold on the nation's saving is the principal objective, deficit reduction should be pursued solely by curtailing government spending. Deficit reduction achieved by reducing outlays is almost certain to release saving from government uses. Unless it can be shown that the government's uses of that saving would afford greater additions to the society's well being than would the private sector's uses, there is a clear cut gain to the economy from deficit reduction produced by curtailing government spending.

On the other hand, deficit reduction achieved by tax increases is likely to have seriously adverse effects on the economy, both in the short run and certainly in the long run. Reducing the deficit by increasing taxes will have little if any effect in raising the national saving rate because the tax increase, particularly if it takes the form most often used, will reduce household and/or business saving by at least as much as the deficit is reduced, hence by at least as much as the government's borrowing of the private sector's saving. Tax increases, moreover, are almost

certain to intensify the distortions of market-generated price and cost relationships, hence result in less efficient uses of the nation's production resources.

Do further deficit reduction actions need to be tailored by monetary policy, foreign economic conditions, or other circumstances that influence the overall strength of the economy?

In terms of economic policy considerations, appropriate deficit reduction efforts should not constrained by monetary policy or economic conditions abroad. The basic constraint on fiscal and budget policies should be to minimize the impediments that government activity erects to the efficient functioning of the market system. Deficit reduction efforts, if successful, will free up household and business saving for growth-generating uses and will moderate the distortionary influences of government spending. Such efforts, therefore, impose no obligations on monetary policy which should aim at stabilizing the price level, not at determining the level of aggregate economic activity.

The view that monetary policy should be somehow calibrated to changes in budgetary policy or anticipated budgetary outcomes derives from the notion that deficit reduction exerts a contractionary influence on the level of economic activity; the companion notion is that an expansionary monetary policy can offset any unduly contractionary impetus generated by deficit reduction. This is readily recognized as the fiscal-monetary policy mix thesis that was formally presented to the Fiscal Policy Subcommittee of the Joint Economic Committee in 1955.[3]

The historical record as well as rigorous analysis rejects the thesis. The influence of monetary policy on real output is difficult to discern, and where seemingly evident, appears to be opposite to that suggested by labels such as "expansionary" or "contractionary." Expansionary monetary policy leads to a heightening of inflation expectations, reflected in higher market interest rates and bond yields, which, if anything, exert contractionary pressures on real economic activity. A contractionary monetary policy, on the other hand, casts up deflationary or disinflationary expectations, resulting in lower market interest rates.

More to the point is that attempting to adjust monetary policy to expected changes in budgetary outcomes generates uncertainty in the financial markets about the longer-term course of monetary developments. Efforts to hedge against this uncertainty impose costs and impair efficient functioning of the financial markets in valuing alternative uses of saving and assuring its efficient allocation among these alternatives. These considerations urge that monetary policy should be geared to stabilization of the price level, not to fine tuning the short-term economic outcomes deemed, often mistakenly, to result from deficit reduction.

The fact that economic activity in the United States takes place in a global economy should urge public policy makers to emphasize budgetary policies that will minimize the obstacles to effective competition by American businesses in the world market place. Reducing government's claims on business and household saving by curbing spending will also decrease the upward pressures on business costs that virtually all government spending exerts.

The difficulties afflicting many nations' economies are perceived by some policy makers as calling for U.S. economic aid in the form of government-to-government grants or loans. The track record for this form of assistance is so bad that one wonders why it is not rejected outright as a waste of our resources and as creating additional barriers to those nations' ability to solve their economic problems. What is called for instead is infusion of private business ventures and private investment to provide new and superior production capacity and real employment opportunities. Much of that kind of economic assistance must come from other nations, including the United States. Providing that assistance doesn't call for abatement of appropriate efforts to reduce government budget deficits.

Are there "speed limits" on the amount of deficit reduction that can be undertaken safely in any one year?

The "speed limit," if there is any such, is imposed by the reluctance to incur the costs of resource reallocation that may be imposed by reducing government spending. As urged earlier, these costs are not likely to be substantial or persistent, particularly if the spending reductions permit the market system to work more efficiently. On the other hand, if deficit reduction is sought by tax increases, the damage done in terms of forgone growth and efficiency gains will indeed be greater the more substantial and speedier is the deficit reduction.

There are, of course, practical road blocks that would slow efforts to achieve appropriate deficit reduction. The impediments to spending cuts are particularly severe in the case of certain entitlement or mandatory spending programs that have developed substantial dependent constituencies. Here, too, the gains to be realized from cutting these programs or curbing their growth should not be ignored merely because significant adjustment costs will be incurred.

So far as economic effects are at issue, the Committee should have little concern that additional deficit reduction may have significant adverse effects on the economy. The danger arises if deficit reduction is sought by tax increases. Indeed, looking not too far into the future, the proper prescription for budget policy may be significant spending reductions accompanied by appropriately designed, i.e., growth-generating, tax reductions.

Political Concerns

I respectfully suggest that the Committee also focus its concern on the political aspects of the deficit problem — on the effects of budget deficits on the size, scope, and quality of government activities and spending.

Generally overlooked in discussions of budget deficits is that borrowing to finance them hides the cost of government activity from the public. The consequences is just what one might expect — more government activity than would be undertaken if the body politic were more acutely aware of how much must be paid for that activity. Tolerating budget deficits, accordingly, implicitly underwrites an expanding public sector.

This government expansion thrust, moreover, is substantially uninhibited by the kind of economizing constraint that households and businesses in the private sector confront continuously. Private sector spending is constrained by the value product, hence the incomes, that people can produce. One can expand one's current spending only by increasing one's income, thereby forgoing leisure uses of one's time and energy, or by forgoing some of one's future spending power — by saving and investing less of one's current income. To be sure, one may borrow to finance increases in current outlays, but only if one can satisfy the lender that the debt will be fully serviced, either by curtailing future spending out of a given level of income or by increasing one's future income.

The lack of any comparable economizing constraint on government spending exacerbates the problem arising from the apparent lack of a bright line to inform public policy makers about what government should and should not do. The growth of the public sector in large part reflects the erosion of any clear consensus that there are some types of activities that should be reserved solely for people in their private capacities to undertake. The scope of government has expanded along with its magnitude. At the same time, and for the same reasons, the quality of government activity appears to have deteriorated through time.

These developments don't represent the preferences of the body politic as a whole or even a majority of it. There are few if any among us who know the content of even a handful of government programs and spending objects. When we vote, we can't endorse or reject specific government activities, most of which we do not know, or the full set of those activities.

As a consequence, policy makers' constituents exert little pressure on them to develop some effective economizing formula for making hard choices among activities. On the contrary, constituents pressure policy makers for government activities or policies that will afford them the economic rewards they can't seem to obtain in the market place. To repeat, nothing inhibits the policy maker from responding affirmatively to these pressures, other than the policy maker's own distaste that is often overcome by the desire to continue in office.

Finding that bright line that would, if obeyed, more closely confine government activities appears to be an extremely difficult task. What is needed, perhaps, is some set of rules that would at least roughly simulate the bright line's effects.

To that end, I suggest that a basic operating rule should be to tie government spending very tightly to government revenues. The collateral requirement is that revenues be raised from taxes that (1) have the broadest possible reach in the population of real people, and (2) are highly visible to those who pay them. In combination, this would establish a much closer nexus than now exists between public policy makers and their constituents. By the same token, spending decisions would be more effectively limited by people's willingness to pay the bill.

Along with an effective constraint on budget deficits there is also needed some budget-making process reform that would intensify pressure for more efficient determination of spending priorities. Balanced budget amendments address the requirement for banning deficits,

but they do not preclude untoward expansion of government over time. Also needed is reform of the tax system to increase tax visibility and to assure that most of the population pays at least some tax and is acutely aware of doing so. In addition, simplification of the budget-making process and adoption of statutory rules that would make spending authorizations binding on actual outlays are called for. The Cox-Stenholm and Lott-Shelby Budget Process Reform Act (H.R. 2929 and S. 1955, respectively) would be a major step forward in this regard.

Without changes of the sort suggested above, without some way of simulating the application of the bright-line constraint on decisions about government activity and spending, there is not much prospect for effectively curbing the growth of government over the long run. By the same token, there is not much likelihood that budget deficits will be averted or even reduced over the long run. The adverse economic consequences of these fiscal developments for the economy's growth potential urge the attention by the Congress to the issues the Committee has sought to illuminate in these hearings.

End Notes

1. For a fuller and more detailed discussion of the neoclassical analysis and its implications for fiscal and budget policies, see Norman B. Ture, "The Economic Effects of Tax Changes: A Neoclassical Analysis," in Joint Economic Committee, *Special Study on Economic Change, Volume 4, Stagflation: The Causes, Effects, and Solutions*, Joint Committee Print, December 17, 1980, pp. 316-347. Also see, Norman B. Ture, "Supply Side Analysis and Public Policy," in *Essays in Supply Side Economics*, David G. Raboy, Ed. (Washington, DC: The Institute for Research on the Economics of Taxation, 1982), pp. 8-28.

2. Indeed, all government activity, irrespective of how it is financed, should be required to meet this test. All government spending either preempts some of the society's production capability or directs the private sector's uses of some of that capability. For this reason, all government spending entails distortion of the results of the market's operations. If one believes that in the absence of such distortions the market system tends to perform efficiently, any government spending should be required to meet the test that the benefits it will provide at least equal the cost it will impose in terms of market impairment. This test is difficult to administer, in practice, and it is often difficult to determine the test results.

There are, to be sure, those who believe that markets operate imperfectly and that government intervention is needed to overcome these imperfections. This is not the venue in which to argue the point. Instead, I invite attention to a study by Dr. Roy E. Cordato, *Social Costs, Public Policy, and Freedom of Choice*, Fiscal Issues No. 7 (Washington, DC: Institute for Research on the Economics of Taxation, 1992) for a rigorous discussion of the enormous limitations on government's ability to improve on market outcomes.

3. See Paul A. Samuelson, "New Look in Tax and Fiscal Policy," in *Federal Tax Policy for Economic Growth and Stability*, Joint Committee on the Economic Report, Joint Committee Print, November 1955, pp. 229-234.