The Federal Deficit: How Does It Matter?

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Government deficits and debt are surpluses and assets of the private sector of the economy that stimulate private spending. Official measures of deficits are misleading, however, for failing to distinguish public investment from current spending and for failing to adjust for inflation. Correctly measured real deficits have contributed to the growth of gross national product, consumption, and imports, and to investment as well. Optimal policy consistent with balanced growth calls not for elimination of the nominal deficit but rather for prudent deficit reduction accompanied by and stemming at least partly from sufficient monetary stimulus to achieve and sustain relatively full employment.

THE FEDERAL DEFICIT IS SOMEBODY ELSE'S SURPLUS. THE federal debt or liabilities are somebody's assets. These relations are not merely accounting identities. They are the fundamental building blocks of any meaningful analysis of the role of government fiscal policy in the economy.

Dispelling Some Myths

Despite recent huge deficits—more than $200 billion per year—and consequent huge increases in the federal debt, to $2.4 trillion, the government is in no danger of going bankrupt. In fact, a sovereign government can hardly default on a debt in its own currency. Since the U.S. government owes virtually all of its debt in dollars, it can always either raise by taxation or simply create whatever money is needed to finance its deficit and service its debt and pay it off.

Indeed, the federal government itself has assets that by appropriate estimates considerably exceed its debt. Although repeated deficits have raised the federal debt, along with increases in liabilities have come increases in assets. I have constructed a federal government consolidated balance sheet which, as of the end of 1984, shows tangible assets of structures, equipment, inventories, and land of $1.1 trillion. With financial assets of cash, gold, securities, mortgages and other loans, and miscellaneous assets amounting to another $900 billion, total assets were about equal to total liabilities (Table 1) (1). If the value of mineral rights on federal land is added (2), the balance sheet would show a positive net worth of close to $1 trillion. This ignores so-called "contingent liabilities" such as the social security benefits to be paid in the future under current law. But it also ignores the present value of all the taxes that the government will raise or can raise.

Further, the great bulk of the federal debt created by our deficits is held by Americans—federal, state, and local government treasuries, agencies, and trust funds, private industrial firms, insurance companies, banks, and pension funds, and private individuals. Only a small proportion—about 12%—is held by foreigners. The repeated references to the United States having become "the world's greatest debtor nation" relate largely to private debt and are misleading if not inaccurate. Income of Americans from foreign investment is running some $25 billion more annually than what we pay foreigners for their investments in the United States. It is not clear, therefore, that in any meaningful sense the United States is a net debtor nation. Although the U.S. net worth vis-à-vis the rest of the world is decreased by our trade deficits, the fall in the value of the dollar since 1985 has vastly increased the dollar value of U.S. assets abroad.

What about the charge that our large deficits and debt are putting an unconscionable burden on our children, or the proverbial future generations? In the obvious sense in which that charge is made, it too has no foundation. As noted, we owe the debt essentially to ourselves. If we fear that our children will have to pay higher taxes to service interest and principal payments on the federal debt, we should remember that it is also our children who will be receiving those payments. There is a subtle way in which federal deficits and debt can place a burden on the future, and that is a critical issue to face. But the converse may also be true. Lesser deficits and debt may also increase the burden on the future.

Deficits Do Matter

It has been claimed that government deficits do not matter. This reasoning says that if the government finances its expenditures by borrowing, the public will realize that it will only have to pay more taxes in the future to service the government debt. It will therefore spend no more if government spending is deficit-financed than if it is paid for by current taxes. Rather, the public will increase its saving by the amount of the deficit so that it will have a nest egg to pay those future taxes.

This "equivalence theorem" originally considered, but dismissed, by Ricardo (3) has been revitalized in recent years (4). To the argument that current taxpayers might disregard the need to pay future taxes because they would be dead before the taxes would all come due, it was countered that they would take into account the tax obligations of their children, who would in turn think of their children. Hence the current generation's holdings of public debt in excess of the present value of their own consequent tax liabilities would be matched by their need to adjust their bequests to leave their heirs uninjured by the increased future taxes necessary to service the deficit-created debt.

To this argument, however, most economists see many decisive objections (5), including obvious ones, such as that some current taxpayers have no heirs and others could not care less about their heirs, or are at "corner solutions," so that the amount they save for

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their children (or receive from them) will not be affected. In addition, delays in taxes may be viewed as wealth-increasing loans financed by the low borrowing rates faced by government rather than higher private rates. And current taxpayers may (correctly) anticipate no greater future tax burden for themselves or their heirs, as debt and deficits continue to grow with the economy. A final point of fact is that the argument's major prediction, that private saving would increase to match the huge government deficits of the 1980s, has proved wrong. Gross private saving as a ratio of gross national product (GNP) has actually declined—from 18.0% in 1981 to 17.6, 17.4, 17.9, 17.2, and 16.2% in the subsequent high-deficit years from 1982 to 1986, respectively.

Deficits and Private Spending

To understand how deficits affect the economy one must first recognize that the deficit is in large part endogenous in the economic system, that is, the economy affects the deficit. When business slumps and income is down, tax payments are reduced, just when payouts of unemployment benefits increase. Thus recessions

Table 1. Federal government consolidated balance sheet, including Federal Reserve and credit agencies, at market or replacement values. (Some figures do not total because of rounding.) [From (1) with permission, copyright 1986, by The Free Press, a Division of Macmillan, Inc.]

Item	Year and amount (billions of dollars)			
	1945	1960	1980	1984
Assets				
Tangible	186.2	205.8	822.5	1118.0
Reproducible assets	179.3	187.4	648.1	915.2
Residential structures	2.2	3.2	20.9	24.5
Nonresidential structures	28.9	60.8	262.9	299.6
Equipment	88.3	65.6	228.6	395.6
Inventories	59.9	57.7	135.7	195.5
Land	6.8	18.4	174.4	202.8
Financial	102.8	124.7	720.9	887.4
Currency and demand and time deposits	31.3	12.8	31.3	40.7
Gold	20.1	17.8	155.9	81.0
U.S. government securities	31.5	35.2	129.8	172.3
Treasury issues	31.5	35.1	120.6	162.7
Agency issues	0.0	0.0	9.2	9.6
Mortgages	2.5	11.2	132.3	202.6
Other loans	4.7	25.1	201.5	288.1
Taxes receivable	9.6	12.7	7.1	−16.2
Miscellaneous assets	3.1	8.4	47.3	94.9
Total assets	289.0	330.4	1543.4	2005.4
Liabilities				
Treasury currency and special drawing rights	2.3	2.7	13.6	17.5
Demand deposits and currency	31.1	30.6	121.5	171.4
Bank reserves and vault cash	19.0	20.4	47.3	40.5
Credit market instruments	264.5	246.7	841.9	1613.7
Savings bonds	43.2	46.5	68.4	76.1
Other Treasury issues	220.4	192.5	625.1	1296.8
Agency issues	0.9	7.8	148.4	240.8
Insurance and retirement reserves	6.5	20.5	85.5	139.8
Miscellaneous liabilities	9.2	10.9	51.8	80.4
Total liabilities	332.6	331.8	1161.6	2063.3
Net debt (total liabilities minus financial assets)	229.8	207.1	440.7	1175.9
Net worth	−43.7	−1.3	381.8	−57.9

bring on or increase deficits. Prosperity and booms will correspondingly reduce or even eliminate deficits. The causation in any association of economic downturns with increasing deficits is clearly then from the economy to the deficits. In fact, each percentage point of unemployment currently adds about $35 billion to the deficit.

How then do deficits affect the economy? Federal deficits add to government liabilities that are assets—in the form of Treasury bonds, notes, bills, and money—of the private sector (and of state and local governments). Paradoxical as it may seem, and contradicting the equivalence theorem, federal deficits thus make private individuals and businesses wealthier. But both economic theory and empirical econometric results confirm that the wealthier households feel, the more they spend as consumers. This fact leads to some divergent conclusions, reflecting some of the differences of view among modern macroeconomists.

The Real Issue—Investment and the Future

Some economists (6) assume implicitly that total output is relatively fixed. They frequently justify this by involving "the long run," over which cyclical fluctuations presumably average out and employment and unemployment reach their "natural" levels. [Keynes's famous retort was "In the long run we are all dead" (7).] They then charge that the increased consumption brought on by greater government debt must mean that less output is available in the form of investment or the capital goods that will provide output in the future. Thus, they see current deficits as a burden on our children.

This view does focus on the one analytically sound argument by which federal deficits can prove costly. If they result in a reduction of productive capital accumulation, they reduce future output. But is this their necessary consequence? Suppose, most fundamentally, that total output is not fixed. Let us argue rather that generally, at least in peacetime, our economy seems cursed by considerable unemployment and excess capacity. If then, emboldened by greater wealth (based on private holdings of government bonds), consumers buy automobiles and personal computers and vacations in Palm Springs, will that lead to less investment or more? Will General Motors and IBM invest less or more if the public buys more cars and computers? Will Palm Springs developers construct fewer or more vacation retreats, to be enjoyed by our children and grandchildren as well as ourselves?

Even if there is full employment and no excess capacity in labor or machines, the federal deficit need not lead to reduced investment. In this case, the resultant increase in our perceived wealth will lead us to plan and try to consume more now and, in accordance with the "life cycle" and "permanent income" theories (8), consume more in the future as well. This situation will lead "rational" producers to try to produce more to meet current consumption demand but also to undertake more investment to provide the capital to produce more in the future. But if, with full employment, there are no additional workers to be hired and there is no spare capacity, the attempts to produce more can only result in higher prices. The immediate result of superimposing a government budget deficit on an economy at full employment is then inflation, but not necessarily a reduction of investment.

A reduction of investment may be forced by restrictive monetary policy initiated by the Federal Reserve to combat inflation. Resultant higher real interest rates would make all kinds of investment, and particularly long-term investment, less attractive. However, it is the application of "tight money" to combat (actual or anticipated) inflation, and not the budget deficit itself, that depresses investment. Tight money will curb investment, as well, when exaggerated or

Table 2. Measures of federal debt: gross federal debt held by the public at the end of fiscal year, in billions of dollars and as percentage of GNP, and net debt per capita at end of calendar year in 1982 dollars. [Adapted and updated from (*1*) with permission, copyright 1986, by The Free Press, a Division of Macmillan, Inc.]

Year	Gross federal debt		Net debt per capita
	Billions of dollars	% of GNP	1982 dollars
1945	235.2	108.4	8639
1946	241.9	119.8	7227
1960	237.2	47.6	3576
1970	284.9	29.4	2815
1975	396.9	26.8	2759
1980	715.1	27.8	2219
1984	1312.6	36.7	4496
1986	1744.6	41.5	5963
Change, 1945–1980	+479.9	−80.6	−6420
Change, 1980–1984	+597.5	+8.9	+2277
Change, 1984–1986	+401.4	+4.8	+1467

misguided fears of inflation lead to its application to an economy suffering from sluggish growth, idle capacity, and excess unemployment.

The Inflation Tax and the Real Deficit

Have federal deficits actually reduced investment or have they increased it? The answer to this question has seemed elusive in part because of the failure of some analysts to see through the confusions of federal accounting and, in periods of increasing and varying inflation, to distinguish properly between nominal and real magnitudes.

Basic neoclassical economic theory tells us that government deficits should be significant to the extent that they increase the real net wealth of the private sector. That means the economically relevant deficit should not reflect government expenditures that merely involve the exchange of assets or of one form of debt for another. But the official federal deficit does include expenditures for the purchase of existing assets from the private sector, and it is reduced by the sale of government assets such as Conrail or mineral rights to the private sector. It also includes Treasury borrowings to finance loans of federal credit agencies. These do not add to the net debt of the government to the private sector because the increased

private holdings of government securities are (essentially) matched by increased private debt to the government-associated creditors. This means that whatever their merits (or demerits) on other grounds, "privatizing" real government assets or selling off loan portfolios of federal credit agencies (probably at bargain basement prices) makes no sense in terms of reducing the real deficit.

But most important, since it is the real wealth of the private sector that matters, the debt must be adjusted for inflation. Because of inflation, as well as growth in population and in real output per capita, despite year after year of official deficit, the gross federal debt held by the public fell from 120% of GNP at the end of 1946 to 28% at the end of 1980, before rising to a current figure of about 42% (Table 2). The net federal debt per capita in inflation-adjusted 1982 dollars fell almost 75%, from $8639 at the end of 1945 to $2219 at the end of 1980, before rising to a current figure of about $6000.

Suppose, for example, that the federal debt at the beginning of 1980 was about $900 billion (as it was). Suppose also that the official federal deficit was $60 billion and that inflation during 1980 was such that the value of the dollar declined by 10% (both of which suppositions correspond approximately to the historical facts). What was the "real deficit" in the relevant sense of the real increase in net federal debt? The 10% decline in the value of the dollar cut the real value of the existing debt from $900 billion to $810 billion. If the $60 billion deficit is added to that, it makes a total of $870 billion in debt in dollars of comparable value to those at the beginning of the year. Since the real debt declined by $30 billion, was there really a deficit of $60 billion or a real surplus of $30 billion? The answer in economic theory for most relevant purposes is clear: taking into account the "inflation tax" on the holders of federal debt, there was a real surplus. And using measures of the real deficit or surplus offers some striking insights into economic relations and economic policy of recent decades.

The corrections that I have undertaken with Pieper (*1, 9*) entail not only the direct inflation adjustment to the value of debt ("price effects") but also corrections for changes in market value associated with changes in interest rates ("interest effects"). In particular, in periods of rising interest rates, the market value of debt declines, adding to the loss from inflation itself. In periods of declining interest rates, however, the market value of debt rises, thus increasing the real federal deficit.

Rereading Recent Economic History

Application of the corrections for price and interest effects to

Table 3. Actual budget surplus or deficit on national income account, official and adjusted for price and interest effects, in billions of dollars. [Adapted from (*1*) with permission, copyright 1986, by The Free Press, a Division of Macmillan, Inc.]

Year	Surplus or deficit (−)	
	Official	Adjusted
1975	−69.3	−48.6
1976	−53.1	−44.6
1977	−45.9	−0.6
1978	−29.5	32.9
1979	−16.1	32.1
1980	−61.2	7.6
1981	−64.3	−18.3
1982	−148.2	−177.2
1983	−178.6	−101.2
1984	−175.8	−154.1

Table 4. High-employment surplus or deficit on national income account, official and adjusted for price and interest effects, as percentage of GNP. [Adapted from (*1*) with permission, copyright 1986, by The Free Press, a Division of Macmillan, Inc.]

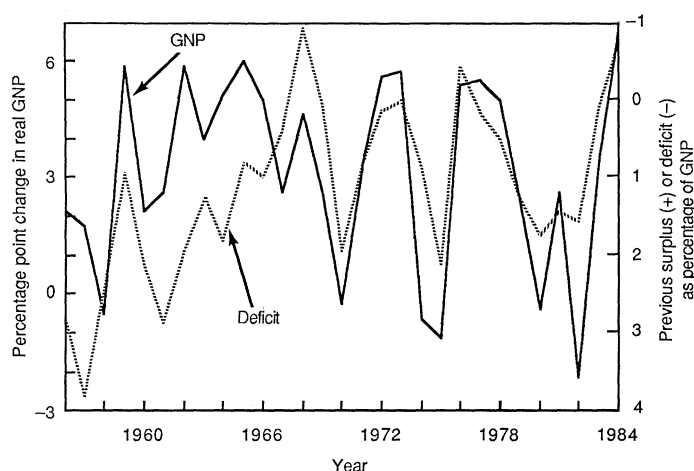| Year	Surplus or deficit (−)	
	Official	Adjusted
1975	−1.88	−0.54
1976	−1.01	−0.52
1977	−1.06	1.30
1978	−0.73	2.15
1979	−0.08	1.91
1980	−0.65	1.97
1981	−0.11	1.45
1982	−1.06	−2.01
1983	−1.72	0.62
1984	−2.51	−1.92

Fig. 1. Adjusted deficit and change in GNP. The greater the price-adjusted high-employment deficit, the greater the subsequent growth in GNP (*13*). [Adapted from (*1*) with permission, copyright 1986, by The Free Press, a Division of Macmillan, Inc.]

stimulus, while an increase in the actual deficit might occur because of a declining economy even though (or perhaps because) fiscal policy was actually turning contractionary. The record of the high-employment budget, shown in Table 4, confirms the evaluation above. Although the official figures (*10*) showed consistent deficits, on an adjusted basis there were substantial surpluses of 1.30 to 2.15% of GNP from 1977 to 1981, before the very sharp move to deficit in 1982.

To measure the impact of deficits on the economy, one may therefore relate the inflation-adjusted high-employment budget as a percentage of GNP to the subsequent percentage change in GNP. As shown in Fig. 1, the greater the real or adjusted deficit from 1956 to 1984, the greater was the next year's increase in GNP. The less the deficit, or the more the surplus, the less was the subsequent increase in GNP, or the more GNP tended to decline. Since more rapid increases in output are associated with declines in unemployment, and less rapid increases (or decreases) with increases in unemployment, a corresponding close fit is seen between the curves in Fig. 2 for the adjusted budget surplus and changes in unemployment.

recent history, as shown in Table 3, are eye-opening. The Carter Administration was charged with inflationary deficits, which finally reached $61 billion (on a national income accounts basis) by 1980 and totaled $153 billion between the years of 1977 and 1980. With the corrections, these 4 years of deficits were turned into surpluses totaling $72 billion. This relatively tight fiscal policy, depriving the public of needed purchasing power, continued through 1981 and the first half of 1982—and contributed significantly to the worst recession since the Great Depression of the 1930s, with officially measured unemployment reaching 10.7% by December 1982. But with declining inflation and interest rates, the huge deficits beginning in 1982 were reduced relatively little by the corrections. Their nominal total of $503 billion between 1982 and 1984 was reduced to a real figure of $433 billion, leaving ample stimulus to total spending to bring about the sharp, if incomplete, economic recovery that carried unemployment back down to its current plateau somewhat above 6%.

As indicated earlier, the actual budget deficit is itself affected by the economy and hence is not a good measure of the deficit's own fiscal thrust or impact. To assess the impact, economists look at the structural, cyclically adjusted or "high-employment" budget. This budget indicates what the deficit would be at some stipulated rate of economic activity or level of employment. An increase in the high-employment deficit would then in itself imply an increase in fiscal

Empirical Analysis

Results of a fuller and more rigorous study of the underlying relation may be seen in the regression analysis shown in Table 5. The real percentage change in GNP was related to the high employment surplus (deficit) and changes in the monetary base, both also taken as percentages of GNP. The price-adjusted or inflation-adjusted surplus was a better explanatory variable, as measured by coefficients of determination, than the official, unadjusted surplus. And, although the change in monetary base, a measure of the money supply, was also positively associated with increases in GNP, it did not account for or explain away the clear association of the deficit with GNP. As indicated (by regression 5 in Table 5), from 1961 to 1984 each percentage point of the inflation-adjusted high-employment deficit as a ratio of GNP was associated on the average with a subsequent increase in GNP of 1.463%.

These results should not be surprising to most economists. It has long been recognized that the fiscal stimulus of structural deficits should be expected to increase aggregate demand and output. Use of the inflation-adjusted high-employment budget merely makes this relation clearer. But what about the effect of greater private spending on investment? Is it "crowded out"? The parameter estimates shown in Table 6 are striking and instructive.

Table 6 shows regressions of the real change in each of the

Table 5. High-employment budgets, official and price-adjusted, changes in monetary base, and changes in GNP. Ordinary least-squares regressions: regression coefficients with standard errors (shown in parentheses), adjusted coefficient of determination ($\hat{R}^2$), and Durbin-Watson statistic (D-W).

$$\Delta \text{GNP}_t = b_{01}X_1 + b_{02}X_2 + b_1\text{HES}_{t-1} + b_2\Delta\text{MB}_{t-1} \ (X_1 = 1, X_2 = 0 \text{ for } t = 1961 \text{ to } 1966; X_1 = 0, X_2 = 1 \text{ for } t = 1967 \text{ to } 1984)$$

where ΔGNP is percentage change in GNP, the *b*'s are the regression coefficients, the *X*'s are dummy variables, as indicated, *t* is the year, HES is high-employment surplus as percentage of GNP, and ΔMB is real change in monetary base as percentage of GNP. [Adapted from (*1*) with permission, copyright 1986, by The Free Press, a Division of Macmillan, Inc.]

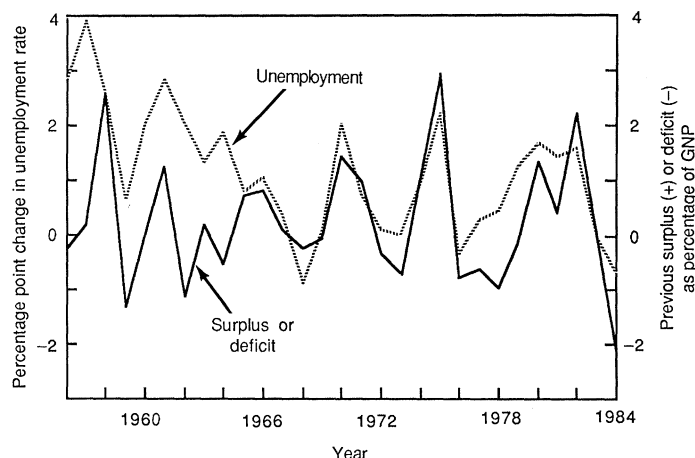|	Regression coefficients and standard errors						
Regres-sion	Constants		HES		ΔMB (b_2)	$\hat{R}^2$	D-W
	1961–1966 (b_{01})	1967–1984 (b_{02})	Official (b_1)	Adjusted (b_1)			
1	7.442 (0.867)	0.759 (0.595)	−2.567 (0.519)			0.556	1.70
2	8.633 (0.846)	4.298 (0.417)		−2.288 (0.363)		0.669	1.88
3	3.228 (0.722)	2.023 (0.409)			12.898 (2.282)	0.618	1.99
4	5.181 (0.973)	1.113 (0.497)	−1.433 (0.540)		8.678 (2.561)	0.704	1.58
5	6.432 (1.250)	3.348 (0.569)		−1.463 (0.496)	6.528 (2.909)	0.721	1.70

Fig. 2. Adjusted surplus and change in unemployment. Lesser surpluses or greater deficits go with the reduced unemployment (13). [Adapted from (1) with permission, copyright 1986, by The Free Press, a Division of Macmillan, Inc.]

components of GNP on the price-adjusted high-employment surplus and again the real change in the monetary base, all as percentages of GNP. As generally expected, deficits were associated with increases in consumption spending, 0.642 percentage point of consumption for each percentage point of deficit (regression 6, Table 6). But each percentage point of deficit was associated with even larger increases in private investment, 1.383 percentage points (regression 7, Table 6). Far from being crowded out, investment was crowded in.

However, deficits were associated with an unfavorable balance of trade. Each percentage point of deficit went with a 0.399 percentage point decrease in net exports (regression 9, Table 6). Some of the additional deficit-induced spending does spill out in buying foreign goods. And that drag helps explain why the large deficits beginning in 1982, which fueled a substantial recovery from a serious recession, still left the United States with a sluggish economy in 1986 and 1987.

Implications for Balanced Growth and Current Policy

The above analysis has significant implications for current policy. First, major reductions of the structural deficit, unless counterbal-

anced by corresponding stimulus elsewhere, carry the threat of a new recession. The original targets of sharp reductions in the official deficit from the Gramm-Rudman-Hollings act—from $221 billion in fiscal year 1986 to $108 billion in fiscal 1988 and further down in even increments to "balance" in 1991—can spell disaster. By 1991, indeed, the federal debt will be about $3 trillion. With forecasts of about 4% inflation, that would mean an inflation tax that would convert a nominal budget balance into a real surplus of $120 billion. Can we safely anticipate stimulus from monetary policy or elsewhere that would make up for this much fiscal drag?

When the federal debt is not zero, a balanced budget is incompatible with balanced growth, that is, with private wealth in the form of government debt remaining in constant proportion to income and output. Specifically, for a constant ratio of debt, B, to GNP, Y, one may write:

$$D/Y = g(B/Y)$$

where D is the deficit and g is the rate of growth of Y. With the federal debt approaching $2400 billion and the GNP about $4500 billion, we may take the ratio B/Y as approximately equal to 0.533. The generally predicted growth in GNP is about 6%—2 or 3% real growth and 3 or 4% inflation. Thus the "equilibrium" or balanced-growth deficit may be taken as 3.2% of income (0.533 times 6%). Currently, that would total a deficit of some $144 billion. The deficit for the 1987 fiscal year, ending 30 September 1987, is now estimated at $157 billion, only $13 billion more.

But while politicians and others have been lamenting budget deficits for years when they were not really big, the deficits of the 1980s have generally been large by any measure. With the fiscal 1988 deficit (for the year beginning 1 October 1987) now projected by the congressional budget office at $183 billion, there is still some way to go to reach the balanced-growth target. A critical vehicle for getting there and sustaining the economy is significantly easier money and credit from the Federal Reserve.

An increase in the money supply, by reducing interest rates, would have an immediate direct effect in lowering the nominal deficit by reducing its major component of Treasury interest payments. Yet the lower interest rates would raise the market value of outstanding Treasury bonds and by thus increasing private wealth stimulate private spending. The increased supply of dollars and lower domestic interest rates, which reduce net foreign demand for the dollar, would lower the exchange value of the dollar. This in turn would bring a lesser volume of imports and raise our exports, thus reducing or eliminating any increase in our debt to the rest of the

Table 6. Price-adjusted high-employment budget, changes in monetary base, and changes in components of GNP. Least-squares regressions with Cochrane-Orcutt, first-order autoregressive corrections: regression coefficients with standard errors (shown in parentheses), adjusted coefficient of determination ($\hat{R}^2$), Durbin-Watson statistic (D-W), and autoregressive coefficient ($\hat{\rho}$).

$$\Delta COM_t = b_{01}X_1 + b_{02}X_2 + b_1 PAHES_{t-1} + b_2 \Delta MB_{t-1} \ (X_1 = 1, X_2 = 0 \text{ for } t = 1962 \text{ to } 1966; X_1 = 0, X_2 = 1 \text{ for } t = 1967 \text{ to } 1984)$$

where ΔCOM is change in component as percentage of GNP, PAHES is price-adjusted high-employment surplus as percentage of GNP, ΔMB is real change in monetary base as percentage of GNP, and b, X, and t are as defined in Table 5. [Adapted from (1) with permission, copyright 1986, by The Free Press, a Division of Macmillan, Inc.]

Regres-sion	Component (ΔCOM_t)	Constants		PAHES (b_1)	ΔMB (b_2)	$\hat{R}^2$	D-W	$\hat{\rho}$
		1962–1966 (b_{01})	1967–1984 (b_{02})					
6	Consumption	3.401 (0.675)	2.339 (0.303)	−0.642 (0.263)	2.393 (1.592)	0.580	1.91	0.092
7	Investment	2.613 (1.176)	1.135 (0.541)	−1.383 (0.414)	3.587 (2.411)	0.570	1.99	0.282
8	Government	1.195 (0.558)	0.483 (0.270)	−0.113 (0.172)	−0.660 (0.981)	0.354	1.52	0.473
9	Net exports	−1.615 (1.273)	−0.766 (1.012)	0.399 (0.137)	1.625 (0.811)	0.512	1.45	0.836
10	GNP	6.208 (1.296)	3.371 (0.585)	−1.568 (0.479)	7.172 (2.830)	0.735	2.03	0.174
11	Domestic demand	7.405 (1.506)	3.934 (0.675)	−2.141 (0.560)	5.149 (3.295)	0.767	1.93	0.155

world, and also contributing to growth in GNP and a decline in unemployment. The lower interest rates may in addition be expected to encourage capital accumulation, particularly long-term investment. All of the resultant increases in income and output would swell tax revenues, without raising tax rates, while payment of unemployment benefits would decline. Thus the deficit would be further reduced. We would have achieved the more proper fiscal-monetary mix consistent with optimal balanced growth that so many economists rightly urge.

Ideology and the Battle over Priorities

On a quite different level, ignoring or rejecting these considerations of aggregate demand and purchasing power, it is argued (11) that the discipline of a balanced budget is essential to prevent wasteful and ultimately harmful government spending. A federal deficit permits the divorce of taxes from government benefits. The effects of this divorce are magnified by the propensity of special interest groups to cause Congress to legislate outlays on their behalf. If deficits eliminate the need for consequent additional taxes, such legislation may be undertaken with impunity. Deficits thus permit government to become larger than optimum and, with these excessive outlays, command resources that would better be put to private use on the basis of decisions—by consumers, investors, and businesses—in the marketplace.

How one evaluates this argument depends on ideological preconceptions. If one believes government activities are too large or perhaps misguided, one is inclined to welcome constraints, such as prohibitions of deficits, which will reduce the role of government. If one believes government is not doing enough in certain areas, such as providing for the infrastructure of roads, bridges, harbors, and natural resources, investing in education, health, and basic research, or maintaining income of the poor and underprivileged, one is inclined to resist the constraints of a balanced budget.

The public debate and controversy on the matter of the federal deficit have been closely intertwined with struggles over national priorities. The large deficits of the past 5 years can clearly be ascribed to the major increases in military expenditures along with major tax cuts originating with the Reagan Administration. As long as these were taken as given, moves to reduce the deficit implied the curbing and reduction of nonmilitary expenditures, both for support of the poor and for public investment.

Although some people view deficits as encouraging consumption at the expense of private investment, efforts to cut the deficit tended to hold back public investment. Yet the private business investment in plants and equipment, about which so much concern is frequently expressed, amounts to less than 20% of total capital accumulation (12). Government-related investment in tangible and intangible capital, including scientific research and the vital human capital of education and health, is close to half of the total. Deficit reduction that reduces such federal or federally supported investment may prove the real culprit in placing a burden on future generations.

REFERENCES AND NOTES

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