

Cato Institute Policy Analysis No. 24: Deficits and the Economy

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Executive Summary

We must get control of the budget monster, get control of our economy and, I assure you, get control of our lives and destinies."

-- Ronald Reagan: March 30, 1981

Two years after speaking those words, President Reagan remains further from controlling the budget deficit than any President has ever been. The reasons for this are numerous and debatable. The direct result, however, is clear -- a \$110 billion deficit for Fiscal Year 1982, the largest deficit ever. Unfortunately, the record will not stand for long. By any estimate, the deficits will be well above the \$110 billion level through FY '88; if Congress does not approve Reagan's budget requests, the deficits will easily be more than double the FY '82 record. The budget monster, apparently, will remain uncontrolled for a long time.

Past and Present Deficit Projections

The latest administration forecast projects a FY '83 deficit of \$210 billion.[1] This differs markedly from the claims that Mr. Reagan made as recently as early February of 1981, when he still insisted that by 1983 the budget would be in balance. In time, he pushed the date of the elusive balanced budget back to 1984. The President's July 15, 1981 "Mid-Session Review of the 1982 Budget" predicted a \$500 million surplus in 1984 and a steadily growing surplus thereafter.[2] Currently, however, the FY '84 budget is projected to be \$226 billion in the red. (If the spending cuts requested by the President are adopted by Congress, and if the economic projections by the administration are accurate, the expected deficit will "narrow" to \$190 billion.)[3]

Although the administration made huge errors in its deficit projections, and although Ronald Reagan's campaign promises to balance the budget will not materialize, Mr. Reagan's actions had ample precedent. Projections of past budget deficits have been abysmal. Originally predicted at \$45 billion, FY '82's deficit reached just over \$110 billion. In 1980, after three years of underestimating deficits, President Carter and the Congress still predicted a \$10.1 billion surplus in the First Budget Resolution for FY '81. Nevertheless, the budget eventually wound up \$58 billion in deficit. Since 1969, the year of the last balanced budget, OMB has correctly estimated the next year's budget deficit to within 25% in only three years.[4]

Like Ronald Reagan, previous presidents also made balanced budget promises which they did not fulfill. In 1976, candidate Carter attacked the spending record of then President Ford and promised that if elected, he would balance the budget by 1980. Carter never did achieve a balanced budget. In the 1976 campaign, Ford, who presided over the largest deficit to date, promised to balance the budget by FY '78 if he was reelected. Unfulfilled budget promises are not confined to recent years. During the 1932 presidential election candidate Roosevelt promised a balanced budget.[5]

President Roosevelt then ran up a continuous string of deficits during the 1930s that, except for World War I, was unprecedented in both size and duration.

What really separates Mr. Reagan's deficits from those of other presidents is sheer magnitude. Although many commentators have claimed that the administration originally used a pessimistic economic forecast (which has since been liberalized) in estimating future deficit levels, the deficits could well be much higher than now predicted. Many outlays are clearly underestimated in the President's budget. For example, the food stamp program will cost \$2 billion more than budgeted this year, and there also will probably be a supplemental request for foreign aid.[6] Also, the costs of new weapons programs are being seriously underestimated.[7] More significantly, if Congress stays its course, it will not pass all of the temporary pay and benefits freezes or other requested budget reductions. Without these and related slow downs in spending increases, the budget deficit will head toward the \$300 billion level for FY '88.[8]

Downplaying the Effects

While most economists argue that the deficit trend cannot continue without grave consequences, some current and former government officials deny that the present deficits are damaging the economy. Norman Ture, supply-sider and former Undersecretary of the Treasury, claims that deficits did not cause the most recent recession and "History shows [that deficits] have no relation to interest rates, inflation or capital formation." [9] Walter Heller, of the Kennedy and Johnson administrations, maintains that "it would [not] make any sense to exorcise our deficit, even if we could, overnight." [10] Murray Weidenbaum, former chairman of Reagan's Council of Economic Advisers, says that "during a time of recession, such as the present, a large deficit will not be 'crowding-out' the rather modest funding needs of business and consumers." [11] William Niskanen, currently serving on the Council of Economic Advisers, says that deficits bear no relation to inflation and high interest rates. [12] (Interestingly, Weidenbaum's and Niskanen's remarks came just after the first estimates of prolonged \$100 billion plus deficits became public.)

There are others who indirectly downplay the effects. Pete Domenici, the Senate Budget Committee chairman, has promised to keep federal deficits under \$200 billion per year. [13] OMB Director David Stockman and Martin Feldstein, current chairman of the Council of Economic Advisers, were "pressing for a long-range plan" to limit yearly deficits to "only" \$50 billion by 1988. Despite occasional rhetoric to the contrary, those responsible for the deficits imply that America can live with budget deficits, and even huge deficits, at least temporarily. The political reasons for the claims are obvious -- no public official would admit to knowingly harming the economy for the sake of political expediency. Not so obvious, apparently, is the effect that deficits actually have on the economy.

Revenues

All economic units must finance their expenditures. Whether the particular economic unit is an individual, the local Rotary Club, or the federal government, it must pay for its spending. After revenues and expenses are tallied, any surplus goes toward savings and investment (or the repayment of past loans); any deficit must be financed through the draw-down of past savings or through borrowing. (The additional alternative available to the federal government -- monetization -- is explored below.)

Deriving its revenue from personal income taxes, corporate income taxes, social insurance "contributions," and various excise taxes, the federal government's revenues increase when the level of taxation rises or when the dollar value of the activities and objects being taxed increases. Usually, Congress attempts to cover the gap between revenues and expenses by increasing the rate of various taxes (most recently, through the Tax Equity and Fiscal Responsibility Act, the 5-cent-per-gallon gasoline tax, and the acceleration of Social Security tax increases). The only revenue-increasing measure for which President Reagan is commonly faulted is the 1981 tax cut -- a novel method advocated by the suppsiders.

Arthur Laffer, one of the first to explicitly advocate the supply-side approach, claimed that cutting marginal taxes from their present rates would increase economic activity, thereby enlarging the number of taxable transactions to such an extent that government's total revenues would grow. President Reagan also claimed that the 25% tax cut would significantly stimulate the economy and minimize or avoid the recession. To date, however, the combined effect of the previously scheduled increase in Social Security taxes, bracket creep, last summer's Tax Equity and Fiscal

Responsibility Act, and the 5-cent-per-gallon gasoline tax, along with the decrease in personal tax rates, produces a net change in total taxes of virtually zero. Writing last January, former Assistant Secretary of the Treasury and leading supply-sider Paul Craig Roberts compared the tax cuts versus tax increases since Reagan assumed office:

[T]he 1981 tax cut measured about \$960 billion (in static terms) over the 1982-87 period. It was 69% repealed before it was passed by scheduled Social Security tax increases and bracket creep of \$660 billion, leaving a net tax cut of about \$300 billion. TEFRA (Tax Equity and Fiscal Responsibility Act) repealed a further \$229 billion, leaving a \$71 billion tax cut. The recent gasoline tax hike chipped away \$16 billion leaving \$55 billion.[14]

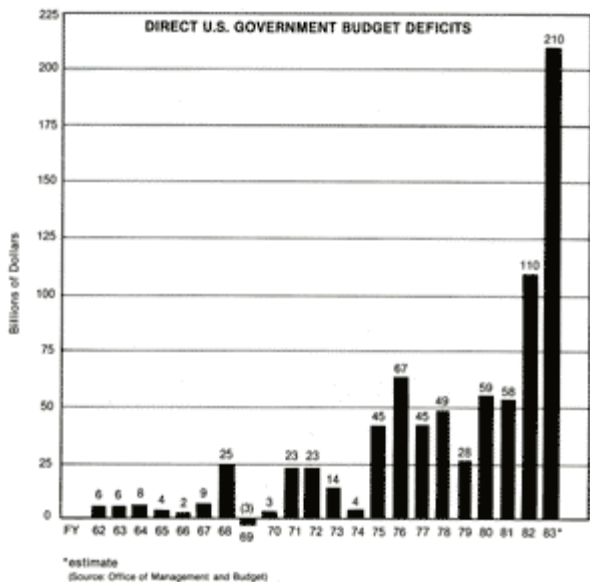
The net tax cut, \$55 billion over six years, is equivalent to less than 1/4 of 1% of the period's GNP. With the recently enacted acceleration of FICA tax increases, that last fraction of one percent has been eliminated. The "supply-side experiment," however, has left one interesting piece of evidence.

Of all the income groups that faced the specter of some taxes rising while other taxes fell, only those who were in the highest income tax brackets actually had a real, net decline in their marginal tax rates. According to preliminary statistics for 1982's estimated quarterly tax receipts (which are primarily paid by those individuals with high incomes), total taxes paid by the wealthy increased by 11%, even after their tax rates had been lowered.[15] Apparently, supplyside claims of higher revenues held true for the only income group that actually had its tax rates lowered.

Unfortunately, total taxes have not been cut. Whether the supply-side method of increasing revenue would have worked for all income groups remains untested. Without an effective tax cut for other income classes, there will only be a minor supply-side stimulus to boost government revenues.

The 20-Year Record

The following chart illustrates the deficits since FY 1962.



As the chart shows, the last budget surplus was in 1969. The net cumulative deficit for the period (excluding 1983) was \$585 billion. This makes up 49% of the present \$1.2 trillion national debt. Over 80% of the \$585 billion was incurred during the past 10 years. Almost half of the 10-year deficit occurred in the past three years. And 1983's projected deficit is 93% of that three-year amount. Deficits are exploding.

To finance the deficits, the Treasury has sold bonds, notes, and bills to the public -- the vast majority of which is short or medium term. Over 95% of the \$1.2 trillion has a maturity of from just under 10 years to just over a few days. This forces the government to continually sell new issues to repay maturing issues. During an average week over the past several months, over \$12 billion in T-bills were sold to pay for maturing bills and to raise new cash. Also, during the first quarter of this calendar year, the Treasury borrowed \$56.4 billion. For the second quarter, the Treasury estimates it will have a net borrowing need of \$40.5 billion.[16] These amounts far surpass anything the federal government ever previously borrowed in such a short period of time.

Unlike an individual's or corporation's debt, lenders generally see no possibility of default on the U.S. government's debt. In the case of a business, bankers consider its sources of funds in relation to its expenses and debts, and few bankers are willing to lend a business more money than they believe it capable of repaying. Lenders, however, rarely consider how the government will (or whether it can) ultimately repay its obligations.

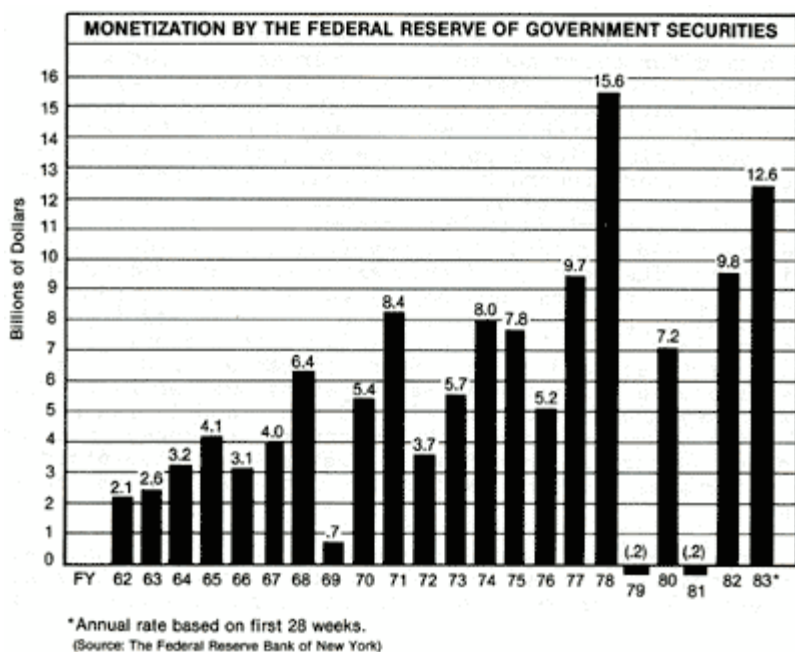
In the 1970s, most sovereign nations were considered to be capable of repaying almost any loan. The famous phrase by Citibank's Walter Wriston, "Sovereign nations do not go bankrupt," rings hollow now. With the de facto defaults by Poland, Mexico, and other countries, and with the dangerously close-to-default situations in countries like Nigeria and Brazil, it is no longer believed that governments can always exact more money through either taxation or currency inflation. Nevertheless, lenders seldom consider where the money to repay the U.S. government's debts will come from.

To see how difficult repaying the national debt would be, consider this illustration. Beginning next year, the budget would have to move from a deficit in excess of \$200 billion to a surplus of \$50 billion. Then the \$50 billion surplus would have to be repeated every year during the next seven administrations to pay off the direct federal debt. Lenders simply assume that government will always be able to sell more debt -- both to finance future obligations and to refinance maturing obligations.

Monetization

Unlike other economic units, the federal government has an additional alternative available to cover its deficits: monetization. At the most basic level monetization is simply the creation of dollars. In a sophisticated financial system like the one in the U.S., the "new" dollars are entered into the bank accounts of individuals from whom Treasury securities are purchased. That simple act produces a series of consequences that throws the entire economy off balance.

The Federal Reserve System retains sole responsibility for monetization. It determines what portion of a deficit will be monetized and, consequently, the residual amount that will be net borrowing from the credit markets. By law the Federal Reserve is a public-private partnership; in practice it serves as the nation's semi-autonomous central bank, and it controls the base on which the country's credit system rests. Chaired by Paul Volcker, the Federal Reserve Board sets guidelines that determine how much debt will be purchased. The Federal Reserve Bank of New York does the actual monetizing.



To monetize part of the deficit, the New York Fed buys some of the Treasury's securities -- and occasionally some municipal debt securities -- on the open market, and it pays for the issues with newly created dollars. Doing so moves part of the government debt to the Fed (which effectively retires it), and the process adds more dollars to circulation.

The process of adding dollars to the financial system is often referred to as monetary stimulus, easy money, or accommodating the deficit. Another name for it is inflating.

The chart on page 7 illustrates the amount of debt monetized during the past two decades (calculated on the present fiscal year calendar).

During the past 20 years, \$112.5 billion of securities have been purchased by the Fed -- effectively retiring an equal amount of the national debt. Although that amount is only 19% of the period's \$585 billion budget deficit, the figures have a more significant effect than it might appear.

Each dollar of securities purchased represents one dollar put into the financial system. The dollars serve as cash and as reserves on which demand deposits are pyramided. As a result, the money supply (as defined by any of the M measures) increases, which leads to several consequences.

First, since the government spends newly created money, the demand for goods and services increases by the amount of new money spent, and businesses receive a temporary boost. The "new" money partially pays for the current construction of a subway in Pittsburgh and a subway link in Philadelphia, dairy and grain price supports, water projects in Western states, military contracts, and so on. Since these projects are partially financed by newly created money, overall demand for goods and services in the economy is greater than if the government had borrowed the money (thereby choking off other projects). The results of this extra economic demand are rising wages, profits, and employment levels -- a temporary boost that ripples throughout the economy, satisfying business and labor. With this higher level of economic activity, aggregate taxes paid to government increase. However, as Nobel laureate Friedrich A. Hayek points out, spending of "new" money causes economic dislocations, and it leads to recurring business cycles. By injecting new money into particular industries, monetization distorts the flow of capital and encourages investments that are not based on true consumer demand.

Once the acceleration of monetization stops, consumer demand, prices, and interest rates adjust to their true market level. and borrowers who overextended themselves cut back

their spending. As evidenced by 1982's post-war bankruptcy record, many businesses fail. In industries where wages were artificially bid up by the inflation's effects, wages must fall back to market levels or employment levels will be permanently lower. In the U.S., union contracts and worker attitudes have made the downward adjustment of wages extremely difficult. Unable to reduce wages, overextended auto manufacturers, for instance, have cut back employment levels of auto workers whose wages had been driven above market levels. Almost a half million auto workers are now unemployed. But after seeing the reality of unemployment, workers have recently begun to accept such unheard of ideas as the 32% compensation reduction at Weirton Steel and "givebacks" by numerous airline unions. New airline successes like People Express have been able to outmaneuver the giant airlines largely because their employees' wages were not set at artificially high levels. Price inflation confuses and misdirects economic assumptions, and ending the inflation is difficult because plans were based on inflation's continuance.

Note that the recessions during the past 20 years were all preceded by a sharp decrease in the amount of debt being monetized. The recession that began in late 1969 was preceded by a sharp cutback in the pumping of new money into the economy; after adding \$6.4 billion in FY '68, only \$700 million was added in FY '69. The '73-'75 recession was preceded by a cutback from \$8.4 billion to \$3.7 billion. (The situation was undoubtedly exacerbated by the dislocations resulting from the "oil shock.") The recession in the first part of 1980 followed a record cutback in monetization from \$15.6 billion in FY '78 to -\$200 million in FY '79. Monetization soared again during the election year of 1980, only to be cut back sharply in FY '81, causing the severe recession that began in the second half of calendar year '81. The economic history of the past 20 years is virtually a story of the Fed monetizing dollars to lower the interest rate to keep the economy "healthy," followed by an accelerating inflation rate, followed by a sharp cutback in money creation to slow the inflation, followed by the inevitable recession.

In addition to providing the temporary economic boost that increases government revenues, monetization also causes price inflation. Milton Friedman has spent much of his career studying the ties between increases in high-powered money (the dollars created when the Fed monetizes) and inflation. In the '60s, Friedman wrote that increases in the money supply are tied to increases in high-powered money[17], and that the lag between the increase in the money

supply and the acceleration of inflation varies between several months and several years.[18] Events support his analysis.

In FY '78 the Fed monetized \$15.6 billion, the largest amount ever. A year later the inflation rate reached 13.3%, the highest rate (excepting 1946) since World War I. To slow inflation the Fed drastically cut its monetizing. The 1980 recession resulted, and the inflation rate began falling. But that inflation, and previous inflations, benefited the federal government.

As nominal wages increase with inflation, taxpayers are pushed into higher brackets. Thus tax rates are higher even though real income has not increased. This means most taxpayers suffer a decrease in their real, after-tax income. For example, with a 10% inflation, the average family earning \$20,000 (and filing a joint tax return) will earn \$22,000 the following year. Unfortunately, their federal income taxes move from \$2,899 to \$3,393 -- a 17% increase.[19] (This will not occur if tax rates are indexed to the inflation rate, which is scheduled to begin in 1985.) Because the inflation-induced increase in income is taxed at a higher marginal rate, the family has a lower real income, and the federal government reaps the windfall in increased real taxes. This bracket creep provides government with a greater proportion of GNP.

The creation of money goes a long way toward reducing future deficits, but there are serious drawbacks. First, much of the deficit reduction comes at the expense of individuals who pay a higher percentage of their earnings to government. Price inflation continues to destroy much of the zero tax bracket's real value, and it moves people in the lower tax brackets to higher tax brackets. For example, a family filing jointly with a total taxable income of only \$10,000 pays \$934. With a 10% price inflation, the family, now earning \$11,000, pays \$1,094 -- a tax increase in real dollars of 6.5%. Although the third installment of the 25% tax cut will lower the real value of the increase, the underlying concept remains valid. Individuals already in the top tax bracket pay the same amount of real taxes with or without inflation. When the government gains real tax revenues from inflation, its gains come at the expense of the poor and the middle class who move to higher marginal tax brackets.

The second drawback to monetization is that the business boom and higher real wages resulting from the initial monetization of debt are only temporary. Once monetization ceases, the jobs created and the higher wage rates supported by the initial influx of dollars do not have any real economic demand to maintain them. Demand that resulted from the "extra" dollars attempting to purchase a limited quantity of goods and services disappears without the creation of additional new money. Although many "extra" jobs and the higher wages could be maintained through increasing the rate of monetization, the corresponding rise in the inflation rate eventually makes this option unpalatable. Recent events provide a vivid illustration.

When price inflation reached 13.3% in 1979, the electorate and the politicians found the inflation rate unacceptably high. Between the time when double-digit inflation first appeared in 1978 and the end of FY 1982, the Fed only monetized 6.5% of the deficits -- a significant decrease compared to its former practices. The result was a 3.9% inflation rate in 1982. Unfortunately, to speed the economy out of recession and lower future deficits, the Fed has been monetizing large amounts of debt since the beginning of this fiscal year. Based on figures for the first 28 weeks of FY 1983, the Fed can be expected to monetize \$12.6 billion this year, a higher level than in any previous year except 1978, when the highest-ever rate of monetization was followed in 1979 by 13.3% inflation. With or without declines in the price of oil, union wages, and other oft-cited causes of inflation, the amount of monetization presently occurring will cause an accelerating inflation rate by the end of 1984. (If the Fed slows the rate of monetization enough to avoid a resumption of inflation, the recession will resume and continue to adjust wages, profits, and prices toward market levels.)

The Effects of Borrowing

Once a deficit has been incurred, the other financing option available to government is borrowing. To borrow, the Treasury sells the previously mentioned bonds, notes, and bills in the credit markets. Although borrowing does not create price inflation, it does produce two interrelated and harmful consequences: higher interest rates and crowding-out of private investment.

The interest rate measures the cost of borrowing money over time. It equilibrates the supply of, and the demand for, funds. Whenever the demand for funds exceeds the supply, the interest rate rises until the two are equal. With higher rates fewer individuals or businesses are willing to pay the price for borrowing money, and more people are willing to save. Aggregate borrowing declines; aggregate saving rises; and at the constantly fluctuating interest rate, the supply of funds balances with the demand for funds.

Price inflation influences the interest rate because it affects the value of money. With a lower expected value of future money, savers do not provide the same amount of money until their rate of return (the interest rate) increases enough to make up for the expected loss of the money's future purchasing power and for the risk that inflation will be higher than expected. Inflation cuts back the supply of funds at any given interest rate, and rates rise until the supply and demand of money again equal each other.

Individuals and corporations supplied funds to the credit markets in 1982 through their gross private savings of \$549 billion.[20] After subtracting \$360 billion in depreciation costs (that part of gross savings that theoretically covers the wear and obsolescence of capital assets), net private savings of \$189 billion remained.[21] To the degree that actual depreciation equaled accounting depreciation, net savings was the amount available for investment in new economic enterprises. If government had had a balanced budget in 1982, the total net national savings would have been invested in private enterprises, and the amount represented by depreciation costs would have been reinvested.

With the federal government running budget deficits, the natural relationships between private borrowers and lenders become distorted. In 1982 the Treasury borrowed \$144 billion from the credit markets (the reported deficit plus \$16 billion of agency borrowings and \$17 billion in "off-budget" items).[22] Government borrowing increases aggregate demand for money without increasing aggregate supply. The increased demand caused the interest rate to rise to a level above what it would otherwise have been. How much further it rose cannot be measured, but it can be estimated. From 1982's T-bill rate of roughly 10%, the "natural" rate of interest -- the rate that would exist in the absence of inflation and government borrowing -- of approximately 2.5% should be subtracted. In addition, the year's inflation rate of 4% and an inflation risk premium of about 1/2% must also be deducted. The amount remaining, 3% of last year's short-term rate, was arguably due to government borrowing. Although the calculation is imprecise, it serves as a good estimate of how much short-term interest rates rose because of the federal government's borrowings last year.[23]

Not only do the higher interest rates make borrowing more expensive for both consumers and businesses, they also cause some of those who would have borrowed at the natural interest rate to drop out of the markets as demanders of credit. Because the government has huge taxing powers, lenders feel a higher degree of confidence in its ability to repay its borrowings than they do in any individual or business

Adding to its advantage of perceived risklessness, the Treasury pays whatever the current interest rate happens to be when it borrows. Consequently, the government always receives the amount that it wants to borrow, and private borrowers are partially "crowded-out" of the credit markets. Instead of private concerns receiving all of the savings generated by the economy, the government appropriates much of it for its purposes. Last year, the federal government borrowed 76% of the nation's net private savings, leaving only 24% for private borrowers. A record \$215 billion is projected as necessary to cover the deficit and other federal spending in 1983, and \$203 billion in 1984.[24] Most estimates of the percentage of net national savings that will be appropriated by the federal government during the next two years range from 90% to 110%.[25] This depletion of capital stock is setting the stage for even more serious long-term economic problems.

The effects of crowding out are compounded by a myriad of government credit programs. By providing guarantees and/or subsidized borrowing rates for everything from FHA mortgages to student loans, the government is moving those people and businesses who qualify for the special loans ahead of others in their attempt to borrow. Federal loan and guarantee programs provided \$101.3 billion in 1982. In 1983, \$151.8 billion in loans will be subsidized and guaranteed, and the administration has asked Congress to approve \$137.6 billion for 1984.[26]

Subsidized lending, above and beyond what was borrowed to cover the deficit, redirects resources from their most productive uses to less efficient uses. Although some of the credit is rechanneled toward private concerns, these funds are almost always allocated on a political rather than an economic basis. Loans encouraging overproduction of grain by

farmers, subsidies for FHA and VA mortgages, and guaranteed loans for small businesses are all examples of a government taking money from the highest bidders in the loan markets and giving it to political constituencies. In addition, most of the regular budget goes toward transfer programs that subsidize consumption and ignore investment, or toward military expenditures that do not increase the nation's productive capacities. Loan guarantees and subsidy programs rechannel credit from concerns with the most viable economic enterprises (those that return the highest interest rate) to politically favored projects.

With government borrowing most of the nation's net savings, there is little net increase in the economy's capital stock. When subsidization rechannels capital that should be replacing depreciation to less effective areas, the value of the nation's capital stock declines. It is no wonder that productivity has lagged.

Prominent Rationalizations

While the amount of the budget deficit has soared seemingly out of control, those responsible for the deficit have looked for excuses either to rationalize why the deficit is not really all that harmful or to explain why they are not really responsible for its magnitude. President Reagan is no exception.

On November 29, 1982 the President made his now-famous claim about a structural deficit before the National League of Cities. He said, "There is no way we can eliminate, by budget cuts alone, the structural deficit built into the budget, nor can it be eliminated by raising taxes." [27] The number of people who took Mr. Reagan's claim seriously is almost more surprising than the claim itself. While the supply-siders could make a good argument that gross revenues will probably not rise significantly even with tax increases, reducing the level of spending by about 25% certainly would balance the budget. [28] Perhaps Mr. Reagan meant that he did not possess the political will to have those cuts enacted. Perhaps he was simply voicing his frustrations that the deficit will not just go away with recovery. Nevertheless, claiming that much of the budget deficit is "structural" and cannot be eliminated is a sham. Like so many recent Presidents, Ronald Reagan is making excuses for his own failure.

To avoid the difficult choices that congressmen would face in cutting the budget, many have hoped that the economy can grow fast enough to provide more tax revenues and balance the budget without spending cuts. As the FY '84 Federal Budget document points out, if the economy grows 1 1/3% larger per year than the projections assume, the budget will be balanced in 1988. This is true, but it also assumes that the requested spending cuts and cost-of-living freezes will be enacted by Congress. So far, enactment of those cuts does not appear likely. The budget document also projects that without them the annual deficits will expand to over \$300 billion in 1988. The indications are that without radical spending cuts, the deficit will be even higher than the supposed worst-case scenarios laid out by the administration.

Three recent items illustrate how spending is likely to grow more and at a faster rate than anticipated.

- 1) Reversing its earlier opposition, the administration supported a \$4.65 billion jobs program, which will increase the deficit by several billion dollars.
- 2) The Social Security Administration in February re-estimated that expenditures will exceed FICA taxes over the next 75 years by \$300 billion more than estimated at the time of the bipartisan compromise several weeks earlier. [29] This higher amount is also not included in the deficit projections.
- 3) In a presentation to the Senate Armed Services Committee that the Pentagon tried to prevent, Senator John Tower sought to keep quiet, and Caspar Weinberger attempted to discredit, Pentagon analyst Franklin Spinney explained why the arms buildup will produce roughly \$500 billion in overruns. [30] None of that \$500 billion is currently included in expense projections.

There are sure to be more expenditures that will lead to larger than projected deficits. Also, since virtually all of the net national savings now goes toward covering the deficit, new investment will suffer to such a degree that the economy may well grow at a slower pace than the current budget predicts over the next five years.

Conclusion

If the estimated deficits for FY 1984 and 1985 were included on the first chart, each would be almost triple the once-record deficit of 1976. Even the most optimistic estimates now place the direct (on-budget) deficit at higher levels for the foreseeable future than any previous deficit. The specific effects of these deficits will depend on the Fed, but only three possibilities exist -- higher price inflation, higher real interest rates, and lower productive investment (plus the various combinations of them).

In recent testimony before the House Budget Committee, Chairman Volcker alluded to the same problem: "[T]here isn't a monetary policy that can successfully resolve the economic and financial tensions that would arise from the clash of demands in the money markets from excessive deficits in a growing economy." [31] In other words, the Fed has no magic wand to wave that will lower interest rates and provide investment funds to business with budget deficits at their projected levels; that is, it cannot be done on a permanent basis. A short-term solution does exist, however, and it appears that the Fed is using it.

Monetization will eliminate some of the short-term strains on the financial markets, and interest rates will fall in the short run. Although it does temporarily ease the strains on the financial system and the economy, high levels of monetization will result in a resurgence of price inflation and backbreaking interest rates in a year or so. Despite Volcker's recent statements to the contrary, the figures from FY 1982 and the first half of FY 1983 indicate that the Fed has embarked on another round of inflating. Stopping now will lead to a resumption of the recession; continuing will lead to accelerating price inflation.

Perhaps Mr. Reagan and the congressmen who have the power to affect the deficits are hoping that Paul Volcker can walk the fine line between prohibitively high interest rates, weak capital formation, and accelerating price inflation. Perhaps they nourish a hope that something will occur that changes the deficit outlook. Or perhaps they are simply misleading themselves and the American people about the true effects of the deficits on the nation's economy.

According to present projections, the direct debt will double in six years. Other federal debts are growing rapidly, and deficits are now escalating in real dollars, as a percentage of GNP or by almost any other measure. The United States' present economic condition has resulted from living beyond its means. Unless the trend is halted, the result, quite naturally, will be a long-term, deteriorating economic climate.

In the final analysis, government deficits represent the spending of resources in excess of those that the government "owns." And like all debts, it will someday come due. The total debt is not a debt that "we owe to ourselves"; the debt is owed by government only to those who have directly or indirectly lent it money. It will be the American people who will pay the cost -- in the form of inflation, higher interest rates, and the decreased economic vitality that results from capital investments being crowded out.

Footnotes

[1] Office of Management and Budget, "Current Budget Estimates," April 1983.

[2] Office of Management and Budget, "Mid-Session Review of the 1982 Budget," July 15, 1981, p. 70.

[3] Office of Management and Budget, "Current Budget Estimates."

[4] Alan Reynolds, "The OMB's Questionable Budget Estimates," *Wall Street Journal*, January 18, 1983.

[5] Herschel I. Grossman, "The American Fiscal Deficit: Facts and Effects," *The AEI Economist*, November 1982.

[6] "Trick or Treat Budget," the *Wall Street Journal*, February 1, 1983.

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[8] Rich Jaroslovsky, "Reagan Weighs Seeking a 4-Year Freeze on Many Outlays and a Delay in Benefits," *Wall Street Journal*, January 17, 1983.

- [9] Paul Taylor, "Rightist Group Says Reagan Has Strayed," *Washington Post*, January 20, 1983.
- [10] Walter M. Heller, "The Deficit: What Do We Do Now?" *Wall Street Journal*, September 27, 1982.
- [11] Murray L. Weidenbaum, "Economic Analysis and Federal Budgetmaking," paper presented to the American Enterprise Institute, Washington, D.C., December 8, 1981, p. 5.
- [12] Hobart Rowen, "Reagan Aides Abandon GOP Stance on Deficits," *Washington Post*, December 9, 1981.
- [13] George Archibald, "Deficit Forecasts Panic GOP," *Washington Times*, January 18, 1983.
- [14] Paul Craig Roberts, "Big Taxes and Big Deficits," *Wall Street Journal*, January 14, 1983.
- [15] James K. Glassman, "The Hard Truth About Taxes," *Washingtonian*, April 1983.
- [16] "Treasury Plans Record Sale of Notes, Bonds Next Week," *Wall Street Journal*, April 28, 1983.
- [17] Milton R. Friedman, *Dollars and Deficits: Living with America's Economic Problems* (Englewood Cliffs, N.J.: Prentice-Hall, Inc. 1968), p. 137.
- [18] *Ibid.*, p. 150.
- [19] 1982 U.S. Federal Income Tax Table.
- [20] Evan G. Galbraith, "Private Borrowing and the Federal Deficit," *Wall Street Journal*, February 3, 1983.
- [21] *Ibid.*
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