ECONOMICS U$A
LESSON #12

(MUSIC PLAYS)

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Stasio: Economics U$A. One of a series of programs designed to explore Twentieth Century micro and macro economic principle. The subject of this edition is Deficits. Our guest is Alice Rivlin, Director of Economic Studies at the Brookings Institution and former head of the Congressional Budget Office. I'm Frank Stasio.

President Reagan : Strong economic growth will keep deficits coming down and make no mistake the deficit is coming down. And it would come down even faster if the Congress would give us a constitutional amendment mandating government spend no more than government takes in.

Senator George McGovern: This…this deficit is not bad. It's obscene and destroys long-term folks for the future of our nation and for long-term economics role, it must be dealt with and they refuse to even discuss it.

Stasio: What happens when a country runs a deficit? Does a nation face the same consequences as a family that falls behind in its payments? For much of our history, economists and policymakers believe that it was irresponsible for the government to end the year in the red. Even Franklin Roosevelt who was thought to have embraced deficit spending recoiled at the thought early in his presidency.

President Roosevelt: And I should like to take this opportunity to say loud enough to be heard in Washington that even in hard times, it is possible to have a balanced budget.

Stasio: There was always a fear that if the government did not balance the budget, people would lose confidence in the economy, creating greater hardships down the road. But as Roosevelt learned during the depths of the Great Depression the warnings about the evils of deficits were overblown and the only thing to fear was fear itself.

President Roosevelt: I am saying over and over that I believe that we can restore prosperity throughout the nation by re-establishing the purchasing power of half of the people of the nation. This nation is asking for action and action now. Our greatest primary task is to put people to work. Let me assert my firm belief that the only thing we have to fear is fear itself.

Rivlin: Some kinds of deficits are really quite useful.

Stasio: Alice Rivlin is the Director of Economic Studies at the Brookings Institution and the former director of the Congressional Budget Office.

Rivlin: If the economy is sliding into an unexpected recession for example, then the federal budget will go into deficit automatically, that’s because that fewer people are working. They aren’t paying taxes. And the revenues fall off and some kinds of expenditures go up like unemployment compensation. So there’s an automatic deficit and that’s good. It helps offset the effects of the recession. It puts more money into the economy. If we were to try to stop that sort of deficit by raising taxes or cutting the expenditures, we'd make the recession worse.

Stasio: The Great Depression was a perfect example of an appropriate time to run a deficit. Robert Nathan is an economist who worked in the Roosevelt Administration.

Nathan: It was quite clear by…by thirty-two, thirty-three that something had to be done. And this was, I think, the changes in the New Deal, but for the first time in history there was a decision that the government had to take a part and move in not to take over industry, not to own and operate, not to socialize the economy, but take fiscal measures and monetary measures and even work measures, work projects administration, public works and the like, to turn the economy around. And…and the Keynsian principles that in times of recession, government deficits could be a very stimulated factor, certainly proved to be true.

Stasio: But what was true for the nineteen thirties may not be true for future generations. Alice Rivlin, speaking in nineteen eighty-five, says the huge budget deficit run up in the nineteen eighties seemed inappropriate.

Rivlin: We have an economy which has been growing for the last couple of years. It's recovered well from the last recession so that the deficit in the federal budget is not caused by a recession. It's what economists call, "a structural deficit." It's there despite the fact that the economy is growing quite well. Now that kind of deficit, whatever its size and this one is big, can have bad effects.

Stasio: Rivlin says it's not the size of the deficit that determines its appropriateness, but rather the economic conditions at the time of the deficit. In the mid-eighties the economy had just recovered from a severe recession. Inflation was low and unemployment while by some interpretations relatively high, was stable. In good times as the economy approaches full capacity, economists usually recommend that the government run a surplus. In other words, take in more than it spends, as a way of cooling off the economy and heading off inflation. Many economists fear running a deficit in good times because they tend to absorb money that might otherwise be used in private investment. But Rivlin points out that the situation in the nineteen eighties was unique. The deficit did not crowd out investment.

Rivlin: The deficit is a use of national savings and we are using a large portion of our national savings to run the federal government, to pay for the deficit, rather than using it for investment and more productive things. That means in order to have a high level of investment, we have to get additional savings from somewhere else. We have to get somebody else's savings, foreigners for example. And that's the way we're solving that problem right now. We're having a big inflow of capital from abroad, but that has its problems, too.

Nathan: Does it make a difference if we're borrowing from ourselves or if we're borrowing from foreigners?

Rivlin: Yes, it does make a difference. Borrowing from foreigners has several problems. One is that it means that the value of our currency, the dollar, tends to be very high. Those foreigners are demanding dollars to uh, pay, to invest in the United States. And uh, that bids up the price of dollars in terms of pounds or yen or…or deutsche marks or whatever. And the effect of that is that it is very expensive then for foreigners to buy our goods because our currency is so high. And it's very cheap for us to buy from them. So that our export industries and our industries that compete with imports suffer. And that is one of the things that's happening right now, particularly in manufacturing. We're having a very hard time exporting and a very easy time importing. And that makes for imbalances in the economy. The other problem is that in the long run, all…all debts have to be paid back. And it…it's no different if you're a…a nation than if you're a person. We will be paying back over a long period these funds that we have borrowed from foreigners. Now that's not necessarily bad, but it means that we'll have less left over for ourselves. The, whatever we produce, part of it will go overseas to pay the interest and the dividends and the repayment of these debts.

Stasio: Americans have never been completely comfortable with the idea of deficit spending. Even Franklin Roosevelt whose budget was in the red for most of his presidency, tried to cut government spending in nineteen thirty-seven, before the deficits of earlier years could bring about a complete recovery. The cry for a balanced budget rose sharply in the early nineteen eighties because of ever-increasing deficits posted through the period. There was a serious attempt to call a constitutional convention to consider an amendment to the constitution that would mandate a balanced federal budget. Backers of the constitutional amendment wanted to bring the budget into balance by the end of each fiscal year.

Rivlin: I think it would be very difficult, probably bad for the economy to force the U.S. government to balance its budget every year. And the reason for that is that it could not then offset recessions with its budget deficits. You really do want the federal government to be able to run a deficit when the economy's in a recession. Or to run a surplus perhaps when there is a high inflation and the economy is fully employed.

Stasio: But there are some experts who say the budget should be balanced over the period of the business cycle. Economists point out that a deficit is good for the economy in a recession and harmful when the economy is near full capacity. They argue that the budget should reflect the cyclical swings in economic activity. Many economists argue that there is no need to balance the budget over any specific time period.

Rivlin: It wouldn't matter if the federal government ran somewhat larger deficits, even if they ran a small deficit every year. As a matter of fact over the period from about uh, the end of World War Two to the early, till about nineteen eighty, we were running deficits in the federal budget almost every year. They were larger in recessions and smaller in good times. But the budget was rarely exactly balanced.

Stasio: It is sometimes helpful in understanding the full impact of deficits and surpluses, to project what the budget would look like at full employment. The so-called full-employment budget has been adopted by recent administrations as a way of gauging the real effect of a budget deficit.

Rivlin: A full-employment budget is just a way of measuring the federal budget deficit. If one is in a recession the federal government budget goes automatically into deficit. And one can say, "well, that's just caused by the recession." If we recompute this deficit and say how much it would be at full employment, then we will get a lower number and a measure of what, in the sense the real deficit is, not just the deficit caused by temporary recession in the economy.

Nathan: And why is that? How does it work? What is the value of viewing the deficit from a full-employment point of view?

Rivlin: It's useful to dev, to view the deficit from a full-employment point of view uh, just really to get an idea of what the net effect of the deficit is, how much of it is simply an automatic effect of the recession? And how much is something extra that the federal government is doing over and above the natural result of an, of recession.

Stasio: The use of a full-employment budget has important policy implications. Remember deficit spending creates a multiplier effect which stimulates the economy and helps reverse unemployment during a recession. Policymakers will be misled if they don't make the distinction between a full-employment budget and the actual budget. So it appeared in nineteen fifty-eight for instance that the Eisenhower Administration was running a ten billion dollar deficit. But economists argued that the deficit was actually caused by the recession. Unemployment was at seven percent. Output was down sharply. An economist calculated that if the economy had been at full employment, the budget would have been in a surplus. Government spending in nineteen fifty-eight did help ease the recession, but Eisenhower was uncomfortable with that seemingly huge deficit of ten billion dollars. Later when Ike was about to leave office, he didn't want to walk away with a budget deficit. So against the counsel of his advisors he ran a surplus in nineteen sixty. Economist Herbert Stein.

Stein: Nineteen sixty, he was leaving office. He was not running again. The pains of the recession …, they were having in nineteen sixty, were not so evident to him as the pains of the nineteen fifty-four recession had been. They were pretty evident to Mister Nixon.

Stasio: I was gonna say, at least he was running.

Stein: Who was…who was running and he was very unhappy about the situation.

Stasio: Vice President Richard Nixon was running for president. He was one of those urging Ike to continue to run a deficit and complete the recovery. But the president stayed with his program and left the government in the black. Surplus in nineteen sixty stalled the recovery and may well have cost Nixon the election. When Richard Nixon finally captured the presidency eight years later, he became the first president to regularly use the full-employment budget. Deficits can have varying effects on the economy depending on how they are financed. One way to finance the deficit is to borrow from individuals in businesses. When this happens, the government absorbs savings, which would have been invested in other ways. This can cancel the stimulative effect of a deficit.

Rivlin: We're not a high-saving country. Japan, for example, saves a much higher proportion of its gross national product than we do. Net national saving in the United States over the period nineteen fifty to nineteen eighty-four was about seven point two percent at, on average of the gross national product. So if we're using say, four percent of that to finance the government, it means we're in considerable trouble. We're going to have to get the rest of our saving from somewhere else.

Stein: If I go into debt and borrow from, essentially from within my economy, in the domestic economy and then pay it back, is that less a burden to future generations than having to pay…pay back that loan to foreign investors?

Rivlin: Well, it is in a sense. It's a little bit like borrowing from your brother. It keeps it in the family. And from the point of view of the family as a whole it's just a transfer when…when one member paying to another. On the other hand, it still does create a problem. The U.S. government even when it borrows from U.S. citizens does have to budget the amount necessary to pay the interest and it means that the federal government has less flexibility in the sense. It has to pay that interest first and then think about what else are we going to buy. If foreigners for some reason just suddenly decided not to lend us anymore money, then we would be in much deeper trouble. Our interest rates would rise very rapidly unless the Federal Reserve was willing to create a lot more money. And I don't think they would be. And then our investment rates would…would drop, because it would be very expensive for firms that wanted to put up new factories, for instance, to…to borrow money.

Stasio: The other way the government may finance a deficit is to create new money. It does this by having the Federal Reserve System buy up the government's debt. This does not absorb savings and consequently will have a greater expansion area effect on the economy than borrowing from the public. But this process increases the money supply and tends to lead to inflation. How do policymakers decide whether to run a deficit and how high the national debt should be allowed to climb? The budget process itself is complicated and fought with competing and often conflicting goals.

Rivlin: Well, the federal budget starts really in the Executive Branch of the federal government with the various agencies, the Defense Department and Health and Human Services and the others, trying to figure out what they need for their programs in the next year. Those needs are transmitted to the president, or really to the Office of Management and Budget. They always exceed the available funds. Everybody thinks they need more for their program and the job of the Office of Management and Budget is to put these competing claims together and to make sure that uh, the budget that the president sends up to the Congress reflects the administration's views of priorities and reflects the, whatever the administration thinks is the appropriate balance between spending and revenues, which may be a surplus or it may be a deficit. Most of the time in recent years, it's been a deficit. So the Office of Management and Budget works hard on this document and uh, with the president sends it up to the Congress in February. But that's just the beginning. The Congress then gets to work on the budget and what it thinks the government should be spending and for what and how this should be paid for. The first action is in the Budget Committees and they take the president's proposals. They take the views of experts that they call as witnesses and the estimated needs from the various committees of Congress that deal with these agencies. And they put this all together in what is called a, "budget resolution," which is a general framework for the budget. It doesn't give specific amounts of how much for tanks or how much for guns and so forth, but it has a number for defense and a number for health and a number for income security and a number for revenues. And that budget resolution is voted on by the Congress. That's been a very difficult process in the last few years. Sometimes the House and Senate vote for very different budgets and have to iron out the differences in conference.

Sometimes the president gets into the act. But in principle by May and usually by a little later in the summer, the Congress has completed its budget resolution or its overall framework. Again that's not the end. Then once they have this overall framework, they have to do the specific Appropriations Bills that fit in that framework and the specific Tax Bills and wrap that all up by the time the fiscal year begins on the first of October.

Stein: To what extent is this whole process coordinated so that if there was a fiscal policy that you wanted to pursue, it could be…it could be, it could stay on target?

Rivlin: Well, that really is the point of the congressional budget process. The president expresses his fiscal policy as well as his budget priorities in his budget and then the Congress debates that and may agree with it or disagree with it, but expresses its philosophy or its fiscal policy in the budget resolution. And then the rest of the Appropriations Acts are brought into line with that. It is a process designed to get a fiscal policy and have it expressed in the budget resolution and carried out in the other Acts. In that sense the difficulty is getting the fiscal policy. It hasn't been so much carrying it out once you have it.

Stein: But isn't, there's a twofold, there are really two things going on. While on the one hand you have a fiscal policy that you'd like to pursue. On the other hand you have a social agenda that…that needs to be covered in these various agencies so that you need so much for defense that or so much for social programs. And you may make that decision without considering its effect on the economy in general. So don't those two agendas, or can't they come in conflict?

Rivlin: Well, a budget is conflict. A budget is a process of putting together conflicting claims and desires and fitting those into the total that the government wants to spend, which is consistent with its fiscal policy. A budget is always a process of adjudicating conflicting claims.

Stasio: As Director of the Congressional Budget Office from nineteen seventy-five to nineteen eighty-three, Alice Rivlin was an important player in the budget process.

Rivlin: The Congressional Budget Office is an… independent analytical arm of the Congress. They produce estimates of what's likely to happen to the economy. Estimates of what the budget will look like if the Congress goes on doing what it's doing. How big the deficit will be in the future if policy isn't changed and that sort of things. Analysis of the impact of alternative changes or alternative legislation on the budget. The Congressional Budget Office is essentially the keepers of…of the numbers of, for the Congress. They do for the Congress what the Office of Management and Budget and the Council of Economic Advisors do for the president.

Stasio: Rivlin says the budget-making process has changed a great deal over the last sixty-five years.

Rivlin: For much of the U.S. government's early history, budget-making was fairly casual and the president himself did not have very strong control over the federal budget. Individual agencies tended uh, at different times of the year to go to the Congress and say, "we need more money for this or that." And presidents understandably felt that they wanted to get control of the government budget. The…the main step in presidential control took place in nineteen twenty with the Budget Act that created the Bureau of the

Budget as it was then called, now called the Office of Management and Budget. And that gave the president a central mechanism for making a government budget and he insisted that the agencies come to him, to his office and say what they needed. And he would make the decisions about what was going to happen in terms of what Congress would be asked to spend for what and what the taxes would be. Over quite a long period the…the president's offices worked hard to improve the process of making the president's own budget proposal. And making uh, taking steps to get more information about what programs actually did to evaluate them. But meanwhile the process in the Congress was just as chaotic and fragmented as ever. In the…the early nineteen seventies for instance even after the president had gone through all this effort to make a budget that reflected his priorities, when it got to Capitol Hill it was almost literally shredded apart and considered in pieces by different committees. There was no overall process for looking at the federal budget. Spending Bills were voted on one at a time on different days and nobody had the ability to say, "are we spending too much on defense and not enough on health or vice versa?" Because those were considered on different days and the question never came up. And taxes were considered on different days so nobody ever asked the question. They asked it, but they didn't answer it. "Do we have enough revenues to pay for this expenditure?" So this was all pretty chaotic and it probably led to higher spending because if you are voting on an Appropriation Bill and you don't have to vote at the same time for the revenues, you may tend to vote for…for higher spending. It was all that that led to the creation in nineteen seventy-four of a new budget process on the Hill. The Budget Reform Act of nineteen seventy-four created a process by which the Congress could look at the budget as a whole. It created two new budget committees which had not existed before whose job was to put the conflicting claims on the budget together and to consider the president's budget as a whole and alternatives to it and bring a budget resolution to the floor that reflected an overall budget policy, not just the conflicting claims. That process has worked quite I think. Its main objective was to focus the attention of the Congress on the budget as a whole and make them vote on it. And they now do that. They have also discovered how hard that is and the difficulty of making a budget and getting a budget resolution has been extraordinary in the last few years. But the process has worked I think reasonably well in forcing the Congress to come to grips with the issue.

Stasio: Let's review some of the main points in this discussion about deficits. Budget deficits occur when the government spends more than it takes in. Deficits can help the economy out of a recession by increasing aggregate demand. However, if the economy is operating near full capacity, deficits can lead to inflation. The prevailing view about government spending before the Great Depression was that the government should balance its books at the end of each fiscal year. There are still some today who argue for that approach. And in fact there was a movement to call a constitutional convention to mandate a balanced federal budget. Alternatively some economists and policymakers feel that the budget should be balanced over the course of the business cycle. And some experts believe there is no need to balance the budget. Rather they argue that the budget should be used to counter the business cycle so that the government could operate with a deficit during a recession and a surplus near full capacity. Many deficits are caused by a slowdown in the economy. Recessions lower tax revenues and increase federal spending on relief programs. One way to adjust for the effects of a recession on the budget, is to formulate a full-employment budget. A full-employment budget shows how revenues and expenditures would balance if the economy were operating at full employment. There are two ways to finance the deficit. The government can borrow from firms and individuals. This tends to absorb savings and raise interest rates which can offset the expansionary effect of a deficit. The other way to finance the deficit is to borrow from the Federal Reserve that in effect print money. This adds new money to the economy and is more expansionary, but is also more inflationary than borrowing from private sources. The process for devising the national budget is long and complex and tries to reconcile many competing and conflicting priorities. There have been a number of reforms in both the Executive and Legislative Branches that have attempted to consolidate the process so the budget can be considered as a whole. Deficit spending was a bitter pill for policymakers during the Depression, but when it cured chronic unemployment, the experts were convinced that government spending was good medicine. However, with deficits in the mid-eighties running over two hundred billion dollars threatening to reduce productivity, the new lesson may be that medicine should be taken only as directed and only when needed.

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Stasio: You’ve been listening to Economics U$A, one of a series of programs on micro and macro economic principle. Our guest has been Alice Rivlin, Director of Economic Studies at the Brookings Institution and former head of the Congressional Budget Office. Economics U$A has been produced by the Educational Film Center in Annandale, Virginia. I’m Frank Stasio.

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