

ECONOMICS USA
Program #12
“Federal Deficits: Can We Live With Them?”

Learning Objectives

PURPOSE:

To show that deficits can be helpful or harmful, depending on the circumstances.

OBJECTIVES:

1. Deficits can rise not only because policy makers raise spending or lower taxes, but also when the economy is in a recession. During recessions unemployment benefits and welfare payments rise automatically while tax receipts drop. One way to separate the cyclical and structural components of the deficit is to estimate what the deficit would be if the economy were operating at full employment. This full-employment budget is a measure of the structural (or policy-induced) deficit.
2. In the short run, deficits can have two potentially damaging effects on the economy. First, if the economy is at full employment, a government deficit is inflationary, because the excess of government spending over government revenues adds to aggregate demand pressures in the economy. Second, to the extent that federal deficits raise interest rates, they can retard growth in investment and housing activities, which are interest-sensitive.
3. In the long run, deficits can be harmful if they add to the debt burden. Persistent deficits mean a rising national debt. If the national debt rises faster than GNP, then this can have serious negative ramifications for the future growth potential of the U.S. Moreover, if a large portion of the debt is held by other countries, then this means that foreigners have a large claim on U.S. resources.
4. Government budgets should not necessarily be balanced at all times. Specifically, in a recession, balancing the budget means cutting spending and/or raising taxes—both of which have a contractionary effect on GNP. Nevertheless, in the long run the structural deficit (as measured by the full-employment deficit, for example) should be close to zero.
5. It is important to distinguish between balancing the budget and reducing the size of the government. A large government can have a balanced budget while a small government can run a large deficit.

KEY ECONOMIC CONCEPTS:

full employment budget
annually balanced budget
cyclically balanced budget
public debt

fiscal drag and fiscal dividend
debt-to-GNP ratio
internal versus external debt
size of the deficit vs. size of the government

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Program Transcript
(Revised 2/25/03)

Annenberg/CPB Project (Logo and Music)

TEASER

ROOSEVELT:

"Our war program for the coming fiscal year will cost 56 billion dollars..."

DAVID SCHOUMACHER:

1945... By the war's end, the price tag will pass 200 billion dollars. How will we pay for World War II?

1960. As President Eisenhower talks of paying off the national debt, the economy stumbles into a recession. How can a budget surplus hurt the economy?

1999. Huge deficits turned to surplus. What would the Government do with the money?

OPEN OF ENTIRE PROGRAM – DS ON-CAMERA:

Almost every year the Federal Government spends more money than it takes in. Year after year the tide of red ink rolls on. Federal deficits. Can we live with them? We'll investigate that question with the help of economic analyst Richard Gill on this edition of Economics USA. I'm David Schoumacher.

(MUSIC PLAYS – OPENING TITLES)

(FEDERAL DEFICITS: Can We Live With Them? Appears on the screen)

PART I

DAVID SCHOUMACHER:

Most of us have been taught that to spend more money than we earn is to court financial disaster, but the federal government seems to play by a different set of rules. Almost every year the country runs a deficit. Yet we're told that deficit is necessary. Even beneficial. But deficits piled one on top of another create a growing national debt. And the interest payments on that debt add more dollars to the next year's deficit. During a five year span back in the 1940's, our national debt more than quadrupled as we fought World War II. How did we pay for that war? And why didn't it bankrupt us?

Early in the morning of September 1, 1939, German armies marched into Poland and the world exploded into war. By 1940, the Germans controlled Europe and were poised to attack Britain. A frightened American Congress appropriated 37 billion dollars for defense, more than the entire cost of World War I. How would the government raise these huge sums?

ROOSEVELT:

"That means taxes and bonds, and bonds and taxes..."

DAVID SCHOUMACHER:

Treasury official, Roy Blough, remembers.

ROY BLOUGH:

"The Treasury view, and I shared it, was you get as much out of taxes as you can, and up to 100%, and of course we never succeeded in doing that. You take the whole war period. The tax revenues for the war period were a little less than half of the total. The rest of it was borrowed."

DAVID SCHOUMACHER:

In England, economist John Maynard Keynes urged the American government to borrow from a pool of money created by a compulsory savings program. But a

group of young American economists had a better idea, as Richard Gilbert recalls.

RICHARD GILBERT:

"The group which I led proposed to finance the war through borrowing, in itself not different from the Keynesian proposal, but with a direct control of prices and wages to prevent the kind of inflation that had always been associated with war in the past; and to bring to full employment, as rapidly as possible, the enormous energies of the American public, once harnessed to the effort."

STEWARDESS:

"As an airplane worker, I ask all of you to help to support our armed forces by buying more war bonds and stamps. As our boys would say: "You buy 'em... we'll fly 'em."

INTERVIEWEE:

"This is a working man's country and I'm doing my part to keep it that way. Buy more bonds today."

DAVID SCHOUMACHER:

Fresh from a decade of hunger and deprivation, the American people cheerfully loaned dollars by the billions to their government. As the war intensified, the economy boomed. Fifteen million Americans went to war. 66 million more went to work. For the first time in ten years Americans had money to spend, but little to spend it on. Not only were luxuries unavailable, but such basics as housing were hard to come by.

GILBERT:

"Construction was limited except by license. The production of cars and other durables was totally eliminated for the war period. In other words, there could be no private investment other than that required for the war effort. And the result was that if the government had not borrowed these sums that were being

saved in the community and not invested, the result would have been not full employment, but another depression.

DAVID SCHOUMACHER:

Government tax revenues increased dramatically throughout the war, but government expenditures increased even more. By the war's end, the federal government had borrowed almost 200 billion dollars, 1/4 of it from private individuals, most of the rest from the banking system. The deficits were huge. The national debt quadrupled in only 4 years.

Dr. Blough, what would have happened if we had tried to pay, as we went, for World War II?

BLOUGH:

"I think it would have probably been rather harmful to the economy. I sometimes extravagantly said we would have lost the war. If we had tried to do it by pay-as-you-go, we would have had to impose very much more of a dictatorship on the community than we did have to."

DAVID SCHOUMACHER:

The end of the war found the country facing a huge national debt. Yet, somehow, the 260 billion dollars we owed in 1945 did not seem as terrifying as the 40 billion we'd owed in 1939. The nation was prosperous. As the economy grew, tax revenues increased and government expenses declined. And years later, as all those billions of dollars of World War II bonds came due, the government simply borrowed new money to pay the old obligation. The nation had gone deeply into debt to pay for the war. The debt never really went away. It just seemed to shrink in size compared to the total GNP. We asked economic analyst Richard Gill if this meant that we had passed on the cost of the war to future generations?

(MUSIC PLAYS—COMMENT & ANALYSIS I)

Economics USA Logo

RICHARD GILL:

The simple answer is no: the basic costs of World War II were borne by the generation that lived and worked during World War II. Look at it in terms of the old standbys, guns and butter. We start before the war with an economy that is producing only butter. That is, civilian goods. Now when the war comes, we have to divert some of our resources to gun production. The economic cost of the war is borne right then and there and is basically the amount of butter we have to give up because we are producing armaments.

The cost of the war in terms of lost butter production was minimal because we entered the war from the Great Depression, with enormous unused capacity and unemployment in the economy. To a great degree, we were able to add gun production onto our previous butter production by simply employing these unused resources. In one basic way, the war did impose direct costs on the next generation.

Our civilian production is composed not only of consumption goods, like butter, but also investment goods: factories, machines and the like, to increase future production. Insofar as the war replaced investment (I) with guns (G), we left a smaller productive capacity to the next generation. But what about the interest payments on the debt? Aren't these a cost to future generations? They are, and we'll indicate how later on. For the moment, we should bear in mind that because of the enormous growth of the American economy in the decades following the war, federal interest payments as a percentage of our GNP remained low, around 1-1/2%. And this percentage was actually falling from 1946 to the mid 1960's.

It was for this reason that most of the economists of the time took the line: "The national debt? No problem! Our growing economy will take care of it!"

PART II

DAVID SCHOUMACHER:

1960 would be President Eisenhower's last year in office. He had just run the biggest peacetime deficit in U.S. history, a result of the recession of 1958. He promised the American people a budget surplus in 1960, and on that rock the presidential aspirations of Richard Nixon would soon founder. What could possibly be wrong with a budget surplus?

The prosperity that began with the end of World War II continued through the Eisenhower years with only minor interruption. But 1958 seemed to be a sharp step backwards, the deepest recession since the 1930's. The government pumped money into the economy to stimulate a quick recovery, spending on such projects as the Interstate Highways Program. This spending during a recession was called a counter-cyclical policy, and it worked. By 1959 the economy was improving.

President Eisenhower wanted to leave office with a balanced budget, so he began to push hard for a surplus in 1960. But Vice-President Nixon was running for president that year. He wanted a growing economy, so he argued for a deficit. Many economists agreed with Nixon, but Ike stuck to his guns. His Chairman of the Council of Economic Advisors, Raymond Saulnier, remembers the pressure.

SAULNIER:

"You don't have any problem with how much money is going to be spent. You are surrounded by people prepared, at the drop of a hat, to spend untold amounts of money. That's never a problem. What the problem is, to raise the funds to meet that. So, if we were pushing hard in 1960, and my recollection is that we were, we were pushing hard to reach this equivalence of income and outgo."

DAVID SCHOUMACHER:

Many of his advisors thought Eisenhower did not have time to oversee a complete recovery from the recession of 1958, that his drive for a budget surplus was premature. They urged him to continue spending to fuel the recovery. 1960 was Ike's last year in office. Perhaps he thought inflation was a more serious threat than unemployment. But, as the economy stalled, the President did not seem worried.

STEIN:

"1960, he was leaving office, he was not running again. The pains of the recession that we were having in 1960 were not so evident to him as the pains of the 1954 recession had been. They were pretty evident to Mr. Nixon, who was running, and he was very unhappy about the situation."

SAULNIER:

"We didn't expect that the next president was going to be John Kennedy. The next president was going to be Richard Nixon. I think that was pretty generally the expectation in the Republican family. It certainly was my expectation. So Eisenhower went out in that message with a strategy that left tax-reduction for the next president."

DAVID SCHOUMACHER:

Nixon urged Eisenhower to stimulate the economy with an immediate tax cut. Ike declined. By mid-summer the economy had ground to a halt well short of full-employment. The budget surplus was holding money out of the economy and costing workers their jobs. While John Kennedy campaigned on a promise to get the country moving again, Richard Nixon was forced to publicly support a policy he privately opposed. The country hit bottom just two weeks before the election. For Nixon, the damage had been done.

NIXON:

"If the present trend continues, Mr. Kennedy, Senator Kennedy, will be the next President of the United States."

DAVID SCHOUMACHER:

Kennedy won with a margin so narrow that people still argue over what tipped the balance. But Nixon had no doubt. He blamed the Recession of 1960 for costing him the election. Historians still argue over the significance of the Recession of 1960, but economists at the time were convinced that the budget surplus cost the economy jobs and growth by keeping dollars in the hands of the government rather than consumers. Had Eisenhower been willing to end his presidency with a deficit, he might have presented his successor with more growth and the prospect of even larger surpluses in the future. We asked economic analyst Richard Gill to explain why economists might be opposed to budget surpluses.

(MUSIC PLAYS—COMMENT & ANALYSIS II)

Economics U\$A Logo

RICHARD GILL:

I've already pointed out that the federal interest payments and the national debt itself were falling all through the 1950's as a percentage of our national income. Thus there seemed no urgent reason to try for a budget surplus at this time. More significantly, the predominant Keynesian view of the time said that the government ought to pursue a counter-cyclical policy. This would involve budget deficits in bad times to expand the economy, and budget surpluses in good times to keep things in check.

Suppose the economy is experiencing a business cycle, and GNP is going up and then down. What the government ought to do, most economists in 1960 were saying, is follow this course: Budget deficits during the recessions; budget

surpluses during the booms. The idea was that this would lead to a much smoother path, so smooth in fact that many economists began asking the question: "Is the business cycle a thing of the past?"... a question, sadly, which proved to be a big premature, as, indeed, did our complacency about the national debt.

BILL CLINTON ADDRESSING CONGRESS IN HIS 1999 STATE OF THE UNION ADDRESS:

“For the first time in three decades, the budget is balanced. From a deficit of \$290 billion in 1992, we had a surplus of \$70 billion last year AND NOW we are on course for budget surpluses for the next 25 years.”

DAVID SCHOUMACHER ON-CAMERA:

President Clinton’s State of the Union message in 1999 was heady stuff. It wasn’t often in the Nation’s history that we had a surplus. Much of the time the Country had been run with deficit spending and it became particularly dramatic in the Reagan Presidency.

CHARLES SCHULTZ ON-CAMERA:

In the 1980's we began to get a different kind of deficit. President Reagan came into office in 1981 having campaigned under promise of a huge tax cut and not only did he get it but the Congress even beefed it up and made it larger than the big one he proposed.

DS VOICE-OVER:

But in one area the Reagan Administration was calling not for less spending but more. A trillion dollars in higher defense spending and 750 billion dollars in tax cuts proved to be an explosive combination... and the deficit shot up. Over 100 billion dollars for the first time in 1982... Over 200 billion dollars in 1985.

RUDOLPH PENNER ON-CAMERA:

That in combination with a very deep recession just caused the deficit to explode and the debt began to grow much faster than our incomes and ultimately reached about 50% of our incomes by the early 1990's.

CLINTON ADDRESSING CROWD:

We must have a new economic policy; no more trickle-down, not tax and spend, but put the American people first, invest in our jobs, control our health care costs, provide education to all of our people, and we can be the greatest country in the world forever.

**STOCK FOOTAGE PROSPEROUS ECONOMY & BOOMING STOCK MARKET.
DS VOICE-OVER:**

President Clinton's campaign mantra was "It's the economy stupid." By the late 1990's that idea started to pay off. A combination of factors accounted not only for reducing the deficit but actually creating budget surpluses. Cuts in spending including defense help, but the overwhelming reasons were a booming economy and a huge run up in the stock market. Capital gains, pension fund withdrawals, huge bonuses on Wall Street... All taxable and pouring into Government coffers.

DS ON-CAMERA:

After many years of wrangling over how to slash the huge deficit—increase taxes or cut spending—the debate shifted. The whole country weighed in on how to spend the surplus, including the presidential candidates of 2000.

**EXCERPT FROM THE OCTOBER 4, 2000 PRESIDENTIAL DEBATE BETWEEN
VICE-PRESIDENT AL GORE AND GOVERNOR BUSH:**

MR. GORE: "...I believe it's important to resist the temptation to squander our surplus. If we make the right choices, we can have a prosperity that endures and enriches all of our people..."

MR. BUSH: "...My opponent thinks the surplus is the government's money. That's not what I think. I think it's the hard-working people in America's money and I want to share some of that money with you."

RUDOLPH PENNER ON-CAMERA:

One of the things you can do with a surplus is to pay down the national debt. Now, I would have liked to have seen the debt go down a little bit more than it actually did but I also believe that it's possible to pay off too much of the debt.

DS VOICE-OVER:

Debt actually serves a useful purpose. It provides a very safe investment for ordinary citizens who buy Government bonds. And international investors find it attractive to buy our national debt. Some economists regard it as our best export product. It is also used by the Federal Reserve Board to operate monetary policy by controlling the money supply either by buying or selling Government debt.

RUDOLPH PENNER V.O & ON-CAMERA:

When there was some prospect that we'd actually pay down the debt to very low levels the Federal Reserve actually got quite worried and wondered how they would run monetary policy. Now they can run it in ways different than buying or selling the debt, but almost all those ways are undesirable.

CHARLES SCHULTZ ON-CAMERA:

Well the real problem with the budget deficit usually isn't that it's a crisis. It's not a wolf at the door; it's termites in the basement. If I had to think about budget deficits and what they mean and what I've thought about them over the years, I have to say I've changed my mind. Initially, like most people, I tended to think of budget deficits, again, budget deficits outside of times of recession, when they are good. Budget deficits in normal times, people tend to think about as something that will blow us into inflation: the government spends too much,

takes in too little revenues, there's too much demand chasing too few goods, you get a big inflation. Well, it turns out it's not normally what happens because if the Federal Reserve Board does its' thing right as you tend to get into inflation, if you should because of a big budget deficit, it'll tighten up interest rates. And it's been doing that off and on over the years. Tighten up interest rates and it won't let the government blow us into deficit; blow us into inflation. But what the budget deficit does is that it represents borrowing by the federal government, which taps private saving and means money that could have gone to finance private investment is not, it's going to finance the budget deficit and that hurts the productive growth in the economy, cause we're not getting enough investment. And that's a little drip, drip, drip, drip that wears away our long-term economic growth. And so, no longer do I particularly worry about budget deficits as something that blows us into inflation, but it's something that hurts our growth.

DS VOICE-OVER:

As the 90's proceeded and went into the new century, budget projections were more and more optimistic so people began to think they could have it all. They could save money to help finance social security in the future. They could have a big tax cut, they could spend liberally on things like education and medical research and highways.

STOCK FOOTAGE BUSH VICTORY CROWDS. DS VOICE-OVER:

When George W. Bush won the Presidency, he too believed we could have it all... so he started with a big tax cut.

STOCK FOOTAGE BUSH SPEAKS, SIGNS TAX BILL:

Across the board tax relief does not happen often in Washington, D.C. In fact, since World War II, it has happened only twice. President Kennedy's tax cut in the sixties and President Reagan's tax cuts in the 1980's. And now it's happening for the third time...and it's about time.

BUSH SHAKES HANDS & SIGNS TAX BILL. DS VOICE-OVER:

But was it about time or was history about to repeat itself?

TERRORIST ATTACKS ON THE WORLD TRADE CENTER AND THE PENTAGON. DS VOICE-OVER:

Terror attacks on the United States in 2001 caused the Bush Presidency to respond with increased homeland security and a war on terrorism starting with the invasion of Afghanistan. Defense spending rose accordingly.

CHARLES SCHULTZ ON-CAMERA:

Budget surpluses that had been projected, assumed continuing growth in the stock market, people sold stocks, get capital, gains, have to pay the government taxes on the capital gains. All of a sudden the stock market collapses and that disappears, so tax cut, increase defense and homeland security and an economy which began to go into a recession, not a big one but a minor one and finally the collapse of the stock market, all combined to take what had been projected as big surpluses and turn them into what are now turning into being actual deficits and at least a lot of people are projecting them out into the future for some time.

DS ON-CAMERA:

After a few all-too-short years, suddenly the surplus was no more. Has the dream of surplus and balanced budgets gone forever? We put that question to economic analyst Nariman Behravesesh.

BEHRAVESH O.C.:

After almost two decades of wrangling over how to distribute the pain of cutting deficits – either by raising taxes or slashing spending ...

BAHRAVESH V.O.:

...from 1998 to 2001, the U.S. government was faced with the theoretically easier choice of what to do with a large – and for a while – growing... surplus – as you can see in the graph.

In reality, the arguments over how to spend the surplus were at least as contentious as debates about how to cut the deficit. In fact this topic was one of the main themes of the very close and contested presidential election of 2000.

There are three basic choices about a budget surplus: (1) spend the money on education, health care, defense and other federal programs; (2) give the surplus back to the taxpayers in the form of tax cuts; or (3) pay down the national debt and, in effect, use the surplus to replenish the trust funds of the Social Security system.

BAHRAVESH O.C.:

In the end, the “great surplus of the millennium” disappeared and the red ink started to flow again for a complex set of reasons. First, the Bush administration, with the approval of Congress, put in place a large multi-year tax cut. Second, after the terrorist attacks of September 11, 2001, federal spending on homeland security and the war against terror increased dramatically. Last but not least, 2001 was a recession year and recessions have a way of making surpluses evaporate.

Are we doomed to another couple of decades of deficits? Probably not, but the temptation to spend surpluses is usually too great to resist. By 2002 the federal budget was back in deficit and most “official” projections did not show a balanced budget – let alone a surplus – until the end of the decade.

DS ON-CAMERA SUMMARY:

In 1981 President Reagan described the national debt as a stack of dollar bills sixty-seven miles high. Since then we've seen stacks considerably higher. And we've used a good part of our annual budget to pay off the IOU's on previous years and to continue accumulating debt. But not all deficits are bad. The increased deficit helped offset the effects of the recession that got underway in 2001. So, were the deficits hurting us? Not always. Had we learned to like deficits? No. But could we live with them? We learned to. For Economics USA, I'm David Schoumacher.

CLOSING MUSIC

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