To Balance or not to Balance: The Federal Budget Deficit

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For every buyer there must be a seller, and for every lender a borrower. One man’s expenditure is another’s receipt. My debts are your asset, my deficit your surplus.

Today, the United States is faced with a national debt of over $4 trillion that continues to grow in astronomical proportions. Under present circumstances, are large deficits detrimental to our economic prosperity as the current consensus seems to indicate, or are they really the public’s surplus? Many consider yearly federal deficits harmful to our economic prosperity. Indeed some Americans believe that the U.S. government requires legislation to balance the budget annually. This article explores this conventional view, along with the less popular idea that deficits really do not matter. It will begin with explanation of the federal budget deficit, followed by an analysis of the two conflicting views on budget deficits. The essay will demonstrate that the United States does not need balanced budget legislation, whether ordinary legislation or a more radical amendment to the Constitution.

THE FEDERAL BUDGET DEFICIT
Put simply, the federal budget deficit arises when federal government expenditures exceed federal government receipts. These annual budget deficits add up to produce the national debt, or gross federal budget deficit. Table One below displays the budget deficits and the national debt for the past thirteen years.

Table One indicates that the trend of increasing deficits seemed to reverse briefly from 1987 to 1989 after a high of $221.2 billion in 1986. After the short reduction in government deficits in the late 1980s, however, the federal budget deficit again reached a record high of $290.2 billion in 1992. This

<table>
<thead>
<tr>
<th>YEAR</th>
<th>RECEIPTS</th>
<th>EXPENDITURE</th>
<th>SURPLUS OR DEFICIT ((-))</th>
<th>NATIONAL DEBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>517.1</td>
<td>590.9</td>
<td>-73.8</td>
<td>908.5</td>
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<tr>
<td>1981</td>
<td>599.3</td>
<td>678.3</td>
<td>-79.0</td>
<td>994.3</td>
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<td>1982</td>
<td>617.8</td>
<td>745.8</td>
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<tr>
<td>1983</td>
<td>600.6</td>
<td>808.4</td>
<td>-207.8</td>
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<td>1984</td>
<td>666.5</td>
<td>851.9</td>
<td>-158.4</td>
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<td>1985</td>
<td>734.1</td>
<td>946.4</td>
<td>-212.3</td>
<td>1,817.0</td>
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<td>1986</td>
<td>769.1</td>
<td>990.3</td>
<td>-221.2</td>
<td>2,120.1</td>
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<tr>
<td>1987</td>
<td>854.1</td>
<td>1,003.9</td>
<td>-149.8</td>
<td>2,245.6</td>
</tr>
<tr>
<td>1988</td>
<td>909.0</td>
<td>1,064.2</td>
<td>-155.2</td>
<td>2,600.8</td>
</tr>
<tr>
<td>1989</td>
<td>990.7</td>
<td>1,144.2</td>
<td>-153.5</td>
<td>2,867.5</td>
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<tr>
<td>1990</td>
<td>1,031.3</td>
<td>1,251.8</td>
<td>-220.5</td>
<td>3,206.3</td>
</tr>
<tr>
<td>1991</td>
<td>1,054.3</td>
<td>1,323.0</td>
<td>-267.7</td>
<td>3,599.0</td>
</tr>
<tr>
<td>1992</td>
<td>1,091.6</td>
<td>1,381.8</td>
<td>-290.2</td>
<td>4,002.7</td>
</tr>
<tr>
<td>1993*</td>
<td>1,147.6</td>
<td>1,474.9</td>
<td>-327.3</td>
<td>4,410.5*</td>
</tr>
</tbody>
</table>

*ESTIMATED

SOURCE: DEPT. OF COMMERCE, DEPT. OF TREASURY, OFFICE OF MANAGEMENT AND BUDGET.

Deficit led to an accumulated debt of over $4 trillion that is expected to rise. Of total annual government spending, half is generally composed of transfer payments (social security, welfare, unemployment compensation, etc.). One-third goes for government purchases of goods and services, and the other major category is interest on the national debt (Economic Rep. of Pres. 1991, p. 45). Interest on the national debt is one of the greatest concerns regarding the accumulating annual deficits. In 1991, this interest stood at $194,541 million. This expenditure was third only to national defense and social security (Economic Rep. of Pres. 1992, p. 387).

How does the government finance such large expenditures each fiscal year? For the most part, these transactions are funded through taxation of the public and through borrowing by selling government bonds. In the past sixty years, however, tax receipts have not been sufficient to cover our national government’s spending habits. In fact, since 1931 the government has managed a surplus of receipts over expenditures only seven times (Fink 1987, p. xiii).

THE CONVENTIONAL VIEW
Deficits and Interest Rates

Incurring large deficits is believed to create many economic maladies. The most often noted is the deficit’s effect on the interest rate. As Daniel Thornton points out, “In the conventional view, increases in the deficit cause the interest rate to rise” (1990, p. 26). Thornton explains that this rise is a consequence of the government’s increased demand for credit to finance its spending. When this demand for credit rises relative to the supply, the
interest rate automatically rises due to market forces. Higher interest rates, in turn, increase the cost of investment throughout the economy and essentially "crowd out" private investment. The lower level of business investment in machinery and equipment will then tend to decrease productivity and reduce future growth in the economy. Housing investment, which is important in maintaining a robust economy, will also stagnate (Fink 1987, p. 260).

Since budget deficits and high interest rates presumably reduce the level of capital formation and economic growth, future generations may experience a lower standard of living than citizens today (Eisner 1986, p. 90). In addition, future taxpayers would be burdened unjustly with mounting interest payments on the debt and the principal itself (Blinder 1991, p. 219). The fear is our children and grandchildren will be forced to endure high tax rates to pay this increasing interest.

**Deficits and National Saving**

According to the conventional view, besides raising the interest rate, deficits also reduce national saving. National saving (NS) consists of government saving (GS) and private saving (PS). Private saving includes the saving of households and businesses (Gramlich 1991, p. 173). If government expenditures exceed revenues, then government saving is negative. On the other hand, if revenues are greater than expenditures, GS will be positive. It follows from the definition of national saving that government deficits (negative government saving) will decrease national saving if not offset by an equal increase in private saving. This loss of national saving will reduce private investment in that there will be a reduction of available funds for that purpose. Again, the loss in investment will lessen the amount of capital formation and deter economic growth in the long run.

**Deficits and the Trade Balance**

Another frequently cited dilemma blamed on budget deficits extends across national boundaries into the arena of international trade. If it is true that high budget deficits create higher interest rates, then foreign investors will be induced to buy U.S. securities, such as bonds, because they will receive a high return on their investment. Before foreign countries can purchase U.S. securities, however, they must first exchange their currency for U.S. dollars. This increased demand for U.S. currency will increase the value of the dollar in comparison to the currencies of foreign nations (Froyen 1990, p. 543). A higher valued dollar, in turn, will cause U.S. goods to be more expensive relative to the price of foreign goods. Thus, it becomes cheaper for Americans to purchase foreign products. This leads directly to an excess of U.S. imports over exports thereby contributing to the large trade deficit.
The preceding assertions appear to be compelling. However, they may, in fact, be inaccurate. Those questioning the conventional view make the following arguments.

**THE UNCONVENTIONAL VIEW: DEFICITS DO NOT MATTER**

*Deficits and Interest Rates*

The connection between the deficit and higher interest rates is questionable. According to Richard Fink, empirical evidence does not indicate a strong link between U.S. interest rates and the level of the federal deficit. U.S. real and nominal interest rates have actually fallen in recent years, while the deficit has sky-rocketed (1987, p. 163). Table Two below compares the prime interest rate and the discount rate to the federal budget deficit. According to these statistics, in the ten years from 1981 to 1991, the prime rate dropped from 18.87 percent to 8.46 percent, a change of more than 55 percent. The budget deficits, on the other hand, rose by more than 200 percent.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>PRIME RATE (%)</th>
<th>DISCOUNT RATE (%)</th>
<th>BUDGET DEFICIT ($ BILLIONS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>18.87</td>
<td>13.42</td>
<td>-58.8</td>
</tr>
<tr>
<td>1982</td>
<td>14.86</td>
<td>11.92</td>
<td>-125.5</td>
</tr>
<tr>
<td>1983</td>
<td>10.79</td>
<td>8.50</td>
<td>-180.1</td>
</tr>
<tr>
<td>1984</td>
<td>12.04</td>
<td>8.80</td>
<td>-169.9</td>
</tr>
<tr>
<td>1985</td>
<td>9.93</td>
<td>7.69</td>
<td>-181.4</td>
</tr>
<tr>
<td>1986</td>
<td>8.33</td>
<td>6.33</td>
<td>-201.0</td>
</tr>
<tr>
<td>1987</td>
<td>8.21</td>
<td>5.66</td>
<td>-151.8</td>
</tr>
<tr>
<td>1988</td>
<td>9.32</td>
<td>6.20</td>
<td>-136.6</td>
</tr>
<tr>
<td>1989</td>
<td>10.87</td>
<td>6.93</td>
<td>-124.2</td>
</tr>
<tr>
<td>1990</td>
<td>10.01</td>
<td>6.98</td>
<td>-165.3</td>
</tr>
<tr>
<td>1991</td>
<td>8.46</td>
<td>5.45</td>
<td>-200.7*</td>
</tr>
</tbody>
</table>


The theoretical connection between deficits and high interest rates, which is also debatable, is included in the following discussion.

*Deficits and Savings*

According to the unconventional view, there are several reasons why an increase in the federal deficit may not reduce national saving. First, deficit spending in the short run will increase the Gross National Product (GNP) and therefore private saving, since private saving varies directly with the level of GNP. The increase in private saving will then offset the fall in government saving, resulting in no change or a net increase in national saving (rather than a decrease). If investment is stimulated by the growth in income and not
offset by higher interest rates, then net investment would also rise instead of fall (Gramlich 1991, p. 175).

According to Robert Eisner, author of *How Real is the Federal Deficit?*, higher interest rates and a crowding out effect could occur in a full-employment economy, but since the U.S. has not experienced full employment over the last thirty years, the *stimulus* of deficits on investment is actually more dominant. Eisner states, “Deficits actually prove positively associated with private investment, and we have ‘crowding in’ rather than crowding out” (1986, p. 7). Crowding in results from government spending on goods and services that is partially financed through private credit markets. This deficit spending increases demand and stimulates capital investment to produce the goods and services necessary to meet that demand (Savage 1988, p. 35).

The Ricardo/Barro equivalence view provides a second reason government deficits may not reduce national saving. This theory asserts that, in fact, private saving actually increases with rising deficits. According to Ricardo/Barro, people anticipate a rise in future taxes to finance the deficit. Thus, American consumers will tend to set aside funds to pay their future tax liability, in turn increasing private saving in the present (Thornton 1990, p. 29). Any increase in the demand for credit because of deficit spending will then be matched by an induced increase in the supply of credit due to increased private saving. Consequently, there should be no effect on national saving or on interest rates.

The Ricardo/Barro equivalence theorem concludes that the budget deficit really does not matter at all. Thornton points out that according to Ricardo/Barro, deficit spending cannot be blamed for high real interest rates or the large trade deficit. Nor does it have any effect on economic growth or inflation (1990, p. 25). Any increase in aggregate demand that may arise from deficit spending will be offset by a decrease in aggregate demand due to the increase in private saving (decrease in spending).

In addition, when the federal government sells bonds and other securities to the public to finance its spending, the bondholders are accumulating wealth. They will be able to exchange their bonds for cash later on, plus collect interest on their value. Approximately 80% of the money our government borrows to finance spending is owed to our own public (Savage 1988, p. 40). It follows that debt owed to our own citizenry is a benefit and serves as a form of saving. The national debt may be seen as a detriment to the government and taxpayers; on the other hand, it is wealth to those who own it (Eisner 1986, p. 5).

However, despite the prediction of the Ricardo/Barro equivalence theorem that private saving will increase as deficits increase, empirical evidence suggests that personal saving has decreased in recent years. George
Hatsopoulos, Paul Krugman, and James Poterba point to four reasons why personal saving has plunged in recent years (“America’s Wasting Disease” 1988, p. 35). They state that more than a third of this reduction in saving is due to the more rapid rise in personal disposable income than in national income, and the fact that this increased income is indeed being spent. The higher level of personal disposable income is due to higher interest rates increasing interest income. The fact that the 1946-1964 baby boomers have reached a high spending age could account for another one-fourth of the personal savings decline. Hatsopoulos and company blame another one-sixth of the reduction in personal saving on the stock market boom. This boom increased stockholders’ paper wealth which, in turn, increased their willingness to spend out of current income. Finally, the authors link the recent wave of takeovers and buy-outs to increased personal consumption and a decrease in personal saving. As a result of takeovers, shareholders “cash in” their stock holdings for cash. Consumers are more likely to spend this cash, regardless of their net worth. Thus, consumption spending is increased and personal saving decreased. The researchers call this “cash for equity” and blame it for another one-sixth of the drop in personal saving.

Deficits and the Trade Balance

The link between interest rates and the value of the dollar (which supposedly results in trade deficits) is also disputable. In fact, the strong value of the dollar can be linked to substantial growth in the U.S. economy during the 1980s resulting in increased U.S. imports. The slower rate of recovery in the rest of the world following the worldwide recession of the early 1980s made it impossible for recovering countries to afford American products. This caused a decrease in U.S. exports and led to the enormous trade deficit that we are experiencing (Fink 1987, p. 168). Another reason to question the link between interest rates and the strong dollar is actual statistics. One might query why the value of the dollar was low in 1975, despite that year’s huge deficit. In fact, the value of the dollar in 1975 was lower than during the 1960s and early 1970s even though both periods experienced deficits (p. 169).

While the unconventional view suggests that current budget deficits do not produce serious effects on the economy, the consensus asserts that federal deficits are a problem. This consensus view has spurred our lawmakers to initiate several programs aimed at balancing the budget.

PROPOSALS TO BALANCE THE BUDGET

The Gramm-Rudman-Hollings Act of 1985 and the Omnibus Reconciliation Act of 1990 are two examples of failed attempts at balancing our federal budget. The Gramm-Rudman-Hollings Act was created 1) to keep government
spending below U.S. budget deficit forecasts through deficit ceilings and 2) actually to balance the budget by fiscal year 1991. Its primary aim was to reduce the size of the deficit each year until a balanced budget was reached. The law called for across-the-board spending cuts from defense and domestic programs if the administration and Congress did not meet or fall within $10 billion of the deficit forecasts (Lynch 1991, p. 44).

These stipulations, however, faced problems almost immediately. For example, the policy of cutting program expenditures was met with the fact that approximately 43 percent of those programs were exempt from potential cuts. Social Security, Medicaid, and welfare are examples of programs with such exemptions. Setting the budget targets also caused a dilemma for Gramm-Rudman-Hollings. The statute identified what was to be projected and the sources of data to be used, but it never specified the forecast method to be employed. This created conflict between the executive and legislative branches as Congress tried to gain more direct control over the execution phase of the budgetary process (Lynch 1991, p. 112).

A multitude of political shenanigans by federal bureaucrats contributed to the failure of Gramm-Rudman-Hollings. Such budget-accounting tricks as moving pay dates forward or back to fit into whichever fiscal year was appropriate were common. Politicians also put programs on-budget when it seemed advantageous and off-budget when it did not. Legally, a program is off-budget when it is not under the fiscal control of Congress. When a program is reported off-budget, it is not included in that year’s budget. However, Congress has used this law to alter the level of the budget deficit. For example, the Post Office was on-budget in years when it showed a surplus and off-budget when it showed a deficit (“For My Next Trick” 1989, p. 17).

Congress even found ways for employers to pay the cost of programs the government could no longer afford under spending ceilings. Social programs previously funded by the government were made the responsibility of the private sector. Perhaps the worst problem associated with Gramm-Rudman-Hollings was not the making of wrong decisions but the habit of making no decisions at all (“For My Next Trick” 1989, p. 18). With the budget amendment, the already difficult task of political decision-making was only worsened. Needless to say, Gramm-Rudman-Hollings was not a success. The government has surpassed the target date and budget deficits continue to occur.

The Omnibus Reconciliation Act passed in 1990 was the most comprehensive deficit reduction package in U.S. history. This Act was designed to reduce the federal deficit by a half trillion dollars by 1995. Omnibus contains such enforcement mechanisms as using caps on spending and “pay-as-you-go” rules to prevent new legislation from increasing the budget deficit.
With the caps, any spending increases must be offset by spending cuts to stay within the cap. Also, deficit targets under this law are adjusted for changes in economic conditions, permitting automatic stabilizers to work more effectively (Econ. Rep. of Pres. 1991, pp. 26–27). In 1992, however, the deficit reached record highs and is expected to continue to be difficult to control.

The failure of Gramm-Rudman-Hollings and Omnibus is a discouragement to future legislation. There are, however, other objections to balanced budget legislation as well. The need for great flexibility in the U.S. economy is a crucial factor in the argument against legislation for annually balanced budgets. The U.S. has continually prided itself on the fact that it is an open economy which avoids regulation that may hinder economic growth. Any government regulation tends to reduce economic flexibility which is necessary to attract investment and spending. To sacrifice this ideology would lead to discouragement within the economy. Thus, regulation should be given a very limited role (Econ. Rep. of Pres. 1991, p. 26).

The dilemma of choosing where to cut expenditures is further increased when regulation on spending is adopted. How can politicians feasibly decide which programs to slash, which to keep, and which to add? Program expenditures that have been in the budget for years and are beneficial to the public may actually have to be done away with. New programs that promise favorable outcomes would have to be turned down because of the budgetary limits. Freeze has noted that, “The reverence for old programs has caused all deficit-relief pressures to fall on new programs” (1991, p. 46). Instead of moving ahead and expanding, our country is likely to remain stagnant under balanced budget legislation.

For those who believe that all previous expenditures are necessary along with new programs, raising taxes seems to be the only answer. The American public, on the other hand, tends to become hostile when faced with the idea of any new taxes. Time and again Americans who are polled say deficits are bad; they say balance the budget, but don’t cut any of my programs and don’t raise my taxes (Freeze 1991, p. 27). This makes politicians’ jobs even more difficult when faced both with budget restraints and an uncooperative public.

WHAT IS THE SOLUTION?

In light of the foregoing discussion: should we or should we not balance the budget? It seems unreasonable to expect that legislation to balance the budget annually would be healthy for our economy. The unconventional view raises enough doubts regarding current “conventional wisdom” that the issue requires careful reexamination. While there are many adamant supporters for and against balanced budget legislation, the final solution will most likely be found in gradual reductions in spending and, inevitably, higher taxes. It is
unrealistic to believe the government can try to balance the budget without cutting expenditures on programs to which many have become both accustomed and dependent. Obviously, any such amendment is never going to produce much reduction in the deficit faced with such circumstances. The budget deficit has been around for the last thirty years and in that time the U.S. has grown to be one of the most productive, prosperous nations in the world and one upon which many other nations depend. We must take this into consideration when making a decision that could permanently injure all that our country has accomplished.

REFERENCES


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