The Heritage Foundation Backgrounder

No. 330 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

January 27, 1984

UNDERSTANDING THE FEDERAL DEFICIT PART 3: THE UNPROVEN IMPACT

INTRODUCTION

Some economists decry deficits as a cancer on the economy. Others say they do not matter much. No wonder the public is confused. Yet the truth of the matter is that, for all the outcry over budget deficits, economists still cannot demonstrate convincingly that government borrowing, as such, has a damaging impact on the domestic economy.* Study after study shows little or no connection between deficits and high interest rates. Even studies by Council of Economic Advisors chairman Martin Feldstein and Council senior staff economist Jeffrey Frankel show no link--in stark contrast to Feldstein's assertions before congressional committees.

Advocates of major new tax increases link practically every economic problem to deficits, including inflation and high interest rates. Despite record high deficits, however, cracks have yet to appear in the foundation of the U.S. economic recovery. History, in fact, contradicts much of the conventional wisdom on deficits. For three years, economists have predicted cataclysmic consequences from budget deficits, but the record has proved them wrong:

--In 1981 many economists opposed the Reagan tax cuts because they believed that larger government deficits would set off a surge of inflation. The percentage increase in inflation during the past two years, however, has been no higher than during the first six months of 1980, when budget deficits were one-third of their current level.

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* This study is the third of a four-part series examining the nature and effects of the federal deficit. Part I explored the problem of forecasting the deficit; Part II analyzed the components of the deficit; and Part IV will explore the trade impacts of the deficit.

--Many economists then cautioned that the economy could not recover unless interest rates were brought down by cutting the budget deficits that allegedly sustained them. Despite higher 1982 budget deficits, and to the astonishment of the deficit watchers, the economic recovery took off rapidly, and interest rates halved.

--The commonly heard charge now is that budget deficits in 1984 and beyond will "crowd out" private sector investment and saving and bring a quick end to the recovery. But after more than one year of exceptionally strong economic growth, there are many signs that this prediction is likely to be as inaccurate as its gloomy predecessors. Government borrowing is not crowding out investment and is not likely to abort the recovery for some very solid reasons:

1) Interest rate-sensitive sectors of the economy are booming. Auto sales are up 18 percent from 1982; housing starts nearly doubled from the recession low; and sales of consumer durables jumped 13 percent in the first three quarters of 1983.

2) Capital spending on plant and equipment--which many asserted would suffer as government borrowing crowded out the capital markets--is surging ahead at twice the pace of the average postwar recovery. The Commerce Department reported on January 12, 1984, that investment, adjusted for inflation, will rise 9.4 percent in 1984--much faster than anyone had previously estimated.

3) An influx of foreign capital is expanding the savings pool, providing more funds for business and government borrowing.

4) Corporate profits--up 15 percent in 1983--are expected to jump another 25 percent this year. This healthy high profit rate allows firms to finance investment in plant and equipment with their own cash, without dipping as much into credit markets. With only moderate private sector credit demand, Washington is much less likely to crowd out businesses from the credit markets when it finances the national debt.

5) Businesses have found the stock market a rich source of new capital. The popularity of new stock issues has helped alleviate the pressure of government borrowing in the debt markets. Corporations raised $97.3 billion in securities markets in 1983, up 54 percent from the year before. Common stock financing was the fastest growing source of funds in 1983, reaching $36.7 billion--more than double the $14 billion 1982 figure.

6) State and local government surpluses are expected to swell to $52 billion in 1984. These surpluses--which often are invested directly in Treasury debt as required by law--will offset about one-quarter of the currently projected federal deficit.

7) Liberalized depreciation rules will generate $46 billion more in depreciation charges in 1984 than the actual value of physical deterioration in corporate plant and equipment, according to Kenneth T. Mayland of First Pennsylvania Bank. Combined with higher retained earnings, corporate cash flow for new capital investment could reach $347 billion--more than enough, claims Mayland, to pay for the projected expenditures. These figures suggest that business largely will finance its investment internally, avoiding collision between government borrowing and business's financing needs. Lawrence Horan, of Smith Barney, Harris Upham & Co., has adjusted the public sector's borrowing needs to account for the improved business cash position. Correcting the deficit for the swapping of public for private borrowing, Horan concludes that the public deficit will represent only 1.6 percent of U.S. GNP in 1984, compared with 2.1 percent in 1976, the second year of the last major recovery.

In short, twelve-digit deficits have not exacted the enormous economic costs which many economists predicted. To their credit, a substantial group of private economists and economists within the U.S. Department of Treasury never did believe that the budget deficits were the main cause of high interest rates, inflation, or crowding out. Supported by a growing body of economic literature and research, these experts have argued that government spending, not deficits, ultimately is the cause of high interest rates and pressure on private sector resources.

These economists marshal persuasive evidence that the capital markets are indifferent as to whether the government finances its expenditures with debt or with taxes. Both methods, it appears, have similar long-term economic effects. The wide fluctuations in money growth, they argue, are the chief cause of economic problems.

THE THEORETICAL ARGUMENT

The economic profession is deeply divided on the effects of budget deficits. Two major groups, the Keynesians and the "rational expectations" school, have dramatically different views of the effects of budget deficits on interest rates, output, and economic growth.

The Keynesian View

Keynesian economists generally have supported deficit spending in recessions. Deficits, generated either by tax cuts or increases in government spending, are seen as boosting aggregate demand by a multiple of the deficit, thereby stimulating Gross National Product (GNP). Keynesians assert that government spending raises GNP more than the equivalent in tax cuts because government spending affects aggregate demand directly, while part of a tax cut initially will be saved. During a recession, the Keynesian theory predicts, the increase in GNP also will push up

interest rates, but not nearly enough to stifle the increase in investment and GNP. Deficits, therefore, will "crowd in" private sector investment during recessions, expanding savings and investment.

In times of full employment, however, Keynesians warn against deficits. At this stage in the business cycle, increases in aggregate demand cannot increase output, since business is already at full capacity. In the short run, therefore, the new demand due to excess government spending will simply raise prices and interest rates, as businesses compete for scarce investment dollars. If the economy is already at full employment, Keynesians predict that greater government deficits merely will generate inflation and raise interest rates. To cool off the price inflation, Keynesians usually prescribe tax increases or spending reductions to dampen aggregate demand.

The Rational Expectations Theory

A relatively new school of economists, dubbed the rational expectations school, views budget deficits in a completely different light. Research by these economists suggests that government actions to stimulate or cool off the economy cannot succeed in a world where most producers and consumers act rationally. In the simplest form, the rational expectations theorists claim to have rediscovered a basic truth: "There is no such thing as a free lunch." What the government gives with one hand, they argue, it takes back with the other. Government expenditures must be paid for with taxes, debt, or inflation--these are really just three different types of taxation. As a result, there can be no stimulus from any government sponsored economic activity.

The crux of the debate over deficts between Keynesians and the rational expectations school concerns whether the national debt is actually net wealth. Keynesians argue that holders of government bonds see bonds as wealth. Individuals simply replace some of the savings with government bonds, and therefore will not change their consumption or investment behavior as a result of government borrowing.

Rational expectations theorists, on the other hand, believe that government bonds are not considered net wealth by the public. These economists believe that investors see government debt as requiring future tax increases. According to this school of thought, the public will react to the issuance of new government debt by reducing its consumption and expanding savings to cover the anticipated future tax.

Critics of this theory argue that gross savings has not expanded. But the data seem to refute them. Household wealth, for instance, has increased a hefty 7 percent between the first quarters of 1982 and 1983.[1] This more comprehensive measure

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1 "The Economic and Budget Outlook," The Congressional Budget Office, August 1983, p. 38.

of wealth includes not only personal savings, but stock and bond holdings, real estate, and consumer durables. Because total household wealth soared, individuals apparently felt less need to save cash.

According to rational expectations economists, then, it is largely irrelevant whether a given amount of government spending is financed by taxes or debt. One is seen by the public as a present tax, the other as a future tax. And the public reacts in basically the same manner whether taxes rise or deficits rise. In either case, it is government spending, not deficits per se, that crowds out private sector savings, investment, and consumption.

If this analysis is valid, government borrowing will not raise interest rates or crowd out private sector savings any more than tax increases will. Moreover, changes in the mix of debt and taxes will be useless as an effective countercyclical device, since government spending cannot stimulate aggregate demand.

The economic literature discussing the Keynesian versus the rational expectations view of government deficits is complex and extensive. There are a number of legitimate questions raised about both analyses. One thing, however, is clear: There is a great deal of economic evidence--particularly in the performance of the economy during the last decade--suggesting that the rational expectations theory describes better than do the Keynesians how the economy has reacted to government deficits.

THE EFFECTS OF GOVERNMENT DEFICITS

Deficits and Inflation

There is ample evidence debunking some of the most common myths about budget deficits. Perhaps the easiest claim to disprove is the charge that budget deficits cause inflation.

The level of federal budget deficits has shown no strong relationship to inflation. For example, the inflation rate dropped from 13 percent in 1979 to 3 percent in 1983. Over the same period, the budget deficit grew from $28 billion to almost $200 billion. The recent budget deficits have not increased inflation, because government borrowing need not cause an increase in the money supply. And only a money supply increase exceeding GNP growth ignites inflation. In fact, the Federal Reserve usually has not expanded the money supply during periods of high deficits--although there is, admittedly, some controversy on this point.[2] If the Federal Reserve does not buy up the government debt, then it must be financed from private sector capital markets.

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[2] See Michael Hamburger, Business Week January 9, 1984, p. 6.

This may have unpleasant economic consequences, but inflation is not one of them.

Deficits and Interest Rates

The charge often is made that high deficits cause high interest rates. Yet the relationship between deficits and interest rates is not well established. Several studies, including the following, have found little evidence to suppose that government borrowing raises interest rates:

--Despite his recent assertions at congressional hearings that deficits are linked to interest rates, Council of Economic Advisors chairman Martin Feldstein draws the opposite conclusion in a study of the years 1954 to 1971. And Feldstein's senior staff economist with the Council, Jeffrey Frankel, also finds no positive link in an analysis of the period 1954 to 1980.[3]

--University of Rochester Professor Charles I. Plosser, in an empirical study published in the Journal of Monetary Economics, finds no evidence to support the proposition that "increases in government debt drive asset prices down and yields up." His research suggests that higher government spending, not deficits, raises interest rates.[4]

--Thomas S. McCaleb, Florida State University Professor and former Senior Staff Economist for the President's Council of Economic Advisors, concludes that there are no studies "which show consistently and unambiguously that real interest rates are high whenever the real value of the government's budget deficit is high...."[5]

--William F. Dewald, in an article for the Economic Review, Federal Reserve Bank of Atlanta, examines the historical evidence for the U.S. and discovers that "...deficits in themselves have not been a critical factor in high real interest rates...." Dewald's study eliminates the effects of cyclical influences, such as recessions, on interest rates, but still "found no strong historical associations between real interest rates and the deficit."[6]

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3 Martin S. Feldstein and Gary Chamberlain, "Multimarket Expectations and the Rate of Interest," Journal of Money, Credit and Banking, November 1973, pp. 873-902; Jeffrey A. Frankel, "A Test of Portfolio Crowding-Out and Related Issues in Finance," Working Paper No. 1205, National Bureau of Economic Research, September 1983.

4 Paul Craig Roberts, "Economic Watch," Business Week, December 5, 1983, p. 12.

5 Thomas S. McCaleb, Federal Budget and Fiscal Policy in the 1980s, unpublished paper, undated.

6 William G. Dewald, "Federal Deficits and Real Interest Rates: Theory and Evidence," Economic Review, Federal Reserve Bank of Atlanta, January 1983, pp. 20-29.

--Charles E. Webster, Jr., in a study published by the Economic Review, Federal Reserve Bank of Kansas City, concludes that "...empirical evidence does not necessarily contradict the view that budget deficits have no effect on interest rates, real or nominal. To the extent that such an impact occurs, the magnitude appears small."[7]

--A U.S. Department of Treasury study finds that "the existing empirical evidence points toward no systematic relationship between government budget deficits and interest rates or exchange rates."[8]

--Ali Reza, manager of economic analysis for Gulf Oil Corporation, and Virginia Polytechnic Institute Professor David Meiselman find no theoretical or empirical foundation for the view that real interest rates are substantially affected by budget deficits.[9]

--At Stanford University, Paul D. Evans concludes that large deficits actually correspond with low interest rates.[10]

--Plosser, Reza, and Evans blame increased government spending for the high interest rates.

The data on Chart 1 strongly support these studies.* Interest rates show no clear relationship to budget deficits. The chart shows that the nominal interest rate on 3-month Treasury bills has fallen substantially since 1981, even though the deficit has risen as a share of GNP. From mid-1981 to the present, the Treasury bill rate dropped to around 9 percent from a 15 percent peak. This large drop occurred at the same time that deficits rose from $110 to nearly $200 billion. U.S. real interest rates (that is, adjusted for inflation) also dropped between 1981 and 1983, although erratically (see Chart 2). Real interest has been cut in half to less than 4 percent, even as deficits more than doubled.

Those who cast deficits as the greatest threat to the economy respond to this evidence by arguing that while current deficits may not be damaging, those expected in 1985 and beyond are causing long-term interest rates to remain high.

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7 Charles E. Webster, Jr., "The Effects of Deficits on Interest Rates," Economic Review, Federal Reserve Bank of Kansas City, May 1983, pp. 19-28.

8 See James A. Girola, Federal Deficits and the Treasury Bill Rate (U.S. Department of Treasury, August 31, 1981); see also "Inflation and the Monetization of Deficits (May 27, 1981), and Inflation, Interest Rates, and Federal Credit Demands (October 22, 1981) by the same staff economist. See also Government Deficit Spending and Its Effects on Prices of Financial Assets (U.S. Department of Treasury, undated).

9 Roberts, op. cit.

10 Ibid.

*Charts 1-5 appear at the conclusion of this study.

The evidence, however, undermines this line of argument. As future deficit forecasts have gone up, interest rates have gone down. Chart 3 shows how the 1985 deficit, forecast by Data Resources Inc., a leading private economic consulting firm, ballooned from close to zero in 1980 to over $200 billion by 1983. Yet both real and nominal interest rates on 5-year Treasury notes have dropped, despite increasingly gloomy forecasts from both public and private sector experts. Clearly the investing public is not reacting negatively to increasingly pessimistic deficit forecasts.

Deficits and Crowding Out

Budget deficits do not raise interest rates significantly or crowd out private borrowers from the capital markets. There seems to be a number of reasons for this paradox:

1) Rapid Economic Growth: About four-fifths of the current U.S. budget deficit is a "hangover" from the recession. Recessions sharply reduce government revenues and increase government spending programs. On the other hand, private sector borrowing falls as economic activity slows. So rather than intensifying credit demand and raising interest rates, government borrowing during recessions simply takes up the slack from businesses (see Chart 4). As the private sector recovers, federal deficits usually fall sharply, thereby freeing up capital for the private sector as the expansion gains steam. The result: total credit demand remains roughly the same over the business cycle.

2) Offsetting savings: If the public sees new debt as leading to a future tax, as the rational expectations school suggests, Americans might save more to offset this future tax liability, thus covering at least part of the government debt.

3) $22 trillion in assets: Government debt is financed not only from the $300 billion savings pool, but from the entire stock of U.S. assets, now approaching $22 trillion.[11] This consists not only of savings, but also of such items as real estate, stocks, bonds, buildings, and equipment. As such, a $200 billion government deficit comprises less than one percent of total wealth. The interest rate on government bonds, therefore, need increase by only a small amount to induce individuals to switch this portion of their wealth into government bonds.

4) Cutting inflation: The reduction in inflation from double digits to less than 4 percent is, according to John Rutledge of Claremont Economics, Inc., sending a flood of money into the capital markets.[12] Every one percentage point drop in inflation,

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11 John Rutledge, "The 'Structural-Deficit' Myth," The Wall Street Journal, August 4, 1983.

12 John Rutledge, "Why Interest Rates Will Fall in 1982," The Wall Street Journal, December 14, 1981.

according to Rutledge's study, should direct about $100 billion from the tangible assets market (including real estate, diamonds, and gold) to the financial markets (bonds, stocks, savings). This occurs because dropping inflation reduces the rate of return on tangible assets (which people often use as inflation hedges), while increasing the prospective return on financial assets. The Reagan Administration's success in cutting inflation should send hundreds of billions of dollars into the financial markets, helping to offset the effects of increased federal borrowing.

There is strong evidence that this capital surge is well under way. Corporations raised $97.3 billion in the securities market in 1983, a 54 percent increase over 1982.[13] Common stock financing was the fastest growing method of raising capital in 1983, rising from $14 billion in 1982 to $36.7 billion in 1983. Just a few years ago, "experts" were writing obituaries for equity financing as a means of raising capital.

5) Tax cuts: The business and personal tax cuts of the Reagan years expanded the savings pool and boosted business profits. Corporate earnings rose 15 percent in 1983, and most economists expect them to expand by another 25 percent this year.[14] The enhanced cash flow of companies allows business to finance much of its investment in plant and equipment from retained earnings--rather than borrowing in the credit market.

The tax cuts also have spurred capital spending, despite the deficit--a sign that crowding out is a red herring. Capital spending in 1983 grew twice as fast as the average rate during postwar recoveries.[15] And the Commerce Department reported on January 12 that firms plan to increase real capital spending 9.4 percent in 1984, the biggest jump in seven years.[16] This is highly unusual since capital spending tends to kick in only late in an economic recovery. Clearly there is no sign that looming deficits are inhibiting investment plans.

6) Foreign Capital: Capital inflows from abroad are also helping to finance both government and business borrowing. This inflow of capital reduces the chances that businesses will be squeezed out of the capital markets by government borrowing.

MONETARY POLICY: THE THREAT TO ECONOMIC RECOVERY

Economists are mistaken when they see budget deficits as the cause of U.S. economic woes. In fact, poorly executed monetary

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13 Analysis by Securities Data Corporation, January 1984.

14 Henry F. Myers, "Firms' Net Will Surge About 25% This Year, Most Economists Say," The Wall Street Journal, January 3, 1984.

15 "Capital Spending Stocks the Recovery," Business Week, November 14, 1983, pp. 44-45.

16 U.S. News and World Report, January 23, 1984, p. 16.

policy is the major destabilizing factor in the current recovery. Nobel Laureate economist Milton Friedman even fears that the current course of monetary policy could send the economy into another recession by mid-1984.[17]

Monetary policy causes high real interest rates chiefly by creating uncertainty about future rates of inflation and future rates of economic growth. During the last three years, Federal Reserve Board measures have caused the money supply to gyrate dangerously. During some months it has grown at a double-digit rate, and at other times it has not grown at all. Such stop and go monetary policy creates enormous uncertainty in financial markets about the future course of the economy--as stock market reaction demonstrates when the money supply figures are released.

To compensate for this risk, investors understandably demand a high real rate of return--that is, high real interest rates. To reduce the real rate of interest, therefore, the Federal Reserve must establish a track record of slow, stable, and predictable money growth. Low and predictable money growth would reduce fears of inflation, lower real interest rates, and boost investment.

Chart 5 demonstrates the strong historical link between the rate of growth of inflation and interest rates. When money growth has surged, interest rates soon have climbed in anticipation of higher inflation. When money growth has moderated or declined, interest rates soon have dropped. The lesson is clear: avoid each extreme, not too tight, not too loose. The chart also shows that interest rates in recent years have not declined as fast as inflation, owing both to a lag in investor expectations and the highly erratic growth in the money supply.

CONCLUSION

Despite hysteria over budget deficits, little is known about the effects of government borrowing on interest rates, capital formation, and long-term economic growth, except that there is scarcely any evidence that deficits, per se, are damaging. The evidence demonstrates that budget deficits do not crowd out private investors, generate inflation, or appreciably raise interest rates.

Countries with large public sectors have suffered stagnant economies, even though many have balanced budgets. Britain, for example, boasts a "structural" deficit of near zero, but has been in poor economic health for many years. Conversely, many countries with a small public sector have enjoyed much healthier economies, even if they have run large budget deficits. Japan, for instance,

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17 Milton Friedman, "A Recession Warning," Newsweek, January 16, 1984.

ran heavy deficits during the 1970s, yet interest rates remained low and growth was rapid. The lesson seems clear: total government spending is what counts, not how that spending is financed.

Each source of government financing--taxes, borrowing, or inflation--has its own set of problems and consequences. None is cost free. But substituting one financing source for another will not solve policy problems. The pressure in Congress to substitute taxes for debt as a preferred means of financing runaway government spending unfortunately diverts attention from the much more important issue of the size of the government sector.

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Chart 1

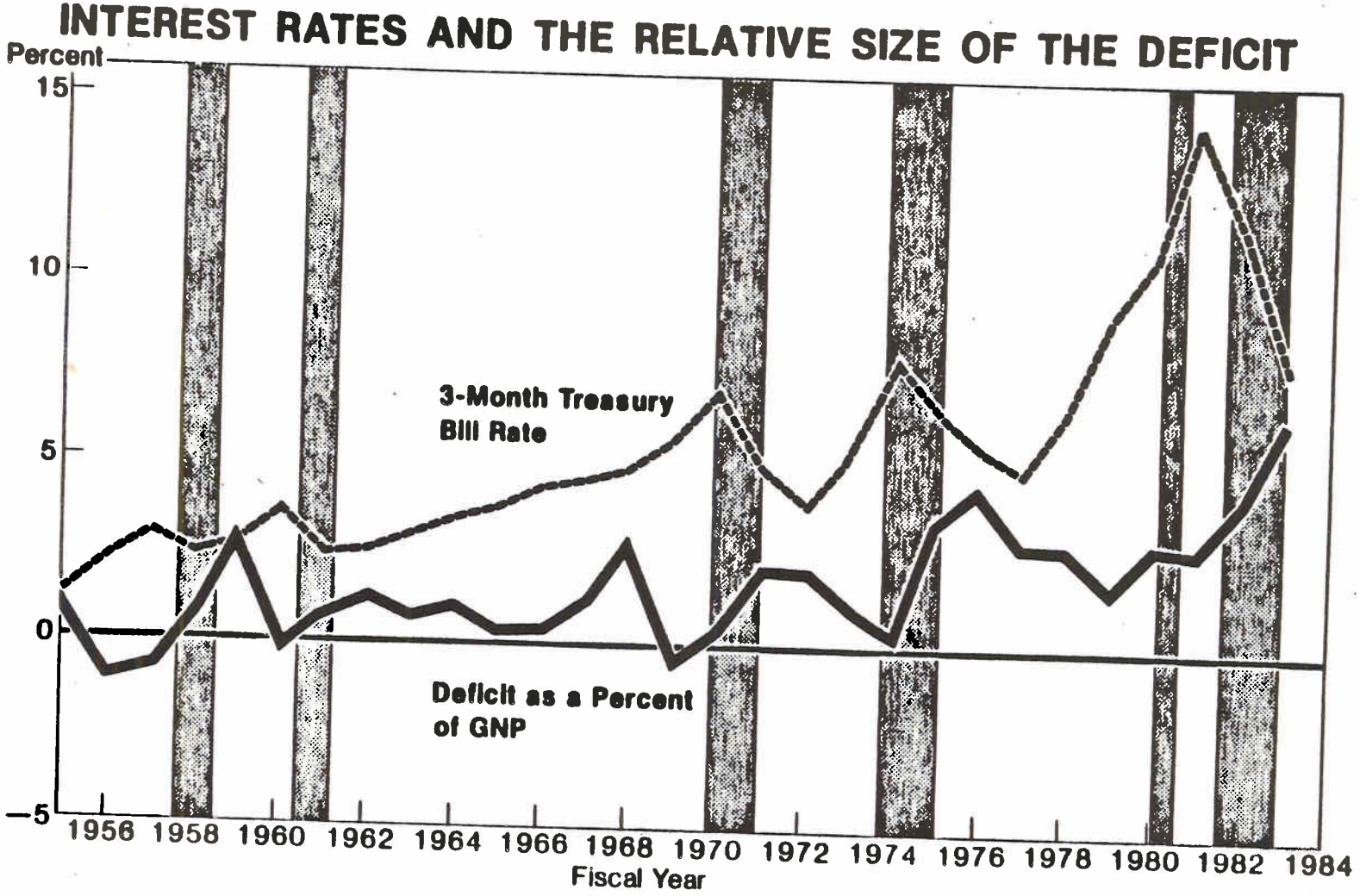
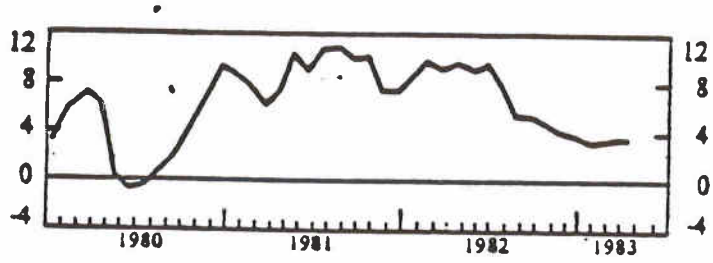

INTEREST RATES AND THE RELATIVE SIZE OF THE DEFICIT
Percent
15
10
5
0
−5
3-Month Treasury Bill Rate
Deficit as a Percent of GNP
1956 1958 1960 1962 1964 1966 1968 1970 1972 1974 1976 1978 1980 1982 1984
Fiscal Year

Chart 2

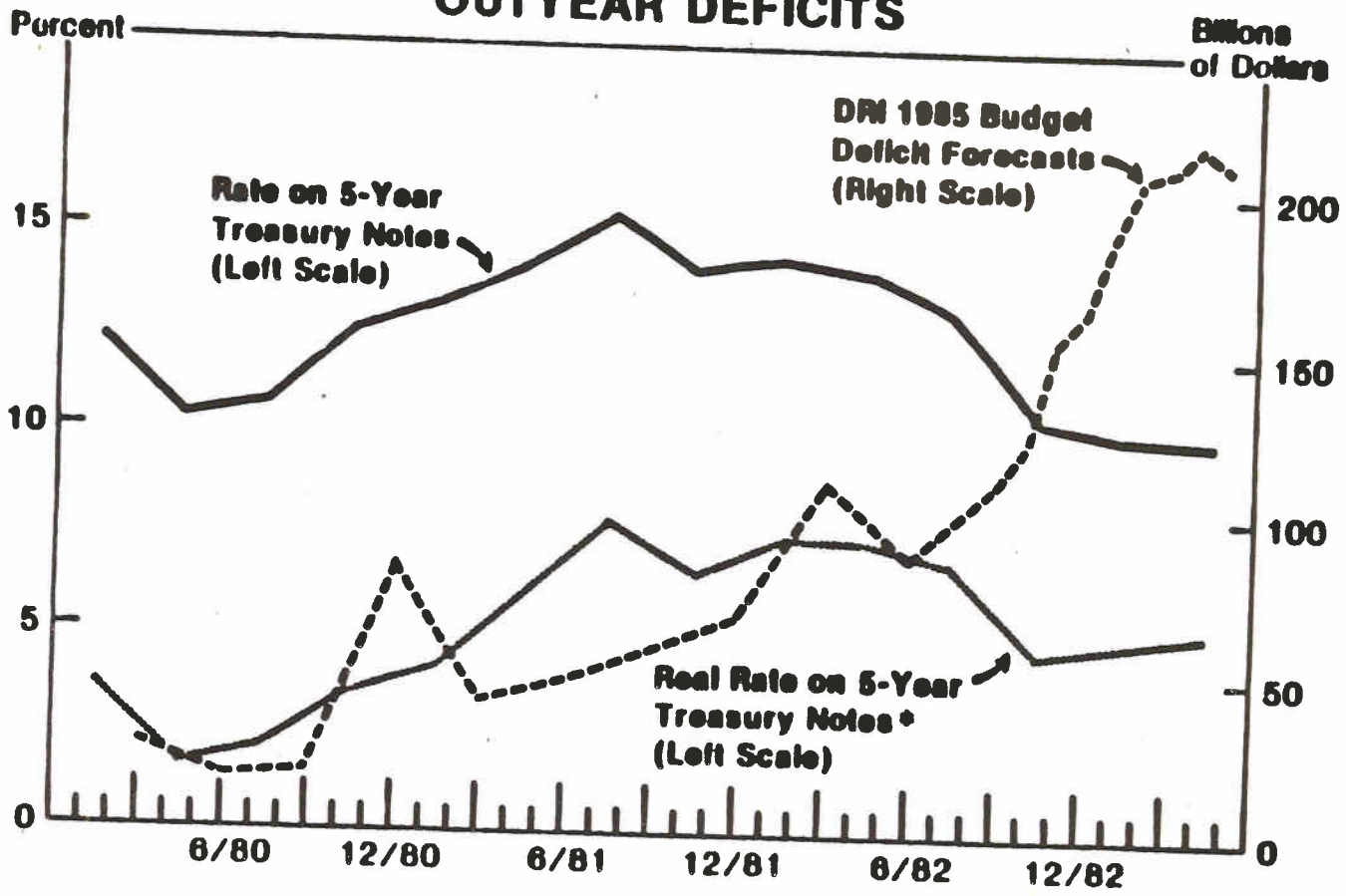
U.S. REAL INTEREST RATE



Source: World Economic Outlook, May 1983

Chart 3

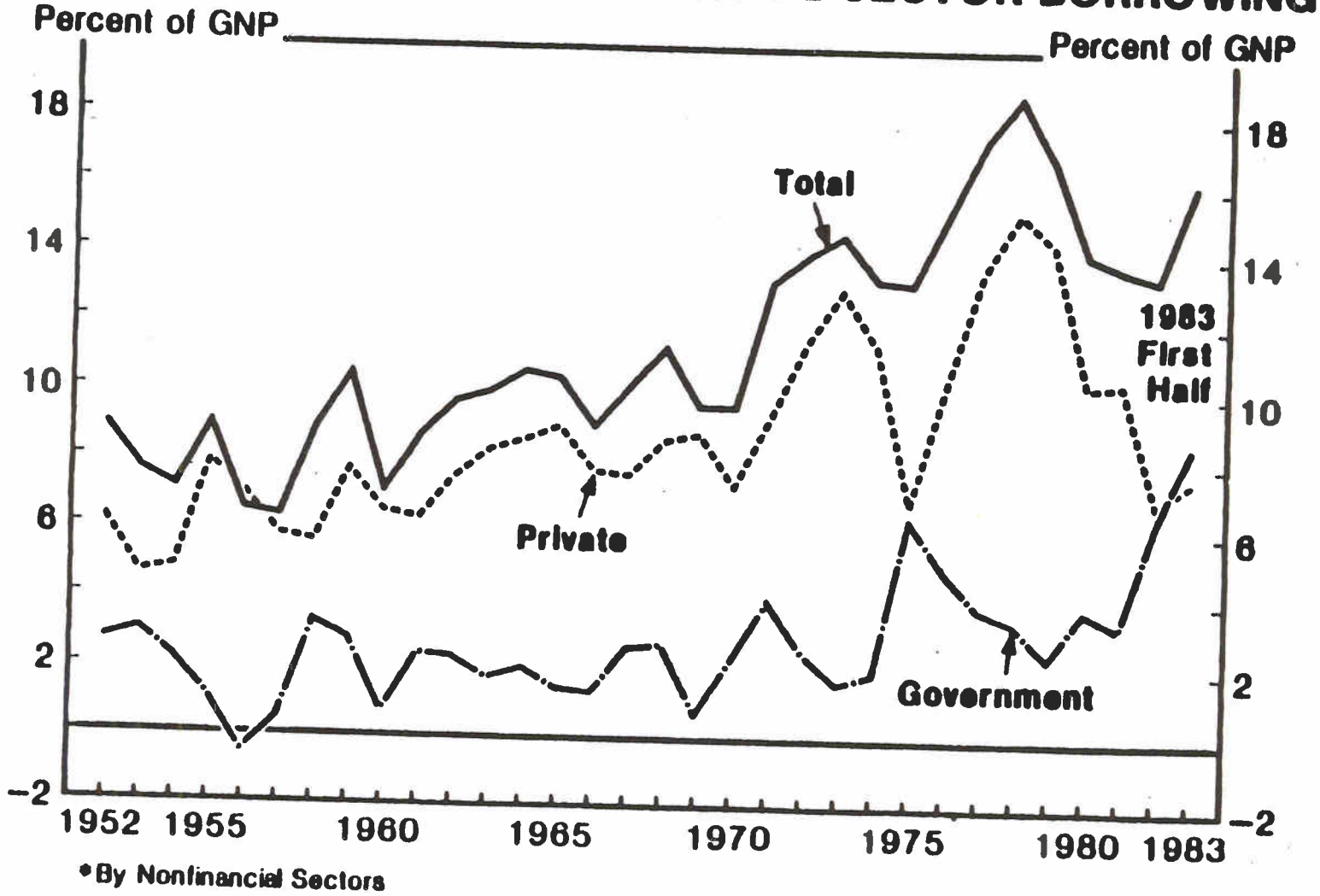
INTEREST RATES AND FORECASTS OF OUTYEAR DEFICITS



*Nominal interest rate less DRI forecast of inflation through 1986.

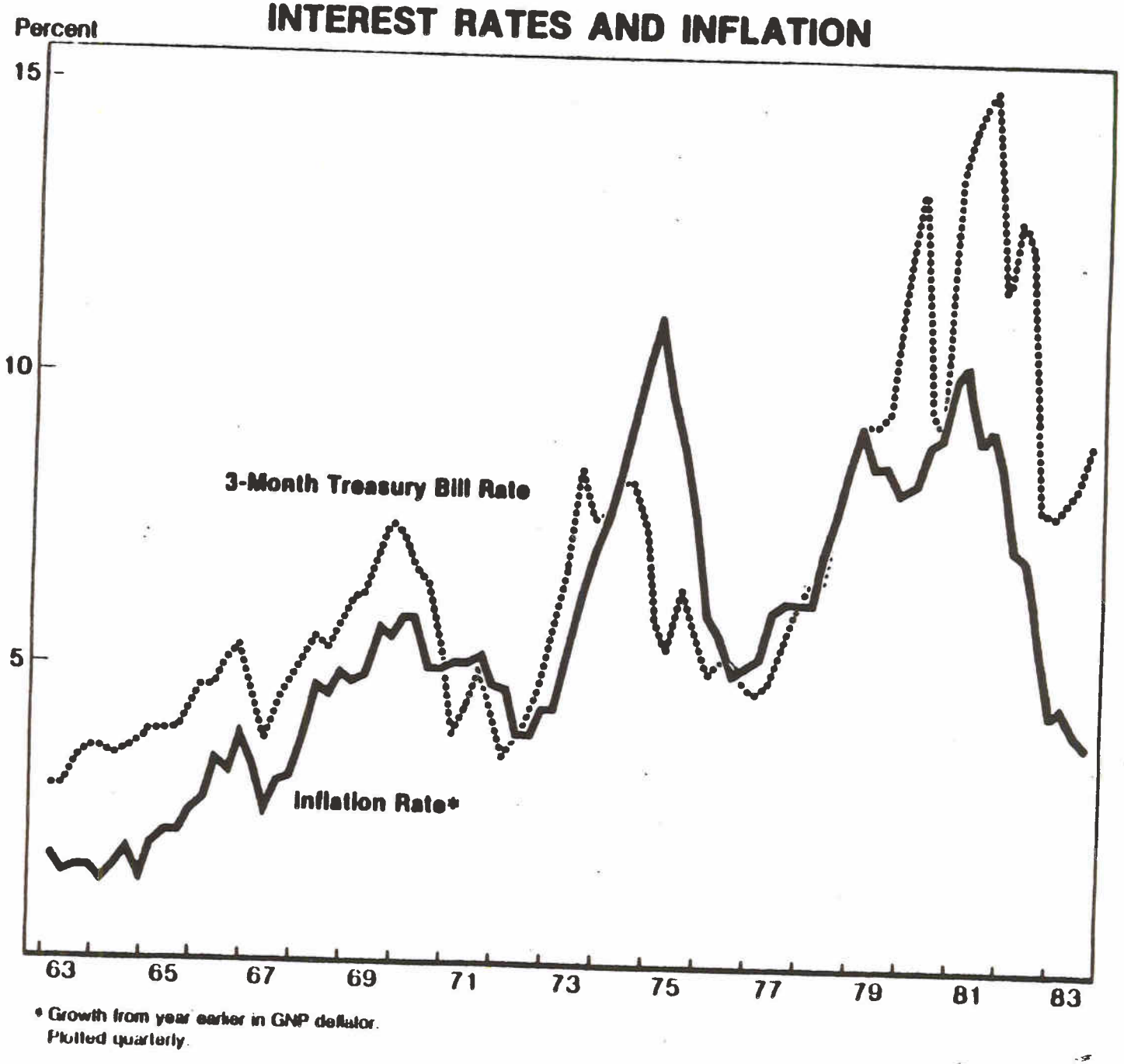
Chart 4

GOVERNMENT SECTOR AND PRIVATE SECTOR BORROWING*



*By Nonfinancial Sectors

Chart 5


INTEREST RATES AND INFLATION
Percent
15
10
5
3-Month Treasury Bill Rate
Inflation Rate*
63
65
67
69
71
73
75
77
79
81
83
* Growth from year earlier in GNP deflator.
Plotted quarterly.