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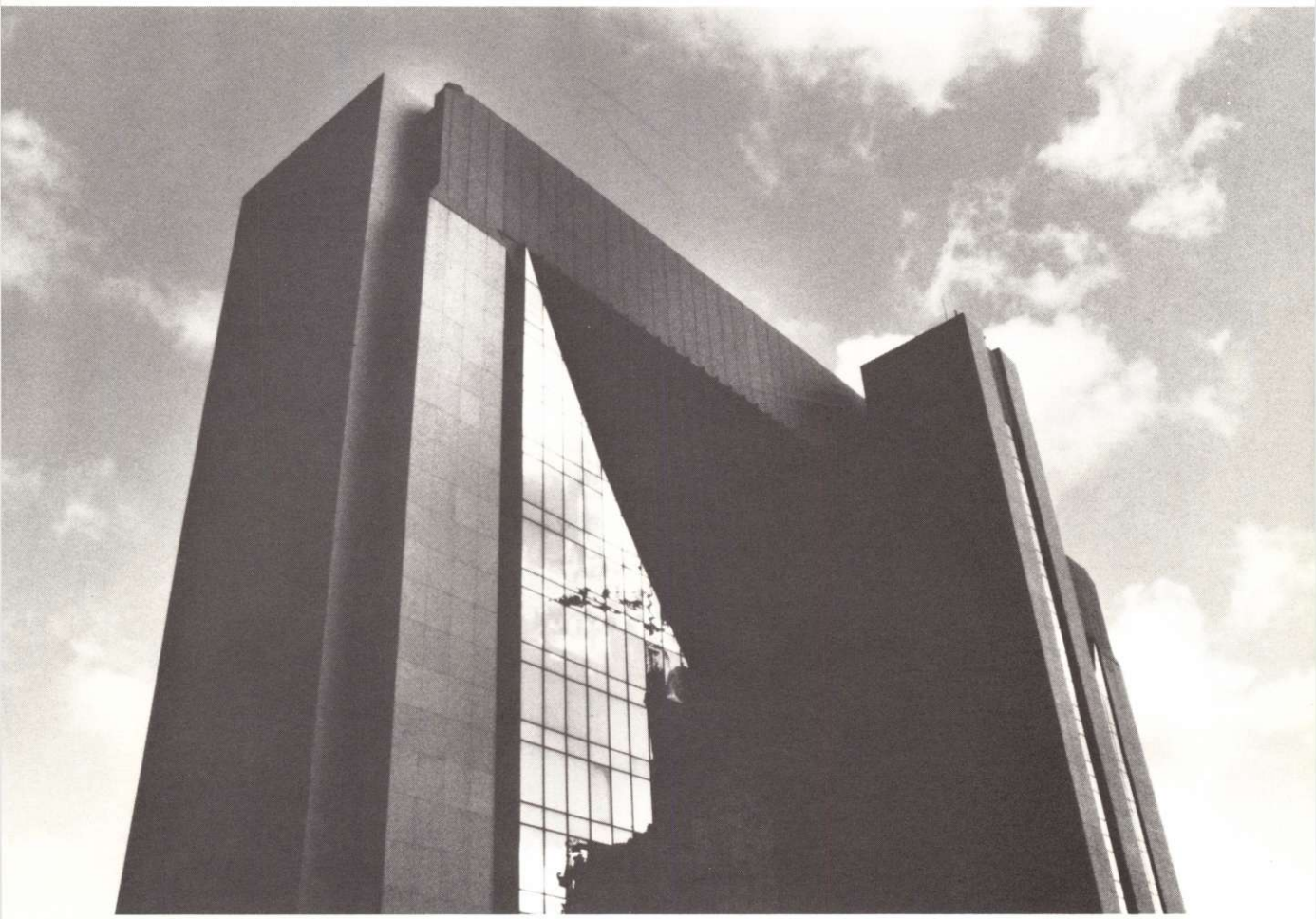

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Deficit Policies, Deficit Fallacies

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More than Mount Saint Helens went up in smoke this summer. The hope for a balanced budget in fiscal 1981 was also reduced to ashes as a recession emerged and sentiment for a tax cut grew. Since the recession has spoiled the hope for a balanced budget anyway, economists have advised both Democrats and Republicans that taxes should be cut to get the economy moving. They seem to think that adding $30 billion to the federal deficit in fiscal 1981 will have virtually no impact on inflation. I disagree. The proposed tax cuts will result in less revenue for the government year in and year out and will thus be inflationary. This inflationary policy is particularly unfortunate because a change in policy toward a balanced budget could reduce inflation at little real cost.[1]

Deficits cause inflation

The proposed tax cuts could be interpreted as a continuation of the deficit policies that the United States has had for many years. The federal government has had 19 annual budget deficits in the last 20 years. Its practice has been to run deficits in all phases of the business cycle, when unemployment is high and when it is low. When the federal government runs these repeated deficits, it simply prints and sells more bonds. This means that the amount of outstanding bonds increases every year. Reasonably enough, few people expect the government to retire its debt. Because the bonds are not likely to be paid off by higher taxes in the future, they are merely promises to deliver currency in the future. In fact, they are really much like currency. They, like currency, are pieces of paper backed by nothing—not by tangible assets, not by future taxes. Nevertheless, as long as the government limits the supply of bonds, they are valued fiat paper that adds to the nominal wealth of the private sector. They are, in most essentials, a part of our ever-expanding money supply.[2]

When bonds are almost identical to money, any change in policy that increases the deficit is inflationary. As is well understood, government can cause inflation by printing more money. It can also cause inflation by printing more bonds. Additions to the stocks of money or bonds, by increasing the total amount of nominal wealth, increase private demands for goods and services. The increased demands, in turn, push up the prices of goods. The average price level will keep rising as long as the government continues to follow a practice of running large deficits.

The data strongly suggest that a change in policy toward larger deficits causes more inflation. Although the United States has had a practice of running budget deficits for 20 years, there is statistical evidence that federal deficit policy changed between the 1960s and the 1970s. The accumulated federal budget deficit (the stock of interest-bearing and noninterest-bearing federal government debt) expanded much faster in the 1970s than in the 1960s. When this country followed a policy of higher deficits, it experienced higher inflation, as the chart shows.

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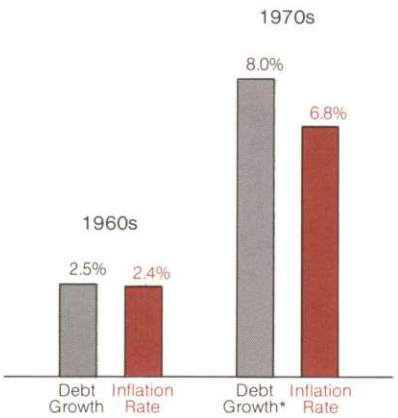
[1] This paper is essentially a sequel to Miller and Struthers 1980, and some of the arguments are more fully developed in the earlier paper.

[2] The notion that unbacked bonds act much like fiat money has appeared often in the literature. Samuelson, for instance, states, "Interest-bearing public bonds, which correspond to no government capital formation and which no taxpayer rationally expects to have to help retire in his lifetime, have effects similar to those of the noninterest IOUs we call M [money]" (1964, p. 342). This point is made also in Bryant and Wallace 1979, Christ 1957, and Martins 1980.

Higher deficits, higher inflation.

Average Annual Growth in Federal Government Debt and the Consumer Price Index in the Last Two Decades



*Not including December 1979.

Sources: Federal Reserve Board of Governors
U.S. Departments of Commerce and Labor

The Importance of Policy

The key word here is *policy*. A budget policy is a strategy followed consistently so that people come to understand it. It is a rule which describes how tax rates and expenditures are to be set in each year based on the economic conditions of the previous year and, perhaps, earlier years. A simple policy, for example, would be to set tax rates and expenditures for all time.

Policy must be distinguished from *result*. The result is the numerical budget deficit or surplus which occurs in a given year. It depends not only on the policy, but on current economic conditions. An identical policy governing tax rates and expenditures could lead to quite different budget deficits in different years, depending on such things as the weather, a war, buyers' tastes, or the ups and downs of the business cycle.

An appropriate deficit policy is extremely important for controlling inflation. Suppose, for instance, that the policy governing tax rates and expenditures in the United States were changed so that starting this year the budget was kept in balance, on average, over the course of the business cycle. That is, deficits in the lean years were all offset by surpluses in the fat years during each business cycle. Such a policy would systematically reduce the average deficit. It would, therefore, reduce the rate of growth of fiat paper and thus reduce inflation, even though deficits would occasionally occur because of business downturns. Of course, balancing the budget in 1981 or any other single year would not necessarily reduce inflation. One balanced budget out of many years of deficits is hardly meaningful. A policy of balancing the budget on average over the business cycle, however, could significantly reduce inflation.

Why is it, then, that some people see little, if any, relationship between inflation and deficits?[3] It is because they fail to distinguish between the effects of different deficit policies and the effects of different economic conditions.

Under a given policy, in which tax rates and expenditures do not change, lower inflation rates generally go along with *higher* deficits. This happens because of economic conditions. Under a given policy, an economic downturn, for instance, typically causes deficits to rise and inflation to fall. High deficits and low inflation may thus coincide, but this does not mean that one caused the other. The downturn, in fact, caused both. Under different policies, however, the situation is reversed: lower inflation rates generally go along with *lower* deficits. If we were to compare two identical economies which differed only with respect to deficit policies, inflation would always be lower in the one with the low-deficit policy than in the one with the high-deficit policy. This means that, over a period of years, we would expect inflation in any particular economy to be lowest under the policy of the lowest deficits.

How Fast and How Costly?

To begin to solve its inflation problem, the United States needs to move toward a policy of lower deficits over the course of the business cycle. Such a policy, once it is understood, has a psychological effect, because people expect lower deficits and lower inflation in the future. This change in psychology, in expectations, will change behavior immediately, not just in the distant future, because economic behavior depends vitally on what people expect in the future. This change is not just symbolic, and it is not just a consideration for the long term.

There is historical evidence that tighter budget poli-

[3]See, for example, Perry 1978, pp. 279–81, and Schlesinger 1980.

cies have quickly reduced inflation.[4] The clearest breaks in government budget policies have occurred after wars or after years of hyperinflation. In these cases, governments typically announce major changes in policy which the public understands. After the U.S. Civil War, the government discontinued deficit financing and inflation quickly subsided. The hyperinflations in Germany after World War I and in five other European countries throughout this century were all corrected by drastic changes in government policy, changes that produced lower deficits.

Furthermore, when changes in policy are clear-cut, their cost in terms of lost output is not nearly as high as has been suggested. After the Civil War, output in the United States grew well, despite the changes in policy and the resultant sharp drops in inflation. In Germany and the other European countries, the cost (in terms of lost output) of eliminating inflation was about the same as that of one ordinary recession in the business cycle.

Even if a change to tighter budget policies in the current U.S. economy should happen to be poorly understood, the cost of reducing inflation would not be crippling. The oft-heard estimates of the cost—like the estimate that reducing inflation one percentage point would cost $200 billion in lost output—simply are not credible, because they all assume there is a stable trade-off between inflation and real output which is independent of policy.[5] Without any question, this is a false assumption. If there is anything economists are sure of, it is that the relationship between inflation and output is not stable.[6] Moreover, whatever the relationship may be, it cannot be exploited by government budget policies.[7] We can't increase output by deliberately creating inflation, and we won't necessarily lose output by deliberately reducing inflation.

A tightening in budget policy could have a small initial cost, as it penalizes people who contract based on expectations of continuing inflation. But the more the policy is understood, the smaller the errors people will make in their expectations and the lower this cost will be. In fact, it is possible that a well-announced and well-designed policy would have no real cost at all. According to at least one careful study, U.S. data suggest that an understood tightening in deficit policy would lower inflation without affecting output.[8] In no case would a tighter deficit policy produce the apocalyptic results foreseen by those who assume that there is a fixed trade-off between inflation and output.

If we want to reduce inflation—without severe hardship—we can do so by designing a concerted and reasonable policy to balance the federal budget on average, or at least to lower the budget deficit, over the course of the business cycle. That is, we need to change policies; we need to stop running continuous deficits and start regularly balancing the budget.

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[4]This section on the evidence is based on Sargent forthcoming.

[5]This estimate can be found in Okun 1978, p. 520.

[6]See McNees 1978.

[7]This argument is made more completely in Lucas 1972 and in the article by Thomas J. Sargent in this *Quarterly Review*.

[8]See Barro 1980.

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