LONG-TERM IMPACTS OF THE FEDERAL DEFICIT

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While the $200 billion deficit in the federal budget is the center of public attention, the $130 billion deficit in the balance of trade is in many ways more important. While the national debt is owed by us to us, the international borrowing necessary to finance a $130 billion trade deficit is real — owed by us to the rest of the world. And at present rates of borrowing the United States will shift, for the first time since World War I, from being a net creditor country to being a net debtor country in mid-1985.

At that point interest payments will shift from being a net inflow into the United States to being a net outflow from the United States and the current account will deteriorate rapidly since interest payments rapidly compound. Next year in addition to whatever must be borrowed to finance next year's deficit in the balance of trade, an additional $13 billion (assuming a 10 percent interest rate) will have to be borrowed to finance this year's borrowings.

In the summer of 1982 no one knew the maximum amount of money that Mexico could borrow. By fall everyone knew the Mexican limit. When the world discovered that it had lent $85 billion to Mexico the rest of the world refused to lend more.

In a similar manner no one now knows the maximum amount that America can borrow. Since the United States is a much larger and wealthier country, the American limit is much bigger, but it remains true that the number is finite. At some point the world will decide that it has invested enough of its assets in the United States and future lending will halt. At this point the dollar will plunge.

The Great Dollar Bubble

While no one knows or can know the precise moment when the dollar will fall, two other facts are known. First, it will happen. No country can forever run a deficit in its balance of payments. The fact that something occurs (an over-valued dollar) for longer than anyone believed possible does not repeal fundamental principles of economic gravity.

Second, when the fall comes it is apt to be very rapid. This can be seen by looking at the situation from the point of view of a foreign money manager. A German money manager wants to keep his liquid funds in the United States since he receives an interest rate almost twice what he can get in Germany. But he also knows that if he moves 300 million marks into the United States when it is 3 marks to the dollar and has to move his money back to the United States when it is 2 marks to the dollar, he loses 100 million marks. As a result he wants to be the first person out the door when the fall comes. And since the last person out the door loses the maximum amount of money everyone will rush for the door at the same time.

Why has the dollar been so high so long? Part of the answer is to be found in higher interest rates, a more rapid economic recovery, and political stability, but only part of the answer. To really understand what is going on, let me take you back in history to Amsterdam in 1633. Leave the world of the rational and enter the world of the irrational.

For some unknown reason the price of tulips starts to rise. Everyone understands that in the long run tulips cannot sell for more than the cost of growing tulips. Yet prices rise above this level. Initially, analysts predict that the price of tulips will quickly fall. But they don't. They continue to rise in 1634 and 1635. Having been proven wrong, analysts start to look for semi-logical reasons as to why tulip prices could stay high forever. (*Business Week* just had an article saying that the dollar could stay high for 10 years.) Tulip prices continue to rise in 1636. And in early 1637 they are selling for hundreds of dollars. But of course such a price is crazy and tulip prices crash in 1637 wiping out all of those who have been speculating in tulip bulbs.

Such bubbles have happened over and over in human history. The South Sea Bubble burst in 1720. The great Florida land booms of the 1920s or the stock market crash of 1929 are reminders of the same facts of life. Greed plus hubris leads to disaster. Everyone understands that tulips or the dollar are overpriced but everyone also understands that they can make money by speculating on even higher prices. Everyone also believes that they are the smart ones that will jump off the roller coaster before it heads down. But they cannot.

At the moment we are in the midst of what might be called the "Great Dollar Bubble". It will burst.

Problems Associated With Large Deficits

But back to the federal budget deficit. Large deficits lead to two problems. First they represent Keynesian stimulus. When breaking out of a recession they are appropriate, but they should be eliminated as the economy approaches full employment. If they aren't the economy will be over-stimulated and inflation will break out.

But let me remind you of some history. General excess demand inflation does not lead to a sudden outburst of inflation in the manner of a food or energy supply shock. In the Viet Nam war it took four years of over-stimulation to raise the inflation rate from 1 ½ percent to 5 percent. Given today's levels of capacity utilization, general excess demand inflation won't really become apparent until 1986 or 1987 at the earliest.

Federal deficits are also negative savings. They represent funds borrowed from the pool of savings and used to finance public consumption. They make a low savings society into an even lower savings society. With large deficits Americans invest less and our growth rate falls below that of our international competitors. But such an adverse competitive effect isn't visible to the average person for five to ten years. Here again there is no Monday morning crisis that will demand attention.

Dealing With the Deficit

The lack of a crisis is important since without it our democracy is unlikely to address the deficit problem. To understand this fact of life it is only necessary to review some elementary budgetary arithmetic.

Suppose that the $200 billion budget deficit were to be eliminated with budget cuts. National defense absorbs $300 billion. To balance the budget using defense would require a defense cut back of two-thirds. Defense is in fact growing more than 10 percent per year and the President won't cut defense. Social Security and Medicare absorb $250 billion. To balance the budget using Social Security and Medicare would require a three-quarters cut in every pension check in America. Tens of millions of elderly people vote and the Democrats say that Social Security cannot be cut. Interest on the national debt is a legal obligation and cannot be cut.

If these three functions are left aside, the rest of the federal government only spends slightly more than $200 billion. The cuts necessary to do the job would essentially mean the end of public roads, no national parks, no FBI, no Congress, no weather bureau.

If the deficit were to be eliminated with tax increases the arithmetic is equally unappealing. The personal income tax only raises $300 billion. To raise what must be raised would require not a 5 or 10 percent surtax but a 67 percent surtax. To mention the surtax number is to understand its impossibility without an obvious crisis.

In addition economists have been repeatedly wrong on their forecasts. Why should anyone now believe them when they say that it is necessary to eliminate the deficit to prevent future problems? President Reagan has just spent the last two years rejecting such advice from the Chairman of his Council of Economic Advisers. Such advice is not apt to be given by the next Chairman, and if it is it will be just as quickly rejected.

Suppose that the Congress were to substantially cut the budget deficit. In the short run this might lead to lower interest rates. But what would those lower interest rates trigger? — in all likelihood a falling dollar. But what is the classic government response to a falling currency? Central banks force up interest rates to slow down or prevent their currency from falling. As a result, in the medium run, higher taxes or lower spending might well lead to higher, and not lower, interest rates. One shouldn't too confidently sell deficit reduction on the grounds that it will certainly lead to lower interest rates. It might lead to precisely the opposite.

What is likely to happen on the deficit front given a Reagan or a Mondale election? If Reagan is reelected little is apt to happen. Why should it? The economy is doing well and there is no crisis. In addition the Republican platform essentially promises no tax increases under any circumstances. If this platform plank were written by unknown delegates it could be ignored, but it was, in fact, written by Jack Kemp and other Republican congressmen. If President Reagan were to propose a tax increase without an obvious crisis he could not carry a majority of his own party with him and without a large majority among Republican congressmen, it would be impossible to get Democratic congressmen to vote for the President's tax increase. Why should Democrats vote for tax increases and then find themselves fighting reelection campaigns against Republicans who did not vote for them?

Mondale has promised to cut the deficit by two-thirds over a four year period of time, but if elected I bet that he would do something quite different. We don't know what a President does when he inherits a large deficit from his predecessor. It has never happened before. But we do know what happens when a governor inherits a large deficit from his predecessor — regardless of whether he is a Republican or a Democrat. He immediately asks for a large tax increase to essentially eliminate the deficit at the beginning of his term and blames the action on his predecessor. For if he does not, he basically doesn't get a chance to be governor or President. Instead he is a custodian of his predecessor's deficit and after taking care of it for four years it will become his deficit. Political factors call for getting rid of the deficit now.

There is a case to be made for reduced spending in the federal budget, but it is a case that involves structural changes that will lead to big spending reductions in the long run but only very small reductions in the short run. To treat the Federal deficit as a short-run crisis is essentially to guarantee that nothing will be done to reduce the deficit.

Consider Social Security. The Social Security system was set up to prevent middle class people from falling out of the middle class when they became elderly. As late as the mid-1960s the elderly had a per capita income that was far below that of the non-elderly. But something happened in the past two decades. The per capita income of the elderly now exceeds that of the non-elderly and the elderly have a lower incidence of poverty than the non-elderly. Yet I know of no one who has it as a social goal to make the elderly richer than the non-elderly. Yet that is exactly what the system is now doing.

To cure the problem the Social Security system needs to be put on a different basis. Suppose that the current system of periodic increases plus cost of living adjustments were replaced with a system where the average Social Security benefit was indexed to the per capita GNP. In such a system the elderly would float with the general economy. If America were economically successful, the elderly would get benefit increases, but if America were not successful the elderly would not get benefit increases. Such a system can be sold to the elderly since it is a win-lose rather than lose-lose situation. If America succeeds, they get a bigger pension than they would under today's system. In contrast, straight forward attempts to simply cut benefits to reduce the budget deficit is lose-lose. Why should the elderly vote for that? And while little is saved in the short run by such a change in the system, billions and billions are saved by the turn of the century if the American economy continues to behave as it has.

Consider Medicare. Here we Americans are refusing to deal with the issue underlying rapidly rising health care costs. Technology is forcing a fundamental change in traditional medical practices. Traditionally doctors stop any treatment when that treatment ceases to have positive benefits or when the adverse side effects overwhelm the primary benefits. But we are now developing technologies that have positive benefits but are so expensive that we cannot afford to use them. Consider the Barney Clark artificial heart. Such a heart kept Barney Clark alive for four months. Suppose that just half of the elderly could be kept alive for another four months with a similar heart. This single procedure would absorb one-third of the entire American GNP. As it is, between 25 and 30 percent of your current Medicare spending goes to people in the last six months of their lives.

The problem is not health care spending — that is but a symptom. The real problem is learning where and how to say "no" to things that can be done technologically but cannot be afforded for everyone.

In many ways we in the United States have the worst of all worlds. Socialists know how to say "no". They appropriate a sum for health care spending and that is all there is. Capitalists know how to say "no". The rich get the treatment and the poor don't. But we in the United States are willing to practice neither approach. The rich get to buy what they can afford and then everyone else expects the state to provide what the rich have purchased.

But you don't break out of such a dilemma by simply shifting to a system of hospital cost containment. The Reagan administration has just shifted to a system where each patient will be assigned to a diagnostic class and the hospital is essentially given a fixed sum regardless of the actual costs of treating that particular patient. Such a system won't work for a simple reason. Who is going to take care of the high cost patient within each diagnostic class? Private hospitals will dump such patients on the public hospitals, as is now beginning to happen, and funds will either be found to treat such patients or they will be forced to go without treatment. But the chances that we as a society will deliberately let people die because they are poor while others live because they are rich is very slight. The cost problem will remain.

Health costs can only be contained when we as a society are willing to confront the real problem — technologically we can do things we cannot afford to do economically — and have developed a technique for saying "no" to both rich and poor that both rich and poor are willing to live with. Economically treatments should be stopped when marginal costs equal marginal benefits — but who is to make this judgment when human life is concerned?

Defense budget problems are similar in nature. Budget deficits don't tell us very much about how much we should or should not spend on defense. That can only be determined by assessing the nature of the threat and the technical parameters of our own defense system. From an economic standpoint there is little that can be said about the nature of the threat. But there are economic conclusions that flow from the technological parameters.

If you believe the nuclear winter hypothesis, there is no justification for buying any more missiles or delivery systems after a nation has achieved the ability to create such a nuclear winter. And what the other side does in terms of its defense spending is completely irrelevant! No nuclear ability above the nuclear winter threshold buys a country anything in terms of deterrence or power. And if nuclear submarines are the cheapest way to deliver such weapons, then all spending on alternative delivery systems is a waste of money.

Yet missile counting or budget comparison is how we now determine our defense budget. If the Russians are buying more missiles or spending more than we, then we must spend more. Such a response is easy to understand but it isn't intelligent.

The real problem is to replace what we now do with a realization that, after a certain point, extra defense spending has zero marginal value regardless of what the opposition is doing. If reductions are to be made in the defense budget it is just such a realization that must be sold to the American voters. For no one will or should cut the defense budget simply because the United States has a large budget deficit.

The same approach must exist on the tax side if we are to make progress. There are taxes that should be raised, not because they reduce the budget deficit, although they certainly do, but because they make it possible to achieve other national goals.

Consider the gasoline tax. Europe and Japan now have taxes in excess of $1.50 per gallon. Why do they have such taxes? Energy is imported and they cannot afford economically or politically to pay for it. Therefore they seek to limit energy imports with high taxes that discourage usage. But when it comes to such motives, we in the United States are no different. We also cannot afford to buy the current amounts of imported oil either economically or politically. No rapid deployment force in the Mideast is a good substitute for simply not needing Middle Eastern oil. The nation has better ways to spend 4 percent of its GNP. It cannot afford $130 billion trade deficits.

Each one penny of gasoline tax raises $1 billion dollars. A $1 per gallon tax would raise $100 billion dollars. That would go a long way toward eliminating our federal budget deficit. Yet politically we cannot now do it. Somehow we have to find a way to make politically possible what is now politically impossible.

Or think about our savings and investment problems. The United States invests one-half as much as the Japanese and two-thirds as much as the Europeans in plant and equipment. It does not take a genius to know that we need to invest more. But to invest more we must save more. In 1983 the United State's personal savings rate was 5 percent. This was the lowest in the industrial world by a factor of almost three. The Canadians saved 13 percent.

But to save more we must consume less. What way better to do this than a value added tax — one of the techniques used by all of our industrial competitors? A 10 percent value added tax raises more than $300 billion. The average European value added tax rate is about 15 percent. If a value added tax were made progressive with a $250 per capita income tax credit a 10 percent value added tax would still net $250 billion.

Here again in the conventional wisdom a value added tax is politically impossible. But it also must be recognized that there is no solution to the budget deficit problem that does not violate the conventional wisdom as to what is politically possible.

PROVIDING PUBLIC SERVICES IN AN ERA OF DECLINING TAXPAYER SUPPORT