

# The Federal Deficit and the National Debt

Drastic cuts to balance the budget will do more harm than good.



The American public has worried about large U.S. government budget deficits and the growing national debt for many years. The concern is understandable. The federal budget has shown a deficit for 19 of the past 20 years, and recently the U.S. government has been running deficits in the range of \$100-\$200 billion. Deficits add to the growing national debt, which is expected to reach \$2 trillion (\$2,000 billion) this year.

National policy decisions being made to cope with this problem are important to educators. They have a direct impact on education funding because they affect the fortunes of the children in our schools.

For example, education is a public investment in human capital (students' minds), which is just as valuable as public investment in physical capital (roads or dams) in contributing to the

nation's economic growth. A better trained and more highly educated work force will be more knowledgeable and productive. Also, reductions in other domestic programs have a direct negative impact on education. When poverty programs get cut, for example, schools face the added burdens that result from having to educate more students from disadvantaged backgrounds. Cuts in poverty and education programs are a double blow to the schools, for there are more needy students to educate and fewer resources to do the job.

From my perspective, the nation does not need to balance the federal budget. Nor do we need to reduce the national debt. Making the drastic cuts necessary to do so will only harm the economy. I base this conclusion on economic rather than political considerations. Let me explain.

## Contemporary Issues

### Cyclical Deficits

The actual deficit figure for any year is a poor indicator of the budget's effect. To understand why, we must distinguish between *cyclical* and *structural* deficits. During an economic downturn (a recession) there are good reasons why the federal deficit increases. The government collects less income tax because more people are out of work or underemployed, and the level of personal income declines. Business profits also fall and so do the corporate tax payments. Recessions increase government transfer payment programs as more people become eligible for food stamps or unemployment benefits. The combination of reduced tax revenues and increased expenditures creates a deficit.

These *cyclical deficits* are caused by weak economic conditions in the business cycle. They are temporary and are not the intentional fiscal policy of the U.S. government. Cyclical deficits have a beneficial stabilizing influence because they provide an automatic stimulus when the economy is in a slump and reduce the severity of swings in the business cycle. There are also political benefits. The U.S. government automatically provides more assistance through food stamps and unemployment benefits. As the economy expands, the conditions that caused cyclical deficit ease and the budget plays a more passive role.

Since World War II most large deficits have occurred only during recessions. The most recent examples were the 1982 and 1983 fiscal year deficits, which were partly the result of the severe 1981-82 recession. If the economy moves into recession again before 1990, we can expect another large federal deficit to be produced for its helpful economic stimulus and political benefits. Forcing the U.S. government to maintain a balanced budget under these conditions would return the nation to the bankrupt economic policies of the 1920s.

### Active Fiscal Policy

The federal government can make intentional changes in its tax and spending policies that produce a *structural* deficit, even in the absence of a recession or period of slow growth. Spend-

ing can be increased without a matching tax increase; tax rates can be cut without offsetting spending reductions. Structural deficits, unlike cyclical deficits, reflect the real longer-term impact of the federal budget on the economy. Recent examples of active fiscal policy that increased the structural deficit were the cut in tax rates and increased defense spending during the early years of the Reagan administration, actions that were not matched by equivalent cuts in domestic spending.

Economists estimate the structural deficit assuming full employment in the economy so as to factor out the role of the business cycle. This is why structural deficits are often called *cyclically adjusted deficits*. They measure the estimated difference between potential revenues and expenditures that would occur if the economy were at a high level of employment with an average level of growth. They can also be corrected for distortions caused by inflation.

By distinguishing between cyclical and structural deficits, we can discuss the force of fiscal policy on the economy that is masked in the actual deficit figures. The origin of the large actual deficits in the early 1980s was partly attributable to cyclical factors, such as the consistently high unemployment rates during that period (9.5 percent in 1982-83), and partly due to stimulative fiscal policy from the 1981 cuts in tax rates and increases in defense spending. Since 1983 the cyclical deficit has declined, but the structural or cyclically adjusted deficit has increased. Current fiscal policy is expansionary as the government takes a larger share of the nation's resources.

For example, from 1950 through 1979, the federal deficit averaged less than 1 percent of GNP. Now the deficit is running over 5 percent of GNP. This percentage is unprecedented in a peacetime when there is no recession. It indicates that the structural deficit accounts for a major portion of the actual deficit as a percent of GNP.

If there is a recession, a strict enforcement of deficit targets through automatic spending cuts as suggested by the Gramm-Rudman-Hollings legislation will only make matters worse. Imagine what would happen if the

government were forced to cut spending or raise taxes during a recession to balance the budget. The public would not tolerate the economic and political effects.

Within limits, then, the move toward a balanced budget is a positive development. The nation should reduce the structural or cyclically adjusted deficit so that fiscal policy is less stimulative and more balanced. This action will also restore the capacity of the federal budget to respond automatically to a cyclical downturn and work toward stabilizing the economy, should that be necessary. But to have a structural budget balance does not mean that the actual budget needs to be in balance.

### The National Debt

The federal deficit and the national debt are closely related. The government accumulates debt by running a deficit and reduces debt by producing surpluses. As with the deficit figure, it is best to examine the level of national debt in relationship to GNP. When the national output (GNP) expands, the nation has a greater capacity to handle the national debt. So long as the size of the economy grows faster than the national debt, the ratio of debt to GNP will fall.

During World War II the national debt grew to over 100 percent of GNP as the nation ran large budget deficits to finance the war effort. Since that time the percentage has consistently fallen, except during recessions. In the 1970s the national debt stood at around 30 percent of GNP. The national debt is now over \$2 trillion and GNP is over \$4 trillion, so the large deficits of the 1980s have raised the national debt/GNP ratio to almost 50 percent. The higher interest costs to finance the debt also command a larger share of the current budget.

Nevertheless, it is the large deficits that are the main problem and not the level of national debt. Large budget deficits with weak economic growth cause the level of national debt to increase faster than the economy grows, driving up the debt-to-GNP ratio. More savings are then required to finance the deficit, and this hurts future capital investment, economic growth, and the efficient allocation of resources.

Even if we are able to control deficits and slow the rate of growth in the national debt, many people will still view a debt of more than \$2 trillion as a burden on future generations of taxpayers. This view is unfortunate because it reflects a misunderstanding about the debt. An increasing national debt will require increasing interest payments. More taxes or less spending will probably be necessary to cover the interest payments. But the interest is mostly paid to other U.S. citizens, and it remains part of our national income. Any future interest payments simply transfer money from taxpayers to other Americans. The debt is not a real burden to the nation.

There is also no pressing need to pay off the national debt. Most people expect the U.S. to be in existence in perpetuity. This means that the U.S. Treasury can finance and refinance the outstanding debt as it needs to over time without worrying about finally "getting out of debt." In an era of modern public finance, reducing the national debt would only hurt current taxpayers and damage the economy.

### Sustaining Economic Growth

In short, deficits and debts are not the curse on the economy that they might seem. Deficit spending during a recession or period of slow economic growth provides the needed stimulus for the economy. Deficits moderate the severity of swings in the business cycle and the impact of high unemployment. They also lend stability to government financing of education and other programs. On the other hand, high structural deficits during an expansion reallocate resources from the private to the public sector, dampen long-term investment for future economic growth, and require a large share of the budget to finance the government debt. The challenge for leaders in our decade is to establish a balanced fiscal policy that contributes to sustained economic growth—and this goal will not be obtained by simplistic legislation calling for an annual balanced budget or automatic spending cuts. □

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