C.2

LABOR CENTER REPORTER

Number 86
March 1983

UNIVERSITY OF CALIFORNIA, BERKELEY
CENTER FOR LABOR RESEARCH AND EDUCATION
INSTITUTE OF INDUSTRIAL RELATIONS
BERKELEY, CA 94720
(415) 642-0323

THE FEDERAL BUDGET DEFICIT

=by Clair Brown=

With 10-11% of the labor force unemployed, and with 33% of the nation's capital stock idle, the Reagan Administration finds itself in a troublesome (and puzzling) position. Its main policy goal is to lower the budget deficit, but this means either raising taxes or cutting social spending at a time when millions of Americans are suffering grave economic distress. Martin Feldstein, Chair of the Council of Economic Advisors, made it clear to Congress that lowering the deficit is the Administration's only solution to the current crisis. He refused to discuss possible jobs programs.

At the same time Reagan announced his budget, a group of 500 government, business and academic leaders unveiled a Bipartisan Plan to cut the federal deficit by $175 billion in 1985. This article discusses what size the deficit should be. Next month, we'll look at the actual composition of the budget.

What is the Appropriate Size of the Deficit? Keynesian economics provides a way to calculate the federal deficit needed to restore the economy to full employment, which is called the "full employment budget deficit" (or F.E. deficit). The federal budget should be planned so that the deficit is zero when the economy is operating at full employment. In general, each percentage point of unemployment adds $30 billion to the actual deficit, since tax revenues are lower and spending for income support programs is higher. Economists disagree over what output level (and unemployment rate) represents full employment, so they calculate the F.E. deficit using a conservative unemployment rate of 6-7% (a more optimistic target would be 4-5%). At higher rates of unemployment, the budget should run a deficit, which will disappear when "full employment" or the target rate rate is reached.

In the table below, the actual (or projected) budget deficit is shown ballooning from -$58 billion in the 1981 fiscal year to -$214 billion in 1985. The "full employment" budget, which showed a surplus of $7 billion in 1981, has projected deficits escalating from -$24 in 1982 to -$120 billion in 1985. Since the F.E. deficit is calculated conservatively, a deficit of -$30 billion is not a cause for alarm and may even represent a better goal with lower unemployment. The federal budget was providing the proper amount of fiscal stimulus in 1981 and 1982, but since then the proposed budgets will be running deficits that are too large for our economy to recover without inflation. There is a structural imbalance in the federal budget, which was caused by the Reagan tax cuts and massive defense build up.

	1981	1982	1983*	1984*	1985*
Actual Budget Deficit (billions)	-$58	-$111	-194	-$197	-$214
"Full Employment" Budget Deficit or Surplus (billions)	+$ 7	-$ 24	-$ 63	-$ 90	-$120
Appropriate Budget Deficit (Congressional Budget Office)	-$51	-$ 87	-$131	-$107	-$ 94

*projected

The tax structure is simply not adequate to generate the revenues needed to pay for current commitments to defense spending and social programs. The deficit projected in the 1984 budget needs to be cut approximately $90 billion (or $60 billion with a less conservative definition of full employment). The 1985 budget deficit needs to be cut $120 billion. The Bipartisan Plan to reduce the deficit by $175 billion in 1985 is overzealous, since such a cut would result in the "full employment" budget running a surplus of $55 billion ($175-$120). Since a budget surplus decreases total demand, a budget surplus before full employment will stop economic recovery.

The Argument Against the Deficit. Why are some economists arguing for a deficit that is too low by Keynesian standards? They argue that financing a large government deficit will cause interest rates to remain high, which affects the economy adversely in two ways. First, higher interest rates depress investment spending and consumer expenditures for housing and autos. Second, higher interest rates keep the dollar overvalued relative to other currencies, so our already negative trade balance (exports minus imports) will deteriorate even further. All three things--lower investment, lower consumption, and imports greater than exports--result in a lower GNP. In this argument, rather than stimulating the economy, the federal deficit actually acts as a drag on the economy.

Although the current high interest rates are choking off a vigorous recovery, the budget deficits did not cause the high interest rates. The culprit must be found elsewhere.

The Role of Monetary Policy. So far, nothing has been said about the role of monetary policy, which sets the growth of the money supply and directly affects interest rates and the amount of credit available. The current recession has been long and deep because the Federal Reserve Board instituted a policy in 1979 of restricting the rate of growth of the money supply. The resulting high interest rates caused investment and consumption to fall and created an overvalued dollar. U.S. goods became overpriced abroad, and foreign goods became underpriced in the U.S. As the trade deficit grew, many policy-makers blamed the uncompetitiveness of U.S. goods on labor costs. Although the wages of steel and auto workers have increased relative to other workers, whose real wages have been falling, the trade problems have been caused by an overvalued dollar.

What's in Store for Us? Since summer of 1982, the Federal Reserve has discontinued its strict control of money supply growth and has allowed interest rates to fall. However, the real interest rate (the interest rate minus the inflation rate) is still almost twice as high as it should be by historical standards. In order to have a sustained period of output growth, the Federal Reserve must allow interest rates to fall further, which will encourage investment spending, increase consumption spending, and improve the trade balance. The argument that financing the federal deficit will crowd out private investment demands for credit is meaningless when firms are operating only 2/3 of their existing capital stock. Large demands for investment by business will not occur until the economic recovery is well underway. As the economy recovers, the budget shrinks, so government needs for credit fall. The current high interest rates were not caused by the budget deficit. They were caused by the money supply growing too slowly and by the business community requiring an abnormally high rate of return on assets because of the uncertainty of the future health of the economy.

If the actual budget deficit is reduced below $107 billion, which means a F.E. deficit of zero, the resulting decline in total demand will thwart the recovery. Right now, our economy needs a budget deficit of $131 billion and a growing money supply that brings down interest rates. If we fear that tackling our grave unemployment problem will result in inflation, then we need to discuss instituting a social contract that governs the distribution of output in terms of wages, profits, interest, and rent. We can no longer afford to fight inflation with depression.

-- Clair Brown