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## Real problem is not the deficit

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If the real rate of interest on government debt were zero, should the government tax or borrow to pay its bills? The recent announcement that the federal government expects to run a \$455 billion dollar deficit this year has caused a flood of confused angst in the nation's press. Editorialists and news writers have taken a symptom of a real problem, misdiagnosed it and prescribed economic medicines that will only make it worse.

To bring some clarity to the situation, let's start with the basics. Government can either tax or borrow to fund any given level of spending. Both have negatives, but some alternatives are far worse than others. Taxes are costly to collect both for the government and the taxpayers, but some taxes are far more costly to collect than others. Taxes also discourage whatever economic activity is being taxed, whether it is consumption (e.g., sales taxes), labor (e.g., income taxes), or saving and investment (e.g., taxes on interest, dividends, and capital gains). In general, less economic damage is done by taxing what people take out of the economy (sales and VAT taxes) rather than what people put into an economy (labor and investment).

Economists estimate that the overall "dead weight loss" (the tax collection costs, plus the distortionary and disincentive effects) on the private sector of the present tax system ranges from approximately \$1.60 to \$2.50 for each dollar that the government actually gets to spend. This means that for any government spending program to make us better off rather than worse off, the benefits need to be at least 60 percent higher than the cost.

Borrowing by the government tends to be less costly to the economy because the extraction and disincentive effects are much lower than taxing. Government debt financing competes with the private sector financing demands and hence can increase real interest rates, particularly if the government debt ratio is increasing relative to private debt. Also, the interest payments on the government debt must be financed either by additional taxing or borrowing.

Most economists agree that during times of national emergency, wars and cyclical downturns it is appropriate for government to run deficits. We borrowed to win World War II and to speed our victory during the end of the Cold War, and clearly we are better off because we did.

Despite all of the hand-wringing, our current situation is not particularly troublesome, but we do need to make some fundamental changes to ensure we do not get into difficulty. This year's deficit will be about 4.2 percent of GDP, which is manageable. We have had a number of years where it has been much higher, including the early 1980s when it was about 6 percent of GDP. The ratio of government debt (held by the public) to GDP will remain close to the 40 percent average of the last 50 years. By contrast, at the end of WW II the debt/GDP ratio was well above 100 percent. Most major countries of the world, such as Germany, France, Italy and, particularly, Japan have much higher debt to GDP ratios than we do. Finally, the costs of servicing the debt are only about 2 percent of GDP, in contrast to much of the 1980s and early 1990s when it was about 3 percent.

The bad news is that government spending has been growing very rapidly both in absolute terms (7.9 percent in 2002 and 10.0 percent this year) and as a percentage of GDP. Also, so-called "mandatory spending" — Social Security, Medicare, pensions, etc. — are growing as a share of federal spending. This situation is not sustainable over the long run.

In sum, the real problem is not the deficit (it is only a symptom). It is the rapid growth of government spending and entitlements.

Congress and the administration can improve the situation by eliminating or, at least, cutting back all of those government programs that are counterproductive or don't meet a basic cost-benefit test. Many public policy organizations have published excellent papers detailing government programs that should be abolished or revamped, so much of the necessary work has already been done.

Congress needs to get serious about reforming social security and Medicare. This is not a question of ideology, but one of arithmetic. Our population is aging rapidly, and the present programs are not sustainable and ultimately must be privatized, at least in part.

The tax system needs to be made less destructive. This means continuing to remove taxes from saving and productive investment. Remember, as previously discussed, when taxes are removed from savings and investment, the supply of capital is increased, offsetting any temporary increase in the deficit and pressure on interest rates, and the costs of tax extraction are greater than the costs of additional borrowing.

Now back to our opening question. If the real interest rate were zero and expected to remain so, the least destructive way to finance government spending would be borrowing rather than taxing. In the real world, interest rates are above zero, and so some combination of borrowing and taxing will be the least damaging way to finance government. To ensure prosperity, government spending should grow no faster and, preferably, slower than GDP and the cost of servicing government debt be kept under 3.5 percent of GDP.

Stop worrying about the deficit, but do be concerned about nonproductive government spending and unnecessarily destructive taxation.

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