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Is the deficit too small?

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The conventional wisdom is our federal government deficit is too large. However, the empirical evidence suggests the deficit might be too small.

When people worry about the size of the deficit, they are not worried about the deficit in a particular year; what they are worried about is the accumulation of debt that needs to be serviced.

Some years, most American families run a deficit (i.e., expenditures exceed income). For instance, most people obtain a mortgage when they buy a home. And the year in which they buy the home, their new debt obligation (the deficit) greatly exceeds their income. This is not a problem so long as the cost of servicing the additional debt acquired each year can be offset by rising incomes. The problem comes when the debt service rises faster than income for an extended time.

The same thing is true of government. If government revenue rises faster or the same as the increase in the cost of servicing government debt, there is normally not a problem. Problems occur when debt costs rise much faster than income, which has happened in some states like California.

Many people believe the government should not incur any debt and should always balance the budget. However, governments' financing expenditures with reasonable levels of debt can be more sensible than balancing the budget each year or even ever. The reasons for this are straightforward. Improperly constructed taxes, like the income tax, tend to discourage productive work, saving and investment more than issuing bonds does, so citizens are better off when the government engages in prudent borrowing. Also, government never needs to pay off or even reduce its total debt because, unlike individuals, the government lives forever.

Recently, a number of presidential candidates and other commentators have charged the current and projected deficits are too big. They claim the deficits will lead to higher inflation, higher interest rates, lower growth and more unemployment. To evaluate these charges, I looked at the numbers for the last 40 years, and you may be surprised at the results.

The total federal government debt held by the public (which is the relevant number to be concerned about) dropped from 42 percent of gross domestic product (GDP) in 1962 to a low of 25 percent in 1975, then rose to a high of 50 percent in 1993, and then dropped back to 33 percent in 2001. Currently, debt as a percent of GDP stands at about 35 percent.

Since 1963, we have had 14 years when debt has been below 33 percent of GDP and 26 years when it has been higher. Conventional wisdom is that economic performance should have been better in the years when we had less relative debt, but the facts are the opposite. Real economic growth averaged 3.47 percent in the high debt years, which was almost 1 percent higher than the 2.59 percent average growth of the low debt years.

Unemployment was also lower in the high debt years averaging 5.65 percent as opposed to 6.43 percent in the low debt years. Inflation averaged a whopping 7.6 percent in the low debt years, almost 3 times as high as the average 2.95 percent of the high debt years.

The Congressional Budget Office (CBO) estimates federal debt could grow to as much as 40 percent of GDP by 2005 and then begin declining again. From 1986 to 1999, it was above 40 percent, and we did quite well during most of those years. Recent data showing both much higher economic growth and higher inflation (meaning much higher nominal GDP) than the CBO forecasted means the debt GDP ratio in fact is likely to remain almost constant.

What we do need to be concerned about is not the deficit, but the very rapid growth in real, nondefense, discretionary federal government spending, which is up an average of 7.2 percent yearly for the last three years. A continuation of this trend could indeed cause real economic damage.

Finally, the analysis of the historical data clearly indicates that if we had properly structured tax cuts (like the first Reagan and the most recent Bush tax cuts) in 1969, 1973, 1979, 1989 and 2000 we may have avoided the recessions, with all their human misery and unemployment, that occurred the year following each of the above dates. Unfortunately, policymakers in all of those years were more preoccupied with reducing the deficits rather than keeping the economy growing.

The lesson is clear, economic prosperity can continue, even if the federal government never balances its budget, provided it keeps government spending from growing as a percentage of GDP, and has an ongoing program of removing tax and regulatory impediments to growth.

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