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A Keynesian Defense of the Reagan Deficit:

The Real Issue Is How Big Should Federal Budgets Be and How Should They Be Met

By ROBERT J. ALEXANDER*

ABSTRACT. Agreement is general that the U.S. *budget deficit* of the *Reagan administrations* is a national disaster. The *supply side* and *Laffer curve economics* of Mr. Reagan and his advisers have proved totally fallacious. Draconian *monetary policy* curbed the *inflation.* But most of the negative charges against the deficit have also proved wrong. The U.S. is not a '*debtor country.*' The *purchasing power* pumped into the economy may have mitigated the crisis in major U.S. *industries.* The real issue in the budget deficit debate is how big a share in the economy should the Federal Government have and should it be financed by *taxation* or *borrowing.*

FEW THINGS ARE MORE TALKED ABOUT today than President Ronald Reagan's budget deficit. Yet, although the great majority of economists, of virtually all schools, and almost every politician from Mr. Reagan himself to those on the far Left of the Democratic Party agree that that deficit is a national disaster, little has been done about ending it. And the Republic has survived. The purpose of this paper is to raise the question as to whether it is in fact in the national interest "to do something" about the deficit.

I

It is Mr. Reagan's Deficit

TO BEGIN WITH, it is important to make clear that it really is "Mr. Reagan's deficit." He and his associates are fond of putting the blame for the state of the government's finances on the "Big spending Democrats." However, the evidence clearly contradicts that assertion.

Here, the "accepted wisdom" among both economists and politicians comes to our aid. Indeed, this is probably the only part of the "accepted wisdom" with which we shall agree in this paper. It is generally agreed the the very large deficits of the Reagan administration are the results of the combination of dras-

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tically reduced taxes and of very greatly increased defense expenditures which was launched in the first year of the Reagan incumbency.

In sponsoring this combination, starting in 1981, President Reagan and his advisers werre following their own new "accepted wisdown," that is, supply side economics and the Laffer curve. According to these theories, a drastic cut in income taxes would so inspire the entrepreneurial initiative of United States individuals and firms that the former would vastly increase their savings, which would be automatically converted into investment by the latter, resulting in a boom in the economy and an increase in actual tax collections in spite of the fall in tax rates.

Of course, John Maynard Keynes more than half a century ago had clearly indicated that there was no automatic relationship between the tendencies to save and the tendencies to invest in the economy. But for Mr. Reagan and his advisers, the ideas of Keynes were anathema, almost in a category with those of the Evil Empire itself.

But Keynes turned out to be right, and the supply siders to be wrong. What resulted from the tax cuts was a large increase in consumer expenditure, with at best a mild increase in investment in some sectors while other parts of the economy were in frank decline, in investment and all other terms. What also resulted was Mr. Reagan's deficit.

There is probably no better witness to what happened than David Stockman, who, during the first phase of Mr. Reagan's administration, was the President's principal economic adviser and policy molder. In the beginning a fervent supply sider, he quickly came to realize that the predictions of Arthur Laffer and others were not to come to pass. When, after a more or less fruitless effort on his part to get the administration to raise taxes to limit the vast increase in the deficit, which he saw as a disaster, was to no avail, he left the administration—and wrote a book about his experiences.

Stockman notes that his and his colleagues' predictions were based on what he calls "the Rosy Scenario," that is, that the 1980–81 inflation would continue, thus automatically raising federal revenues. Under these predictions, he says, "the old, 1970s tax and spending policy would have projected out over five years to produce an unprecedented surplus without cutting a dime of domestic spending."[1] But, he notes, the inflation was broken by the drastic policies of Paul Volcker's Federal Reserve Board during the first Reagan years. So the predictions of Stockman and others proved wrong.

He castigates what he saw as the resulting situation. He notes that "I cannot be so patient with the White House. By 1984 it had become a dreamland. It was holding the American economy hostage to a reckless, unstable fiscal policy

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based on the politics of high spending and the doctrine of low taxes. Yet rather than acknowledge that the resultant massive buildup of public debt would eventually generate serious economic troubles, the White House proclaimed a roaring economic success. It bragged that its policies had worked as never before when, in fact, they had produced fiscal excesses that had never before been imagined."[2]

Whatever one thinks of Mr. Stockman's judgment about the disastrous nature of what happened, he certainly makes clear where the cause of the budget deficit lay. He confirms this in another passage in his book, citing a memo he wrote to the President, in which he commented that "as for the mess we'd inherited from Jimmy Carter, well, oops! Under his policies, the deficit by 1986 would only have been $80 billion. 'A weak argument for our case' I noted."[3]

Of course, the figures of the deficit are the most definitive proof of whose deficit it was. In fiscal 1979, the deficit was $40.2 billion; in fiscal 1981, it was $78.9 billion; in 1982, the first full Reagan fiscal year, it was $127.9 billion, and by 1986, the deficit was $220.7 billion.

II

Charges Against the Deficit

THIS DRAMATIC INCREASE in the deficit during the Reagan years has provoked a Greek chorus of lamentations from economists and politicians alike as to its dire consequences. At least four major charges were made: the deficit contributes to inflation, it leads to high interest rates, it "squeezes out private investors," and it has converted the United States into a "debtor nation." I wish to refute all of these claims, and then point out a virtue of the deficit of the last eight years which has been largely overlooked.

The Deficit and Inflation

First, the charge that the huge increase in the deficit has stimulated inflation is clearly shown by the relevant figures to be fallacious. Exactly during the period in question, the consumers' price index steadily fell from 13.5% in 1980, the year before Mr. Reagan took office, to 3.6% in 1985, and has been at about the 1985 level since.

Of course, there were at least two major factors which have brought a fall rather than an increase in inflation during the years in which the deficit was skyrocketing. One has been the collapse after 1981 of world petroleum prices, with its repercussions throughout the economy. The other has been the fact that the exceedingly drastic use of monetary policy by the Volcker Fed provoked the worst recession since the 1930s in the 1981–1983 period and broke the inflationary spiral of the 1970s. With unemployment running in the vicinity of

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10%, as it was in 1982,[6] it was no longer possible for businessmen to continue to increase prices if they intended to sell enough to stay in business.

Ironically, the figures would seem to argue that if there is any connection at all between the rise in the deficit and the rise in prices during recent years, it has been a perverse one, that is, that the deficit increase has provoked lower prices. But that argument reminds one of the correlation between the migration of storks to Sweden in certain months of the year with the high birth rate among Swedes during those same months.

Interest Rates and the Deficit

Somewhat the same kind of analysis might be made of the supposed responsibility of the rising deficit for rising interest rates. The figures don't bear out that claim.

Everyone's favorite interest rate, the prime rate, rose from 12.67% in 1979 to 18.87% in 1981,[7] and then fell more or less steadily to 8.5% in 1986.[8] Thus, the prime rate rose drastically during the period of the relatively modest deficits of President Carter, and fell drastically during the period that President Reagan was more than tripling the deficit.

The fact is, of course, that it is the Federal Reserve System which has largely determined the direction and rapidity of change in general interest rates. This is clearly demonstrated when one looks at the correlations between the prime rate's behavior and the Fed's changes in its own discount rate.[9]

In July 1979, the discount rate at the New York Federal Reserve Bank stood at 10%. By the end of December 1980, it had risen to 13%, and reached its high point in May 1981, at 14%. Thereafter, the discount rate began to fall, and by August 1986, it had been reduced to 5½%.[10]

Here again, if there has been any relationship between growth of the deficit and interest rate trends, it has been perverse. The best conclusion one can reach is that they have little to do with one another during the Carter-Reagan period.

The Deficit and "Squeezing Out" Private Investment

The argument that the growth of the deficit has "squeezed out private investors" would seem to be as fallacious as the charges having to do with inflation and the interest rate. Certainly there is little evidence that there has not been enough credit to go around.

Clearly, one of the most spectacular features of the United States economy during the Reagan years has been a vast amount of borrowing to finance takeovers, friendly and unfriendly, and mergers and related activities. Ingenious new or expanded credit instruments, such as junk bonds, second mortgages and other devices, have assumed great importance.

Nor would the boom in the stock markets during the last decade seem to indicate any lack of financial resources in the private sector because of the

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increase in the federal government's debt. Prices in those markets have tripled during the last decade and the amount of shares bought and sold each day have expanded almost ten times over.[11] During the same period, some economists have expressed growing worry over expansion of consumer debt—not an indication that would-be borrowers have been "squeezed out" of the market.

Professor Robert J. Barro of the University of Rochester has recently commented on the "freezing out" issue. He wrote that "Real private investment expenditures, when measured in the appropriately broad manner to include purchases of consumer durables, were at the post-World War II high of 28% of real GNP from 1984 to 1986. Instead of demonstrating crowding out, these figures indicate a robust economy with a favorable climate for investment."[12]

Some economists have argued that the still historically high levels of interest are an indication that private borrowers are being "squeezed out," in a process of rationing through price. But earlier on, we indicated that it is the FRS which basically sets interest rates—one might suggest that if the FRS wants them lower, they will get lower.

The Deficit and the U.S. As a "Debtor Country"

The final charge against the deficit is that it has contributed to making the United States a "debtor country." The simple answer to that is that the United States is not a "debtor country," as that has been understood until the charge began to be raised a year or so ago.

The concept of debtor country has until yesterday meant that a country owed more in foreign currencies than it had coming in in foreign currencies. The United States was a debtor country until 1914, owing more in francs, marks, guilders and pounds than were owed to it. It ceased being in that situation during World War I, and has not returned to it since.

To comprehend this concept, one may compare the present situations of the United States and Brazil. The latter nation is indisputably a debtor nation. It owes approximately $110 billion, which it must pay in dollars, which are not the currency of Brazil. In contrast, all but an infinitesimal part of what the United States owes abroad is owed in United States dollars. Only the monetary authorities of the United States can legally issue United States dollars, and they can do so whenever they take it in their mind, for one reason or another, to do so. In other words, the United States doesn't have to earn foreign currencies in order to pay its debts; Brazil does have to earn dollars from abroad in order to pay its debt abroad.

It is probably true that a significant portion of United States federal debt is owed to foreigners. It is also true that to an increasing degree in recent years foreign firms and individuals have been buying property and otherwise investing their financial resources in this country. But this is far from making United States

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a debtor country; what buyers of federal bonds or other property are entitled to if they decide to liquidate these investments is, in any case, United States currency, which as the old slogan used to say, is "made in the U.S.A."

Some people have expressed fear that the federal government may at some point have trouble in continuing to market its debt if the foreigners who have been purchasing it suddenly decide for whatever reason to stop doing so. Such a decision by foreign purchasers of the debt is certainly conceivable, but it certainly won't mean the end of a market for U.S. government obligations—but that would be the subject of another paper.

In any case, whether foreign purchasers of the debt reach such a decision is likely to depend much more on the general state of the United States economy than upon the continuing expansion of the federal debt. Certainly, one can conceive of a situation in which the U.S. economy has moved so far from being principally a maker of goods and real services and so far towards being an economy of speculators, that the continued purchase of securities denominated and payable in dollars will seem to have lost all purpose. This is conceivable, and is, it seems to me, a real cause for future worry, but we are still a considerable distance from that state, and the reversal of the trend from a productive to a speculative economy is still eminently possible.

III

The Positive Aspects of the Deficit

FINALLY, HAVING SEEN that most of the negative aspects of the deficit are illusory, we come to the positive aspects of the growth of the deficit under Mr. Reagan's aegis. In simplest terms, the existence of a federal government deficit means that the government is putting more income into the economy than it is taking out of it. During Mr. Reagan's presidency, this excess has been between $100 billion and a bit more than $200 billion a year in a total CNP which is now about $4 trillion.

This has meant that the federal government has been injecting into the economy a larger amount of effective demand than it had formerly been providing. It is hard to see why that has been bad for the general health of the economy. There are at least two other aspects of the U.S. economy during the last six years which underscore this fact.

First, President Reagan presided over the worst recession in fifty years during the first two and a half years of his administration. Since it was consumer buying rather than anything else which began the recovery from that recession, it seems likely that the increased purchasing power provided by the 1981 tax cuts contributed substantially to that modest recovery.

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Second, the underlying state of the economy has not been healthy during recent years. Major United States industries have been in crisis, with disinvestment rather than investment and zooming unemployment characterizing them. It seems likely that the additional income provided by the federal deficit has at least in the shorter run made the impact of this underlying crisis less severe than might otherwise have been the case.

IV

Conclusion

HOPEFULLY, THIS PAPER has indicated why there should be some skepticism about any serious efforts to abolish or even seriously reduce the deficit. It is certainly not clear that such an eventuality would contribute to the general health of the economy. The deficit is not responsible for most of the evils attributed to it; its possible virtues are generally overlooked.

To end, let me tentatively put forward a somewhat different view of how to look at the whole question of the federal budget and its deficit. What the government budget decides, basically, is what part of the output of goods and services of the economy will be directed by the federal government. Perhaps the whole approach to the issue ought to be cast in those terms.

From that point of view, there would seem to be two basic questions to raise. First, there is the issue of what it is felt, from economic, ideological and political perspectives, should be the share of the federal government in the total GNP. The second relevant question would then be that of what things the government should be doing, or doing more extensively, than it is now doing. The answer to this, too, would have not only economic but ideological and political parameters.

If these questions are first addressed, the issue of the deficit would acquire the secondary importance which it deserves. Given a modicum of agreement on how big a share in the economy the federal government should have, and what responsibilities should be attributed to it, the issue of whether the government should get the financial resources needed to fulfill its agreed-upon role from taxation or from borrowing would become a matter of convenience rather than principle. At least it might be hoped that there would be less demagoguery and posing provoked by the issue than has recently been the case.

Notes

1. David A. Stockman, 1986. *The Triumph of Politics: Why the Reagan Revolution Failed.* New York: Harper and Bros., pp. 133–34.

2. *Ibid,* p. 377.

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3. *Ibid,* p. 358.

4. *Statistical Abstract of the United States 1986,* 106th Edition, U.S. Department of Commerce, Washington, DC, 1985, p. 305; and *Federal Reserve Bulletin,* Board of Governors of Federal Reserve System, Washington, DC, Vol. 73, No. 1, January 1987, p. A29.

5. *Statistical Abstract of the United States 1986, op. cit.,* p. 479; *Monthly Labor Review,* U.S. Department of Labor, Washington, DC, January 1987, p. 108.

6. *Statistical Abstract of the United States 1986, op. cit.,* p. 406.

7. *Ibid,* p. 853.

8. *Federal Reserve Bulletin,* January 1987, *op. cit.,* p. A23.

9. *Statistical Abstract of the United States 1986, op cit.,* p. 479.

10. *Federal Reserve Bulletin,* January 1987, *op. cit.,* p. A6.

11. For details on stock market behavior, see Robert J. Alexander: "Is the United States Substituting a Speculative Economy for a Productive One?" *Journal of Economic Issues,* Vol. 20, No. 2 (June 1986).

The Ideology of American Liberalism

BASED ON AN ANALYSIS of the work of six leading sociologists—Albion Small, W. I. Thomas, Robert Park, Louis Wirth, William Ogburn and Morris Janowitz—Dennis Smith explores the interplay between the constraints and opportunities of sociology, liberalism and capitalism, the key to the work of the prominent scholars who compose the Chicago School.

Smith reports the result of his investigation in *The Chicago School: A Liberal Critique of Capitalism,* a new volume in the distinguished series, Theoretical Traditions in the Social Sciences (New York, NY 10010: St. Martin's Press, 1988, $45 cloth, $14.95 paper).

He discusses the fundamental concerns of these pioneering sociologists, with particular emphasis on their attempt to construct a morally relevant and socially-useful academic discipline. They considered very seriously the goals and values lauded as "the American Way" and wrestled with the inherent ambiguities of this historically grounded myth and its many implications.

Among their other preoccupations—in keeping with their interest in civic responsibility—were urbanism, ethnography, demography, symbolic interactionism, criminology and economic patterns.

The intellectual and moral outlook of the Chicago sociologists within the tradition of American liberalism is examined, as well as how these views offer a critical perspective on modern American society. Early influences, such as John Dewey and Thorstein Veblen, are highlighted, as well as later parallels to Jürgen Habermas and the Frankfurt School. An underlying theme in the work is the relationship between American and European intellectual currents in the late 19th and early 20th centuries, providing an historical context in which the ideology of the Chicago School was fostered. (From Rachel Berek for the publisher).

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