The Economy: Hard Choices

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Source: *The Journal of Negro Education* , Summer, 1989, Vol. 58, No. 3, Shaping the Urban Future: People and Places, Problems and Potentials (Summer, 1989), pp. 270-275

Published by: Journal of Negro Education

Stable URL: https://www.jstor.org/stable/2295659

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*The Economy: Hard Choices**

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I would much prefer to talk about easy choices, but I will do as I was told and talk about hard choices. I will not try to cover all of the choices which this nation must make in the next decade because there are a lot of them and they range from social and economic issues to foreign policy issues. I will, however, pick one very difficult choice that the American people are going to have to make in the period ahead.

For six years now, the whole country has been on a spending binge. As a nation, we have been spending more than we produce. That over-spending is symbolized by our two big deficits. By simultaneously cutting taxes and sharply increasing defense spending, the outgoing federal administration stimulated a growth in domestic spending by consumers and by government. In turn, because we spent more than we produced, the nation had to borrow the difference from abroad. That is what we have been doing; we have run up a huge trade deficit by importing a lot more than we exported and by financing our spending with overseas borrowing. We cannot keep this up. Even if we could, we should not. As a nation, we are going to have to adjust our national spending habits, and that is not going to be easy.

The overspending binge—what caused it? What are its consequences? What must we do about it? What happens if we do nothing? Let me start with the first of our two deficits, the budget deficit. My first chart simply depicts the size of the federal budget deficits in the post-war years [see Figure I]. Note that I express the deficit as a percentage of our gross national product (GNP) because that is the only way to compare the deficit to the size of our economy. Up until 1979, the budget deficits as shares of GNP were not very

*Presented at the Twenty-first Anniversary Convocation of the National Urban Coalition (Washington, D.C., May 1988). The speech has been modified for publication.—ED.

Journal of Negro Education, Vol. 58, No. 3 (1989)
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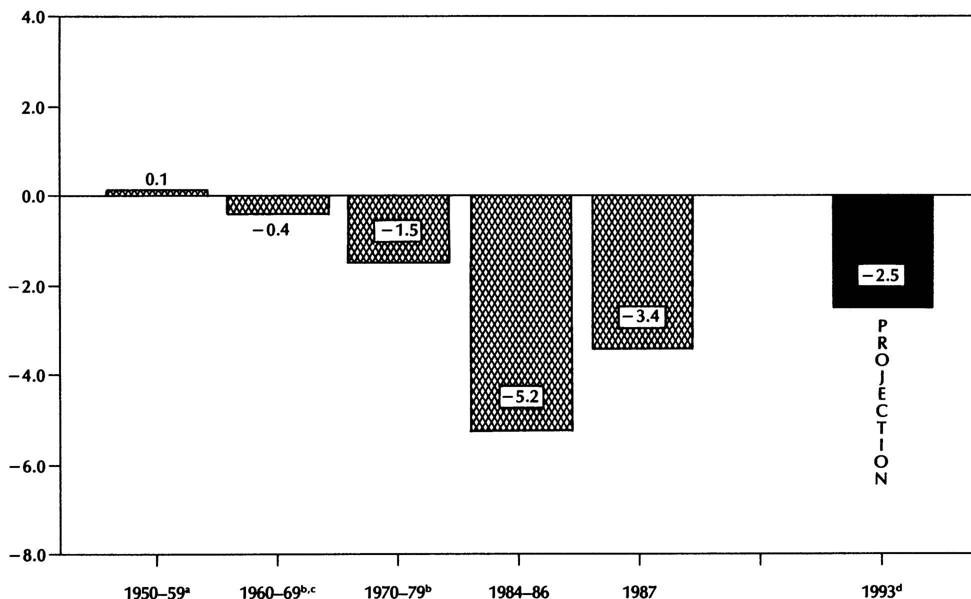
FIGURE I

U.S. Budget Deficit in Nonrecession Years as Percent of GNP (Fiscal Years)



Note:

a. FY 1950–59 excludes 1950, 1955, 1959.
b. FY 1960–69 excludes 1961–2, 1968; FY 1970–79 excludes 1971–2, 1975–6.
c. Note that 1960–69 average excludes 1968 (large Vietnam War deficit).
d. Assumes $160 billion "Current Service" Budget Deficit.

large and they increased only little, from virtually nothing in the 1950s to 1.5 percent of GNP in the 1970s. Beginning in 1981, those budget deficits bloomed to over 5 percent of GNP. The subsequent years were ones of $200 billion, back-to-back budget deficits. In 1987, mainly because Congress stopped the growth in defense spending and also discovered a few neat accounting gimmicks, the budget deficit dropped again, down to 3.5 percent of GNP. My best guess is that it will fall further, to something like 2.5 percent, by 1993.

Using dollars rather than percent of GNP, this year's budget deficit is likely to be about $160 to $170 billion. The Congressional Budget Office, whose forecasts can be trusted much more than those of the administration in this matter, projects a $135 billion budget deficit by 1993. Even that figure is too optimistic, for two big reasons: first of all, in the past five or six years, the Congress and the president together have cut the nondefense budget. Unfortunately, they did not cut it selectively. They penny-pinched every-

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where, nipping the good, the bad, the wasteful, the not-so-wasteful, the low priority, and the high priority. Of course, everyone's definition of high priority is different, but, in effect, Congress held everything down.

The result has been that we have accumulated a backlog of needs and quite a plethora of social problems. Even apart from dealing with the social problems, it will take increased budget spending simply to maintain a modern government with a federal aviation agency, a bureau of prisons, a national parks system, and so on. In all of those agencies we have been building up a bigger and bigger backlog of needs that we cannot postpone forever. Thus, over a period of five years, we need to add $20 to $30 billion to the budget deficit of $135–140 billion that is now projected under current policies just to take care of the backlog in our ordinary national housekeeping needs. If nothing is done about these basic needs, I put the budget deficit by 1993 at something like $150 billion, which is 2.5 percent of GNP.

Now, you might ask, so what? That is only half the 1984–86 ratio of the deficit to GNP. Plus, you may recall that we had those big budget deficits of 1984, 1985, and 1986 without any surge in inflation; indeed, inflation and unemployment actually decreased during most of that period. Five years ago, if I had asked most of my economist colleagues what the consequences of running a $200 billion budget deficit year after year would be, they all would have warned that such a practice would stimulate excessive spending in the economy and blow us into inflation; with inflation accelerating, the Federal Reserve eventually would have to slam on the brakes, and we would have a big recession. That, however, did not happen. We have learned how to handle huge budget deficits without inflation and without the subsequent unemployment that comes when inflation rises sharply. That does not mean that those deficits are not harmful.

What harm has the budget deficit wrought and why do we need to get rid of it? As I have noted, our deficit went from 1.5 percent of GNP in the 1970s to 5 percent of GNP in the mid-1980s. How did we finance that? To explain, I must digress for a moment.

There are only four ways to finance a budget deficit. The first way is to have the Federal Reserve pump a lot of new credit into the economy. The Federal Reserve can turn on the printing presses and manufacture enough new credit to finance both the normal spending of the economy and the government budget deficit. Unfortunately, all of that excessive financing would blow us into inflation. Yet, we did not take that route; we avoided inflation.

The second possible way to finance a big budget deficit is for

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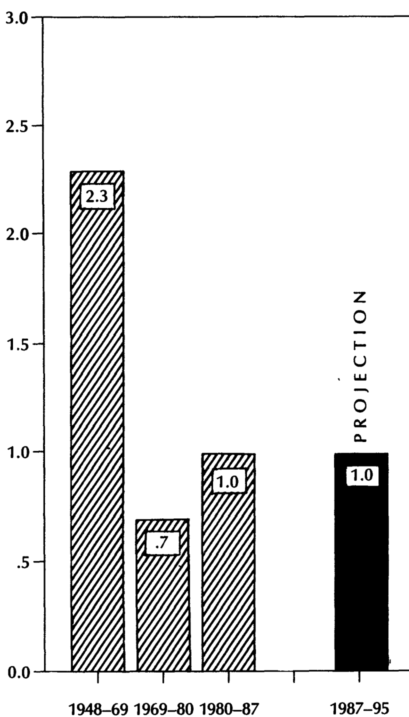
the private sector of the economy to save more. If consumers and business firms save more, the additional funds become available to finance both the budget deficit and our normal needs. We did not follow that route. In fact, the private savings rate in the United States actually went down, not up.

The third way is to rein in investment spending, diverting funds that would have flowed into business investment into financing the budget deficit. We did not take this route, either. We did not limit investment spending as a way of meeting the government's borrowing needs.

Instead, we took route number four: we borrowed the funds from abroad. We spent more than we produced and imported the difference. How long will this last? Foreigners will not keep on financing our spending boom indefinitely. Figure II shows that, in order to get our spending back in the line with our production, we are going to have to limit the combined growth in government

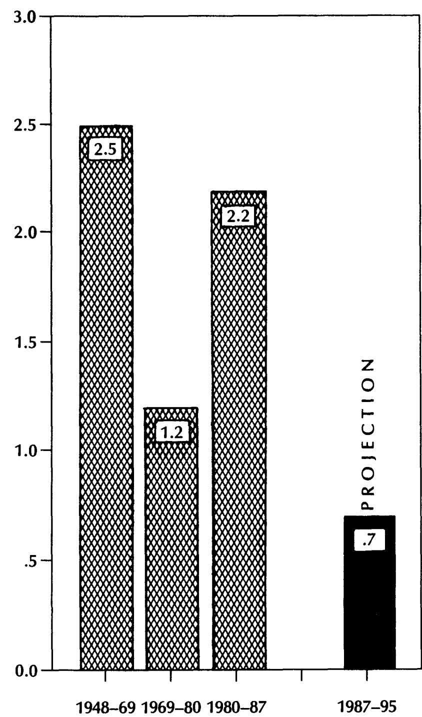
FIGURE II

GNP Per Worker
Annual Growth Rate (Percent)



Note: All changes are based on data in dollars of constant purchasing power.

Consumer & Gov't Spending Per Capita
Annual Growth Rate (Percent)



Note: All changes are based on data in dollars of constant purchasing power.

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spending and consumption to less than 1 percent a year for the next eight years. We must squeeze the growth of some combination of consumer and government spending to about a third of what it was during the Reagan years.

Let me say that another way. If we look back on the Reagan years, we see that national production did not grow any faster during that period than it did in the previous years [see Figure II]. National spending, however, did grow faster; thus, some of us could say that we were better off than we were eight years ago. Measured in terms of spending, we were, we were able to spend more than the nation could produce by importing the difference from abroad. However, that luxury ultimately will come to an end. The nation is going to have to make a very difficult set of adjustments to cut the growth of spending—which, for 7 years now, has been increasing by 2-2.5 percent a year--back to well under 1 percent a year. That will not be easy.

Can we avoid these adjustments? Can we go on about our merry way with our 1980–87 habits, spending much more than we produce? Possibly, we can, if we can convince foreigners to keep on pumping lots of funds into the United States. Even then, we would be building up overseas debts, on which we and our children would have to pay interest and which, in turn, would lower our future living standards.

In estimating the future growth of consumption [Figure II], I have assumed that the inflow of foreign funds into the United States will dry up by 1995. Suppose, though, that it does not. Suppose that we keep the spending and foreign borrowing binge going. I do not think that we can, but suppose that we convince foreign creditors to let us do that. If, belatedly and gradually, we make the adjustments, then not long into the twenty-first century, the United States as a nation will owe $2.6 trillion abroad, not to ourselves but to others. It will not be as if we borrowed $2.6 trillion to invest in education, business plants, factories, or houses; rather, the money will have been blown on government spending for defense and other items and on consumer goods. Furthermore, the interest on $2.6 trillion—$150 to $200 billion annually—will be thrown away forever.

If the U.S. trade deficit remains large and the foreign funds keep flowing in, we could, indeed, postpone repayment for a while. We should not postpone it, however. We ought to make the adjustment now. The longer we postpone, the nastier the medicine will be in the future. How, then, do we adjust? How do we cut our national spending down to fit our rather modestly growing national production? Again, we do have some choices. There are two basic

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ways: (1) we can cut the budget deficit with tax increases, or (2) we can raise interest rates.

Cutting the budget deficit will require a big tax increase. Tax increases will cut consumer spending; and we can, of course, cut government spending. That approach is painful and difficult to carry out. Among the current presidential candidates, only Jesse Jackson has suggested doing so. The second route, raising interest rates to a very high level, robs our children in an important way by reducing spending on long-term investments such as housing, business plants and equipment, and other items.

So, either we raise taxes now and cut consumer and government spending, or we raise interest rates and limit investments in the future. We have already robbed our children by saddling them with a huge and growing foreign debt on which they will have to pay the interest. So, fundamentally, the hard choice is between now and the future.

There are many ways that we can make the adjustments. There is legitimate room for all sorts and levels of taxes and spending cuts, and there is also a lot of room for legitimate partisan and nonpartisan arguing about how to go about them. Now, George Bush and Michael Dukakis can talk until they are blue in the face, but there is absolutely no way in the world that we can get by without a tax increase. We cannot escape it. We are going to have to do it, eventually. The question is, do we do it in a way where we take on some of the burden ourselves and give back some of those ill-gotten gains of the last seven years, or do we do it in a way that will penalize our children? That is the hard choice: now or the future.

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