



Policy Note

1998/6

What to Do with the Surplus: Fiscal Policy and the Coming Recession

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Neither Congress nor the president is on the right track. Rather than protecting the surplus, we should be increasing spending and cutting taxes to contain the looming world recession.

The United States has enjoyed a Goldilocks economy since the early 1990s: robust growth, low unemployment, and low inflation. After much debate, many resolutions, historic budget agreements, and a strong equity market, the federal government finally managed to balance its fiscal 1998 budget (indeed, ran a surplus) for the first time in more than a generation. Predictably, a new debate--over "what to do with the surplus"--has emerged. Some policymakers favor tax cuts, others prefer debt reduction, and the president has advocated the rescue of Social Security. We argue that the budget surplus will be short-lived as the coming worldwide recession slows growth in the United States and lowers tax revenues. In our judgment the deficit reduction during the 1990s played a significant role in depressing aggregate demand, which was offset only by unsustainable private sector borrowing. As the private sector in the United States becomes cognizant of declining equity markets, the spread of financial crises from Asia to Russia and Latin America, and falling world demand, it will be forced to reduce borrowing and repay loans. This will cause an economic downturn in the United States. While we applaud the Federal Reserve's recent timid moves to lower interest rates, we do not believe that monetary policy alone can stabilize the U.S. economy. Rather, substantial fiscal stimulus will be required. Although well-targeted tax cuts may do some good and should be considered, the stimulus should be supplied mainly in the form of an increase in the federal government's budget.

Background

Tonight at midnight America puts an end to three decades of deficits and launches a new era of balanced budgets and surpluses," President Clinton declared on September 30 as the federal government closed out its fiscal year with an estimated budget surplus of \$70 billion. Surpluses are projected to continue over the next decade, with the accumulated total projected to reach more than a trillion and a half dollars by 2007. Many have credited the nation's long expansion to declining deficits since the early 1990s, agreeing with Robert Reischauer's assessment that "The strength of the economy that we're all enjoying now is in no small part attributable to the efforts we've made to eliminate the deficit. We can be buffeted by the winds from Asia and the waves from Latin America, and still our economy chugs along."

In recent days, some Republican members of Congress have proposed to use the government's projected budget surplus to "finance" a tax cut. President Clinton has rejected such proposals and argued that Americans should "continue building a stronger America" and that surpluses should be set aside to protect Social Security. He chastised congressional Republicans who "want to drain the surplus to fund a tax plan before we make the most of our opportunity." He threatened to veto any tax relief that does not preserve "all the surplus" and provide a plan that "rebuilds our crumbling schools, helps working families with child care, and supports small businesses in getting pension plans." He implored Congress to "send me a tax cut that keeps us on the path of fiscal responsibility." Alas, Congress has been able to achieve a budget agreement for the current fiscal year leaving the surplus basically intact.

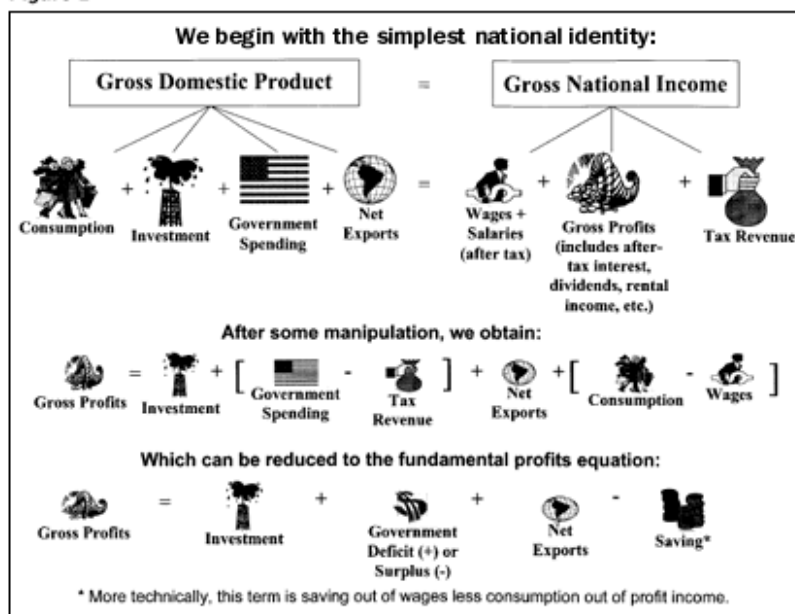
It appears that neither Congress nor the president understands the economic issue at hand. While a tax cut might be a good idea given the deflationary pressures around the world today and given the strong likelihood that the United States faces a deep recession in the coming year, the notion that a budget surplus should finance a tax break is muddled. It is as if a household were to use its savings to negotiate a pay cut. Federal government surpluses are almost always short-lived because they unleash tremendous deflationary pressures that eliminate private sector profits and cripple the economy. Surpluses generally result from strong economic performance rather than from discretionary budget cuts. The reduction of deficits under President Clinton was mainly a result of the robust expansion; the reduction did not cause the expansion. Indeed, for reasons we discuss below, the expansion occurred in spite of deficit reduction.

The International Monetary Fund has recognized that the likelihood of a world recession is much higher than it previously believed; it fears that the world faces the worst economic crisis of the past 50 years. The Japanese economy will shrink by 2 percent; the Russian economy will shrink by 6 percent this year and the next; the world economy will probably grow at a pace well below 2 percent. While the IMF has called for swift and "concrete" action to stem the crisis, it has not offered any specific policy recommendations--beyond rejecting President Clinton's call for earlier IMF intervention to lend to troubled countries. We believe that the deficit-cutting mania that has afflicted IMF policymakers, and the policymakers in Washington, has blinded them to the role that government spending must play in containing the looming world economic crisis.

The Role of Deficits

As economists have long understood, government spending generates private income. Government spending can contribute to productivity when it adds to the nation's stock of physical and human capital, when it finances innovation, when it encourages research and development, when it improves health and education, and when it lowers private sector costs. Government budget deficits can be beneficial. Not only do deficits result in a net increase of private sector disposable income (since the income created by the government exceeds the taxes collected whenever there is a deficit), they directly add to corporate profits. Everyone understands that the behavior of a capitalist economy depends on profits. The fundamental profits equation shows national (gross, after-tax) profits are, by definition, equal to spending on investment plus the government's deficit spending plus net export spending minus household saving (see Figure 1).¹ In other words, all of the major categories of spending except household consumption add to the flow of profit income, and household saving detracts from profits. It might appear strange that saving reduces profits, but if one remembers that saving is income received but not spent, then it follows that saving cannot add to business sector profits; it is not a revenue source, but a leakage that diminishes profits. Government spending in excess of tax revenue (that is, deficit spending) is a net revenue source to firms. Government adds to profits directly when it purchases output of the private sector and adds to profits indirectly by providing transfers to households to purchase more output.

Figure 1



Public sector deficits generate private sector wealth in the form of the government bonds that are normally issued when the federal government runs deficits. As Hyman Minsky frequently observed, government deficits provide highly rated financial instruments that are crucially important for the safety of portfolios of retirement plans and nonprofit institutional endowments.

We do not mean to imply that deficits can never be too large. Our task is to dispel the ideas that deficits are always bad, projected government surpluses must be protected, and outstanding debt must be reduced at all costs. Alexander Hamilton proclaimed, "A national debt, if not excessive, will be to us a national blessing." Similarly, Thomas Paine recognized, "No nation ought to be without a debt [for] a national debt is a national bond." In other words, public deficits create private sector wealth, which is accumulated in the form of claims on government. Unlike private sector debt and equity, federal government debt is free of default risk and is highly liquid. Trying to use the projected surplus to retire outstanding government bonds is exactly the wrong policy prescription for an economy moving into recession and with private wealthholders already fleeing the equity and other financial markets to high-quality government bonds!

Those who argue that deficit reduction stimulates private saving and thus private investment do not recognize the impact that higher taxes and lower government spending have on private sector income flows. Most importantly, lower deficits must lower private sector profits, unless some other spending component increases to compensate. Since today's profits are an important stimulus for tomorrow's investment, deficit reduction is not likely to encourage investment unless expectations about the future overcome the negative shock that reduction has on current profit flows. In today's pessimistic environment, it is unlikely that investors are sufficiently upbeat to overlook profits reports. Further, household saving is not likely to rise as deficits are reduced since the reduction will reduce household incomes--unless some other spending component rises to keep income from falling. Again, there is no reason to suppose that any of the categories of domestic spending or the export sector is likely to grow quickly enough to increase household or business income; indeed, deficit reduction has--thus far--neither raised household saving nor changed the abysmal imbalance in the trade sector at all. Rather, the "consumption binge" of the current expansion, as noted by some observers, has been fueled by rising household indebtedness (and, in some cases, by a "wealth effect," as households have spent and borrowed based on stock market gains). Unless Wall Street regains what Federal Reserve chairman Alan Greenspan characterized as its "irrational exuberance," we expect that households, like firms, will begin to cut spending. This must, all else equal, reduce national income.

Another look at the fundamental profits equation tells us that although positive net exports add to profits, a trade deficit, such as that suffered by the United States, reduces profits. Ours is a for-profit economy in which production is primarily undertaken on the expectation of profit. When the country simultaneously runs a trade deficit and reduces its government deficit, this necessarily reduces profit and the incentive to undertake production.

How, then, can we explain the robust growth the United States enjoyed in the last few years? The key has been an investment boom, and, as our Institute colleagues Wynne Godley and Jan Kregel have demonstrated, this boom has been fueled by record private borrowing and overindebtedness. When private expenditure stops rising relative to income, the U.S. boom will end, unless this source of growth is compensated for by an improvement in the U.S. trade balance or by fiscal stimulus. Given that the IMF has already revised downward its projection of world economic growth, it is highly unlikely that the United States will be able to increase exports; the Asian crisis has already increased efforts to sell products to the United States at discount prices. This means that a revised fiscal stance will be required to maintain the income flows that firms and households will need to service record debt levels.

Government revenues will be affected as growth slows, eliminating the projected budget surplus and creating a deficit. This is the so-called automatic stabilizer, which occurs when a tax system collects fewer taxes as private sector income falls. However, we doubt that the automatic stabilizer will be sufficiently powerful to prevent the coming recession, particularly since the progressivity of the tax system has been significantly reduced since 1980 and social spending "reforms" have eroded the ability of the budget to move in a countercyclical manner. Stabilizing our economy will require discretionary spending increases and tax cuts to move the budget deficit to the \$300 billion level that, as Wynne Godley has projected, most likely will be required to keep the economy operating close to capacity.

Policy Recommendations

The Japanese have demonstrated that tax cuts and low interest rates, alone, cannot move an economy out of recession and, thus, spending will be required. Moreover, unless tax cuts are well targeted, we doubt they can be of much use. In order to prop up private demand, tax cuts have to put more disposable income into the hands of those who are likely to spend it. An increase in the earned income tax credit would be an ideal way to accomplish this, and at the same time it would reward low-income families who are working hard to move out of poverty. Tax cuts aimed at high-income groups, such as further cuts in capital gains taxes, would probably do little to stimulate spending.

Similarly, not all spending programs will have the desired effects. We agree with President Clinton that rebuilding the public schools and improving child care for working families are examples of programs that will not only provide the temporary stimulus needed, but will also provide the basis for long-term growth that we desire.

However, the most important point in considering policy opinions is that President Clinton is on the wrong track when he argues that surpluses must be protected at any cost and that Social Security can be rescued by steadfastly preserving surpluses. The best way to provide for the future is to invest in education, decent child care, public infrastructure, research and development, and technological innovation *now* --to increase human and physical capital that will be able to produce the goods and services required by young and old alike. As far as we know, the only argument advanced in defense of the notion that budget surpluses encourage the development and creation of human and physical capital is that surpluses cause interest rates to fall. However, we do not need surpluses to reduce rates. As we all know, the Fed can lower interest rates any time it wishes. We also know that lower interest rates are usually not sufficient to counteract the pessimistic outlook that reigns during downturns; no matter how low interest rates go, few want to borrow when the future looks grim. Investment is sensitive to interest rates only in relation to the outlook for profits. Since budget surpluses erode profits, it is not likely that lower interest rates alone will stimulate investment.

During World War II, the United States ran huge budget deficits--reaching a phenomenal 25 percent of GNP (five times greater than those President Reagan achieved)--and accumulated huge debt. In the early postwar period some economists worried about government indebtedness and advocated surpluses to retire the debt. Professor Evsey Domar (on the Fed's Board of Governors at the time) understood that the best way to eliminate the supposed "burden of the debt" was to achieve rapid income growth, for, as he said, "the faster income grows, the lighter will be the burden of the debt." He concluded that "If all the people and organizations who work and study, write articles and make speeches, worry and spend sleepless nights--all because of fear of the debt--could forget about it for a while and spend even half their efforts trying to find ways of achieving a growing national income, their contribution to the benefit and welfare of humanity--and to the solution of the debt problem--would be immeasurable."

He was right, of course. Following the war, the United States enjoyed unprecedented economic growth--and the "debt burden" disappeared, exactly as Professor Domar predicted. President Clinton's expansion proved to be another verification of the wisdom embodied in this view--robust expansion eliminated the deficit and squelched the speeches about the debt burden. It appears, however, that the president, many economists, and some policymakers drew the wrong conclusion from this experience: they assumed that the Goldilocks economy was caused by the deficit reduction and that prosperity would be guaranteed by continued "fiscal responsibility." To act on the basis of this mistaken conclusion would have horrendous consequences.

Examination of every budget surplus achieved in U.S. history demonstrates that surpluses nearly always lead to recessions, which then generate renewed deficits. As Frederick Thayer has shown, before 1930 there were six periods during which the government ran surpluses that allowed it to reduce the outstanding debt significantly; in every case, a depression followed (1819, 1837, 1857, 1873, 1893, and 1929). Figure 2 plots the annual change of nominal GDP and federal government expenditures from 1939 to 1998. While the correlation is not perfect, there is a strong relationship between growth of government spending and growth of GDP. If fiscal policy allows federal government expenditures to increase, GDP grows by three to five times as much. However, when the year-over-year growth of government spending drops, the annual growth of GDP also falls. This does not appear to be consistent with the belief that budget cuts spur economic growth.

Figure 2 Annual Change in Nominal GDP and Federal Government Expenditure, 1939-1998

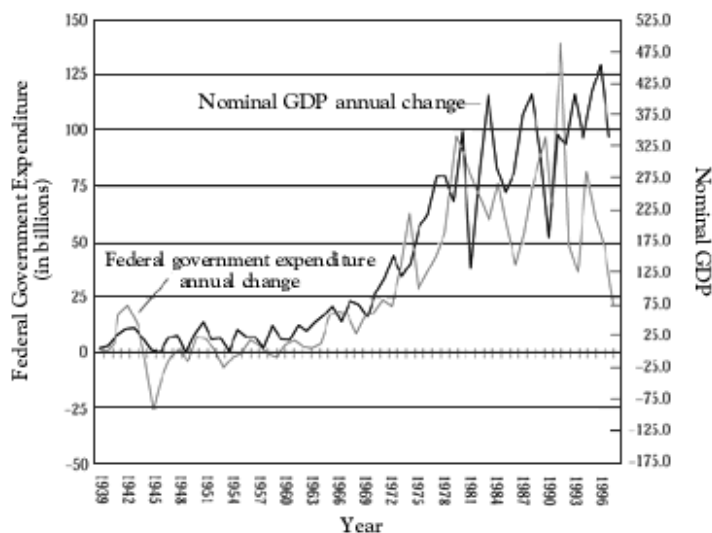
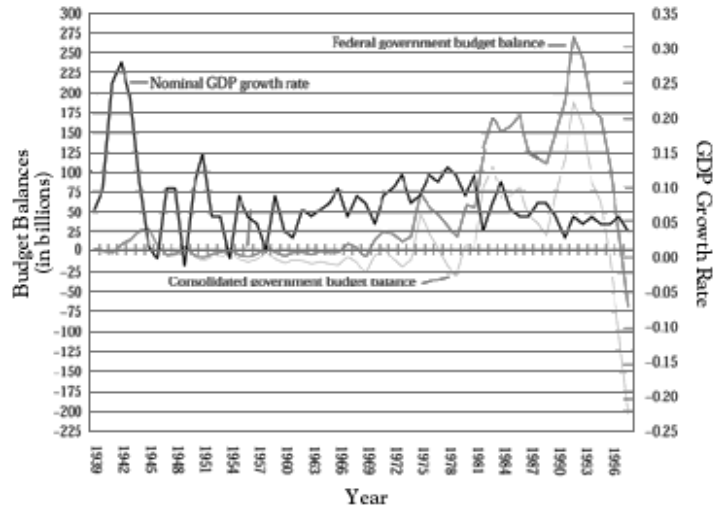


Figure 3 plots the rate of growth of nominal GDP, the federal government budget balance, and the consolidated government budget balance (federal plus state and local government budgets, which are usually in substantial surplus). Again, there is a remarkable correlation. Increases of government deficits almost always are accompanied by a faster rate of GDP growth; reductions of deficits almost always lead to slower economic growth. Significant deficit reductions occurred at the end of World War II, at the end of the Korean War, in 1958-59, in 1972-73, in 1978-79, in 1983-84, in 1987-89, and since 1992. In all but 1983-84 and the last case, an economic slowdown followed immediately or within a year or two. In absolute terms, the largest deficit reductions by far have come since 1992. The stable economic growth we have experienced since 1992 might seem to be an exception to the rule that deficit reduction leads to slower growth, but it is important to remember that this period also saw record private sector deficits, which financed spending and maintained growth. In this case, the expansion occurred in spite of the reduction in the federal budget deficit.

Figure 3 Nominal GDP Growth and Consolidated and Federal Government Budget Balances, 1939-1998



Note: Federal and consolidated budget signs are reversed; for example, a deficit of -2.5 billion is represented as 2.5 billion

Slower growth has usually led to larger government deficits. As most current economic forecasts indicate a slowing economy, the projected surpluses will prove to be wildly off the mark. Both Presidents Hoover and Roosevelt showed the folly of trying to run surpluses in a downturn--Hoover's surplus of 1929 helped to bring on the Great Depression and Roosevelt's surplus of 1937 made it a "double-dip" depression. We got out of the depression only when World War II allowed us to abandon "fiscal responsibility" so that we could spend our way to victory and, as it happens, to spend our way to prosperity. Will it take another Great Depression or World War III to teach us again the lessons we have forgotten?

Note

1. The "saving" term in the fundamental profits equation is made up of two elements: consumption out of profit income (which adds to profits) and saving out of wages (which reduces profits). Consumption out of profits flows back to firms as revenue, which explains why it is not a deduction from profits--there is a "widow's cruse" with respect to spending out of profits--but, rather, generates more profits. Saving out of profits "disappears" because profit income that is received but not spent is removed from the circular flow of income and cannot flow back to firms as revenue. Saving out of wages actually reduces profits since firms have incurred a cost (wages paid) that cannot be recovered in the form of revenue (for example, sales of consumer goods.)

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