

READING 37

DEFICIT, DEFICIT, WHO'S GOT THE DEFICIT?

James Tobin

ministration and a statesman during those years. When the economy is in a state of growth, we must exerted toward the building of surpluses. We must learn to live with induced deficits as a part of the growth process. But we should not take on mortgage our nation's credit and an inflationary

from these facts and be the policy of the government determinedly for the future, for, clearly, if the government work to upset financial equilibrium prevail as a matter of fact in the next decade we have the last decades to guide

persist and in most cases, the programs are difficult to curtail them. In a growing economy—historically. This means we tend to reduce or to increase the purposes for which the government spends (eighteen such projects President Eisenhower's last year 1960). It is important to use temporary expedients and change programs and programs on. We have learned from earlier years that new ones for

learn to live with financial emergencies. But we should use surpluses later on

could pay as we see debt reduction or growth—as we should. We must plan for surpluses in good times to further the good ahead.

every buyer there must be a seller, and every lender a borrower. One man's expenditure is another's receipt. My debts are your assets, my deficit your surplus.

If each of us was consistently "neither borrower nor lender," as Polonius advised, no one would ever need to violate the revered wisdom of Mr. Micawber. But if the prudent among us insist on running and lending surpluses, some of the rest of us are willy-nilly going to borrow to finance budget deficits.

In the United States today one budget that is usually left holding a deficit is that of the federal government. When no one else borrows the surpluses of the thrifty, the Treasury ends up doing so. Since the role of debtor and borrower is thought to be particularly unbecoming to the federal government, the nation feels frustrated and guilty.

Unhappily, crucial decisions of economic policy too often reflect blind reactions to these feelings. The truisms that borrowing is the counterpart of lending and deficits the counterpart of surpluses are overlooked in popular and Congressional discussions of government budgets and taxes. Both guilt feelings and policy are based on serious misunderstanding of the origins of federal budget deficits and surpluses.

American households and financial institutions consistently run financial surpluses. They have money to lend, beyond their own needs to borrow. Figure 1 shows the growth in their combined surpluses since the war; it also shows some tendency for these surpluses to rise in periods of recession and slack business activity. Of course, many private households have financial deficits. They pay out more than their incomes for food, clothing, cars, appliances, houses, taxes, and so on. They draw on savings accounts, redeem savings bonds, sell securities, mortgage houses, or incur installment debt. But deficit households are far outweighed by surplus households. As a group American households and non-

profit institutions have in recent years shown a net financial surplus averaging about \$15 billion a year—that is, households are ready to lend, or to put into equity investments, about \$15 billion a year more than they are prepared to borrow. In addition, financial institutions regularly generate a lendable surplus, now of the order of \$5 billion a year. For the most part these institutions—banks, savings and loan associations, insurance companies, pension funds, and the like—are simply intermediaries which borrow and relend the public's money. Their surpluses result from the fact that they earn more from their lending operations than they distribute or credit to their depositors, shareowners, and policyholders.

Who is to use the \$20 billion of surplus funds available from households and financial institutions? State and local governments as a group have been averaging \$3–4 billion a year of net borrowing. Pressures of the expanding populations of children, adults, houses, and automobiles, plus the difficulties of increasing tax revenues, force these governments to borrow in spite of strictures against government debt. Unincorporated businesses, including farms, absorb another \$3–4 billion. To the rest of the world we can lend perhaps \$2 billion a year. We cannot lend abroad—net—more than the surplus of our exports over our imports of goods and services, and some of that surplus we give away in foreign aid. We have to earn the lendable surplus in tough international competition. Recent experience shows clearly that when we try to lend and invest too much money abroad, we either have to borrow it back or else pay in gold.

These borrowers account for \$8–10 billion. The remainder—some \$10–12 billion—must be used either by nonfinancial corporate business or by the federal government. Only if corporations as a group take \$10–12 billion of external funds, by borrowing or issuing new equities, can the federal government expect to

From James Tobin, *National Economic Policy* (Yale University Press, New Haven and London, 1966). Originally published in *The New Republic*, January, 1963. Reprinted with kind permission of the author and publisher.

Fig. 1 Financial surpluses of consumers, non-profit institutions, and financial institutions, 1947-61.



SOURCE: Board of Governors of the Federal Reserve System

break even. This is, moreover, an understatement of what is required to keep the federal debt from rising, for the federal government itself provides annually \$3 to \$4 billion of new lending; the Treasury would have to borrow to finance these federal lending programs even if the government absorbed no *net* funds from the economy. It is *gross* federal borrowing that offends the conservative fiscal conscience, whether or not the proceeds are used to acquire other financial assets.

The moral is inescapable, if startling. If you would like the federal deficit to be smaller, the deficits of business must be bigger. Would you like the federal government to run a surplus and reduce its debt? Then business deficits must be big enough to absorb that surplus as well as the funds available from households and financial institutions.

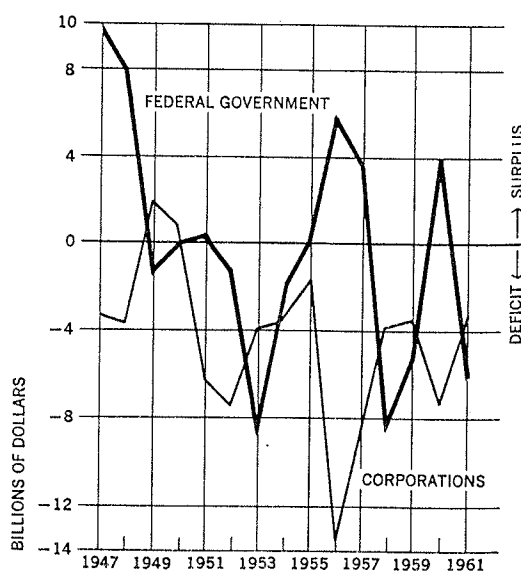
That does not mean that business must run at a loss—quite the contrary. Sometimes, it is true, unprofitable businesses are forced to borrow or to spend financial reserves just to stay afloat; this was a major reason for business deficits in the depths of the Great Depression. But normally it is businesses with good profits and good prospects that borrow or sell new shares of stock, in order to finance

expansion and modernization. As the President of American Telephone and Telegraph can testify, heavy reliance on outside funds, far from being a distress symptom, is an index and instrument of growth in the profitability and worth of the corporation. The incurring of financial deficits by business firms—or by households and governments for that matter—does not usually mean that such institutions are living beyond their means and consuming their capital. Financial deficits are typically the means of accumulating nonfinancial assets—real property in the form of inventories, buildings, and equipment.

When does business run big deficits? When do corporations draw heavily on the capital markets? The record is clear: when business is very good, when sales are pressing hard on capacity, when businessmen see further expansion ahead. Though corporations' internal funds—depreciation allowances and plowed-back profits—are large during boom times, their investment programs are even larger.

Figure 2 shows the financial deficits or surpluses of corporate business and of the federal government since the war. Three facts stand out. First, the federal government has big deficits when corporations run surpluses or small deficits and vice versa. Second, govern-

Fig. 2 Net financial surpluses and deficits of the federal government and of nonfinancial corporations, 1947-61.



SOURCE: Board of Governors of the Federal Reserve System

ment surpluses at their peaks in periods when industrial capacity is in excess, as in 1947-48, 1951-52, and 1959-60. The combined deficits of the federal government and of business firms in the early postwar years of the upward trend shown in Figure 1.

Recession, idle economic slack—the balanced government budget—economy is faltering, but surpluses available to the federal government are less inclined to be

The federal government is cutting its deficit in the economy, perpetuating business firms from increasing taxes and cutting obvious ways to balance the budget because of their effective lending, and borrowing exactly the contrary—cutting taxes and raising borrowing may so stimulate private borrowing that the end actually reduces the deficit.

This may seem paradoxical. Why is it that the family finance and which our decisive federal fiscal policy leads us? If John F. Kennedy is spending \$8,700 a year, the remedy is to need do to balance the budget live resolutely within the means, increasing some \$700 less in expenditures or the impact of either expenditures of other

ment surpluses and business deficits reach their peaks in periods of economic expansion, when industrial capacity is heavily utilized, as in 1947-48, 1951-52, and 1956-57. Third, the combined deficit of corporate business and the federal government is greater now than in the early postwar years; this is the counterpart of the upward trend in available surpluses shown in Figure 1.

Recession, idle capacity, unemployment, economic slack—these are the enemies of the balanced government budget. When the economy is faltering, households have more surpluses available to lend, and business firms are less inclined to borrow them.

The federal government will not succeed in cutting its deficit by steps that depress the economy, perpetuate excess capacity, and deter business firms from using outside funds. Raising taxes and cutting expenses seem like obvious ways to balance the budget. But because of their effects on private spending, lending, and borrowing, they may have exactly the contrary result. Likewise, lowering taxes and raising government expenditures may so stimulate private business activity and private borrowing that the federal deficit is in the end actually reduced.

This may seem paradoxical, and perhaps it is. Why is it that the homely analogy between family finance and government finance, on which our decisive national attitudes toward federal fiscal policy are so largely based, misleads us? If John Jones on Maple Street is spending \$8,700 a year but taking in only \$3,000, the remedy is clear. All Mr. Jones need do to balance the family budget is to live resolutely within his income, either spending some \$700 less or working harder to increase his earnings. Jones can safely ignore the impact of either action on the incomes and expenditures of others and the possible ulti-

mate feedback on his own job and income. The situation of the President on Pennsylvania Avenue, spending \$87 billion a year against tax revenues of \$80 billion is quite different. Suppose that he spends \$7 billion less, or tries through higher tax rates to boost federal revenues by \$7 billion. He cannot ignore the inevitable boomerang effect on federal finances. These measures will lower taxpayers' receipts, expenditures, and taxable incomes. The federal deficit will be reduced by much less than \$7 billion; perhaps it will even be increased.

Incidentally, many of the very critics who are most vocal in chiding the government for fiscal sin advocate policies that would make fiscal virtue even more elusive. They want to keep private borrowing in check by the use of tight credit policies and high interest rates. They want to increase corporations' internal flow of funds by bigger depreciation allowances and higher profit margins, making business still less dependent on external funds to finance investment, even in boom times. When these apostles of sound finance also tell the government to shun external finance, have they done their arithmetic? If everyone is self-financing, who will borrow the surpluses?

The nation is paying a high price for the misapplied homely wisdom that guides federal fiscal policy. The real toll is measured by unemployment, idle capacity, lost production, and sluggish economic growth. But fiscal conservatism is also self-defeating. It does not even achieve its own aim, the avoidance of government deficits. Federal fiscal and monetary policies consciously and unashamedly designed to stimulate the economy would have sufficient justification in economic expansion itself. But they might well "improve" the federal budget too—by inducing *business to use the private surplus, that now has no destination other than a rising federal debt.*