The Federal Budget Deficit and Inflation

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In fiscal year 1991, our nation's federal government will spend \$1.45 trillion, \$200 billion more than it spent in 1990. Twenty dollars of every \$25 of this amount will come from taxes. The remaining \$5 will come from government borrowing. A dollar borrowed for every five spent.

Imagine the consequences of running that kind of budget at home. What if *you* earn \$20,000, spend it all, borrow an extra \$5,000 and spend that, too. Then you do the same thing the next year, except that you borrow even more to pay the interest on last year's loan. Soon, you would be over your head in debt. Any debt counselor would correctly tell you that your budget is "out of control" and "lacks management." "In fact," the debt counselor would continue, "you really don't have a budget at all."

Of course, I don't run my budget like this, and I'm sure you don't either. We can't afford to. But if we as individuals cannot afford to run our budgets like this, how can our nation afford to do so? Is there any way that the hard budget choices that you and I must make as *separate* individuals, can somehow be avoided or ignored as a *collection* of individuals—as a nation? Is there perhaps some aggregate economic magic made possible by sheer national bigness or by Congress' legislative might, whereby we can turn our heads to the national budget forever without consequence?

Of course not. Government spending does not create wealth; it merely transfers wealth from citizens to government.

Our Attempts to Tame the Deficit

In 1985, Congress passed the Gramm–Rudman–Hollings Act, which called for Congress to reduce the share of federal spending in gross national product (GNP) to about 19 percent between 1987 and 1991, with the goal of balancing the budget by 1993. But in 1990, faced with continuing deficit overruns, Congress suspended the across-the-board spending cuts of Gramm–Rudman and replaced that act with the celebrated Omnibus Budget Reconciliation Act of 1990. The Omnibus Act called for a combination of spending cuts and tax increases to bring the budget in balance, theoretically, by the mid-1990s. The act is predicated on several assumptions, however, the most crucial of which pertains to our nation's economic growth.

To achieve the projected deficit reductions, the Omnibus Act relies on the assumption that our nation's production of goods and services (real GNP) will grow by 1.3 percent in 1991, 3.8 percent in 1992, 4.1 percent in 1993, 3.7 percent in 1994 and 3.5 percent in 1995. Yet, the nation has been in recession for the first half of the fiscal year. Thus, achieving the needed 1.3 percent growth for 1991 may be difficult. Furthermore, our nation's economic growth has averaged less than 3 percent for the past three decades—not the near 4-percent growth needed to reach the deficit-reduction estimates. So, the plan to grow our way out of the deficit may be ill-fated.

Too Few Taxes or Too Much Spending?

With the Omnibus Act, taxes are creeping back up to one-fifth of GNP. But also for the first time since World War II, the federal government will spend more than 25 percent of the nation's annual income. The federal government will buy \$25 of every \$100 produced by working Americans. The evidence suggests, then, that the deficit problem is not one of inadequate taxes but inadequate courage—inadequate courage to cut government spending.

Where will uncurtailed government spending lead? Possibly to more inflation. When a government *spends* more money, pressure invariably builds to *print* more money to help pay for the spending. Unchecked, this pressure could lead the Federal Reserve into a trap of higher inflation. Everyone wants the Fed to deliver lower interest rates. But when Congress borrows \$300 billion to finance spending, interest rates tend to rise. To prevent higher interest rates, the Fed can print money and buy the government debt, thus keeping the debt out of the economy. But with more money in circulation, the prices of goods increase, resulting in inflation.

The Fed fell into this trap in the late 1970s. Government budget deficits began to grow sharply, driving up (real) interest rates, and the Fed eased monetary policy to avoid the rising interest rates. Eventually, these policies only made matters worse, as so much money was printed that inflation hit double-digit rates, and interest rates rose to record heights. During the 1980s, the Fed was largely successful at climbing—and staying—out of this trap. The Fed chose not to monetize the huge government budget deficits and, in doing so, has charted a course for money that is largely independent of government debt—one designed instead to control inflation.

The solution to the federal deficit problem does not lie in quick-fix, inflationary monetary policy. As a nation, the time has come for us to make the same difficult budget choices we must make as individuals. The time has come for us to exercise the same fiscal responsibility as a nation that we must rely on at home.

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