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ON THE DRY SIDE

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BROOKINGS ON DEFICITS

The Brookings Institution has been described as the Democratic Party in exile. When the Democrats are out of the White House, and cannot call upon its resources, Brookings helps them with their thinking. Like all of the great American think tanks it publishes advice on public policy for whoever will learn from it, but there is no doubt that its views have been more tuned to the more interventionist, or as the North Americans say "liberal" side of politics. Brookings provided Mondale with facts and argument to combat Reagan. Its publication Economic Choices 1984 contains many of the arguments used by Walter Mondale on the hustings. The wheel of ideas may not have turned a full turn, but it has turned a long way from the free spending days of Lyndon Johnson. Brookings' greatest quarrel with the Reagan administration is now the deficit; in effect they accuse him of being a fiscal whimp.

Brookings' position on the deficit differs from Milton Friedman's position (Tyranny of the Status Quo, 1984) in only two important regards: they blame the President, whereas Friedman blames Congress; and they wish to eliminate one third of the problem by increasing taxes and the remainder by reducing expenditure, whereas Friedman would eliminate all of it by spending less.

Brookings say the same about deficits as John Stone said in his 1979 speech to the Centre for Applied Economic Research Workshop. If the cabinet in 1979, or for that matter the present cabinet, understood the arguments it was not evident in their subsequent performance. Although the wheel of performance turns some way behind that of ideas it may yet get to the same point.

It is well to keep the seven percent Australian public sector borrowing requirement in the back of our minds when looking at this U.S. deficit which is so roundly condemned by everybody.

In 1983 the U.S.Federal deficit equalled 5.5% of their gross domestic product. Accustomed to state and local governments which contribute substantially to public debt, I was wondering why in the considerable debate about the United States' deficit nothing is said about the states and local authorities. The reason may be that they don't help a critic's case. In the U.S. state and local authorities are in surplus to the tune of 1.6% of GDP. The net public sector borrowing requirement is about 4.0% of GDP. This doesn't mean that the U.S. has not got a problem. It has; but it is sensible to keep a sense of proportion, particularly when offering critical advice.

"High deficits in the federal budget, together with high interest rates, are endangering the future growth of the U.S. economy and undermining the ability of American industry to compete in world markets. Change is needed. The federal deficit should be drastically reduced - indeed eliminated by the end of the decade - and interest rates should be lowered.... Cutting the federal deficit will be painful." We have heard that much before but Brookings say how they would do it, which makes them unusual. See also, with relevance to Australia, Brian Buckley's Cutting the Deficit.

Brookings' central objection to a high budget deficit (loose fiscal policy) is that it will reduce economic growth by increasing consumption at the expense of investment. "It is likely that federal dissaving of such unprecedented magnitude will diminish the domestic resources available for investment in plant, equipment and housing and will drive up interest rates." They note that in the short run fiscal deficits, even when accompanied by tight monetary policy are stimulatory but, "The result is a shift in the mix of total spending - more resources for consumption, less for investment and housing. A low level of investment in plant and equipment is likely to reduce productivity increases and hamper economic growth in the long run. Penalising investment is borrowing from the future to increase consumption now."

Since, printing money aside, a government deficit must be financed by bidding for the same funds which private investors seek, there are only two possibilities:

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either the supply of funds increases or the private sector invests less. In fact both happen. Private sector investment is curbed and funds are borrowed from abroad. The mechanism is higher interest rates which snuff out some investments and attract some foreign investors.

Deficits permit governments to spend money they are not game to raise in taxes. If a government were to invest as productively as the private sector its debt at current levels would not matter, but it subsidises consumption and low return investments - Medicaid and Medicare, moon shots and agriculture or, in Australia's case, Medicare and Ord River dams. If a government were to raise taxes instead of loans its impact on consumption would be greater and on investment less. Both by adding to a government's share of resources and substituting for taxes the deficit shifts the balance of spending from investment to consumption - from the future to today.

To the extent that fiscal deficits are financed overseas they punish the traded part of the economy. Capital inflow must be matched by a deficit on current account - that is more imports and/or fewer exports. The mechanism here is the exchange rate.

Import competing industries and the export industries find themselves in competition for slices of a shrinking cake. Import competers try to force the "cost" of the capital inflow on to other import competers and exporters by demanding protection, and U.S. exporters demand farm support schemes which have a similar effect.
To make that sort of nonsense "transparent" Brookings recommend an Agency patterned on the Australian IAC.

Mr. Hawke has promised that our deficit will be cut and that taxes will not be increased. Our deficit looms even larger than the U.S. deficit and must be cut. The Prime Ministerial word should be accepted and I trust there will be no cause to remind Labor of the indecorous precedent it set when it waved a newspaper headline in the House reading "Lies, Lies, Lies".

As for Mr. Keynes: he would not quarrel with Brookings over the deficit, his concern was with the short term - in the long run we were all dead. 104-3