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Remarks by

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Over the past months the answer to everything has been the deficit -- now what is the question? The deficit has been blamed for everything from America's supposed lack of competitiveness, to a low savings rate, to contributing to or even causing, the trade deficit. It is always useful to have a simple answer to complex problems, and the deficit has served that purpose admirably. Much of the rhetoric about the deficit is political -- the President is responsible for the deficit, the Congress is responsible for the deficit, lowering the marginal tax rate is responsible, increased defense spending, increasing social outlays -- the list is endless. Since money is fungible, the principal culprit is in the eye of the beholder. The fact that the Federal Reserve in its very successful effort to fight

inflation brought on the greatest recession since the 193O's, which crippled our economic output, and thus caused a sharp decline in tax revenues, is often not even mentioned. Whatever the reason, everyone agrees we have a problem, and anyone who suggests that things may not be as bad as portrayed is immediately dismissed as living in a dream world.

Most people would agree, however, that the first step in solving a problem is to get the facts -- in the case of the deficit, this is not as easy as it seems since many figures that are bruited about are based on somebody's estimate of what is going to happen. Such estimates are often politically biased. The numbers produced by the congressional budget office are often substantially at variance with those produced by OMB. All estimates, from whatever source, of what our Federal deficit is going to be in the future are by necessity based on someone's idea of the future growth of our G.N.P. The rosy scenario clashes with gloom and doom. The facts are that no one knows just how the economy will behave in the future, and the Government is incapable even of telling us what the last quarter's G.N.P. growth was with any precision. Final figures are not issued until three years after the close of a quarter. The difference between the Commerce Department's first reports on the G.N.P. for a quarter and the final figures show huge variations. If, for example, the initial report indicated a G.N.P. growth of three percent, half of the time the final figure would show a growth of less than 1.5 percent or more than 4.5

percent. One time in ten the adjusted final figure would show less than one half percent or more than 5.5 percent. Figures that move about that much rarely furnish a firm foundation for policy decisons. The record of looking ahead for most forecasters, public or private, is even worse.

To understand the dimensions of the problem we should look at the deficit in three ways: first in an accounting sense, that is by what rules were the numbers assembled and do these rules produce meaningful data on which to base policy decisions; second, we must look at the deficit in a comparative sense, that is how do we as a nation compare to other sovereign states in the OECD; and third in an economic sense, that is what is the impact on the

economy of the Federal Government running deficits of the size we have seen.

The accounting rules used to determine the size of the deficit are determined by Congress. If these accounting principles were adopted by your business, the SEC would doubtless bring criminal charges of misrepresentation of fact. We had a similar situation in New York City during the fiscal crisis, and one of the first things we did was to require the city to put in GAAP accounting so we could understand the problem. This new system produced numbers that furnished a sound basis for the policy decisions that helped restore the city to financial health.

The Federal Government has made no such progress. Since fiscal 1969 it has used a unified, cash-based budget. This system of accounting does not produce results that are congruent with GAAP accounting. All of us have learned that numbers by themselves mean nothing, unless we know how they are derived. There are off-budget entities such as the Social Security trust funds and some other federal operations whose transactions are excluded from the budget totals by law. This law produces an on-budget surplus or deficit number. The Gramm-Rudman-Hollings Act includes two out of three Social Security trust funds and places all other off-budget items on-budget for the purpose of computing that deficit or surplus figure. Differences between the two numbers are estimated in the 4O billion dollar range for 1988

The new element in the economic equation is the Social Security system -- currently in surplus, and building at the

rate of \$76,000 a minute. Gramm Rudman recognizes that in the real world it is a fact that a separate tax stream funds the Social Security Trust Fund, and that the cash thus accumulated is loaned to the U.S. Treasury, which then spends the money it borrowed from the Trust Fund on whatever the Congress decrees. The Social Security system's surpluses following the Greenspan Commission in 1983 are now coming on stream, although many at the time called the projections of surplus "pie in the sky." We had a \$2O billion surplus in fiscal '87 and should have a \$4O billion surplus in '88. If the projections made from the Social Security Administration's own numbers are correct, no government bonds will be sold to the public after the mid 199O's as the Trust Fund will take all the paper the Government will issue.

The yearly surplus peaks around the year 2O3O at a mind boggling $450 billion and the total value of reserves in the system will reach $11.9 trillion, and then decline. Experts can debate whether these estimates will prove to be accurate, and political analysts can speculate on whether the politicians can resist the temptation to take the money and spend it for other purposes, but few would question the trend. This is a brand-new situation, since for 5O years there were no trust funds -- benefits were paid out to retirees about as fast as taxes were collected from current workers. Whatever the future holds, it is a fact today that part of our outstanding national debt is now funded by direct taxes on workers and much more of it will be in the future. The Social Security tax is now the biggest tax bite felt by most Americans, and it is scheduled to go up again in January 199O.

The second anomaly in the deficit numbers we are used to looking at is that everything the Federal Government buys is expensed -- a several billion dollar road system, the space shuttle, an extension to Yellowstone Park or a ten cent pencil. The IRS might get a little upset if your business did this, but that's the way the Federal budget works. It would be hard to find an accountant who thinks that this bookkeeping system makes any sense or that it reflects financial reality. The familiar refrain that every family must balance its budget, so why can't the Federal Government, has a nice ring to it, but no family I know of expenses its home. It buys a home with the help of a mortgage since it is a capital asset, and balances its family budget not against a one-time capital cost, but on a cash-flow debt-service basis. All businesses are run on the same principles, or very few of us would be in this room. In 1987 business capital expenditures exceeded the before tax business profits of all American corporations by more than $100 billion. At the state level, this vital distinction between capital assets and operating costs is recognized, and some 37 states have a distinct capital budget with current operations reported separately. On the Federal level, the Office of Management and Budget data show that in fiscal 1986, Federal outlays for physical investments ranged from $84 billion for acquiring federally owned assets, to $107 billion if one includes grants to states and local entities for their capital projects. In

addition, Federal direct loans, loan guarantees and government sponsored loans amounted to about $42 billion. All in all capital expenditures added up to 13.2% of total Federal outlays, a not inconsiderable amount to expense, and if funded in a capital budget, would produce near balance in the operating budget. While honest men and women may differ about what items should be capitalized, there are few people who are knowledgeable about the subject who would not agree that our present Federal accounting system is misleading at best. The General Accounting Office has urged a capital budget within a unified budget. To date, little movement in this direction is visible. The reason the Federal Government has not brought its accounting into the 20th century is political, not economic. Everyone remembers

that New York City got in deep trouble partly by classifying operating expenses as capital and thus "balancing its budget." It is a sad fact, but the principal reason against instituting a capital budget is that many do not trust the national political process to maintain the discipline needed to distinguish between capital expenditures and operating costs.

Another anomaly in the way we keep our books, is that we are perhaps the only country in the world which does not include the deficits or surpluses of the nation's political subdivisions, in our case the 5O states, in computing the amount of our national deficit. This is akin to a business corporation failing to include the results of some of its divisions when reporting its earnings. Recent experience with FASB has taught us all to pay attention to how accounting rules affect reported results; we should do the same with the Federal accounting system as the one now in use must be treated with extreme care in formulating policy.

The second way to look at the budget deficit is on a comparative basis--how do we do in the real world in comparison with our neighbors. Exact comparisons are difficult because foreign countries keep their books differently than we do, both by generally not expensing capital assets and maintaining some form of a capital budget, and by counting the results of political subdivisions. Even so, the American budget deficit as percent of G.N.P. is smaller than that of France, for example, and falls in the middle of the range for all OECD countries. Despite the concern about what is described by some as America's credit card economy, if we look at net government debt Federal, state and local as a ratio to G.N.P., the United States position is not particularly noteworthy. Today our ratio of net government debt as computed by the OECD is about 3O% of G.N.P., just about the same as Japan, Canada, and West Germany, and much lower than Italy or Great Britain, although sometimes to hear our friends from abroad talk about the United States one might form a different impression.

The third perspective on the budget deficit is its effect on the economy. While the deficit, as presently computed, has been blamed for all of society's ills, there is little hard evidence on which to form a judgment. Not long ago, we were warned by experts that government borrowing would crowd

out private financing and thus cripple our economic expansion. The crowding-out theory was all the rage, but it did not happen. As a historical note, most people have forgotten that when we emerged from World War II, the gross Federal debt was in excess of 100% of our G.N.P. Much of the rhetoric regarding the presumed effects on our economy is based on the concept of closed national economies. While this view once had some validity and, indeed, is the framework surrounding much economic theory from Adam Smith to modern times, the world can no longer be understood as a collection of national economies managed in isolation from the rest of the world. The reality of a global market tied together with an electronic infrastructure has created a totally new state of affairs which we are only just beginning to understand. Borders

that were once the cause of wars are now becoming porous. Money moves over, around and through them with the speed of light. The flows of capital are now in the range of 3O to 5O times greater than world trade. The world's capital which moves along this electronic highway goes where it is wanted and it stays where it is well treated. This is why there was no crowding out, this is why foreign capital comes and stays in the United States. Capital does not come to the United States for charitable reasons, it comes to earn a rate of return. As long as our free market system permits and delivers an acceptable rate of return on investment in an environment of political stability that is competitive with other alternate areas of investment, the capital will keep coming.

Before we succumb to statistical hypochondria and focus all our attention on one deficit number of very questionable accounting validity, we should look at the entire economic picture. For the first hundred years, America ran trade deficits and built our railroads and factories with the foreign capital attracted to our country. On the other hand, America ran a trade surplus during the great depression of the 1930's. In more recent times Japan ran big trade deficits in the 195O's and early '60s and was chastised by financial "experts" at the time for failing to put its house in order. Very few people understood that during that period Japan was building an industrial powerhouse that would challenge the world in the '70s and '80s. In contrast, Brazil, Argentina and Mexico today run huge trade

surpluses, but fail not only to attract foreign capital, but even to retain local capital despite very high interest rates. In our country the simultaneous decline of inflation and unemployment has cast grave doubt, if not totally destroyed the Keynesian Phillips curve theory along with the crowding-out theory.

Large budget deficits are often said to cause high interest rates, but nominal rates on long-term treasuries have fallen from over 17% to around 9%. Real interest rates remain in the high end of the historical range. There are good economists who say the real interest rates are higher today than they would have been, had we not had these deficits, but there are other scholars with equal credentials who believe that is really an assertion and not a documented fact. Both

points of view are supported by reams of statistics.

Today the world looks at America and sees our GNP moving toward $5 trillion; it sees a huge creation of new jobs; it sees manufacturing productivity rising at an annual rate of 4.3 percent since 1982, with unit cost falling, making the U.S. the lowest cost producer in the G-7 according to recent IMF data. It sees our deficit, as measured, falling both in absolute terms and as a percent of GNP.

While we are on the right track, we will always have problems to deal with. The real worry in the economy has been a trend that has been going on for decades and spanning many administrations: the growth of Government spending on the Federal, state and local level. In 1951 Federal expenditures were 14.4% of G.N.P. and by 1987 had grown to 22.8% of G.N.P. State and local expenditures moved from 6.1% to 9.3% during the same period. The good news is that Gramm-Rudman is having a salutary effect. The growth rate of Federal spending reached a peak of 19% in fiscal 198O and fell to 2% in fiscal 1987, a dramatic improvement that has been largely ignored by commentators. Measured as a ratio of the G.N.P., spending has fallen from a peak of 25% in 1983 to about 23% now. All in all, this adds up to real progress.

Despite all this, our ability to compare America to a Utopia that never existed is almost unlimited. Daniel Boorstin called it "our imprisonment in the present" and "as a result," he says, "we get our nation and our lives, our strengths and our ailments, quite out of focus." Today, I tried to put our

obsession with the deficit in focus. We have looked at the accounting system which produced the numbers. We have examined how we compare to others in the real world. We have touched on the massive change produced by the movement from closed economies to a global market, and, lastly, applauded the democratic process which produced Gramm-Rudman. In the great American tradition, it is a compromise. As one observer put it, "Budget experts don't like it because it puts the budget on automatic pilot. Conservatives don't like it because it prohibits heavy spending in the military defense area. And liberals don't like it because it cuts into spending on domestic social services and entitlements." But it is clearly working.