

November 18, 2002

Brad:

A few quick comments on your Wiley Coyote post from a more conservative reader:

Let me ask a basic question. What is the downside of reducing federal spending as a share of GDP? (This is not necessarily the same as asking the downside of reducing government spending as a share of GDP.) Where's the correlation between federal spending and the public welfare? Even assuming that government spending is more effective or efficient than the private sector in improving the standard of living of our citizens, why must that spending be done at the federal, as opposed to the state or local levels?

I would be concerned about a legitimate deficit, but I do not know whether we are running one currently and, if so, its magnitude. Calling the amount by which government spending exceeds tax receipts over an arbitrary period of time a "deficit" is silly. It ignores the difference between investments in capital assets and current expenses. There is a difference between spending \$1 on the construction of a school and spending \$1 on a teacher's salary.

Every time I bring this up, economists tell me that any attempt by government to adopt a capital budget would end up a political nightmare as there would be interminable debates about proper classification of various expenditures and this is why it is not done. But, academic economists certainly should make some attempt to evaluate government spending on a more realistic basis than by treating all expenditures as current expenses.

Although I am not an economist, I suggest that significant spending in excess of cash receipts on current expenses (that is, not on creation of capital assets, whether or not they are recognized as such) should raise interest rates and should be inflationary. The current cost of debt capital does not suggest that government is overspending, and there seems to be almost as much concern about the potential for deflation as inflation.

You discuss the impact of federal deficit spending on economic growth, but is there any difference between deficit spending and non-deficit spending? In other words, doesn't all federal spending – in fact, all government spending – involve some sacrifice in terms of economic investment, particularly since government spending is a "zero sum game" as there is no earnings multiplier effect? [I know this is not very clear. My point is that \$1 invested in a for-profit enterprise has the potential to yield a return, and this return can then be invested. This is not the case with \$1 spent by government. I recognize, of course, that in the real world there are some collateral benefits or payoffs from government spending, but in theory – and at the 30 thousand foot level – I think my point is sound. Also, while there may be a sacrifice inherent in all government spending, I am not suggesting that the sacrifice not be

made.]

Finally, a provocative opinion on "tax cuts." At current levels of aggregate government spending (federal, state and local), there are no tax cuts. Government is now consuming a share of GDP comparable to that during WWII and cannot increase that share materially without unacceptable adverse macroeconomic effects. Meanwhile, demands for government services are not declining. The result is that any decrease in taxation at one level of government – the Bush "tax cuts", for example – are immediately offset by increases in taxation at other levels. My state (Indiana) just enacted a very large tax increase, which I believe basically took any benefit I have, or will, receive from reductions in tax at the federal level. Seen this way, federal tax reductions are really no more than a transfer of power from the federal government to the states. There are those of us who do not believe that this is a bad thing.

As always, these opinions are personal and do not necessarily represent those of my firm or my clients.

Regards,