The Changing American Attitude toward Debt, and Its Consequences

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The Congress and the President have been struggling with the federal government budget deficit for six years, thus far with little result. The fundamental reason for their failure is the fact that the American people no longer view the deficit as a significant problem. This represents a radical change in the attitude of Americans from thirty years ago, when even small deficits were viewed with great concern. People are not much concerned about our long string of trade deficits, either. Those working in industries affected by foreign competition are, of course, worried about their jobs; others may feel uneasy about Mitsubishi buying Rockefeller Center; but people in general are not clamoring for the steps needed to eliminate the trade deficit. Moreover, there is no perception of the linkage between the federal budget deficit and the trade deficit.

This article will describe the factors that have produced this change in American values and assess the consequences, both past and future. Although society's values most often refer to social issues, they also help to shape the macroeconomic options open to a democratic government.

Early Influences

Dean Acheson chose as the title for his autobiography *Present at the Creation*. He was referring, of course, to the creation of the Marshall Plan, NATO and other aspects of U.S. foreign policy in the years following World War II. I was present at the creation of the changed American attitude toward national debts.

It began in the Kennedy Administration in the early 1960s. The President had run on a platform of getting the American economy going again. His principal economic advisers, Walter Heller, Chairman of the Council of Economic Advisers, and Douglas Dillon, Secretary of the Treasury, argued that the way to achieve that objective was through a major tax cut, which would stimulate economic growth and, in the process, increase Treasury revenues sufficiently that the tax cut would not result in any substantial increase in the federal deficit.

This was a radical idea in those days and President Kennedy was quite conservative in fiscal matters. It took a long time for his advisers to persuade the President that it made economic sense to cut taxes even though the government was already running a deficit. It took much longer to persuade the Congress. One of the key features of the Kennedy tax program was the investment tax credit. I remember being stunned to learn that the leading business organizations had testified against the investment tax credit. In part it was due to a preference for accelerated depreciation, but in part it reflected an uneasiness with the general idea of cutting taxes when the government budget was in deficit.

The popular view of the day was the view of President Eisenhower—that the federal budget was akin to a family budget and if the government ran deficits, trouble was certain to ensue. Walter Heller complained that what he called the "Puritan Ethic," an unreasoning fear of deficits, was keeping the government from following sound economic policies. And so a big educational effort was undertaken to deal with the "Puritan Ethic."

My small role was to talk to the banking groups that regularly visited the Treasury. We argued that there certainly were times when an increase in the deficit would be inappropriate. If the economy were operating close to capacity, an increase in the deficit could be inflationary, and would raise interest rates and squeeze out private investment. But in the conditions of 1962 and 1963, when the economy was operating well below capacity, a tax cut would raise total output and increase private investment, without enlarging the deficit significantly.

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In the event, the Kennedy tax cut was a triumph. In the first three years that the tax cut was in effect, 1964–66, the growth rate of real GNP averaged 5.6 percent, federal government revenues rose by 23 percent, and the fiscal 1966 deficit was slightly less than in fiscal 1963.

This was the first of five factors that changed American attitudes toward the federal debt, and perhaps the most important, because if the Kennedy tax cut had been viewed as a failure, subsequent U.S. fiscal history would have been very different and the "Puritan Ethic" might be alive and well today.

Theoretical Justifications

The second factor changing attitudes was the emergence of the doctrine that large deficits were needed to control federal government spending. A principal advocate of this position was Milton Friedman. He argued that deficits were not important; what was important was the percentage of the GNP absorbed by federal government spending. Government deficits would not be inflationary if the Federal Reserve refused to monetize the debt, and the presence of large deficits would constrain spending. What Friedman did not emphasize was that this combination of a loose fiscal policy and a tight monetary policy would, in an economy operating close to capacity, drive up interest rates, squeeze out private investment, and make American industry less competitive in world markets.

The large deficits have had the effect that Friedman anticipated. Because of the rise in military spending, total federal government spending as a percent of the GNP was higher in the last year of the Reagan administration than it was in Carter's last year. However, excluding the military, entitlement programs, and interest costs, the remainder of the budget declined as a percentage of the GNP. More important, the deficits have restrained the Congress from initiating new social programs. President Bush has been talking about establishing a new space program, improving the educational system, initiating a war on drugs, and aiding the Eastern European countries. Because of the deficit, however, only nominal amounts of money are being allocated to these programs. The United States is not in a financial position to undertake new initiatives or address new challenges. Because of the restraint on spending, conservatives who traditionally have opposed government deficits are now comfortable in defending a policy of continuing deficits.

The *Wall Street Journal* has been a constant advocate of this position on its editorial pages. The following is from an editorial of January 31, 1990:

> Spending measures the government's real command over resources; it's a secondary matter whether it's financed by taxes, by borrowing or by even higher taxes with a budget surplus. While we'd like something a lot more surgical, an item veto for example, the deficit has been the only spending restraint we've had. The inexorable climb of outlays as a percent of GNP was checked by holding the line on taxes even at the expense of a budget deficit. Revenues are already climbing back toward their postwar high. On that ground alone it's time to cut them again, letting the people who earned the money decide how to consume, save and invest.

Other Contributing Factors

The third factor affecting attitudes has been the massive net inflow of foreign savings, totaling about $800 billion during the past seven years, which has mitigated the effect of the deficits on interest rates and private investment. Without this $800 billion in foreign savings, interest rates in the United States would have been much higher and the man in the street would be much less complacent about the deficits than he is today.

The fourth factor changing attitudes toward debt is the apparent success of the Reagan economic policies. I say "apparent" because we lack historical perspective, but without question a good feeling is widespread in the country. The unemployment rate is low. The inflation rate and interest rates are high by historical standards, but they are so much lower than they were in the early years of the decade that they seem quite satisfactory. For example, students today cannot relate to the fact that the mortgage rate on a house built in 1970 is 5½ percent—they think anything below 10 percent is pretty good. The very fact that the economy is in the eighth year of economic expansion with no recession in sight has caused people to discount concerns about the deficits.

The fifth and a very important factor changing attitudes toward debt, is the fact that the United States has not had a major depression in fifty years. This has made people much less cautious in financial matters. The clearest examples are in corporate finance, with many major companies taking on levels of debt that would not permit them to survive a serious depression. Some are even having trouble dealing with a slower growth rate. The top managers of American companies in the 1950s and 1960s were people who had come to maturity during the Great Depression. The willingness of today's managers to leverage their companies must seem to them to be reckless behavior, and the willingness, until recently, of investors to buy the bonds of such highly leveraged corporations must seem to them to be naive. The fact that nobody under the age of sixty has any memory of the Great Depression has contributed substantially to the new attitudes about debt.

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The Consequences

Having discussed the reasons for the changed American attitude toward debt, I would like to turn to the consequences of that change. Economic theory tells us that if the government runs large deficits when the economy is running close to capacity, the result will be high interest rates, the squeezing out of private investment, and a slower rate of growth in productivity and real income. All of these consequences are clearly apparent in the 1980s, mitigated only by the large inflows of foreign capital.

Since World War II the U.S. economy has had two economic expansions that lasted more than seven years. It may be instructive to compare the first seven years of the present expansion (1983–89) with the first seven years of the earlier expansion (1961–67).

During the 1961–67 period the federal government budget deficits averaged 0.8 percent of the GNP versus 4.5 percent in the 1983–89 period, almost six times as large. At the same time, the gross private savings rate dropped from 17.2 percent during the 1961–67 period to 15.8 percent during 1983–89, which means that the burden of the deficits on our capital markets in the 1980s was even greater than the ratios of the deficits to the GNP would suggest. During the 1961–67 period, U.S. government long-term bond yields averaged 4.25 percent and the bank prime lending rate averaged 4.8 percent. These interest rates seem almost impossibly low today, but they are not very low relative to the rates that have prevailed in recent years in Japan and Germany, our major competitors.

Given the high cost of capital, it is not surprising that the investment performance of the United States in the 1980s was the poorest of any decade since World War II and that the rate of growth of productivity and real income was also the poorest. Net fixed domestic investment as a percentage of GNP during the 1983–89 period was only 72 percent of the 1961–67 level, and net fixed nonresidential domestic investment as a percentage of the GNP was only 58 percent of the 1961–67 level. We shall note later that the rate of growth of output per person in the nonfarm business sector during 1983–89 was 56 percent of the 1961–67 level. These domestic investment figures tell only part of the story. During the 1961–67 period the United States invested more abroad than foreigners invested in the United States, in an amount averaging 0.8 percent of the GNP. Net foreign investment during 1983–89 averaged a *negative* 2.7 percent of the GNP.

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Since 1983 the level of investment in the United States has clearly been subpar despite the fact that in the past seven years the economy has enjoyed net imports of foreign savings totaling more than $800 billion. If this inflow had been associated with an exceptionally high level of investment in state-of-the-art plant and equipment, this country's future prospects would be greatly enhanced, but the facts clearly indicate that this inflow was consumed rather than invested.

While a national budget deficit is clearly not like a family's budget deficit, an international deficit is very similar. A family can consume beyond its income as long as its credit remains good. The same is true of a nation in international transactions. The credit of the United States has been amazingly strong during the past seven years. This has led one prominent economist to argue that the United States can sustain current account deficits indefinitely at around the $100 billion level. I am skeptical of this proposition. My experience suggests that the fact that something has gone on for several years is no basis for assuming that it can go on forever.

When I was a graduate student in the 1950s, a common theme was that the world was going to have a perpetual shortage of dollars. When I arrived in the Treasury in 1961, I found that the dollar shortage was over. Foreign central banks had more dollars than they wanted to hold. The span of time between perpetual dollar shortage and dollar glut was very short.

One of the most worrisome aspects of the large international deficit is that the United States has lost sovereignty over its financial markets. The year 1987 was a case in point. In the spring of 1987 the inflow of private foreign capital suddenly dried up. Private foreign investors were unwilling to finance our deficit at prevailing interest rates and exchange rates. The dollar dropped and the deficit was financed entirely by an inflow of foreign central bank funds, as these banks sought to dampen the rate of decline of the dollar. While private foreign investors had been absorbing 30 percent or more of our new bond issues, central banks do not buy bonds; they invest short-term. As a consequence long-term bond yields rose by 150 basis points and this, in turn, triggered the great stock market collapse of 1987.

Prospects

The United States is currently vulnerable to another financial shock stemming from any change in the attitudes of private foreign investors. The major interest rate advantage that the United States offered in earlier years has largely been eliminated for German investors and is very much smaller for Japanese investors. The dollar has fallen by 18 percent against the deutsche mark since September, although it has thus far been steady against the yen. There could well be ahead of us another period in which the demand for U.S. assets by private foreign investors dries up. Again the United States would experience a sharp decline in the dollar and a rise in long-term interest rates. Despite an easing in Federal Reserve policy, long-term government bond yields have increased 75 basis points since December 20. At least in part, this rise in long-term yields reflects a recognition by the market that U.S. assets may be less attractive to foreign investors than they have been in the past. This is a matter of concern, since the economy in 1990 may be less capable of absorbing financial shocks than it was in 1987.

In 1981 the United States had net investment income of $34 billion, meaning that income on U.S. foreign investment exceeded income on foreign investment in the United States by that amount. This was a substantial American asset, the product of decades of heavy investment abroad. It permitted the country to run a trade deficit that in 1989 dollars would amount to $700 for every American family, and still balance its international accounts. In seven years this asset was dissipated; net investment income turned negative in 1989. At some point in the future, the United States will have to run a trade surplus in order to cover the interest payments due on the debt that we incurred so that we could consume more than we produced in the 1980s.

It should not be surprising that the poor investment performance of the 1980s has been associated with a poor productivity performance, the poorest of any major industrial country. Productivity growth during this expansion has been only 56 percent of the level of 1961–67, roughly the same proportion as the relative rates of growth of fixed nonresidential investment. Real compensation per hour in the nonfarm business sector rose by 20 percent during the expansion in the 1960s but only by 5 percent during this expansion.

With such an abysmal record of real income growth, why do Americans feel good about the 1980s? I think there are four reasons. First, the almost negligible real income growth dates back to 1973, the year of the first oil price shock. During the previous twenty-six years, 1947–73, real compensation per hour doubled. During the following sixteen years it rose by only 5 percent. Americans no longer expect a rapid rise in real income, as they did in the 1960s. Second, the decline of the inflation rate and interest rates from the high double-digit levels of the early 1980s is viewed, quite properly, as a success of economic policy. But there is no perception that the current levels of the inflation rate and interest rates are very high by historical standards. Young people find the cost of housing to be very high, and it is much higher in real terms than it was for my generation; but they do not understand that it is the higher mortgage rates rather than the higher purchase price of housing that is the source of the problem. Third, the labor force participation rate for women has risen by almost 30 percent since 1973. The United States has many more two-earner families, and this has helped to mask the fact that real income per person has made little progress. Fourth, the poor U.S. economic performance was also masked by the large trade deficits that permitted us to consume more than we as a nation produced.

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Americans are a much less compassionate people than we were in the 1960s. We are now much less willing to sacrifice for the benefit of the disadvantaged, at home or abroad. The reason, I believe, is that with real incomes rising at 3 percent a year during the 1960s, Americans felt affluent. Today after sixteen years of little growth in real incomes the sense of affluence has gone and along with it some of our compassion for others.

In the American democracy, with all of its checks and balances and diffused power, we are often not able to act except in a crisis environment. While the economic policies of the 1980s have carried with them considerable costs, the costs are long-term in their impact, not the stuff to generate crises. The most likely disturbance to capture the attention of the American people would be a prolonged reluctance of private foreign capital to finance our trade deficit, which would produce a declining dollar and sharply higher long-term interest rates. We had a taste of this in 1987. More may come.

In the early 1960s economists of all persuasions agreed with President Kennedy's theme of the need to get the economy going again. In a congressional hearing in 1964, Keynesians argued that fiscal policies were too restrictive in the 1950s and monetarists complained that the Federal Reserve had not permitted the money supply to grow fast enough. They agreed on the need for more expansionary policies to enable the economy to reach its full potential. I shared this conventional wisdom.

President Eisenhower and William McChesney Martin, Jr., who presided over fiscal and monetary policies during most of the 1950s, were indeed conservative men. However, if we look at the economic statistics of the 1950s in the perspective of history, we might wonder why economists of that era were so unanimously dissatisfied with the results. During the 1950s we had an average rate of growth of real GNP of 4.1 percent, the unemployment rate averaged 4.5 percent, the increase in the Consumer Price Index averaged 2.3 percent per year. Not too shabby, but the dramatic numbers were those for productivity and real incomes. During the decade of the 1950s, output per hour rose by almost 30 percent, an average of 2.6 percent per annum, and real compensation per hour rose by almost 37 percent, averaging 3.2 percent per annum. We are unlikely to achieve that kind of economic performance in the 1990s.

In retrospect, I have reluctantly come to the conclusion that the country would be a lot better off today if we in the Kennedy Administration had failed to destroy the "Puritan Ethic" in the early 1960s.