

## Fiscal Discipline Requires Public Support

The U.S experiences will be useful. Public debate should be fostered.

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Document date: May 23, 2002

Released online: May 23, 2002

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To an American, the Japanese budget situation is truly alarming. It can be said that the United States followed an irresponsible fiscal policy through much of the 1980s, but the U.S. structural deficit peaked at only 4.8 percent of the GDP in 1986. The IMF estimates the Japanese structural deficit at about 7 percent of GDP. With Japan facing a more rapidly aging population than does the United States, it is impossible to ignore the risk that the Japanese budget will spiral out of control.

The American budget deficit disappeared rapidly in the late 1990s and the nation enjoyed four surpluses in a row from 1998 through 2001. That had not happened since the 1920s. But as soon as surpluses emerged, politicians became careless. They let spending rise rapidly and passed a substantial tax cut in 2001. The attack of September 11 increased the need for even more spending on defense and homeland security, and the resulting recession, although very shallow, depressed revenues further. As a result, the U.S. surplus disappeared and the 2002 deficit could possibly exceed \$100 billion. But to put that in perspective, the 1983 deficit, adjusted for the size of the economy, would be over \$600 billion.

The United States experienced some good luck on the road from deficits to surpluses. The end of the Cold War allowed a substantial cut in defense spending, and technological improvements in computing and communications allowed the economy to grow rapidly. However, the good luck was nurtured by deregulation that allowed entrepreneurship to thrive, by an immigration policy that supplied eager workers, and by a foreign policy that skillfully managed the demise of communism.

But good luck was not enough. Through the long period from 1982 through 1997, the U.S. Congress took many painful steps that raised taxes and curbed spending growth. These are not activities that elected politicians enjoy.

Deficit reduction did not proceed smoothly. Mistakes were made along the way, but in the end the effort was successful. Can Japan learn anything useful from either American successes or American mistakes?

That question is raised by an on-going, comparative study of the fiscal challenges facing Japan and the United States. The study is being carried on jointly by NIRA of Tokyo and the Urban Institute of Washington, D. C.

During most of U.S. history, the budget process was disciplined by a powerful unwritten rule that the budget should balance. For the most part, budgets did, in fact, balance except in wars and serious recessions. The Keynesian revolution destroyed the universal appeal of this rule. Economists argued that deficits could be useful to counter recession and to finance temporary surges in spending. Although the new ideas had intellectual merit, they greatly weakened fiscal discipline. No new rules evolved to restrain the system.

Although deficits could be justified to ameliorate short-run problems, it was clear that they had negative long-run effects. Deficits burden future taxpayers with interest payments on an increased public debt, and deficits draw away savings that otherwise could be invested in the private sector to increase productivity and wages.

America's success in eliminating deficits would not have been possible without the support of a broad public consensus that focused on the long-run negative effects of deficits. The public had to be willing to give up the benefits of using fiscal policy to stimulate the economy in the short run.

I do not want to imply that the consensus was universal. A vociferous group of supply-side economists strongly opposed the many tax increases of the 1980s and early 1990s, because they believed that tax increases sap initiative and reduce economic growth. Although the predominant view in both political parties was that deficits should be reduced, there was much argument as to how it should be done. Republicans generally favored spending restraint and Democrats favored tax increases. But in the end, there was a

mixture of both. It is noteworthy that the two largest deficit-reducing packages, those of 1982 and 1990, were enacted during recessions. The somewhat smaller, but important, package of 1993 was passed before it was clear that the recession of 1990 had ended.

Although taxes were raised in 1982, 1983, and 1984 and spending was constrained, the deficit was slow to decline. The Congress became frustrated and passed the Gramm-Rudman-Hollings Act in 1985 (GRH). It set rigid, declining targets for the deficit and enforced them with a complex formula that automatically cut spending if targets were exceeded.

GRH was bound to fail and this approach should be avoided in Japan. The deficit is affected much more by fluctuations in the economy in any year than it is by changes in spending and tax policy. It becomes a rapidly moving target that cannot be controlled precisely in the short run. When the U.S. economy grew slightly less fast than expected and the deficit rose far above its target, the required automatic cuts in spending were too painful to be politically plausible. The deficit target was first revised upward, but in 1990, GRH was abandoned altogether. The experience suggests that it may be appropriate to enunciate numerical goals for the deficit, such as Prime Minister Koizumi's goal of a 30 trillion yen deficit, but numerical targets should not be enforced too rigorously or promised too fervently.

GRH was replaced by a much more sensible approach to deficit reduction. A large package of spending constraints and tax increases was negotiated with the first President Bush and the Congress enforced the deal by imposing caps on the spending that it controlled directly and insisted that subsequent increases in entitlement spending or tax cuts be paid for with other entitlement cuts or tax increases. These rules worked extremely well until surpluses emerged after 1997.

The rules worked for three reasons. First, they were aimed at solving a widely perceived national problem. Second, the actions that they required imposed only moderate political pain. They did not try to balance the budget overnight. Third, they were aimed at controlling something that can be controlled—Congressional actions—and not at precisely controlling something that cannot be precisely controlled—the budget deficit. The importance of the first point is revealed by the fact that the rules disintegrated as soon as the national problem, the deficit, disappeared.

Such rules could possibly be applied effectively in Japan. The Prime Minister would have to apply them to his own proposals, because he has much more budgeting power in Japan's parliamentary system than the president of the United States has in our Congressional system of budgeting.

However, the rules will not work without first developing a public consensus that the deficit must be reduced. This implies giving up the idea that fiscal policy should be used to stimulate the economy in the short run. It is not my impression that there is yet a Japanese consensus on this point. A vigorous debate is required. In the United States, the debate was fostered by the work of many think tanks and official bodies, such as the Congressional Budget Office, that studied policy options. Japan does not have as many resources of this type, but that does not obviate debate. The debate must proceed quickly. Time is not an ally when the public debt is soaring.

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