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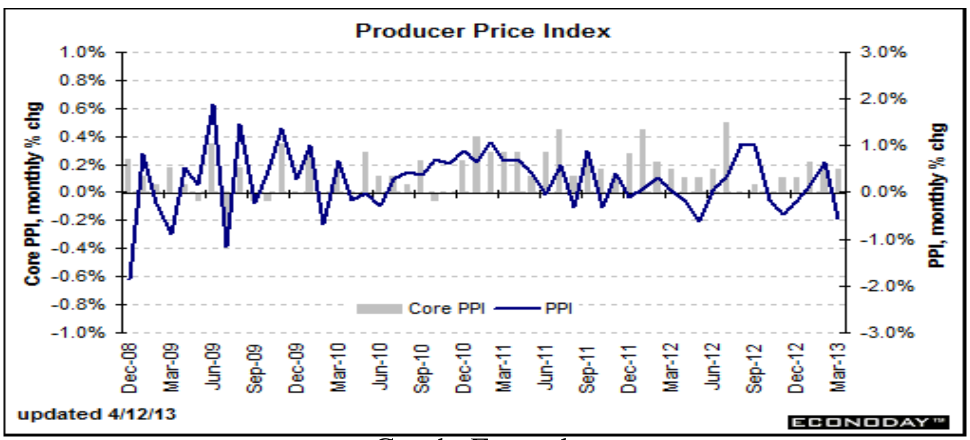
Popular Economics Weekly

Deflation and Our Plunging Deficit

The federal budget deficit is shrinking rapidly, says Goldman Sachs Chief Economist Jan Hatzius. And that is not such a good thing at the moment, since the private sector isn't spending enough. It means this very weak recovery will continue, with deflationary tendencies still in the air. We do not want even lower inflation right now, as it depresses incomes and economic growth.

President Obama's new budget proposal doesn't really help, since he wants to cut entitlement spending, which takes money out of circulation when more money in circulation is needed.

Deflationary tendencies are showing up in the Producer Price Index for wholesale goods, which has been close to zero since the end of the Great Recession. The annual rate in March just dropped to 1.1 percent from 1.8 percent in February (seasonally adjusted). The core rate held steady at 1.7 percent.



Graph: Econoday

The federal budget deficit is a subject Hatzius has been following for some time...."[I]n the 12 months through March 2013, the deficit totaled $911 billion, or 5.7 percent of GDP," he said in a research note. "In the first three months of calendar 2013--that is, since the increase in payroll and income tax rates took effect on January 1--we estimate that the deficit has averaged just 4.5 percent of GDP on a seasonally adjusted basis. This is less than half the peak annual deficit of 10.1 percent of GDP in fiscal 2009."

So it's not hard to understand what caused the **March plunge in retail sales of 0.4 percent**, versus the 1 percent increase in February. Some of it was due to bad weather and the payroll tax increases, but most was due to shrinking private and government spending.

Personal incomes are fluctuating wildly due to the payroll tax increases, so my take is, it ain't the weather as some pundits are saying! Sure personal income rebounded 1.1 percent in February after a drop of 3.7 percent in January and a 2.6 percent jump in December, as we said last week. But it's not enough to boost demand. Consumer spending just isn't holding up, the main reason for government to keep spending.

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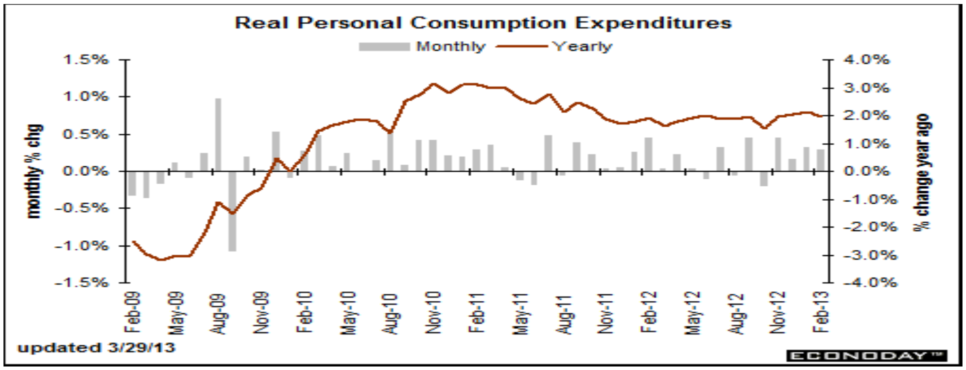

Graph: Econoday

Personal spending jumped 0.7 percent after rising 0.4 percent in January. Strength was in nondurable goods, but that was mostly higher gasoline prices. Consumer outlays are up 3.3 percent annually, but if prices aren't rising then that's not enough to boost overall growth.

Government spending has already decreased 4 percent in the past 2 years, **the largest amount since demobilization of the Korean War.** For then important spending priorities can be met—such as infrastructure, research and development, as well as hiring back some of the 600,000 teachers let go because of state budget shortfalls.

What about the mounting debt? Rutgers Economic Historian James Livingston has an answer. Bring corporate taxes back to the levels during the Eisenhower era, when they were taxed at a 52 percent rate and made up some one-third of tax revenues, instead of the much less progressive payroll tax that burdens most of us. Corporate taxes now make up just 9 percent of revenues, according to Professor Livingston.

So where there's the will there's a way, as the saying goes. We know how to climb out of the debt trap. Lessen the burden of taxing personal incomes and increase it for corporations that have record-breaking profits and are hoarding some **$4.25 trillion in cash**, according to the St. Louis Federal Reserve. It is a case of some good history repeating itself, for a change.

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