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Why Deficits Still Matter

by Austan Goolsbee

The United States has run massive budget deficits every year the Bush administration has been in office. The latest budget projections from the White House show annual deficits in the $250 billion range for the rest of the president's term, at which point nearly $3 trillion will have been added to the national debt.[1] In fact, George W. Bush has presided over the biggest fiscal deterioration in American history—a sorry legacy considering his predecessor left him a healthy budget surplus projected to be $5 trillion over 10 years.

This did not happen by accident. White House officials have repudiated the Clinton administration's view that fiscal responsibility lays the groundwork for sustained economic growth. Often identified with former Treasury Secretary Robert Rubin, this view held that by running massive deficits and borrowing heavily, the federal government drove up the cost of capital. By cutting the deficit, it could bring interest rates down and thereby stimulate new waves of private investment. The economic boom of the 1990s seemed to prove Rubinomics right.

But Republicans have nonetheless rejected that approach. Glenn Hubbard, formerly President Bush's top economic adviser, said in a December 2002 speech: "One can hope that the discussion will move away from the current fixation with linking budget deficits with interest rates." When pressed on the point, he responded: "That's Rubinomics, and we think it's completely wrong."[2] More recently, in an editorial marking the 25th anniversary of Ronald Reagan's inauguration, the conservative *Wall Street Journal* opined that Rubinomics was a failure, and argued that history had vindicated the supply-side line that tax cuts are the most important policy that government can undertake.[3] Meanwhile, the Bush White House has pointed to higher-than-expected tax revenues in the last two years as further proof that we do not need to worry about fiscal responsibility in the near future.

Times have changed since 1992, and the economic case for fiscal discipline has changed, too. But it remains strong. It is true that the globalization of capital markets in the last 15 years means that America no longer displaces an inordinate percentage of the world's capital when it borrows heavily from abroad. Therefore, the interest rates that the U.S. government has to pay for its massive borrowing are not as high as they might be

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"One person with a belief is a social power equal to ninety-nine who have only interests."
—John Stuart Mill

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otherwise. In addition, governments and central banks have helped our situation. Lending countries such as China and the world's oil exporting nations seemingly have been willing to hold U.S. debt even though higher returns might be available elsewhere.

Of course, it is nice to be able to borrow money without having to worry much about the impact on interest rates. But if globalization has made borrowing from abroad easier, it also exacts new penalties for fiscal profligacy. In fact, there are three big reasons why Americans should still be concerned with big budget deficits: (1) they have unfair distributional consequences between generations; (2) they make it harder for our government to respond to fiscal crises; and (3) they subject America's economic well-being to the potential whims of foreign governments and central banks.

Before looking at each of these, however, it is important to address the administration's claim that our current fiscal position is basically healthy. The recently released budgets of the Congressional Budget Office (CBO) and of the president show the government going back into surplus by 2012, which makes it sound as though the problem has been solved.[4]

A closer look at the numbers, however, reveals that the positive news is overstated. The CBO's projections, for example, assume that all the Bush tax cuts will expire; that the Alternative Minimum Tax (AMT) will affect a growing fraction of people earning between $75,000 and $100,000 over the next five years; that federal spending will grow only with inflation, rather than with population or GDP growth; and, most importantly, that the federal government will go on raiding the Social Security trust fund "lock-box." The president, by requesting hundreds of billions of dollars in further tax cuts, has painted himself into such a tight corner that he cannot produce a fiscally responsible budget without leaning heavily on such dubious assumptions. A more realistic analysis shows very significant deficits for at least the next several years, after which the baby boomers' exploding health and retirement costs will make the fiscal picture dramatically worse.

Make no mistake: Deficits still matter. A balanced budget may be less central to economic growth today than in the 1990s. But deficit reduction now functions as a crucial insurance policy against global financial shocks and over-reliance on foreign

lenders, as well as national emergencies such as Hurricane Katrina's devastation of the Gulf Coast. It should not be a goal in and of itself—pain for pain's sake. Fiscal responsibility should be our goal because it remains an important foundation of economic justice and growth.

Here is a closer look at the adverse social and economic consequences of the Bush administration's irresponsible fiscal policies.

Who Will Pay for the Bush Deficits?

Although fiscal policy is seldom viewed through the lens of economic fairness, the first and biggest problem with fiscal irresponsibility is distributional. When we borrow money without paying it back, we are leaving our children and grandchildren a legacy of much higher tax rates and much lower public benefits than we enjoy, because they will have to foot our bill.

Economists use what is known as "generational accounting" to calculate how much of the nation's debt burden will need to be borne by later generations compared to ours and previous generations as a function of today's large fiscal imbalances. The results are stark: As a share of their income, future generations will have to pay about twice the taxes as today's workers have paid or else they will receive around one-half the public spending.

The money we spend beyond our means today takes away the money our children will have for Social Security benefits, Medicare, Medicaid, and every other spending priority. The interest payments on the country's growing debt—already accounting for approximately 10 percent of the federal budget, pushing $300 billion dollars—will ultimately become the government's biggest budget item. The payments for the spending of the past will increasingly crowd out the spending priorities of the present.

The country is in for a double disappointment because all these new deficits have not been used for investments. It is one thing to run deficits to invest in activities that might improve productivity or standards of living for future generations. This, after all, is what FDR did to pull America out of the Great Depression and win World War II. A bigger economy would allow us to soften the distributional blow of deficit financing. But that is not what the Bush administration has done. It borrowed to finance huge tax cuts for a fortunate few, and most of the money went straight into consumer spending with little lasting impact on the kids who will one day have to pay the bills for this splurge.

How Deficits Handcuff U.S. Policymakers

The second major problem with running big deficits is that it diminishes the government's ability to respond to crises. It eats up the rainy day fund, if you will. When the government operates without the fiscal cushion that budget surpluses provided in the late 1990s, it is hard-pressed to respond to emergencies, such as Hurricane Katrina, or even fulfill more basic commitments. It is especially troubling today that despite an economy in full-blown recovery, record-smashing corporate profits, low interest rates, and strong productivity growth, the country's budget deficits have still been in the $250 to $400 billion range. On top of that, the true size of the fiscal mess is masked by the fact that we are dipping into the Social Security surplus to finance current consumption. Since 2001, we have effectively borrowed almost $1 trillion from the trust fund, and the CBO forecasts another

$200 billion or so every year for the foreseeable future. Our *true* annual deficits have been in the $400 billion to $600 billion range and are forecast to continue in that range for the rest of the Bush term.

What are we going to do in the event of another recession, a decrease in corporate profits, another Hurricane Katrina, a collapse of the Pension Benefit Guarantee Corporation, or another major war? And how will we finance future Social Security and Medicare benefits? The probable answer is, we'll borrow more—but this will only postpone the day of reckoning and make it more severe.

The United States has a strategic petroleum reserve to guard against unforeseen disruptions in our oil supply. It is not a long-term solution. It is crisis insurance. Similarly, cutting the deficit would give us a *strategic fiscal reserve*. Without it, the country must either raise taxes to deal with a crisis or else significantly increase the federal debt burden, which already totals almost $80,000 for every household in America.

Foreign Leverage Over the U.S. Economy

The third risk of today's fiscal irresponsibility is the negative impact it has on our international position—both economic and, potentially, geopolitical.

Our economic position is seriously undermined by a low savings rate—and the deficit is like an anchor that drags our national savings rate down. We need to get our low savings rate up.

One of the stated goals of the big tax cuts the president pushed through a compliant GOP Congress—including dividend tax cuts, capital gains tax cuts, estate tax cuts, and top-bracket income tax cuts—was to increase incentives for high-income people to save. On the most practical level imaginable, this policy—call it Supply Side 101—has failed. The savings of high-income people have not increased dramatically, certainly not enough to offset the plunge in the national savings rate that the big Bush deficits represent (because a nation's savings rate combines personal, corporate, and *government* savings).

For a country to maintain investment by entrepreneurs and companies when there is not enough domestic capital to be had, it must by necessity borrow from abroad. It is a good sign for the economy that our investment rate—the part of GDP spent on machinery, capital, buildings, factories, and the like—has finally recovered from the recession of the early 2000s. But because that investment has been coupled with low national savings, the United States has had to borrow an astounding amount of money from foreign countries. Foreign ownership of U.S. Treasuries alone increased $1.2 trillion dollars in the first five years of the Bush administration, after falling more than $200 billion in the last two and a half years of the Clinton administration. Most often it is foreign governments and central banks that own our debt. That is what raises the potential threat to America's geopolitical position.

It is certainly less concrete than the impact on the savings rate, but the impact of borrowing on America's geopolitical posture might be important in the event of a crisis. Because America has had to borrow from abroad, it has ended up owing a great deal of money to governments whose interests do not always mesh with our own. Our government owes China some $350 billion, for example, and we owe oil exporting countries such as Saudi Arabia, Libya, Algeria, Venezuela, and Qatar a combined $100 billion more. Most of the time, it does not matter who holds a country's debt. Investors around the world, no matter who they are, simply respond to market forces. But in times

of crisis, if investors happen to be the governments and central banks of other countries—as is predominantly the case today with U.S. debt—then lenders can have inordinate influence over a borrower's international policies.

Take one example from our own history: the Suez crisis of 1956. Britain—which was heavily indebted to the United States—joined with France and Israel in an invasion of Egypt after Egypt's president, Gamel Abdel Nasser, nationalized the Suez canal. The Eisenhower administration, which had lambasted the Soviet Union's invasion of Hungary that same year, was determined to keep its anti-colonial credentials intact by opposing the British-French venture. The United States refused to float its World War II ally further loans to support their currency—and even threatened to dump its holdings to precipitate a currency crisis. The British, desperate to avoid a devaluation of the pound, caved in, and the Suez misadventure heralded the end of European colonialism in the Arab world.

Could other countries exercise the same kind of economic leverage over the United States? Hopefully, we are a long way from having that sort of situation in reverse—where our foreign policy goals are stymied because of financial pressures from our debt holders—but it is not inconceivable that we would be forced to choose between our geopolitical goals and financing the debt we owe foreign countries.

This debt is primarily owned by governments with political motives, not just economic ones. If these governments decided to dump U.S. treasuries, we could plunge into crisis mode. Since there is not enough domestic savings to cover our investment, either our investment rate would need to fall, or interest rates might need to shoot up in order to attract capital from somewhere else. Either way, it would be bad news for the U.S. economy.

Further, as the risks associated with our accumulating debt grow, oil exporting countries will be tempted to sign their contracts in euros or yen rather than dollars, as they do now. If that happens, then anything that devalues the dollar—including policy initiatives designed to reduce the trade deficit—will directly increase the price of energy rather markedly.

A Legacy for Future Generations

Given the hazards of continuing down the current path of fiscal excess, Congress should act soon to get things under control. That does not mean immediately balancing the budget by draconian cuts to necessary investments. Small deficits—say on the order of 1 percent of GDP—will not run the economy into the ground and occasional big expenses on emergencies like Hurricane Katrina are a fact of modern life. But we know that entitlement spending will grow dramatically in the next 20 years and we need to make space in the trunk for a few very large suitcases, as it were. We should not be filling up the space before those bags even arrive.

The debt our generation accumulates becomes part of the legacy we leave to the next generation. The "greatest generation" that fought WWII sacrificed a great deal for the next generation—for us, their children and grandchildren. Not only did some give their lives, but over the next 20 years they largely paid off all of the massive debt they had to accumulate during the war. At the end of the war, America's debt exceeded its entire GDP. By the Kennedy administration, the ratio was back down to the same level it was before the war. Opportunity, not debt, was the legacy our grandparents wanted to leave behind.

Endnotes

[1] "Budget of the United States Government, Fiscal Year 2008," Office of Management and Budget, *http://www.whitehouse.gov/omb/budget/fy2008/budget.html*.

[2] Chait, Jonathan, "Deficit Reduction," *The New Republic*, January 13, 2003.

[3] "Still Morning in America: Reaganomics 25 Years Later," *Wall Street Journal Editorial*, January 20, 2006, *http://www.opinionjournal.com/editorial/feature.html?id=110007843*.

[4] See: "Budget of the United States Government, Fiscal Year 2008," op cit., and "The Budget and Economic Outlook: Fiscal Years 2008 to 2017," Congressional Budget Office, *http://www.cbo.gov/ftpdocs/77xx/doc7731/01-24-BudgetOutlook.pdf*.

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