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Breaking Out of the Deficit Trap

The Case Against the Fiscal Hawks

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"Reagan proved deficits don't matter."
Dick Cheney (quoted in Suskind 2004, p. 291)

Far be it from me, a card-carrying member of the Texas Left, to defend the moral character of Richard Cheney, the Apogee of Evil. But fiscal policy is not a matter of moral character. It is a matter of economic argument, of theory and evidence.

That being so, this essay reviews an influential recent paper, which outlines the widely accepted case for treating current and future budget deficits as our most urgent economic policy priority. The results are not pretty. To a large extent, my review shows that the paper's theoretical arguments are flawed, and the empirical evidence is inconclusive. Overall, the case for treating budget deficits, either current or prospective, as a deeply threatening phenomenon is surprisingly weak.

In a September 2004 paper—to be published later in 2005—entitled "Budget Deficits, National Saving, and Interest Rates," William G. Gale and Peter R. Orszag of the Brookings Institution and Tax Policy Center argue that "sustained budget deficits reduce national saving and raise interest rates by economically and statistically significant quantities."

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Does Anyone Remember a Fellow Named Keynes?

Gale and Orszag (hereafter referred to as GO) begin by identifying three "principal perspectives" or models of the effect of deficits on the macroeconomy. They are:

1. "The Ricardian equivalence hypothesis, [according to which] such deficits are fully offset by increases in private saving and have no effect on national saving, interest rates, exchange rates, future domestic production, or future national income."
2. "the small open economy view, [which] suggests that budget deficits reduce national saving, but that international capital inflows finance the entire reduction in national saving."
3. "the conventional view, [which] suggests that deficits reduce national saving and that the reduction in national saving is at least partly reflected in lower domestic investment."

The GO paper is a brief for the conventional view: that deficits raise interest rates and lower "national saving" and, therefore, national investment, and, ultimately, the capital stock and national income. But before assessing the theory and the evidence behind the case, there is an elementary question of scholarship. In the GO taxonomy of models, has anything been left out?

Well, something has been, for there is a fourth perspective. It is associated with the followers of a once-prominent British economist of the early 20th century, by the name of John Maynard Keynes. GO make no reference to Keynes in their paper. Nor is there mention of any modern Keynesian economist. It is a scholarly lapse. And it is not innocent. It permits GO to proceed without considering the most serious objections to their position.

As GO state, "the distinction between the first model [i.e., Ricardian equivalence] and the latter two is most fundamental"—that is, of those models they are willing to consider. What is Ricardian equivalence? According to this proposition, with which Robert Barro has been beguiling the gullible for 30 years, the effects of budget deficits on spending are completely, immediately, and fully negated by the reaction of private savings. Households always fully anticipate, and fully offset through increased savings, the ultimate increase in taxes that must inevitably come as the government eventually is forced to balance its accounts.

It is truly difficult to overstate the silliness of Ricardian equivalence as a starting point for a discussion of fiscal policy. GO investigate the obvious implication of the Ricardian hypothesis, that a cut in taxes will have no impact *whatever* on aggregate consumption expenditure. What they find, after a great many pages of detailed and careful work, is that, in the estimates they find most convincing, "a range of about 50 to 80 cents of every dollar in tax cuts is spent in the first year. This range . . . is inconsistent with the Ricardian prediction of a full offset from private savings and the difference . . . is economically important." So far, no one can disagree.

But GO go on to make the following theoretical argument: "An increase in the budget deficit reduces national saving unless it is fully offset by an increase in private saving. If national saving falls, then national investment and future national income must fall as well, all else equal. In other words, *to the extent* that budget deficits reduce national saving, they reduce future national income."

This is a simple, seemingly inexorable argument. But it is built on a very poor and shallow theory of economic output and of economic growth. And by GO's own account, as we shall see, there is little evidence that the mechanisms on which they rely to implement their syllogism in fact operate as advertised in the real world.

The underlying growth theory in the GO vision of the world holds, in essence, that the future size of the real GDP depends solely on the size of the real capital stock, which itself depends solely on the physical quantity of new capital investment. Full employment of labor is assumed. The sole effect of a budget deficit, in this construction, is to shift resources from saving and investment to consumption. That is the relevance of the 50 to 80 percent estimates quoted above. In this way, budget deficits are per se injurious to future growth.

But, since they merely shift resources from investment to consumption, it also follows inexorably that in the GO model—apart from the escape clause "all else equal," which GO never explore—*budget deficits also have no effect on current GDP.*

This is where the Keynesian begins to see red.

Radical Crowding Out and Extreme Monetarism

The possibility suggested by GO is that the rise in consumption engenders an exactly offsetting fall in gross private business investment, as indeed GO state explicitly in the passage quoted. This is a proposition of 100 percent crowding out,

embedded in an assumed world of permanent full employment and full-capacity production.

Indeed, when GO consider the effect of their "adjusted baseline" deficit projections—basically the Congressional Budget Office (CBO) budget baseline rendered somewhat more credible by allowing for certain actions Congress is highly likely to take—they come close to an explicit—and, as we shall see, even more extreme—statement of their GDP determinism. GO write of this scenario: "Under the adjusted baseline, the debt–GDP ratio would rise steadily throughout the decade and by 2014 would equal 55 percent, well above the most recent high of 49 percent in 1992 and the highest level since 1955. The debt–GDP ratio would continue to rise thereafter." A footnote goes on to suggest that under these conditions the debt–GDP ratio would rise to 139 percent of GDP in 2030, 505 percent in 2060, and 942 percent in 2080.

What is the estimate of nominal GDP used to calculate this debt–GDP ratio? Evidently, *it is exactly the same nominal GDP* forecast that was used to calculate the debt–GDP ratio under the CBO's original baseline forecast, under which deficits decline nearly to zero by 2014. In other words, GO explicitly postulate that a fiscal shift of 3.5 percentage points of GDP—roughly $420 billion, in today's terms, every year into the indefinite future—has not a pennyworth of stimulative effect on GDP.

This is truly an improbable view.

To repeat: The national debt is a financial stock, a nominal number. The debt-GDP ratio is a ratio of nominal numbers. If nominal GDP rises—whether the cause be real growth or inflation—the debt–GDP ratio will fall, *all else being equal.* GO deny the very possibility that *nominal* GDP can rise.

The Fetish of the Real Capital Stock

A second and perhaps more subtle problem with the GO theory lies in their total reliance on growth of the capital stock to explain growth in real (inflation-adjusted) output. Except insofar as one might like to consume *something* today, future GDP can always be enhanced by shifting resources from consumption to investment.

The difficulty here is twofold. First, it is not true that future real GDP is always enhanced by more investment. Investment can be excessive, pointless, unproductive, a complete waste. In the early 2000s, according to press reports, 98 percent of newly laid fiber-optic cable lay dark and unused.

Second, it is not true that GDP growth relies mainly on new capital investment. This is not true even in the most orthodox, most conventional, most upstanding, and most neoclassical formulations of growth theory. What does? The "Solow residual," of course—sometimes referred to, tautologically, as "technical change."

For instance, while the rise in real GDP of the late 1990s owed much to a rise in new gross capital formation, it also reflected a broad rise in the rate of productivity growth, which is to say to higher output achieved from each working American. Economists purport to be puzzled by the exact causes of the rise in productivity growth, but in this period they are not especially hard to find. The Verdoorn law (known to Keynesians) predicts rising productivity in the upswing toward full employment. It is entirely consistent with that law, that businesses should seek more efficient use of scarce labor, with existing capital, when employment becomes full and labor becomes relatively scarce. There is every good reason to believe that just this did occur in the late 1990s.

Summing Up So Far

The Keynesian rejoinder to the GO theoretical vision can be summarized in three points:

1. It is not possible to stimulate nominal GDP through fiscal policy without experiencing *some* actual expansion of nominal GDP. The expansion may be real in part, inflationary in part.
2. The economy does not normally operate at full employment and capacity, and some growth of *real* GDP is therefore a *characteristic* response to fiscal stimulus. Such growth raises the potential for accumulation of capital goods and durable goods, and hence the possibility of a higher living standard in future years. It is even possible, in principle, to have a lower *investment share of GDP* and more *actual investment* at the same time.
3. When demand for real output exerts pressure on the supply of labor, induced productivity growth tends to occur. This raises living standards now and in all future years, whether or not there is any increase in net investment or capital formation.

On theoretical grounds alone, therefore, the fears GO express about future budget deficits are plainly overstated.

Will Our Creditors Do Us In?

We next turn briefly to the international aspects of this question. GO distinguish between two cases: one in which the "flow of capital from overseas is infinitely elastic" and a second case in which it is not. In the first case, budget deficits are fully offset by capital inflow at the unchanged interest rate. However, these flows must eventually be repaid.

But it is not true that today's imports necessarily imply tomorrow's exports. Yes, foreigners acquire dollar assets. But if in future they happen to want more U.S. exports, those assets are almost completely irrelevant to that demand. The rich regions especially, such as Europe and Japan, do not need dollars to buy U.S. goods, and their accumulation of dollars today does not imply larger purchases of U.S. products later on. They may, of course, some day decide to sell their dollars for other currencies, including their own. But then, the dollar will merely be devalued. This reduces, after the fact, the value of all dollar holdings, until the selling stops. Such action does not constitute "repayment." And even if foreigners do decide to buy U.S. products eventually, such sales do *not* necessarily imply any fall in future real GNP. With stronger demand from exports, real GDP (and GNP) will grow, partly through productivity growth induced by full employment.

Deficits and Interest Rates: What Theory Are We Using Here?

We now turn to GO's principal claim, which rests on their third model, the second that they consider plausible, under which the supply of foreign capital is not potentially infinite at the going interest rate. In this formulation, budget deficits suppress investment by raising real interest rates here at home. The question is, by how much? And what is the applicability of the GO estimates to the current actual situation of the United States?

This economist read with some astonishment GO's presentation of their theory of the linkage between budget deficits and interest rates. It is done entirely in real terms, and the calculation of the interest rate effect is entirely in terms of an effect on the "marginal product of capital." This is a slippery concept that implies that there is such a thing as the output due to an additional unit of capital, whatever that is.

The mere use of the notion of the marginal product of capital is enough to make the skin of any Cambridge-bred economist crawl. Not only have Keynes, Keynesians, recession, and inflation been airbrushed from history, so, too, have the capital controversies, whose force was once conceded by no less a neoclassical than Paul Samuelson (1966). It is in no way legitimate to derive an interest rate from a marginal-product-of-capital calculation. The aggregate capital stock is not a homogeneous mass of physical substance (a pure fund, corn, or "leets," as Joan Robinson called it) with a physical "marginal product." It is a complex mass of physical machinery and process goods, only measurable as a valuation in financial terms. That valuation depends partly on an exogenous rate of interest. Further, as the rate of interest rises or declines, choices of technique within this complex mass of equipment are prone to change in erratic ways—owing to different time patterns in the life of particular elements of the stock, and to the varying profitability of alternative techniques at different rates of interest. Thus there is no consistent relationship between the "capital intensity" of production in the aggregate and the interest rate. It is certainly wrong to claim that a reduction in physical quantities of capital is coherently associated with a rise in the rate of interest.

For those for whom the above is too complex, arcane, and obscure to grasp, and who do not have a copy of Harcourt (1972) handy, it may be enough to point out that in the GO theory of the interest rate, there is no financial market at all. Banks play no role. Nor is there any central bank. Alan Greenspan does not exist in this model. Or perhaps it is better to say, he is a mirage, an apparition, a humbug, a wizard of Oz. Believe that, and truly you can believe anything.

I do not offer these points to disparage the econometric skill GO present in this paper, both in their calculations of the effect of tax reductions on consumption at the margin and in their review of estimates of the empirical effect of projected deficits on interest rates. But the econometrics makes sense only if it can be embedded in and is consistent with a well-framed theoretical worldview. And GO embed good estimates in indefensible theory.

Having said that, a Keynesian has no trouble accepting GO's estimates of the marginal effect of tax reduction on consumption, for their estimates of a 50 to 80 percent marginal propensity to consume in the first year pose no problem for the Keynesian theory. The idea that budget deficits might modestly raise interest rates is not troubling to a Keynesian either. However, except in a single, extreme case, nominal output will normally rise in the face of expansionary fiscal policy—and usually real output gains will be part of that.

Do Deficits Increase Interest Rates? What the Regressions Showed

We turn now to the GO interest rate regressions. Here the question is whether, after taking account of suitable control variables, one can discern a stable empirical relationship between rising deficits or federal debt and some measure of the interest rate.

GO's controls include variables for recession and measures of defense spending, oil prices, and the equity premium, as well as a variable covering Federal Reserve purchases or sales of Treasury securities, which they treat as a measure of monetary policy. They find that their measure of monetary policy has an "economically significant and statistically precise" effect on current long-term interest rates. This is again reassuring to a Keynesian. But it is destructive to GO's argument about deficits and interest rates. It suggests, against the view clearly stated in GO's own theory, that *in principle* Federal Reserve action could completely offset the effect of rising deficits on interest rates. But if monetary policy can offset the effects of deficits on actual interest rates, it can clearly—in principle, anyway—prevent any harm of deficits to investment.

The second preliminary issue concerns the specification of the relevant long-term interest rate. GO choose two variants: the actual current 10-year interest rate, and a calculation that they call the "forward 10-year interest rate," which is not an actual forward rate but a projection of what the 10-year rate will be five years from now. The forward rate is nearly a pure reflection of market sentiment, with little to no practical importance for the cost of funds to the government or the interest rate charged on private borrowing.

This distinction becomes important when one looks at the empirical results, where we discover a wide range of estimates of the effect of deficits on interest rates. Thus, GO highlight the finding that: "An increase in the projected unified deficit equal to 1 percent of GDP raises the forward long-term real interest rate by 29 basis points."

However, when one goes on to examine the effect of GO's model on actual 10-year interest rates, the picture changes: "With only fiscal variables entered or only fiscal and recession variables entered, the coefficients on the fiscal variables tend to be somewhat smaller . . . but are still statistically significant. . . . *The coefficients become smaller and statistically insignificant when the additional control variables are included.* The coefficient on primary deficits falls to 17 basis points."

Moreover: "When real current rates are used and both projected debt and primary deficit variables are included . . . the estimated coefficient on the primary deficit variables increases to over 50 basis points in the specifications that include only fiscal variables or only fiscal and recession variables, *but disappears when all control variables are included*."

In other words, projected deficits appear to exercise an influence on a constructed measure of the 10-year interest rate five years into the future. But so far as actual current long-term interest rates are concerned, there are no consistent results. When control variables that GO themselves chose are entered into the equation, the effect of projected deficits on actual interest rates disappears.

And How Much Would Higher Interest Rates Really Cost?

At this point GO plunge to their conclusions, which involve a fast calculation based on their "preferred" estimates, of the effect of a 3.5 percent of GDP budget deficit, as compared to budget balance, from now through 2015. They find that this raises the forward interest rate by a mean estimate of one percentage point (80 to 120 basis points). They then argue that this will reduce national assets by 20 to 30 percent of GDP "compared to their level if we balance the unified budget over the next decade." Finally, they argue that this effect will reduce national income by 1 to 2 percent.

Several points can be made in summary critique of these estimates. First, they apply only to the forward and not to the actual interest rate. Second, by GO's own estimates, the effects on those costs could be as low as zero.

GO's calculation of the effect of deficits on savings and asset ownership is transparently done by a pure act of arithmetic. Plainly, they did it by subtracting two-thirds of the projected deficits from private investment, and compounding for 10 years. This has nothing to do with the channel of effect through the interest rate, which is manifestly far too narrow to carry the force of their argument.

The present 10-year interest rate is under 5 percent, or around 2 to 3 percent in real terms. Currently, private investment as a share of GDP is at 16.9 percent—about a point *higher* than its long-term historical average going back to 1950. Can anyone believe that present deficits are causing an investment shortage? Can anyone believe that a rise in the interest rate of

one percentage point five years hence would be a disaster from which private businesses could not recover their financial footing—despite the fact that just five years ago they were borrowing furiously at much higher rates? Can one therefore seriously believe, *on this evidence*, that present or future budget deficits are the calamity that GO, and other prominent voices, including the International Monetary Fund and the leadership of the Democratic Party, make them out to be?

Conclusion

In effect—though not in intent—GO have proved that deficits don't matter, at least not on the scale presently projected. Their theory to the contrary doesn't hold, and their econometric work does not support their case, though it is consistent with a Keynesian view whose existence they decline to acknowledge. If this is the best scientific argument of which the antideficit camp is capable, the entire position is in deep trouble. And those who oppose the drift of America under Cheney and Bush *ought* to stop hiding behind platitudes of public finance. They ought to be looking for a bolder, more substantial, more coherent economic program, one that addresses real problems—such as jobs, health care, energy, global warming, and the risks and costs of war.

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