

## Overview

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*Martin Feldstein*

Although we have had two days of lively discussions, there has been fundamental agreement about the main themes of this conference. First, budget deficits are damaging and should be eliminated. Second, the tax rates that would be required to finance current levels of government spending and, even more so, the future government spending implied by existing entitlement rules, are unacceptably high. Therefore, budget deficits should be eliminated by reducing government spending in general and by reforming entitlement programs in particular.

Canadian Finance Minister Paul Martin stated these same conclusions with great strength and conviction at lunch yesterday. I expect that the Swedish Finance Minister will be equally emphatic when he speaks to us in a few minutes.

Not surprisingly, the economists stated their concurrence with these conclusions in the more cautious and muted tones familiar to academic discourse and with all of the appropriate caveats. But there is no doubt about our general agreement about the broad conclusions of this meeting.

### **Monetary policy**

What then can I add? Since this is a Federal Reserve conference, I want to say something first about the implications of our discussion

for monetary policy. For most of the countries represented in this room, that is, countries with well-developed domestic bond markets, an increased budget deficit need not cause higher inflation. Whether it does so or not is up to the central bank. The U.S. experience in the early 1980s is the clearest evidence that it is possible to have a sharp rise in structural budget deficits and a simultaneous fall in the rate of inflation. The responsibility of central banks to achieve price stability cannot be evaded by pointing to fiscal deficits.

This comment is related to yesterday's discussion of the effect of a change in the budget deficit on the exchange rate. I believe that an increase in the budget deficit per se—that is, with all other things equal—causes the currency to strengthen.<sup>1</sup> This is a standard conclusion that was noted also by Larry Ball and Greg Mankiw, by John Taylor, and by Allan Meltzer. Why then is there a controversy about this in which many of those who are close to financial markets believe the opposite: that an unanticipated increase in the U.S. budget deficit would cause an immediate decline of the dollar?

I believe the basic reason for the difference in views is that when the budget deficit changes, all other things may not stay equal. The academic economists are focusing on the pure effect of the deficit while the practitioners are talking about the effect of the increased deficit and the other economic changes that may be associated with it.

Alan Greenspan emphasized that an increase in the budget deficit often leads to an increase in expected inflation. The primary response to an increase in expected inflation is an increase in the nominal interest rate that keeps the real interest rate unchanged and therefore puts no pressure on the exchange rate. But under some conditions, an increase in expected inflation can cause a decline in the real interest rate and therefore a decline in the spot exchange rate. In particular, if the Federal Reserve were to keep short-term nominal interest rates unchanged despite the rise in expected inflation, the real rate would decline. If the Federal Reserve was expected to keep the short rate low for a longer time despite the rise in expected inflation, the expected real rate would decline over that

horizon as well. Any such decline in the real interest rate could cause the spot value of the dollar to fall.

The implications of this for monetary policy are clear: if an increase in the budget deficit causes a fall in the value of the currency, that's not because of an increase in the budget deficit per se but is a sign that the expected rate of inflation has increased and therefore a warning to the central bank that it needs to reinforce its message of price stability and its actions to achieve that end.<sup>2</sup>

### **The case for a balanced budget**

I turn now from monetary policy to the central issue of this meeting: the case for eliminating budget deficits. Some of the papers and comments, while noting that budget deficits are bad, suggested that the adverse effects of existing deficits are small. One paper even questioned whether eliminating the deficit should be a central concern of policymakers.

I think that characterization is wrong. Budget deficits are a serious problem. They are a major problem for our economies. Reducing deficits and moving toward budget balance are goals that deserve the high priority that governments are now giving them. Why?

First, the ability of governments to run budget deficits undermines responsible decisionmaking in government spending. When you don't have to pay for things, every kind of spending looks good. For politicians, the opportunity to use deficit finance provides a seductive temptation to establish and expand politically popular programs without paying for them. The economic waste that results from sloppy budgeting can be enormous. Only the "hard budget constraint" of having to balance the budget can force the political process to subject each spending option to an evaluation of whether its benefits really justify its cost to the taxpayers. That alone would be a strong case for budget balance.

But it is not the only reason for wanting a balanced budget. Budget deficits are also bad because they crowd out capital formation,

reducing real output. The current U.S. government debt has reduced the nation's real capital stock by \$3.5 trillion. That means lower productivity, lower real wages, and a lower standard of living.

Eighty percent of our national debt has been accumulated since 1980. In just a decade and a half, the annual deficits have cumulated to \$2.8 trillion of debt.<sup>3</sup> If we had had a balanced budget in every year since 1980, our national debt would now be only 10 percent of GDP and we would have been discussing a different subject for the past two days.

The importance of crowding out depends on the level of private saving of households and businesses. A country with a high private saving rate can have high budget deficits and still have a high rate of investment in plant and equipment. But the United States has a very low rate of private saving and our budget deficits therefore absorb a very large share of that saving. Private saving in the United States, net of depreciation, is now only 5 percent of GDP. The current budget deficit of about 2.3 percent of GDP may look small to some observers but it absorbs nearly half of that saving, leaving us with a net national saving rate of less than 3 percent of GDP. Without the budget deficit, the net national saving rate would be almost double what it is today.<sup>4</sup>

Our low private saving rate reflects other government policies: unfavorable taxation of savings that reduces the reward for saving and social security retirement benefits that reduce the need to save. Because of these government policies and the budget deficit, the United States is foregoing the opportunity to investment in new capital that would have a real pretax return of about 10 percent. In the end, the very low net national saving rate means low investment, low growth, and a lower standard of living in the future.

The adverse economic effect of budget deficits is, however, not just that it leads to bad spending decisions and reduced capital accumulation. The accumulated national debt also hurts the economy because paying the interest on that debt means higher taxes and increased distortion of economic activity.

The interest on the debt that has accumulated since 1980 is equal to 30 percent of current personal income taxes. If we had had a balanced budget in every year since 1980, the current marginal tax rates could now be reduced from 40 percent to 28 percent, from 30 percent to 21 percent, and so on, without worsening the fiscal outlook. High marginal tax rates of the sort that we now face distort incentives and reduce real incomes. In the language of economics, these high marginal tax rates cause deadweight losses (that is, reductions in individual well-being that exceed the gain in government revenue). Deadweight losses rise sharply as marginal tax rates increase. If we didn't have to pay interest on the deficits accumulated since 1980, the deadweight loss of the personal income tax would be cut in half.

The old Keynesian argument that deficits don't matter because we only owe the national debt to ourselves is wrong. The taxes that are required to pay the resulting interest to ourselves distorts incentives and causes a massive deadweight loss, probably more than \$100 billion a year at current levels.<sup>5</sup>

So in my mind, there is no doubt that eliminating budget deficits would be a critical goal of government policy. Doing so would lead to more responsible expenditure budgeting, higher investment and economic growth, and lower tax rates with a resulting increase in the efficiency with which our nation's resources are used.

### **The political economy of deficit reduction**

Why then do budget deficits not get reduced more aggressively? And what is the political outlook for deficit reduction in the near future in the United States?

I first became alarmed about budget deficits in the early 1980s when I served as a member of the Reagan Administration. Some of us in the administration were fighting for policies to reduce the projected budget deficits. Others were resisting, despite the fact that Ronald Reagan, himself, was a fiscal conservative who disliked deficits and favored a balanced budget. Why weren't we more successful in deficit reduction?<sup>6</sup>

First, there were fundamental disagreements between President Reagan and the Democratic leadership that controlled Congress about the form that deficit reduction should take. Although the President proposed budgets in 1983 and 1984 that called for a combination of reduced domestic spending and higher business taxes, the Congressional Democrats insisted on deficit reduction dominated by cuts in defense spending and increases in personal taxes. That combination was unacceptable to the President.

Second, deficit reduction is politically costly. It requires cutting popular programs and or raising taxes. President Reagan's political staff always saw the political costs of deficit reduction as greater than the benefits of a lower deficit. They showed no desire to push the negotiations in Congress to a compromise that the President would accept.

Third, the economic outlook was unclear. The economy reached the bottom of a very deep recession in November 1982. There was a great deal of unused capacity, allowing some economists to argue that we would be able to "grow our way out of the deficit" as the economic recovery raised tax revenue.

Finally, some economists inside and outside government who feared an increase in tax rates more than the persistence of deficits argued that "budget deficits don't matter."

The combination of these different forces allowed the stalemate to continue while the ratio of national debt to GDP increased in virtually every one of the past fifteen years.

Now, a decade later, the situation is different and the prospect for deficit reduction is better.

First, *we didn't grow our way out of the deficit*. Although the ratio of deficit to GDP is lower than it was in the early 1980s, the budget deficit is still 2.3 percent of GDP with the economy above the full employment level and the ratio to GDP is expected to continue rising over the next decade unless legislative changes alter the path of

spending or taxes. By the year 2005, the Congressional Budget Office projects that the full employment deficit would be 4 percent of GDP.

*We now see the effects of deficits more clearly.* There is stronger academic and professional understanding of the adverse effects that I have discussed today. The old Keynesian view that deficits are benign or helpful is no longer intellectually acceptable. The public sees the rapid growth of the national debt and worries about its impact on future generations.<sup>7</sup> Many suspect (correctly) that the large budget deficits are partly responsible for the decline in the rate of growth of real wages. The result is stronger support for the cuts in entitlement spending that would make deficit reduction possible.

Finally, *there has been a very strong political change in the Congress.* The House and Senate are both controlled by the Republican party and the House leadership is now dominated by a group that is committed to reducing government outlays. Entitlement spending is no longer “off the table.” There is agreement between Congress and President Clinton that Medicare outlays should be cut. The question that needs to be resolved is how those cuts will be made and how much will be cut.

Even the social security retirement program, generally assumed to be the untouchable part of the budget, is being considered. Earlier this year, Alan Greenspan revived the proposal to reduce the inflation adjustment to less than the full Consumer Price Index (CPI) increase by noting that the CPI overstates the true rise in the cost of living. A technical advisory committee appointed by the Congress is examining this measurement issue in detail. Replacing the full CPI indexing with CPI-minus-two-percent would have an enormous effect on the deficit within just a few years.<sup>8</sup>

### **Conclusion**

In conclusion, I think one can be optimistic about the near-term outlook for the deficit: optimistic that professional thinking and public understanding of budget deficits has improved; optimistic

that the seriousness of the problem is much more widely recognized; optimistic that governments will take steps to move toward budget balance and lower debt-to-GDP ratios.

Looking further ahead, it is the transfer programs for retirement and health that loom large. The challenge for the future is to restructure the benefits of these programs so that their purposes can be served without the adverse effects on the economy and the budget. Health benefits can be restructured to provide incentives (through cost sharing) for controlling health spending. Retirement benefits can be restructured to encourage more saving and later retirement. More significantly, we can move from the existing pay-as-you-go structure to a system of funded private pensions.

With such a restructuring of benefits, it is possible to have budget balance, lower effective tax rates, and higher economic growth.



## Endnotes

<sup>1</sup>I have discussed this relationship and the reasons why noneconomists may reach the opposite conclusion in “Lower Deficit, Lower Dollar,” *Wall Street Journal*, May 16, 1995.

<sup>2</sup>There is another possible explanation of the dollar decline in response to the budget deficit. If foreign investors fear that the larger budget deficit might lead to a future repudiation of debt held by foreigners, the value of the dollar would fall. An increased risk of default in general (that is, not just foreign debt holders) would be balanced by higher interest rates without a shift in the value of the dollar.

<sup>3</sup>One speaker suggested that the deficit is a “small” problem and should not be confused with the damage done by the entire national debt because the deficits are only about 5 percent of the national debt. By that argument, monthly deficits are an even smaller problem! The fact that 80 percent of our current national debt has been accumulated in the past 15 years shows how rapidly these deficit flows cumulate to a massive national problem.

<sup>4</sup>The Congressional Budget Office now estimates that current laws imply that the deficit will rise to 4 percent of GDP by the year 2005. With no change in private saving, the deficit would absorb 80 percent of all private saving, leaving only 1 percent of GDP to finance net investment in plant and equipment, inventories, and housing.

<sup>5</sup>The increase in the national debt between 1980 and 1994 was equal to 40 percent of 1994 GDP. The interest on that increased debt is now about 2.4 percent of GDP. Since the personal income tax collects 8.2 percent of GDP, the interest represents about 30 percent of personal income taxes. Without that interest obligation, the government could reduce personal taxes by 30 percent. In that hypothetical situation, the government could, of course, use the reduced interest obligations to lower the budget deficit instead of lowering taxes. If such deficit reduction implies a greater gain in terms of economic welfare (that is, a greater reduction in the present value of deadweight losses), the deadweight loss caused by the accumulated debt is even greater than the loss associated with 30 percent of existing marginal tax rates. For more on this complex issue, see my article “Debt and Taxes in the Theory of Public Finance,” *Journal of Public Economics*, 1995.

<sup>6</sup>For a more complete discussion of this, see my introductory essay in M. Feldstein, *American Economic Policy in the 1980s*, (Chicago: University of Chicago Press, 1993) and the essays in that volume by David Stockman, Charles Schultze, and James Poterba.

<sup>7</sup>Some economists argue incorrectly that anyone who doesn’t like the effect of the increased national debt on the tax burdens of his children and grandchildren can offset that effect by “saving his tax reduction” and transferring that to the next generation. That argument is incorrect because the deficit increase has not been due to tax cuts but to a rising share of GDP devoted to government spending, particularly on health care for the poor and aged. As a taxpayer who has not been a recipient of those spending increases, I have no tax cut to save.

<sup>8</sup>There is also hope for longer term Social Security reform as voters come to recognize the reduced attractiveness of the current pay-as-you-go Social Security system. Historically, the sharp rise in the payroll tax rate that is used to finance retirement (from 2 percent when the program began to 12 percent today) has permitted a very high implicit rate of return on Social Security contributions. That return substantially exceeded the after-tax return that most individuals could receive on financial assets. But the combination of the demographic change and the inability to raise the tax rate to finance higher benefits means that in the future the

return on Social Security contributions will be less than the return on private financial investments, especially those in IRAs and private pensions in which the investment returns are not taxed. Social Security has become a bad deal. As that becomes better known, younger voters will become increasingly attracted to the idea of radical Social Security reform.