Commentary: What Do Budget Deficits Do?

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Public debt and budget deficits arouse great concern. Households, financiers, and social scientists expend great energy on this topic. While there are many dimensions to the problem, I would tend to organize my thoughts around three main questions. First, there is definition and measurement. What are the constituents of the deficit? Issues such as contingent liabilities, unfunded liabilities, capital budgeting implications, and cyclical versus structural estimates help us to clarify what the dynamic trajectory of the budget deficit will look like.

The second question, one which is addressed in the paper by Professors Ball and Mankiw, asks: What are the consequences of the deficit? Consequences can be broken down into many categories including the impact on 1) macroeconomic variables, 2) the relative performance of sectors, 3) the distribution of income and wealth, and 4) long-term growth.

The third question is: How do capitalist democracies come to produce fiscal deficits? This question takes on great importance if the answer to the second question is that the consequences of fiscal deficits are, on balance, adverse.

Understanding under what circumstances, and what type of institutional arrangements were in place in countries where deficit spending roared out of control can help us to try and avoid the
circumstances or change them when we recognize that our current environment exhibits characteristics similar to those that have proven to lack fiscal discipline.

I will not focus on the question of definition and measurement. Recent work by the Organization for Economic Cooperation and Development (OECD), the World Bank, Professor Yukio Noguchi, and Alan Auerbach, Robert Eisner, and others, has helped us all to understand the dynamic nature of the problems that many countries face in both developing and developed countries. From that body of work one can conclude that the challenges we face in years ahead are formidable. In many OECD countries the past may not have been too dangerous. But the projections of future deficits that are associated with, as yet, unfunded pensions liabilities are daunting. It is there that I believe the real concern of public policy lies at this time.

**What does the deficit cost?**

Professors Ball and Mankiw present us with a stimulating perspective on the second question, the consequences of the deficit for the economy. They look at the short-run, Mundell-Fleming-like analysis and then the longer-run implications for growth, intertemporal wealth distribution, and income distribution, and provide us with a parable to frame the possible order of magnitude we are dealing with.

The first part of the paper uses the familiar open economy savings investment identity to illustrate that a rise in government dissavings must result in either a fall in investment, a decline in net exports, or a rise in private savings. The perspective provided by the authors has an implicit neoclassical flavor which emphasizes that the interest elasticity of investment and the real exchange rate elasticity will do the work while private savings remains fixed. It seems that this format provides a reasonable guide to adjustment behavior when the economy is near full employment. When the economy is slack, a Keynesian style specification, which emphasizes the role of income in private savings and investment, may prove to be more illuminating. In either case the ex post accounting identities hold.
The trouble arises when we try to understand the medium- and longer-term implications for productivity and capital formation. Here we are out at sea. Empirical work on business fixed investment and private savings has yet to provide us with a lot of confidence that we understand what drives them and little evidence that business fixed investment is highly interest elastic. It may be that government deficit produces interest rate increases that crowd out interest sensitive expenditure. But those expenditure declines may be concentrated in consumption and show up in our identities through the back door of private savings increases. Housing investment does appear to be more sensitive to interest rate changes and does qualify as investment, but it does not offer us the productivity/income distribution pot of gold at the end of the rainbow that a good slug of fixed investment would provide.

I wish that I could believe that the linkage between government deficits and future productivity and living standards were so strong. I would surely strengthen the case for action to reduce the deficit. Without more reliable estimates showing that interest rates bite hard on business fixed investment, I do not believe we can make strong claims regarding the productivity enhancing benefits of deficit reduction.

That linkage, between investment and government deficit crowding out, is at the heart of the results provided in the paper on the impact of deficit reduction on income distribution. The presumed increase in capital that is crowded in by deficit reduction reduces the return to capital and increases the return to labor. It would be outstanding if one could confidently state that reducing the budget deficit would both reduce income disparities and enlarge the pie through increases in the capital stock!

The debt fairy parable in the paper, which attempts to measure the order of magnitude of the opportunity cost of running deficits, is implicitly driven by this notion that deficit cuts crowd in capital formation one for one.

If the aggregate economy exhibits the production function characteristics specified in the paper, then it is a reasonable approximation
to suggest that increasing the capital stock by the amount of outstanding U.S. government debt would increase GDP by 6 percent. Whether this constitutes a measure of the opportunity cost of running deficits is a different question entirely. First of all, as discussed above, I question whether the crowding in effect would have produced a one-for-one increase in the capital stock. Other interest rate sensitive or exchange rate elastic components of aggregate demand might have been crowded in instead.

Second, we don’t know how the deficit was reduced. There is a free lunch here. Raising taxes on capital to close the deficit would likely have discouraged capital formation. Cutting spending or raising taxes in some past periods of slack in the economy would likely have reduced investment at that time. Some foregone government spending may have been a complement to, rather than substitute for, private investment in capacity. (Highways may increase demand for automobiles and, therefore, auto production plants.) Government spending that creates research and development benefits or that augment the productivity of other factors of production (like education) would have to have been withdrawn.

The debt fairy parable is provocative. What I find fascinating about the result is that, with a free lunch like this, one can only muster 6 percent of GDP. By the time one pays for the free lunch in one form or another and allows for something other than capital expenditure to occupy the economic space created by deficit cutting, the result may be very small indeed. The authors identify this as an upper bound on the costs of deficit reduction and suggest halving the number to 3 percent of GDP. I would find it hard to argue with confidence that the estimate of 3 percent is any better guess than an estimate of zero percent. Whatever the case, 3 percent, or minus 3 percent, the number is relatively small and raises the question of whether a relatively minor problem historically has been blown out of proportion to the point of becoming an obsession.

**Hard landings**

Even if these considerations are small, there is another dimension of the cost of running deficits and increasing the ratio of debt to GDP
that the authors believe warrant attention. That is the contingent risk of experiencing a hard landing, a disruption of the terms upon which one can finance a budget and/or trade deficit.

The authors cite two possible types of asset rejection. The first is a large country problem. A country that runs persistent external deficits may saturate the portfolios of foreign investors and experience a rapid rise in the cost of placing liabilities with them. A country like Sweden is unlikely to experience this problem because the size of the economy is small enough that outstanding debt held by foreigners could be quite large, in fact dangerously large, before force feeding would become a problem. In a race, the alarm of insolvency is likely to go off for a small country long before the international investors choke on paper. For the United States, such concerns might conceivably play a role.

The second type of crisis of confidence can occur when the ability or willingness to repay debt comes into question. When I was growing up in Detroit I often was advised not to hang out in bad neighborhoods. I was told that even if I wasn’t looking for a fight, a fight might be looking for me in those tough areas. Running a high level of debt-to-GDP ratio is like hanging out in a bad neighborhood. It increases the risk that you will experience a rise in borrowing cost through no fault of your own. Just ask the Canadians, Swedes, and Italians how the Mexican crisis of 1994-95 affected them. Many of them were making substantial progress on their domestic problems at the time and they watched their borrowing costs skyrocket. Guilt by association.

Why do financial investors react so indiscriminately? I have observed several reasons. First of all, confidence gets shaken. After all, if I believed Mexico was OK and I just incurred a large loss, maybe my judgment has been wrong about all of these high debtor countries. From too confident to too afraid in a matter of minutes.

Second, portfolios need to be re-balanced after a loss. If I hold $100 of Mexican debt and $100 of Italian debt before the crisis, and then Mexico loses 50 percent, I have only $150 of wealth left. To
re-balance the portfolio so that I only hold 50 percent in Italian debt, I would need to sell $25 of Italian debt to get down to $75. Many funds are structured in such a way that they stay in a certain category of assets such as high-yield debt. When one area gets hurt, the re-balancing affects all other assets of the class as well.

A country could be teetering on the edge of dynamic debt stability when a crisis originates in another country and then be pushed onto an unsustainable path of debt growth. A rise in the risk premium may, depending on the maturity structure of your debt, raise the cost of debt service and enlarge the deficit. So the moral of the story is that it is a good idea to stay out of bad neighborhoods. That is the point of sound policies.

I have discussed only the occurrence of an asset crisis thus far. What does it cost to incur one? How much is the increase of the cost of funding the debt? This depends upon maturity structure, rise in the interest rate risk premium, and the duration of the risk premium. A crisis over a couple of months may do little damage. A crisis that leads to a re-rating that lasts a decade is another matter entirely.

The cost also depends upon how it affects the behavior of the real economy. The channels are numerous. There are wealth effects associated with the loss in value of domestic stocks and bonds. Investment demand may be curtailed as irreversible commitments, either domestic or foreign direct investment, fall victim to a rise in option value. The value of waiting to see how things play out before bolting down your machine makes a great deal of sense. Capital fastened to the ground is captive to new taxes that may result from policymaking in a crisis. Better to wait for the dust to settle. And, of course, an abrupt and marked fiscal deficit cut may be necessary to convince the financial markets that there is light at the end of the tunnel.

How does a policymaker reduce these costs? How does one make the speculator turn from adversary to friend? In this regard, I believe that financial markets behave in an interesting manner. Very few participants focus on long-term debt stability conditions. In the
parlance of mathematics, the investors “bump it up one derivative.” They look for rate of change rather than level. They look for a tangible sacrifice of a sacred cow as evidence of structural change rather than the medium-term implications for debt ratios. It is often difficult, if not impossible, to comprehend the inside baseball of a foreign country’s politics. How do we infer structural change? Slaughtering a sacred cow right there on the table is a credible way to convince investors of a change in regime when a more subtle analysis is incapable of generating widespread confidence.

It is interesting to note at the present time that many investors appear impressed with the developments in Sweden and Italy, and particularly Finland, while concern in France is rising. We smell denial in France whereas the others are making progress. Countries like Sweden have not yet reached the level of primary budget surplus necessary to stop a rise in the debt-to-GDP ratios but they look toward the goal. France appears to be running away from the goal. Focus on rate of change favors Sweden, Italy, and Finland over France right now. This is true even though France’s debt-to-GDP ratio is far better than that for the other countries I mentioned.

This raises the question of whether a hard landing is really a cost. Surely fiscal prudence to assure that you do not experience a hard landing at all is first best. But is it better to just sit on the curb and bleed to death or is it better to get hit by a bus, have someone take notice, and be taken to the hospital so that you can be saved? A crisis in financial markets may be a blessing in disguise and induce a regime shift toward greater fiscal discipline that would not otherwise occur or would only occur later in time when the accumulation of debt, and the associated debt service, makes it even harder to get back on track. The first best is to stay out of bad neighborhoods clearly. But if you’re in one, then there may be benefits to having the fight sooner rather than later.

What sort of structures produce deficits?

The third question I think is very important to address is this: What conditions in capitalist democracies seem to lead to rising fiscal
imbalances? Here a methodology of comparative economic and political analysis may be called for. It is all fine and good to pretend that we are benevolent dictators and go through the thought experiment of resetting the dials. That is the first stage. A deeper investigation must look at the history of fiscal experience and the associated structures of governance that led to fiscal irresponsibility or, equally important, fiscal prudence. It may be that a precondition for doing what one wants is to learn how it can be implemented and what obstacles stand in your path.

For instance, I have often heard it said that the generosity of the social wage in a country was inversely proportional to the distance from their border to the Russian border before the end of the Cold War. Apparently there was some interest in buying anti-Communist insurance. Are there similar common or unifying traits which can be associated with fiscal prudence? Professor Guido Tabellini and some of his colleagues have worked on this question. They find that durability of governments is necessary to produce responsible fiscal policy. Countries with a large number of small parties appear to have a weakness for running deficits when compared to countries with few parties. This type of institutional and inductive empirical work is very important.

In his presentation, Dr. Mankiw mentioned that a citizen of Orange County had distanced himself so far from the behavior of his elected government that he felt that default on county debt was not his problem but theirs. Such behavior is shockingly immature. Economists who do not study the positive analysis of what produces deficits are similarly irresponsible. The job is not done until the results are in. Leaving this blindspot in our analysis of fiscal policy is tantamount to resignation in defeat. We must address questions such as, “Is campaign finance reform a necessary condition for fiscal deficit reduction?” This is a giant principal agent problem. A little bit of Mancur Olson and Thomas Ferguson would go a long way toward understanding how to put in place structures that serve us better. It is not satisfactory to hold our nose and speak of politicians as a corrupt “they” who do it to us. Like it or not, “they” are us.