The Government Debt Bomb

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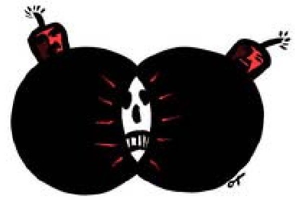

STANFORD – As economies around the world return to growth after the deepest recession in a generation, renewed attention is being paid to enormous fiscal deficits and vast expansions of government debt. This year's projected deficits (as a share of GDP) are estimated to be a remarkable 13.5% for the United States, twice the previous record at the depth of the horrific early 1980's recession. Among other major economies: the United Kingdom, 14.4%; France, 8.2%; India, 8.0%; Japan, 7.4%; Italy, 5.4%; Germany, 4.7%; China 4.2%; and Canada, 2.4%.

In addition to the automatic decline in tax revenues and increase in social-welfare spending during a recession, many nations added large spending increases and/or tax cuts to try to stimulate their economies. The increase in the deficit is the sum of these "automatic stabilizers" and discretionary programs. The discretionary policy response has been largest in the US, at a cumulative 4.8% of GDP, and China, at 4.4%, over 2008-2010, while it has been modest in Germany and Canada, and smaller in the UK, France, and India.

The automatic increase in the deficit has also been largest in the US, modest in the UK and Germany, and smaller in Japan, India, Canada, China, France, and Italy. These automatic effects should soon begin to reverse as economic activity recovers, but there is much debate, including at the G-8 and G-20 meetings, over whether the discretionary stimulus should be extended or ended, repeated or reversed.

Since every dollar, euro, yen, rupee, or yuan borrowed today requires the same present value in future interest payments – and therefore future taxes – there are important long-term costs to balance against whatever benefits the deficits create today; there is no fiscal free lunch.

Some politicians, for example President Barack Obama in the US, herald their fiscal stimulus programs as effective responses to the economic crisis. They pledge allegiance to long-term fiscal responsibility, yet propose budgets with large deficits for years to come and big hikes in the debt-GDP ratio.

Politicians from political parties out of power denounce the deficits and debt as a horrific legacy for our children and an insurmountable burden on the economy. In the US in the 1980's, Democrats excoriated President Ronald Reagan on deficits; Republicans now excoriate President Obama on his much larger deficits and debt. Deficits are convenient for politicians as they hide and delay the true tax cost of spending. But when are deficits desirable, and when are they damaging?

The impact of the economy on the budget balance is swifter, surer, and larger than the impact of the budget balance on the economy. All economists agree that we should allow the automatic stabilizers to work. Discretionary fiscal policy is often clumsy in responding to recession, given the usual lags in legislative and administrative implementation and the politics of pork and special interests surrounding spending and tax decisions. The current US stimulus has been much slower to enter the economy than promised. Indeed, most of the stimulus money will be spent after the recession "appears to have ended," and the evidence is that so far it has had little effect.

It is appropriate to finance (some) long-lived public-capital investment by government borrowing, since the benefits will accrue for many years, and future taxpayers might equitably bear part of the burden. This is standard practice for US state and local governments. It is also more efficient to keep tax rates stable over time, and thus to finance with debt temporary large spending needs such as military buildups during war (or to prevent war), while reversing the debt buildup thereafter.

The US federal government's borrowing exceeded tax revenues in every year since the end of World War II. Such debt finance is both equitable and efficient. But little in the current stimulus programs is justifiable on either of the grounds mentioned above.

The level, composition, and growth of spending and taxes are the fundamental fiscal indicators. Even with a balanced budget, there is still the issue of the effectiveness and efficiency of spending, as each dollar of government revenue costs the economy about $1.30, given the distortions to private decisions caused by taxes.

Large deficits shift the bill for today's consumption to future generations and can crowd out private investment, thereby slowing the improvement of living standards. Deficits are riskier if the level of the national debt, the accumulation of all previous deficits, is high or rapidly rising relative to GDP.

The debt-GDP ratio varies a lot by country. It will double in the US unless President Obama reverses course, as President Bill Clinton did when he and a Republican Congress balanced the budget.

Deficits are problematic if they finance consumption, not productive public investment on infrastructure. The crisis funding of the modest delayed infrastructure component of most stimulus programs suggests that much of it would not pass a rigorous cost-benefit test. Some US federal agencies are trying to spend ten times their previous budgets – not a recipe for efficiency or speed. And deficits can lead to inflation if central banks monetize the government debt, a serious concern in financial markets, as China has warned America.

These concerns require that fiscal exit strategies be planned, announced, and implemented soon, before the stimulus programs become permanently entrenched, develop powerful dependent constituencies, and greatly increase the risk of rising interest rates, inflation, and taxation. On this score, citizens everywhere, from Boston to Berlin, Mumbai to Moscow, are right to be appalled at the explosion of government debt.