

Do budget deficits affect long-term interest rates?



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U.S. federal budget deficits are back big time. What will be their long-term consequences? Seven big thinkers enter the ring, gloves up.



Deficits aren't wonderful, but the interest rate argument can be easily overstated.

GLENN HUBBARD

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President Bush has proposed a tax cut to shore up near-term growth prospects and raise output in the long term. The Council of Economic Advisers estimated that the proposal would add about a percentage point to GDP growth this year and next. As I describe below, my own calculations suggest that in the medium and long run, the President's proposal to eliminate the double taxation of corporate income would add about one-half of one percent to the level of GDP every year.

While there are few critics of the President's proposal on tax policy grounds, some economists and policymakers have argued that to the extent the President's proposal is debt-financed, it will raise long-term interest rates, limiting or even wiping out the pro-growth effects on capital accumulation. While intuitive, the argument can be easily overstated. While an autonomous change in the budget surplus in a large open economy like that of the United States can effect world interest rates, that effect is likely to be small—in particular, relative to the pro-growth effects of the current tax proposal.

Conventional economic analysis enables us to quantify the likely effect of additional government borrowing on interest rates. Let's start with the basics: To the extent that incremental government debt "crowds out" capital, the higher return to capital increases the required return on other assets, including bonds, driving up interest rates. How can we measure the productivity of capital being crowded out? A simple measurement can be obtained from the portion of total U.S. output paid to suppliers of labor. Because gross capital income is about one-third of total U.S. output, the marginal product of capital increases by about 0.67 percent for each decline in the capital stock by 1.0 percent [that is, $(\text{Percent change in } Y) - (\text{Percent change in } K) = (-0.33 \text{ percent}) - (-1.0 \text{ percent}) = 0.67 \text{ percent}$].

One percent of the U.S. capital stock (using 2001 data) is approximately \$280 billion. Using the estimate

by the Council of Economic Advisers for the United States as a large open economy, one dollar of incremental government debt reduces the U.S. capital stock by about 60 cents; hence crowding out one percent of the capital stock requires an increase in government debt. For modest changes in government debt, then, each \$100 billion increase in the stock of government debt would be predicted to increase long-term interest rates by about 1.5 basis points. The present value of borrowing to finance the President's proposal to eliminate the double taxation of corporate income, accordingly, might increase long-term yields by about 10 basis points.

How likely is this to offset the economic growth stimulated by the President's proposal? Here it is useful to focus on the long-term effects of eliminating the double taxation of corporate income. Most easily measured economic gains come from increasing the capital stock and improving the efficiency with which the capital stock is used. Both of these changes raise U.S. output. Based on research by many economists on the impact on capital formation of changes in the cost of capital, the higher capital stock from the proposal should raise output by about 0.25 percent each year going forward. Using estimates from the 1992 Treasury report on corporate tax integration, improved efficiency of the capital stock should add about another 0.25 percent each year to output going forward. This extra 0.5 percent of output going forward dwarfs the interest rate effect of deficits in this range (I will spare you the calculations.)

None of this should imply a "free lunch" or that deficits are "good." While I believe the President's proposal to eliminate the double tax on corporate income and decrease marginal tax rates is good tax policy and economic policy, I remain concerned about the looming fiscal imbalances in the nation's entitlement programs—Medicare and Social Security. These programs require timely reform.

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Interest rates jump 25–50 basis points for each 1 percent increase in the long-term federal deficit as a share of GDP.

PETER G. PETERSON

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By championing permanent cuts in federal revenues unaccompanied by significant cuts in budget outlays—and no cuts at all in fast-growing senior entitlements—this Administration, supported by Congress, has now set our nation on a course of rising and virtually endless budget deficits.

This is a cause for grave concern. Most important, chronic deficits soak up national savings and crowd out productive investment. Along the way, they also raise interest rates, by 25 to 50 basis points (according to most studies) for each one percent increase in the long-term federal deficit as a share of GDP. Since America's savings pool is already very shallow, relative both to other developed nations and to our own history, the impact of large deficits is especially harmful. From 10.9 percent of GDP during the 1960s, the U.S. net national savings rate slid to 4.8 percent during the 1990s and has fallen more recently to two consecutive postwar lows—3.3 percent of GDP in 2001 and 1.7 percent in 2002. Current fiscal policies are due to push net national savings still lower.

This brings us to history's bottom line, as insisted on by one economic luminary after another, from Adam Smith and Karl Marx to Alfred Marshall and John Maynard Keynes: No country can enjoy sustained living standard growth without investing, and no country can sustain high investment without saving. All of these thinkers agreed that nothing undermines the "wealth of nations" as predictably as a government that cannot live within its means.

To be sure, temporary deficits are sometimes good policy—for example, to finance massive outlays during wartime or to stimulate consumption during a recession. Right now, with real interest rates along with industrial capacity at a cyclical low, such deficits are probably advisable. But that is not what the Administration wants. Instead, with a mere wink at "sunsets," it is pushing through permanent tax cuts that will keep the budget underwater beyond the next business cycle and the next several after that.

Almost no economist believes that the much-touted "incentive" impact of these tax cuts will prevent them

from suppressing national savings. Most agree, to the contrary, that they will eventually suppress overall GDP growth and raise taxes even higher for future generations, either to pay off the extra debt or simply to service the extra yearly interest. As Milton Friedman once put it, if you cut long-term taxes without cutting long-term spending, you aren't really reducing the tax burden at all. You're just pushing it off yourself and onto your kids.

Some conservatives say that these tax cuts, by starving the government for funds, are the only way to compel liberals and the general public to go along with spending cuts. But this stratagem is hypocritical, unfair, and cynical. It is hypocritical because on the spending front, they do nothing to reform entitlements, allow debt service costs to rise along with debt, and urge greater spending on defense—when these three functions comprise over four-fifths of all federal outlays. It is unfair because no end, however legitimate, can justify holding the next generation hostage on the dubious bet that another party will have the good will to relent. It is cynical because it assumes that our democratic process is broken and that we can no longer directly advocate a policy for the common good. It is also shortsighted, because it wrongly assumes that liberals can't play the same game and raise the ante—by proposing large new benefit programs (say, national health care) in place of tax cuts.

Our nation faces at least two history-bending challenges: global terrorism and global aging. Meeting the first may require marshalling new resources far above the extra spending already legislated. Meeting the second will test the ability of our society to provide a decent standard of living for the old without imposing a crushing tax burden on the young. It seems obvious to me that America should not approach this fiscal gauntlet encumbered by deficits as far as the eye can see. To do so would be to ignore every principle of public finance, generational equity, and economic stewardship.

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The link between deficits and long rates is embarrassingly weak.

LAWRENCE KUDLOW

Chief Executive Officer, Kudlow & Co., LLC, and Co-Host of CNBC's "Kudlow & Cramer"

If current and prospective budget deficits do in fact drive up interest rates, then why is the 10-year Treasury note trading at a 45-year low at around 3.5 percent? The answer: deflationary recession, not deficits, is driving rates down.

Japan, which has much larger deficits than the United States, has a 10-year government bond of 0.59 percent. Germany, with deficits running about the same as the United States (3 percent of GDP), has a 10-year government note of 3.8 percent. When President Clinton and

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Treasury Secretary Robert Rubin raised taxes in 1993, the 10-year note bottomed at 5.25 percent. Today, with large tax cuts and rising deficit forecasts on the horizon, the 10-year is at 3.5 percent. Doesn't this tell us something?

The preponderance of research argues strongly that inflation expectations and expected real investment returns are the major determinants of interest rates. While there may be a link between deficits and rates, it is a very weak link.

As U.S. inflation descended from roughly 15 percent in 1980 to about zero (core CPI for April), long-term Treasury rates dropped to 3.5 percent from about 15 percent. During the whole period, as government revenues downshifted in response to disinflation, budget deficits were a recurring theme. But it was disinflation, not rising deficits, that drove interest rates lower and lower.

Washington revenue estimators who project rising deficits in response to tax cuts have circled the wagons in order to form a Flat Earth Society intended to persuade

the public that the planet is not curved. They will probably also claim that Christopher Columbus did not discover America.

But he did, and it corroborated his view that the world was round, not flat. Similarly, lower tax rates that raise the after-tax return to work and investment do in fact induce a behavioral change. Investors supply more capital by saving and investing more. Workers supply more labor, including overtime hours worked. Hence, projected deficits from tax-rate reductions never pan out.

The so-called static revenue cost of the present Bush plan is overestimated by one-third to one-half. Credit markets are not fooled by deficit forecasts. Neither is the public. Tax cuts under Presidents Kennedy, Reagan, and Clinton's second term all produced faster economic growth, more jobs, and higher revenues. Indeed, Clinton's 1997 capital gains tax cut was the driving force for late-decade budget surpluses as revenues soared from profits accruing from stock market gains and stock options, a near-perfect illustration of the Laffer curve.

Here's another point. Congress and most state governments, in their wisdom, have substantially increased so-called sin taxes on alcohol, beer, and tobacco. Especially tobacco, where the latest liberal mantra aims to save smokers from themselves. But doesn't this assume a behavioral change by smokers in response to the higher tax cost of cigarettes? Why wouldn't the same logic prevail for investment taxes? If we tax investment more, won't we get less investment? But if we tax investment less, including the dividends portion, won't we get more investment?



What's behind the Bush deficit embrace is an ideological and not economic motivation, a political bait-and-switch.

BARNEY FRANK (D-MASSACHUSETTS)

Ranking Member, Financial Services Committee, U.S. House of Representatives

There is one glaring exception to the Bush administration's eschewing all things French—King Henry IV is their role model. When told that he could not accede to the throne as a Protestant, he converted to Catholicism explaining, "Paris is worth a mass."

The highest economic policy positions in the Bush Administration—after Karl Rove—are filled by men

Barney Frank, continued

who once thought poorly of deficits, but enthusiastically accepted positions which require them to defend not only deficits, but policies which prolong and deepen them. Their version of Henry IV is “Washington is worth a deficit.”

By paying for two wars with three tax cuts, the Bush Administration has guaranteed large deficits for the foreseeable future. This is not a temporary acceptance of red ink to combat an economic slowdown. As befits conservative anti-Keynesians, the Bush economic team is not seriously arguing that they are creating only a short-term deficit for counter-cyclical purposes.

In defense of this policy they deny linkage between constantly rising government debt and long-term interest rates. Inconveniently, Federal Reserve Chairman Alan Greenspan in recent testimony asserted that there is an even more robust causal relationship between deficits and higher long-term rates than he had previously thought. Earlier, Mr. Greenspan did seek to soften his disagreement with the Administration (on the Bush tax cuts his head and heart are in a struggle which, due to his intellectual integrity, his head always wins). He noted that the debt problem will be much worse after 2013. The Administration has seized on this and in contradiction to Mr. Greenspan denies that the indebtedness of the next ten years will be any problem at all.

In this theory, the trillions of dollars of debt we will incur over the ten-year budget cycle is not important, because it is not as large a percentage of the gross domestic product as were the deficits in the Reagan years. The real problem will come when Social Security and Medicare start to drain government revenues rather than contribute to them. This artificial chronological separation between the years of not so bad deficits and the years of insupportable deficits is both intellectually flawed and politically revealing.

The basic logical structure of this argument is that of the joke in which a man falls from the top of a fifty-story building and when asked how he is doing, replies “Fine so far.” Deficits cumulate. Just as it makes a difference whether someone hits the ground from one story or one hundred, the magnitude of the negative affect of Social Security and Medicare outflows ten years from now will surely turn significantly on whether or not we enter that phase with a surplus in the trillions or a multi-trillion dollar debt. The “fine so far” argument is that there will be no negative effect as we accumulate trillions of dollars of deficits between now and 2013, but that debilitating impacts on the economy will suddenly appear in 2014 when people read the latest Social Security actuarial tables.

Politically, this argument demonstrates that what is behind the Administration’s deficit embrace is an ide-

logical and not an economic motivation. What we are seeing here is a political bait-and-switch operation.

The highest priority of the right wing has been and is a series of large and continuous tax cuts greatly deepening our national debt. But as these tax cuts take effect they will fall ardently back in love with balanced budgets—indeed, bizarrely, the Republicans on the House Judiciary Committee are now preparing a Constitutional amendment to require the budget to be balanced—and use the large deficits they are creating as arguments against government programs in education, housing, environmental clean-up and transportation. Most importantly, these large deficits will be crucial to the effort to cut back Medicare and Social Security.

A substantial privatization of both of these successful and popular social programs is high on the conservatives’ agenda, and the reluctance to embrace that goal on the part of those who benefit from them is an obstacle. Thus, the role of deficits: creating a situation in which a scarcity of resources forces far more fundamental changes in both Social Security and Medicare than would otherwise be achievable.

The movie that the conservatives are now producing—“How I Learned To Stop Worrying and Love the Deficit”—ends like its predecessor with a huge explosion, but in this script, it is the notion that the public sector has an important role to play in approving the quality of our lives that gets blown up.

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JACK KEMP

Co-Director, Empower America

“Nor shall the argument seem strange, that taxation would be so high as to defeat its object and that given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget.”

—John Maynard Keynes

Contrary to the above admonition of John Maynard Keynes, the notion that deficits cause interest rates to rise and therefore slow economic growth—Rubinomics, more in the tradition of Hoover economics—has now become the mantra of many of those opposed to President Bush’s proposal to pass incentive-based tax rate reductions.

It’s time we overcome our collective deficit phobia and embrace the growth imperative.

This new conventional wisdom is best evidenced in the February 11, 2003, edition of the *New York Times*, where no less than ten Nobel Laureates and a host of left-leaning economists took out a full-page advertisement to bemoan President Bush’s tax cut proposal. In particular, these economists noted that, “Passing the tax cuts will worsen the long-term budget outlook, adding to the nation’s projected chronic deficits.” The

theory that deficits lead inexorably to higher interest rates and, as a result, lower economic growth is at the heart of the “deficit hawk” opposition to President Bush’s tax rate reduction plan.

There is little empirical data to back up the theory that deficits lead *ipso facto* to higher interest rates. As Larry Kudlow points out in a recent article, “In bondland, long-term interest rates continue to decline. If a lower dollar and rising budget deficits are so bad, why are Treasury rates at 45-year lows?” For even more dramatic and long-term evidence, simply observe the Japanese economy where the debt is greater than 130 percent of GDP while interest rates remain near zero—not coincidentally this debt was largely accumulated in the last ten years while pursu-

ing a decade of government-driven “economic stimulus” packages advocated by many of the same economists signing on to the *New York Times* advertisement.

Moreover, even though the empirical data indicates that annual deficits are unreliable as an indicator of future economic growth, there is substantial evidence and correlating data showing that unchecked growth of the federal government does lead to slower economic activity. (See generally the comprehensive International Monetary Fund study by Alberto Alesina and Roberto Perotti.) Therefore, to the extent Congress is worried about deficits, they should look to reducing the size of the federal government as a percentage of GDP, rather than incessantly seeking new revenue streams for the ever-increasing size and scope of the federal government. To paraphrase Nobel Laureate Milton Friedman, “I would rather the federal government run a deficit while spending \$1 trillion than have a balanced budget at \$2 trillion.”

Perhaps the most significant problem with the deficit hawk argument is that it confuses cause and effect: it is slow growth that leads to budget deficits, not deficits that lead to slower growth. And, it is renewed growth that will solve our deficit woes, not simply raising taxes to balance the budget. Therefore, the President’s plan has the economics exactly right. We need to pursue fiscal policy that will provide incentives for companies and individuals to work more, save more, and invest more. It’s time we overcome our collective deficit phobia and embrace the growth imperative.



Of course there’s a link, and watch what happens when the economy picks up.

GENE SPERLING

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Like Nixon secretary Rose Mary Woods straining to show that her foot could have stayed on the pedal to erase the Watergate tapes, advocates for deficit-exploding tax cuts are straining to justify the view that deficits have no effect on interest rates. But political agendas don’t usually amount to waivers from the laws of sup-

Gene Sperling, continued

ply and demand, and the current push for more and more tax cuts is no exception.

Deficits lower national savings, reducing the pool of funds from which the private sector can borrow to make investments. As investors compete for scarcer funds, they bid up the interest rate. This is hardly a controversial theory. Indeed, even top conservative economists—such as

The handful of empirical studies that have failed to find this relationship each share a fundamental flaw. They compare today's deficits to today's interest rates without adequately examining the impact of expected future deficits on forward-looking financial markets.

Harvard professor Martin Feldstein, current Treasury undersecretary John Taylor, Fed Chairman Alan Greenspan, and the Councils of Economic Advisers under President Reagan and the first President Bush—have each affirmed that (to use Taylor's words) “lower budget deficits will lower real interest rates, increase investment, and thereby increase productivity growth and real incomes.”

The handful of empirical studies that have failed to find this relationship each share a fundamental flaw. They compare today's deficits to today's interest rates without adequately examining the impact of expected future deficits on forward-looking financial markets—a comparison that Martin Feld-

stein has rightly argued is insufficient. Those studies that properly examine expectations find overwhelmingly that deficits boost long-term interest rates. (A recent comprehensive review of the literature found that sixteen of the seventeen such studies find an impact.) For example, a recent study by three Georgetown economists found that an increase in projected deficits by 2 percent of GDP raises the spread between long-term and short-term interest rates by more than 100 basis points. Studies by Feldstein and Taylor have found comparable or stronger effects.

Of course, during times of economic weakness like the present, long-term interest rates will be low. But the two important questions are (a) would they be even lower if we weren't facing exploding deficit projections; and (b) what will happen when the economy picks up? On the first, it is instructive to note that the spreads between long-term and short-term interest rates have remained high and are undoubtedly higher than they would have been without growing deficits. On the second, as Alan Greenspan has said, “history suggests that an abandonment of fiscal discipline will eventually push up interest rates, crowd out capital spending, lower productivity growth, and force harder choices upon us in the future.”

In the 1990s, we experienced just the opposite of this dire outcome. Instead of huge deficits, the government was running surpluses by the end of the decade, adding to national savings, and “crowding in” private-sector investment. Net national savings rose from 3.4 percent of GDP in 1993 to 5.9 percent in 2000, even as personal savings fell. Consequently, despite extremely high investment demand, interest rates remained low. Goldman Sachs has estimated that deficit reduction in the 1990s was responsible for lowering interest rates by 2 percentage points. The low rates helped spark a virtuous cycle that supported strong investment and growth.

The Bush Administration's tax cut agenda is leading us in the opposite direction. They have tried to paint each of their tax cuts as moderate, but adding up the cuts tells a different story. Taken together, the cost of enacting the 2001 and 2003 tax cuts (including interest), making sure they don't expire, extending their temporary Alternative Minimum Tax reforms, and other proposals in the President's budget will increase the deficit by more than \$4.5 trillion through 2013. In fact the cost in 2013 alone of extending the expiring tax cuts will be \$400 billion—\$500 billion when you consider lost interest savings.

The tax cuts have been a major factor in the enormous fiscal deterioration of the past two years. In January 2001, CBO projections suggested that the government would run surpluses of close to \$7 trillion over the next ten years. In March 2003 Goldman Sachs estimated likely deficits of more than \$4 trillion over the same period (an estimate which they now say is too optimistic, due in part to the passage of larger-than-expected tax cuts). That is a deterioration of at least \$11 trillion—meaning an \$11 trillion reduction in the supply of capital available to the private sector over the coming decade.

To claim that won't matter to the economy is quite a stretch.



Charlie Brown believes in the great pumpkin. Gale and Orszag believe budget deficits raise interest rates.

ALAN REYNOLDS

*Senior Fellow, Cato Institute, and
Creators Syndicate columnist*

Charlie Brown believes in the Great Pumpkin. Bill Gale and Peter Orszag believe budget deficits raise interest rates. If such beliefs are more than a leap of faith there has to be some observation that would prove the hypothesis false.

Claims of a link between any two variables are usually tested by cross section or time series evidence. The Gale-Orszag hypothesis predicts that Japan's huge deficits over the past decade must have pushed their interest rates far above those of countries with surpluses, such as Denmark and Australia, yet the opposite happened. The Gale-Orszag hypothesis implies that shifting from huge projected U.S. surpluses to equally huge deficits since 2000 must have pushed mortgage rates sky high, yet the opposite happened. The only reason the hypothetical link between deficits and interest rates persists is that the theory itself is somehow described as evidence.

In a January 9 letter to the *Wall Street Journal*, Gale and Orszag said, "[S]tandard economic reasoning, present in almost all macroeconomic textbooks, implies that budget deficits reduce national savings." But an appeal to standard reasoning and textbooks is evidence of nothing. The authors' Brookings Institution paper quotes "the views of numerous leading academics, policy makers and government agencies." Yet those same apostles of standardized reasoning were once equally self-assured about "twin deficits." If orthodoxy was proof of reality, the world would still be flat.

From 1998 to 2001, while the budget was in surplus, national savings amounted to 18 percent of GDP. From 1981 to 1989, when deficits averaged 3.8 percent of GDP, national savings was 18.2 percent of GDP. When other countries moved from deficit to surplus, their national savings also did not rise. Taking a dollar from a taxpayer's budget and adding it to the government's budget does not improve both budgets. And governments do not borrow from the flow of national savings, as the authors theorize, but from the world's stock of assets.

The letter goes on to say, "Recent evidence supports the view that deficits affect interest rates. This evidence

comes from almost all major macroeconomic models...and in particular from studies that properly focus on the relation between interest rates and expected future deficits." But those models are built on assumptions, not facts, and cannot predict interest rates or anything else.

The "recent" evidence shows "a strong positive relationship between deficits projected by the Congressional Budget Office and the spread between long-term interest rates and short-term interest rates." But the spread between long and short rates is actually widest when bond yields are low and the fed funds rate even lower. Gale and Orszag simply showed that short-term interest rates fall after recessions, when the CBO forecast turns gloomy. The CBO's August 1994 projected deficit for 2000 was exaggerated by 5.3 percent of GDP, an annual error of \$520 billion. The Gale-Orszag theory that such projections are more potent than actual deficits is nonsensical. And their own evidence about the yield curve refutes their hypotheses about the level of interest rates.

According to the Gale-Orszag hypothesis, expected future deficits have fallen dramatically since 2000 because mortgage rates fell by two percentage points. With standardized textbook theory so obviously at odds with the facts, it is the facts and not the theory that Gale and Orszag find expendable. ♦

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