America cannot afford a huge deficit

WILLIAM GALE and PETER ORSZAG

Financial Times (London)
February 5, 2003, Wednesday London Edition

This year's US budget proves that George W. Bush is no Ronald Reagan. In 1981, President Reagan signed massive tax cuts into law. The next year, realising that the budget outlook had deteriorated more than expected, he reversed about a third of the tax cut - limiting its adverse effects on the budget. Even with that adjustment, the nation suffered substantial budget deficits throughout the 1980s.

It is now clear that Mr Bush's tax cut of 2001 is also too large. In the face of pressing security needs and the coming retirement of the baby-boomers, the nation cannot afford it. Rather than reversing part of the tax cut, however, Mr Bush wants to expand it and make it permanent. The administration's budget proposes Dollars 1,460bn (Pounds 910bn) in new tax cuts over the next 10 years - and the result is unending deficits.

The White House's ideological attachment to tax cuts is striking. With this year's budget, it has now proposed or enacted cuts that, if left in place, would amount to more than double the Social Security deficit over the next 75 years.

Meanwhile, the budget refers to the Social Security deficit as "the real fiscal danger". The administration claims that, under normal circumstances, the federal budget should be in balance. But at the same time it projects a structural deficit of Dollars 190bn in 2008 and about Dollars 2,000bn over the decade. That indicates a fundamental imbalance between tax and spending that persists long after the economy has reached full employment and war has presumably subsided.

Fiscal prospects are in fact worse than even these figures suggest. The budget ignores the substantial costs involved in reforming the alternative minimum tax. It excludes the cost of a war with Iraq. The new proposals for tax-free saving would artificially shift revenue from the future to the present, making the five-year budget look rosier, but at the expense of reductions in long-term funding. More importantly, the budget figures include the temporary surpluses accumulating in Social Security and Medicare but ignore the long-term shortfalls.

The administration says not to "hyperventilate" about deficits. So it is worth looking calmly at when and why deficits matter. As long as growth is sluggish and capacity is under-utilised, current budget deficits can be beneficial, by stimulating aggregate demand and helping move the nation back to its full-employment growth path.

(Over, please)

Permanent deficits are another matter. The economic evidence indicates that budget deficits reduce national saving, which in turn reduces national investment. The reduction in national investment can take

the form of lower domestic investment or lower net foreign investment by Americans. In either case, the expected future income received by Americans falls.

A simple calculation can illustrate the point. Under the administration's proposals, the cumulative projected budget balance for fiscal years 2002-11 will have deteriorated by almost Dollars 8,000bn since the beginning of 2001. Under reasonable assumptions, that deterioration implies an annual reduction in national income of about Dollars 1,000 per person in the US by 2012.

In short, the fundamental cost of chronic fiscal profligacy is a reduction in future national income. That reduction occurs regardless of whether deficits affect interest rates. An increase in interest rates is just one channel through which the decline can occur.

Of course, the policies that create deficits can also raise growth by improving economic incentives. But the administration's tax-free saving plans would mostly allow high-income households to shift their assets into subsidised accounts, reducing revenue without appreciably increasing private saving. And the proposal to exempt dividends from taxation would generate little or no net growth over the long term, because the adverse effects of the reduction in national saving would outweigh the benefits of an improved allocation of capital.

When Mr Reagan put Americans on a fiscal roller-coaster, it took almost 15 years for the nation's finances to recover. With the leading edge of the baby-boomer generation eligible for Social Security benefits in 2008 and Medicare in 2011, the luxury of a slow adjustment is no longer available.

These should be the easy years for fiscal responsibility. After the boomers start retiring, it will only get harder to balance the books. The US can no longer afford tax cuts for every season.

The writers are senior fellows at the Brookings Institution