The Budget Deficit:
Does It Matter?

Peter R. Orszag[1]
Joseph A. Pechman Senior Fellow, The Brookings Institution
Co-Director, Tax Policy Center
Director, Retirement Security Project

City Club of Cleveland
July 16, 2004

Thank you. I am honored to be here at the City Club of Cleveland, and I'd like to express my thanks to Jim Foster and Bud Talbott for extending the invitation. As you may know, Bud's son is now the president of Brookings, where I work. I'm told that Bud has particularly high standards, and I suppose if I don't live up to them this afternoon, I may hear about it back at work next week.

My topic today is the U.S. budget deficit and its effects. In 2003, the budget deficit amounted to slightly less than $400 billion. That's about 3½ percent of GDP. Under reasonable projections, the deficit is expected to remain about this share of the economy over the next decade – and then grow much larger as the costs mount from the retirement of the baby boomers.

The title of my talk asks whether these deficits matter. I assume that a simple "yes" would not suffice in this intellectually rigorous environment. So I'll spend most of my talk describing the various ways in which substantial budget deficits are economically harmful, and then provide some thoughts on how we can bring the deficit under control.

I want to emphasize at the beginning that *temporary* budget deficits can be beneficial in providing a jump start to a weak economy. Ongoing, sustained budget deficits are a different story.

To begin exploring why such sustained deficits matter, let's start with some basic macroeconomic analysis. We as a nation are simply not saving enough, and the budget deficit plays a large role in explaining why.

[1] The views expressed are those of mine alone and should not be attributed to the trustees, officers, or staff of the Brookings Institution or the Tax Policy Center. Much of this talk draws upon joint work with William Gale of Brookings, Robert Greenstein and Richard Kogan of the Center on Budget and Policy Priorities, Robert Rubin of Citigroup, and Allen Sinai of Decision Economics, Inc. I also thank Robert Cumby of Georgetown University, Peter Diamond of MIT, Doug Elmendorf and David Wilcox of the Federal Reserve, Robert Bixby of the Concord Coalition, and Maya MacGuineas of the New America Foundation for helpful discussions.

National saving

In 2003, the net saving rate for the nation as a whole amounted to less than 2 percent of income. This level of national saving was the lowest since 1934.

National saving is equal to private saving minus the budget deficit; so when the budget deficit goes up, national saving goes down. The federal deficit increased by more than 6 percent of income between 2000 and 2003, which more than explains the substantial decline in national saving over that period. A broad array of more rigorous evidence suggests that budget deficits have a considerable effect on national saving.

But why does national saving matter? The reason is that it determines how rapidly Americans accumulate financial and real assets. The returns to those assets have a substantial effect on our future national income. The bottom line is that a larger budget deficit and lower national saving today reduce income in the future.

Let me illustrate the point. Over the next 10 years, as I will describe in a moment, the budget deficit is expected to amount to roughly $5 trillion. Let’s be a bit generous and assume that private saving increases to offset one-third of that deficit. Then the capital accumulated by Americans over the next decade will be $3.3 trillion lower than it would have been in the absence of the deficits. If capital earns just 6 percent a year, that’s $200 billion a year in lost future national income in 2014 and thereafter. That’s more than $1,200 per household per year, on average.

Another way of making the same point is that with a saving rate of 2 percent of income, there are necessarily only two options: Either we reduce the amount we invest at home to 2 percent of income, which would starve future workers of computers, buildings, and other productive capital in the future. Or we borrow the difference from foreigners. Let me explore each of these possibilities in turn.

Deficits and Interest Rates

First, one possible outcome of a large budget deficit and a low national saving rate is weak domestic investment. That is, the budget deficit could crowd out private investment in the United States. Lower investment here at home harms future productivity because each worker has less capital with which to work in the future.

This crowding out is brought about through higher interest rates. The budget deficit soaks up available private saving – leaving a smaller pool of national saving to finance domestic investment. Firms that want to borrow for investment projects compete for that smaller pool of available funds. In the process, they bid up the interest rate that they’re willing to pay. The higher interest rate dissuades some firms from undertaking their investment projects, with the net result that investment declines.

A survey I conducted with my colleague Bill Gale of Brookings shows that each percent of GDP in projected deficits raises long-term interest rates by 30 to 60 basis

points. Using that range, the implication is that a sustained deficit of about 3.5 percent of GDP would raise long-term interest rates by about 100 to 200 basis points compared to a balanced budget.

To put these figures in context, an increase in interest rates of 200 basis points on a 30-year, $150,000 mortgage raises the annual mortgage payment by more than $2,000. For borrowers, these higher interest costs occur in addition to, not instead of, the overall reduction in national income I mentioned before; lenders would enjoy a corresponding increase in interest income. In other words, the net effect on national income is negative, but there is also a transfer within that lower level of national income from borrowers to lenders.

Current account deficit

As an alternative to reduced domestic investment, low national saving could trigger increased borrowing from abroad. Indeed, as national saving has plummeted over the past few years, our domestic investment has increasingly been financed by foreign borrowing. The increase in such borrowing is reflected in our growing current account deficit, which has expanded from about 2½ percent of national income in 1998 to more than 5 percent in 2003.

This enormous borrowing from abroad – of roughly $500 billion a year now – has spurred a heated debate about whether our large current account deficit is sustainable. Will foreigners continue to lend to us on such a massive scale? Rather than wading into that debate here, let me instead emphasize the real issue: Even if one believed that the current account deficit were sustainable, it is not desirable for three reasons.

First, borrowing from abroad mortgages the future returns from our domestic investment. Foreigners do not lend us money for free, so we must share at least part of the future returns from our domestic capital stock with them. To a first approximation, borrowing more from foreigners has the same adverse implications for future national income as reduced domestic investment does.

Second, our current account deficit is heavily financed by foreign governments rather than private investors. Increases in foreign government holdings of U.S. assets financed about 40 percent of the current account deficit in 2003. This heavy reliance on foreign official creditors may raise political economy concerns, since it raises the possibility that foreign policy decisions will be distorted by financial considerations.

Finally, a large current account deficit, especially in the context of a weak labor market, increases pressure for protectionism. The current debate over outsourcing seems to underscore the risks.

Summary of conventional costs

So just to review, the basic story thus far is that an increase in the budget deficit reduces national saving and thus reduces future national income. That reduction in future national income can occur either because interest rates rise and domestic investment falls, or because we borrow more from foreigners and therefore owe more to them in the future. Or it could occur through some combination of these two effects.

Now, our low national saving rate would not be of much concern if it were expected to be temporary. But we have been remarkably unsuccessful in boosting private saving, so there's little reason to expect a marked increase there. So unless we get the deficit under control, we appear to be on a path that entails essentially no increase in our inadequate national saving rate. Unfortunately, under current policies, the most reasonable projections of the budget deficit also suggest little improvement over the next decade.

The budget outlook over the next decade

The official budget projections published by the Congressional Budget Office suggest a deficit of only 0.1 percent of GDP in 2014. But this projection assumes that all of the tax cuts enacted in 2001, 2002, and 2003 will officially expire in 2010 or before. It also assumes that the number of taxpayers on the alternative minimum tax, or AMT, will rise from about three million taxpayers currently to more than ten times that number. And it assumes that real discretionary spending per person will decline by 8 percent by 2014.

None of these assumptions seems particularly plausible. If instead, the expiring tax provisions are fully extended, the AMT is reformed to keep the share of taxpayers facing it roughly constant, and real discretionary spending keeps pace with population growth, the deficit is more than 4 percent of GDP in 2014.

Under these revised assumptions, we can also examine the deficit over the next decade, rather than just in 2014. Over the next 10 years as a whole, the total deficit would amount to more than $5 trillion, or more than 3½ percent of GDP. The Concord Coalition, Goldman Sachs, and others have all made similar projections to these ones. In other words, there is little reason to expect a sizeable reduction in the budget deficit over the next 10 years. In the absence of a substantial increase in private saving, these continued large deficits mean there's little reason to expect a significant improvement in national saving over the next decade.

The budget outlook over the longer term

Unfortunately, that's the good part of the story.

As our horizon extends beyond 2014, the cost of entitlement programs looms ever larger. Social Security, Medicare, and Medicaid currently cost the Federal government 8

percent of GDP. By 2050, they are expected to cost 18 percent of GDP – a full 10 percent of GDP more.

One factor causing these increased costs is demographic: the aging of the baby boomers and ongoing increases in life expectancy. By the way, one trend that has not received sufficient attention in the discussion of life expectancy is the extent to which it has been rising particularly rapidly for people with higher earnings relative to those with lower earnings. In other words, life expectancy is rising, but it is rising particularly rapidly at the top of the income distribution.

In any case, an even more important factor than life expectancy in driving the long-term fiscal projections is health care costs. Over the next 50 years, Social Security costs rise by 2.5 percent of GDP, and that's largely because of demographic changes. Medicare and Medicaid costs, though, rise by almost 8 percent of GDP. The differential – of more than 5 percent of GDP – basically reflects projected health care cost growth.

This differential growth in health care costs is the single most important factor affecting the nation's fiscal imbalance. In other words, the long-term budget problem is principally a health care one.

Fiscal crisis

The growth in health care costs, demographic trends, and other factors all combine to generate huge budget deficits. Indeed, the long-term fiscal gap now amounts to between 7 and 10 percent of GDP, which means that we would need to raise revenue or cut spending by that amount immediately – and then sustain the changes – to stabilize the public debt as a share of the economy.

As Bob Rubin, Allen Sinai, and I have emphasized, the adverse consequences of such large, sustained budget deficits may be far more substantial -- and occur far more suddenly -- than the conventional analysis focused solely on national saving may suggest. For example:

- As concerns arise that the government may be forced to resort to high inflation or that a fiscal deadlock with unpredictable consequences would arise, investor confidence may be severely undermined;

- The loss of investor confidence may trigger a shift of funds away from dollar-based investments, causing a depreciation of the exchange rate and sharply higher interest rates on U.S. government debt;

- The increase of interest rates and depreciation of the exchange rate can reduce stock prices and household wealth, and raise the costs of financing to business;

- The disruptions to financial markets may impede the intermediation between lenders and borrowers that is vital to modern economies; and

- These various effects can feed on each other to create a mutually reinforcing cycle. For example, increased interest rates and diminished economic activity may further worsen the deficit, which can then cause a further loss of confidence and potentially spark another round of negative feedback effects.

Although it is impossible to know at what point market expectations could trigger these types of dynamics, once they were in motion, the harmful effects would substantially magnify the costs associated with any given deficit. Indeed, the potential fallout from such fiscal disarray provides perhaps the strongest motivation for avoiding substantial, ongoing budget deficits.

What to do about it

So what should we do about this?

I have several suggestions that would start us moving in the right direction, but I don't have a complete solution. Indeed, given the complexities involved in reforming the health care market, I don't know anyone who has a complete solution to the nation's projected deficits. But on the theory that we need to learn to walk before we learn to run, let's talk about some things we can do now to improve the situation.

First, the tax cuts. Many policy-makers seem to be under the illusion that the tax cuts can be paid for indefinitely by borrowing. Ultimately, however, the bill will come due. In other words, a permanent tax cut ultimately has to be financed either through lower spending or through higher revenues from other sources. The only question is whether we pay for them now or make our children and grandchildren pay for them later.

The debate in Washington these days is over whether we should "pay for" extending the tax cuts. This debate seems somewhat artificial, since in the long run, there is no alternative to paying for the tax cuts: fiscal accounting and arithmetic demand that the tax cuts be financed somehow. Alan Greenspan is one of the few supporters of the tax cuts who acknowledge the necessity of paying for them with offsetting policy changes.

No one, however, including Mr. Greenspan, has put forward credible proposals that would actually come close to financing the tax cuts. Perhaps that is understandable: The required reductions in government programs are simply too large to be plausible.

Paying for the full tax cuts in 2014, for example, would require a 48 percent cut in Social Security benefits; complete elimination of the federal part of Medicaid; or an 80 percent cut in all domestic discretionary spending (such as for environmental protection, education, and health research). If the reductions were spread across all government programs, they would require a 12 percent reduction in all non-interest government spending.

Given these figures, my view is that the tax cuts are simply not affordable and therefore should be substantially scaled back or repealed altogether.

After all, the tax cuts cost about 2 percent of GDP over the long term – a noticeable share of the 7 to 10 percent fiscal gap we face. What do we get for this cost? Despite some claims to the contrary, we don't get more growth, less inequality, or a better tax code. All in all, it doesn't sound like such a good deal to me.

Let's look at long-term economic growth first. The net effect of the tax cuts is likely to be a *reduction* in growth over the medium term. Deficit-financed tax cuts have offsetting effects on economic growth. The tax cuts themselves can have a modest positive direct effect on the economy, by reducing marginal tax rates and encouraging people to work or save more. But as I have discussed, tax cuts also increase the budget deficit, which reduces national saving and eventually has a negative effect on economic growth. Given the structure of the 2001 and 2003 tax cuts, all the studies of which I am aware suggest that the net effect is likely to be negative in the medium term.

Second, the direct effect of the tax cuts is unquestionably to widen after-tax income inequality. If the tax cuts were extended and not erased over time by the AMT, after-tax income will rise by 6.4 percent for the top 1 percent of the income distribution – but by only 0.3 percent for the bottom 20 percent. And don't forget that ultimately, we'd have to pay for these tax cuts somehow. If we pay for them by cutting back on government programs, the pain will flow disproportionately to the bottom end of the income distribution.

Some advocates of the tax cuts argue that they represent a piecemeal approach to tax reform – in particular, that they're moving us toward a consumption tax. A consumption tax, though, is intended to raise national saving. The tax cuts will undoubtedly reduce national saving. The result is the worst of all worlds: all the regressivity associated with a consumption tax and none of the potential macroeconomic benefits.

By now, I've undoubtedly made clear that I'm not a huge fan of the tax cuts.

In addition to scaling back or repealing the tax cuts, we need to reform Social Security. Peter Diamond of MIT and I have recently written a book, entitled *Saving Social Security,* in which we put forward a progressive reform that combines modest benefit reductions and modest revenue increases to restore sustainable solvency to Social Security while strengthening its social insurance protections. Interestingly, given how much more important Medicare and Medicaid are to the long-term budget picture, the most important consequence of Social Security reform may be to take the issue off the table, so that policy-makers, analysts, and the public can focus on the real problem – health care.

Finally, in addition to scaling back or repealing the tax cuts and enacting Social Security reform, both of which would help to reduce the budget deficit and thus raise national saving, we can do more to boost private saving.

The Federal government currently provides more than $150 billion a year in tax preferences for retirement saving, but we get too little in exchange. The reason is that the existing set of incentives is basically upside down. They give the strongest incentives to higher-income households, who too often respond to pension tax incentives by shifting assets from taxable accounts into the tax-preferred ones. But shifting assets is not new saving. The net result is that the pensions serve to shelter income from taxation, rather than as a vehicle to encourage new saving.

Additional savings incentives targeted at high-income households will only exacerbate this problem: Too much of the revenue loss would reflect asset shifting rather than new contributions.

A better strategy would encourage expanded pension coverage and participation among low- and middle-income households, who both need more help preparing for retirement and typically don't have much other wealth to shift into the tax-preferred accounts. So we can be reasonably sure that most money they deposit into tax-preferred accounts is actually new saving.

Now you may be skeptical that such households can actually save. But I am more optimistic than many people on this issue. I am directing a new Retirement Security Project, sponsored by the Pew Charitable Trusts, which is exploring various ways of encouraging private saving among moderate- and middle-income households.

For example, the 2001 tax legislation created a saver's credit, which provides a progressive, matching tax credit for contributions made by moderate-income households to 401(k)s or IRAs. The early results are quite encouraging, but despite a good start, several changes are important if the credit is to realize its full potential.

The evidence also suggests that automatic enrollment plans work – and they should be substantially expanded. These plans enroll workers in a 401(k) plan unless they specifically opt out – and achieve much higher participation rates than if workers must sign up to be included.

Finally, tax refunds are a significant potential source of savings, yet many households are reluctant to have their entire refund deposited to a tax-preferred savings account. Allowing refunds to be partially deposited into a savings account and partially into a checking account, as proposed by the Bush Administration, is a highly promising mechanism for raising saving.

These types of policy changes – expanding the saver's credit, expanding automatic enrollment plans, and allowing split refunds – could encourage saving among

moderate-income households in a cost-effective manner. And although we shouldn't expect miracles, they would help to lift our private saving rate.

Conclusion

I'm eager to get to the question-and-answer period, so let me close merely by reiterating the main message of my talk. Under reasonable projections, the nation faces a long period of sustained high budget deficits. The existing deficits are already forcing us to borrow hundreds of billions of dollars a year from abroad, especially from foreign governments. And the costs will only grow over time.

Yet many policy-makers appear to be insensitive to the longer-run risks to U.S. economic performance from sustained, large budget deficits. Those risks are real, and the sooner we start to reduce them, the better.