THE BROOKINGS PODCAST ON ECONOMIC ACTIVITY

“How does Congress react to budget deficit projections?”

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Episode Summary:

Fiscal deficit projections are used by policymakers to understand the trajectory of U.S. debt. Between 1984 and 2003, Congress was responsive to these projections, raising taxes and cutting spending when projections showed that the deficit would grow. However, since 2004, fiscal policy has ceased being responsive to debt projections regardless of the party in power. In a new paper, “Robust Fiscal Stabilization,” Alan Auerbach and Danny Yagan of the University of California, Berkeley, quantify this phenomenon by comparing fiscal legislation across the two periods. On this episode, Auerbach discusses the findings and their implications with Brookings Senior Fellow William Gale.

[music]

EBERLY: I'm Jan Eberly, the James R. And Helen D. Russell Professor of Finance at Northwestern University.

STEINSSON: And I'm Jón Steinsson, Chancellor's Professor of Economics at the University of California, Berkeley.

EBERLY: We're the coeditors of the *Brookings Papers on Economic Activity*, a semiannual academic conference and journal that pairs rigorous research with real time policy analysis to address the most urgent economic challenges of the day.

STEINSSON: And this is the *Brookings Podcast on Economic Activity*, where we share conversations with leading economists on the research they do and how it will affect economic policy. Thank you for tuning into the fourth episode of our fifth season of the podcast.

For a long time, Congress paid close attention to long-term federal deficits and would raise taxes or cut spending if deficits were predicted to spiral upwards based on current legislation. But the paper we discuss in today's episode, which is titled "Robust Fiscal Stabilization" and is by Alan Auerbach and Danny Yagan of the University of California, Berkeley, finds that this time has ended with potentially serious consequences for federal debt. William Gale, co-director of the Urban-Brookings Tax Policy Center and discussant of this paper, leads the discussion.

EBERLY: These are crucial issues as the U.S. confronts higher debt and deficits and policymakers contemplate the consequences and how to address them. People often talk about having various kinds of budget rules and this paper points out that there was implicitly a rule or at least a practice that brought budget deficits down when they had tended to grow over the last few decades. This paper argues that this practice has ended and raises the question of what comes next.

STEINSSON: I'm really glad to see Alan and Danny drawing attention to this troubling change in fiscal policy. I worry that deficits are a bit like high blood pressure. Everything seems fine for the longest time and then something really bad happens. But let's pass it off to Bill and see what the authors have to say.

GALE: Thanks, Jan and Jón. I'd like to welcome Alan to the podcast.

AUERBACH: Thank you.

GALE: And let me say, I'm very excited to talk more about this paper having served as the discussant at the conference. So, let's jump right in. Alan, your paper with your colleague Danny Yagan looks in the past and in the future about how policymakers respond to budget deficits and debt. Let's talk about the past first. The question you're asking is basically when indicators suggest that the federal deficit is going to go up, do lawmakers pass laws that respond to those projections by either increasing taxes or lowering spending? You've looked over the last four decades and come up with different results over different time periods. Talk us through the basics of what you found.

[3:10]

AUERBACH: Thanks, Bill. Well, when I first studied this issue a little over 20 years ago for a paper I also wrote for the Brookings panel, I estimated the effects of projected budget deficits on government policy and found that there were strong responses by the government. At the time, people were a little surprised. They didn't realize the government had it together as much as it had to do these things. And I found that taxes went up and spending went down in terms of legislative activity when it looked like deficits were going to be high in the future, according to Congressional Budget Office projections.

Danny and I decided to have another look at that relationship with all the additional years of data we've had since then and found very surprisingly that that relationship had completely gone away. My original paper was in the Brookings Papers in 2003, and if you look at the period from 2004 to the current year, the same relationship that I found to be very strong from 1984 through 2003 had completely disappeared in the last 20 years. And it had very important implications for the path of fiscal policy in the U.S.

GALE: Great. And we'll come back to that in just a second. But the second half of the paper looks at the future where you look at projections of federal debt and deficits several decades out and the extent to which it matters whether policymakers respond like they did in the last 20 years or in the 20 years before that. So, what are your main findings there?

[4:51]

AUERBACH: Well, we start with CBO projections for the next 30 years. But of course, as CBO makes quite clear, they're not taking into account either the good or the bad things that can happen to the economy and to the budget. They don't predict recessions. They don't predict unexpected booms. They just have a nice, smooth trajectory. And we incorporated shocks, surprises of both the positive and negative variety based on what we've observed over past history. And then we did projections of what the range of possible outcomes would be for the deficits and debt relative to the size of the economy over the next hundred years.

And what we found was that it matters a lot whether the government follows the fiscal approach that it had in the 1980s and '90s, where it was responsive, as opposed to following the rules it's done in the last 20 years, which is to do nothing when deficits loom large. Because in the latter case there's a serious possibility that things will really go off the rails in terms of exploding national debt. And there'll be no reaction based on the last 20 years of behavior. There'll be no reaction to that, and the debt will just explode, and we'll be in an unsustainable fiscal situation.

It doesn't take much. That is, we found that even a weaker response than was observed in the '80s and '90s would be enough to keep things on a stable path most of the time. We measure a stable past by having the debt-to-GDP ratio not exceed 250%, which is more than twice what we've ever experienced in the United States. We don't set a very high bar, but we say, well, for sure if we get to a point like that, we've really lost control of the fiscal situation.

So, we ask whether no feedback—that is, no government response—or some government response is enough to keep that from happening. And if we do what we did in the '80s and '90s, it is enough. Even if we do a little bit less than we did in the '80s and '90s, that'll be enough. But if we do nothing, which is what we've done since 2004, then it clearly won't be enough and we're very likely to have massive fiscal problems.

GALE: Let's talk about that 250% GDP threshold for a second. That seems, at least at first glance, to be a very weak criteria for fiscal stability. On the other hand, it's over a hundred years and you're measuring the probability that we get to there. But I think it's worth mentioning that 25 years ago, if people were told the U.S. had a debt-to-GDP ratio of about 100%, which we have now, everyone would have thought that was the end of the world, a financial crisis. Is there any chance that we have enough fiscal space to get out to 250% of GDP and it's not a crisis?

[7:53]

AUERBACH: It depends in part on what happens to interest rates. One of the reasons why we've been able to get up to 100% without all kinds of alarms going off is that interest rates have been quite low over the last several years, much lower than one would have predicted 20 years ago. Indeed, if you look at interest rate forecasts made by any government agency or by the private forecasters over that period, you'll see continual downward revisions in terms of what people thought interest rates would be.

And having low interest rates, particularly interest rates that are low relative to the growth of the economy, gives the government more fiscal space. It makes deficits less problematic, at least while that condition holds. It lowers debt service. It makes the national debt grow less quickly. And I think that's something that we really didn't anticipate back when we thought that debt equal to one year's GDP would be a catastrophe.

We've also seen what's happened in other countries. Japan, for example, which has a higher debt-to-GDP ratio than the United States, and people have issued warnings for Japan, too. But like the United States, Japan's had very, very low interest rates. And that's one of the things that's allowed it to sustain the path that it's on.

But talking about 100% versus 250% and whether it's a weak criterion I think highlights one of the problems in motivating government to do something, which is we know that at some point we won't be able to continue on the path we're on, but we don't know where that point is. We might have thought it was 100% of debt-to-GDP ratio. We obviously don't think that now because that's where we are and nothing terrible has happened yet. And we chose 250% because we figured it just had to be no higher than that and probably lower than that.

[9:46]

But who knows? If interest rates are zero or negative for many years in the future, then very, very high levels of debt-to-GDP are sustainable. But part of the problem is that even if that is something that's likely to happen, it's not necessarily going to happen with certainty. There's possibilities that interest rates will rise. Economic

conditions in the U.S. and in other countries may cause a shortage of capital and interest rates to be higher as a result, or other factors may cause interest rates to be higher. And if that happens, it will put us in a very bad situation.

Also, we've in the last 20 years had two massive recessions: the global financial crisis, which although it officially only lasted for about a year-and-a-half, it really lingered for several years in terms of slow growth. And then the COVID pandemic, which was an extremely short recession, but also a very, very deep one. And both of them involved very, very rapid accumulations of national debt.

Now, we hadn't had that kind of experience for many years before the financial crisis. And so, we really don't have any idea how frequently these catastrophes or near catastrophes in terms of the budget and the economy are going to occur. But we have to allow in our planning for the possibility that they will occur. But again, that's something that's hard to bring to the policy process, to say, well, we may not have anything bad like that happens for the next 20 or 30 years, but we should still be planning for it and taking measures that are needed only if that happens.

GALE: At the risk of oversimplifying the paper, I would describe it as follows: Policymakers acted responsibly in the '80s and '90s. And if they act responsibly in the future, things will be pretty good, manageable. But policymakers didn't act responsibly the last 20 years. And if they continue to not act responsibly, then we've got a real issue on our hands. So, the question that comes to my mind is what caused policymakers to change their behavior, and what will it take to get them to change their behavior back?

[11:56]

AUERBACH: Those are two very difficult questions. So, the first, I would say policymakers learned over time that trying to bring the deficit down or at least get it under control by undertaking spending cuts and tax increases is not a winning political strategy. It obviously causes short-term pain. There are going to be constituencies for the spending that's being cut. No one wants to face increased taxes. And so, undertaking those policies involves a tradeoff. There's a short-term political pain. But presumably, one would think—and policymakers did think in the '80s and '90s—that there were reasons to do it nonetheless, because it would help keep the budget under control and therefore help the economy at least over the medium- to long-run, if not immediately.

And I think policymakers believed that. And you can think of particular episodes in the '80s and '90s. Just to cite one example, the budget agreement between the first President Bush and Congress, which is the Democratic Congress, in 1990, which involved tax increases very much to his political misfortune as well as spending cuts. And it was clear at the time that both the president, who was a Republican and the members of Congress who were led by Democrats, both thought this was something that needed to be done. That followed a period after the Graham-Rudman-Hollings legislation, which was aimed at controlling deficits, which was also bipartisan.

So, you had this period then when there was bipartisan belief, not universal by any means even then, but there was a strength in both parties that believed that dealing with the deficit was a responsible thing to do and good for the economy.

[13:42]

And over time, I think in part because some of the signals we expect to see when we run deficits haven't occurred, that sense by politicians I think has disappeared. For example, we haven't had, until the last few years, we haven't had any inflation to speak of since Paul Volcker through monetary policy brought the inflation rate down in the 1980s. And so, when we had deficits rising, for example, during the global financial crisis, there was absolutely no increase in inflation, even though we had enormous deficits over several years.

Now, there was an increase in inflation in recent years in the aftermath of COVID. There are different explanations for why that might be, including problems in supply chains. And that may very well be the most important explanation. But government fiscal policy has also been implicated, and it's possible that that experience may move politicians somewhat back toward where they were in the '80s and '90s. But I'm not that confident about that.

It used to be they would say if we run deficits, it's going to raise interest rates and you won't be able to buy a house. And so, that's why we're raising taxes and cutting spending. Well, not only didn't inflation go up, but interest rates didn't go up either.

Now, of course, those aren't the only effects of running large deficits. There's questions of whether you'll have enough fiscal space for dealing with future recessions and simply a question of whether at some point no one will want to hold your debt, in which case interest rates could rise very sharply. So, there are reasons beyond the immediate effects deficits might have on inflation and interest rates to be concerned about deficits. But they're much harder to use in our current political environment to justify undertaking tough fiscal measures.

GALE: Yeah, I totally agree with that. The benefits of fiscal responsibility are in the long term and hard to see. One example I gave once was if an earthquake knocks down a building, you can walk by the rubble and say, yeah, the earthquake knocked down that building. If there's an empty lot and you walk by it, it takes a great power of concentration to say, well, the government borrowed too much and now people can't borrow in the private sector, so that building was never built. But that's the nature of the cost.

But so, I think I and others have found your paper very compelling and important in the academic and the research community. How would you convey this to the person on the street, why they should care about this? Given what you just said about long period of low inflation, low interest rates.

[16:25]

AUERBACH: There's a term that is often used in talking about the deficits that we tend to make fun of. But I think in this case might be the best argument we could give, which is that we're mortgaging our grandchildren's future. Now, that is a customary thing to say when people are criticizing the debt. Unfortunately, in the current political environment, it's usually only when they're out of power and they're criticizing the party in power for increasing the debt to do the things it wants to do instead of the things that the party out of power wants to do. And so, they don't really

care about deficits. They care about their opponent's deficits. But nevertheless, they often use that argument, that this is irresponsible, we're mortgaging our grandchildren's future.

Well, we are. If we run deficits, we don't see an immediate rise in interest rates or inflation that causes us to stop, and we just let the debt-to-GDP ratio rise and rise and rise, at some point, we won't be able to keep doing that. If there's a loss of confidence in the U.S. ability to service its debt, interest rates are going to rise. And when they rise, the government simply won't be able to run the deficits it's running and it's going to have to cut them. And at that point, it's going to have to either cut spending substantially, much more than it would have to do now if it were pursuing a gradual policy or raise taxes substantially. And you and I will have passed from the scene at that point, unless it happens, you know, in the relatively near future. But our grandchildren are more likely to be around. And if we care at all about them, we would be thinking about what kind of economy we're leaving for the U.S.

We struggle to think about these issues in the context of global warming. There's a close analogy in the sense that these things happen gradually. But this is a problem that's easier to deal with than global warming because global warming is a worldwide problem, and the U.S. can only do so much on its own. It isn't doing all that much, but it can't do it all on its own. We can fix our fiscal problem on our own. We don't need anybody's help from other countries. They may be the ones who eventually force us to do it if they cease to hold the substantial share of the debt that they're currently holding. But it's something that we have the capacity to fix on our own.

GALE: Yes. Speaking of mortgaging our grandchildren's future and climate change, I just want to bring in an issue that's often left out in the discussion of deficits. And that is it depends a lot what the money is spent on. If we borrow money to invest in infrastructure or to invest in climate change adaptation, then we're improving our grandchildren's future. But under the current budget projections, as you well know, that's not what we're doing, we're borrowing to pay old age entitlements. Maybe comment on that.

[19:05]

AUERBACH: Well, there's nothing wrong with paying old age entitlements if we think that's what we should be doing. But there are other things that we should be doing, too, and we should be thinking about the range of things that we wish to spend money on and then think about how much it costs to do that and make sure that our spending and our taxes align. We have an asymmetry in the way we deal with old age entitlements and other spending, such as on education and other things for the future, which is that the first category of spending is entitlement spending, and it's sort of on automatic pilot. We don't have to do anything for it to keep increasing every year given that the population's aging and health care costs are going up. In fact, we would need to do something about it to keep that from happening.

Whereas with discretionary spending, whether it's on education, or infrastructure, or other things, it's something that takes active decisions by Congress to pass legislation to accomplish these things. And of course, when you're thinking about whether or not to do something, then do you have the money given how much you're

spending on other programs, is this something you want to spend money on? And unfortunately, it disadvantages programs like that in the political process.

GALE: So, whether the deficit and debt remain mere talking points or become guides to action on behalf of policymakers is really a critical issue.

[music]

And your paper with Danny Yagan has really highlighted just how important policymakers reactions could be. So, thank you for being on the podcast and thank you for your paper.

AUERBACH: Thanks very much, Bill.

STEINSSON: Once again, I'm Jón Steinsson.

EBERLY: And I'm Jan Eberly.

STEINSSON: And this has been the *Brookings Podcast on Economic Activity*. Thanks to our guests for this great conversation and be sure to subscribe to get notifications about new releases of this podcast.

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