

**Senate and House Democratic Policy Committees
Joint Hearing**

“The President’s Budget Request for Fiscal Year 2004”

Bruce R. Bartlett

National Center for Policy Analysis

February 7, 2003

Mr. Chairman, thank you for the opportunity to discuss the administration’s budget request for FY 2004. I would just like to emphasize at the outset that I am not an administration official and do not in any way speak for the administration. Furthermore, while I am generally sympathetic with the administration’s philosophy, I don’t necessarily support every particular of its budget priorities. I am here speaking only for myself and not on behalf of the National Center for Policy Analysis, the Bush Administration, the Republican Party or anyone else.

Having said that, I would like to address what I assume is the principal concern of this panel: the return to deficit spending and its likely impact on the economy.

My view is that deficits are very exaggerated in terms of their economic impact. I have held this view for many years throughout Republican and Democratic administrations. In fact, the first article I ever published in the *New York Times* (January 24, 1979) was an attack on the idea that budget deficits were inflationary and that a balanced budget was necessary to bring down inflation. I mention this only to indicate that I have been consistent in my views on this subject and have not suddenly decided that deficits don’t matter because it is politically expedient to do so.

I realize that common sense dictates that deficits must raise interest rates. After all, if you hold the supply of anything constant and then increase the demand, the price must rise. In this case, we are holding saving constant and increasing the demand for it via deficits, meaning that the price in terms of interest rates must rise. I do not dispute this formulation. All other things being equal, a rise in deficit spending will raise interest rates to some degree.

However, all other things are not equal. Moreover, simply saying that deficits will raise interest rates tells us nothing about the order of magnitude. In my view, deficits have a very small—and much overrated—impact on interest rates. I will try to explain why.

Interest rates are probably the least well understood important issue in the entire field of economics. In theory, the interest rate is mainly the discount between present and future. That is, how much would you need to be compensated in order to give up a dollar of income today in order to receive a dollar one year in the future? Historically, people

have been willing to forego consumption today in return for a 4 percent premium or so in a year.

It's important to understand that the 4 percent premium is not really "income" in the ordinary sense of the term. It is less a reward than compensation for a loss. We all give up something real when we forego current consumption. We always want more today. Having the same thing in the future diminishes its value. In other words, saving necessarily involves sacrifice. All interest does is make us whole again. It is akin to receiving an insurance settlement—something no one deems to be income.

In practice, of course, interest means much more than that. Market interest rates embody a great many things, including the rate of return on capital, general economic conditions (foreign and domestic), inflationary expectations, compensation for risk, the demand for liquidity (as opposed to saving), taxes, Fed policy, federal deficits and many other things. At any given moment in time, any one of these factors can overwhelm the others. They may also affect some elements of the yield curve without affecting others.

Determining what factor is most critical in setting interest rates at any particular time is more art than science. If it were otherwise, then all economists would be millionaires. Knowing with certainty how interest rates will move in the future is information upon which a great deal of money can be made very quickly. No one ever gets it right consistently. Certainly, any investor looking solely at federal borrowing as the prime indicator of interest rate movements would have lost his shirt over the last 20 years.

In the 1980's, budget deficits rose to levels unprecedented in peacetime. Common sense would have indicated that interest rates would rise sharply. In fact, they fell sharply. The main reason is that inflation collapsed, thus reducing the inflation premium in interest rates. (Economists generally assume that the expected rate of inflation raises long-term interest rates by an equal amount. That is, the market rate will equal the real rate plus the expected rate of inflation.)

Furthermore, the rise of growth in the 1980's would have also suggested a rise in interest rates. Growth generally increases the demand for credit by businesses for expansion. But growth also raises saving and asset prices, meaning that the supply of capital is rising along with higher demand. Consequently, interest rates need not rise.

Foreign capital is also an important factor in setting interest rates. If the rate of return on capital is rising in the United States, capital from foreign countries will flow inward to take advantage of those higher returns. This is especially the case when some major foreign countries, such as Japan and Germany, have pursued growth-inhibiting policies by raising taxes and other measures. In the long run, it is not desirable to be dependent on foreign capital inflows, but there is no question that they play a significant role in reducing interest rates below what would exist without them.

Putting all this together, I have trouble believing that the federal budget deficits projected by President Bush in his 2004 budget will have more than a trivial impact on interest

rates. As a share of GDP, they will peak at a rate half as high as that achieved in the 1980s, and half that existing in Japan today, where interest rates are actually negative.

Furthermore, many of the tax initiatives proposed by President Bush will unquestionably raise private saving by both households and businesses. The proposal to expand tax-deferred saving accounts is the most obvious example. It is worth keeping in mind that from the point of view of interest rates, \$1 of increased saving is the same thing as \$1 of increased federal revenue. If a tax cut brings forth an equal amount of private saving to offset the revenue loss attributable to the tax cut, there should be no impact on interest rates at all. (Conversely, a tax increase can sometimes reduce saving by more than the revenue it raises, thus causing interest rates to rise, not fall.)

Some analysts argue that even if deficits do not raise interest rates, they still deplete national saving and thus will reduce productivity and living standards. This assumption is based on national income accounting, wherein government deficits are assumed to be negative saving. It's important to remember that it is merely an assumption, which tells us nothing about the impact of a tax change on economic behavior, such as saving, investment and labor supply.

Without a change in interest rates, there is no mechanism for reducing the private sector's use of saving. In other words, you cannot turn an accounting identity into something that affects the economy unless there is some price change that alters economic behavior. To say otherwise is to believe that debits somehow cause credits and vice versa. This is obviously not the case.

Moreover, the assumption that deficits necessarily constitute dissaving assumes that the spending or tax cuts that give rise to the deficits constitute nothing but pure consumption. This may or may not be true. I would argue that tax cuts of the sort that President Bush has proposed can be viewed as investments in our nation's productive capacity. I believe that they will pay dividends not only in terms of higher growth and living standards, but also in terms of federal revenue. A larger economy will expand the tax base and offset some—not all by any means—of the static revenue loss. If we only get back enough revenue to pay the interest on the government bonds issued to cover the revenue loss, it would be a good deal.

Finally, I think it is important to distinguish between deficits that arise from higher spending and those that arise from tax cuts. In the former case, resources are being extracted from the private sector and are no longer available for use by individuals and businesses. But in the latter case, the government is adding resources to the private sector. Thus they will not impact on financial markets the same way. Higher spending will have a far more negative effect than cutting taxes.

Just because I believe that federal budget deficits don't have much of an impact on interest rates does not mean that I am predicting no increase in interest rates in coming months or years. Quite the contrary, I am certain rates will rise even if surpluses were still expected. The main reason is that interest rates today are abnormally low due to the

low level of economic activity that has lowered the return to capital. As the economy inevitably pulls out of recession, one would expect rates to rise as businesses find new investment opportunities.

Moreover, Federal Reserve policy cannot remain as expansionary as it has been indefinitely. At some point, it will have to tighten monetary policy lest it contribute to inflationary expectations. If it does nothing, long rates will rise; if it tightens, short rates will rise. Either way, Fed policy will almost certainly lead to higher interest rates.

Of course, if we also have large federal budget deficits at the same time these other factors are causing rates to rise, it will be very easy for some people to say that it is because of the deficits, not the other factors. Therefore, this issue cannot be resolved for all time. There will always be evidence supporting the idea that deficits raise interest rates, if only due to the “noise” in the economy that necessarily makes it hard to isolate one effect from others. I should note, however, that academic research attempting to isolate the impact of deficits on interest rates has consistently found little if any relationship.¹

I will conclude with a bit of political history. As a Republican, I am well aware that my party worked hard for decades to make budget deficits a winning issue. Year after year, I heard my party’s leaders attacking your party for running up deficits, which exacerbated inflation, raised interest rates, caused premature balding, brought on postnasal drip and all manner of social evils, they said.

And year after year after year, the voters of America voted to keep Democrats in control of Congress. Sure, they told pollsters that they were terribly concerned about deficits and deplored them. But when it came time to cast their ballots, it was never a factor. As William Greider recently wrote in *The Nation*, not exactly a Republican journal, “No party ever won the White House (or Congress) by balancing the federal budget, nor did anyone ever lose a national election by producing huge deficits.” (February 17, 2003, p. 12)

I am sure that those in my party who railed against deficits all those years felt very good and righteous about the position they took. But it was a losing position. For that reason, I am more than happy to see the Democratic Party take up the issue of deficit spending as its principal fiscal issue. I hope you take it to heart and vote against every tax cut that comes through Congress and propose tax increases instead. At the end of the day, it will only add to the Republican majority.

¹ For an excellent survey of the literature, see John J. Seater, “Ricardian Equivalence,” *Journal of Economic Literature*, vol. 31 (March 1993), pp. 142-190.