Why Deficits Matter

Testimony Before the U.S. House Budget Committee

Edward Gramlich

Document date: January 23, 2007
Released online: January 23, 2007

Edward M. Gramlich is Richard B. Fisher Senior Fellow at the The Urban Institute.

Abstract

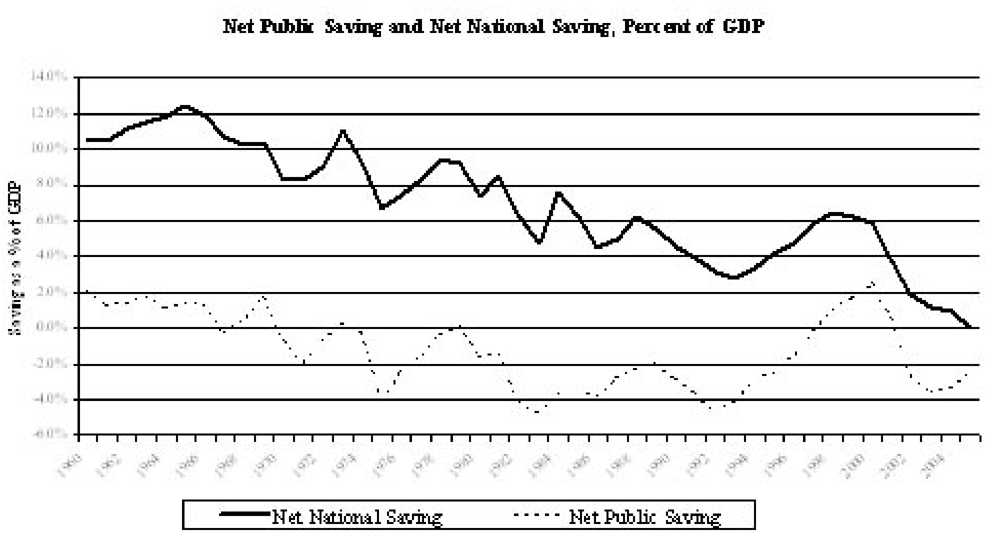
With rapid increases in entitlement spending just over the horizon, now is the time to get deficits down and national saving up, senior fellow Edward Gramlich told the House Budget Committee.

Testimony

Thank you, Mr. Chairman and committee members, for soliciting my testimony on the federal budget deficit problem. It is indeed a problem, as I will try to argue.

Arguments about budget deficits have gotten into the political domain, and it is probably no surprise that controversy has grown up about deficits—just how bad are they? To try to illustrate the exact nature of the problem, I will paraphrase Charles Schultze, the Brookings scholar and former budget director. Some years ago, Schultze asked whether deficits could be likened to a pussycat, a wolf at the door (huffing and puffing to blow the house down), or to termites in the basement. Answering this question is critical in knowing whether deficits are a problem and why.

The pussycat argument holds that deficits are not a problem because private savers offset them. As deficits rise, the argument goes, perceptive citizens foresee that future tax payments will be higher, or transfer payments less, and will save more to cover their future costs. Personal experience can contradict this view—how many families do each of you know who save more when federal deficits rise? But if this reasoning is not convincing, refer to this chart, which compares the Bureau of Economic Analysis (BEA) concept of national saving with federal budget surpluses (where net public saving is positive) or deficits (where net public saving is negative).



Over nearly 50 years, the two track very well. This indicates that as federal deficits rise, private saving changes little, and national saving falls. In other words, private saving does *not* offset the deficits.

The argument for the wolf at the door, huffing and puffing to blow the house down, takes almost a completely opposite position. This time the argument is that high federal deficits will either put pressure on the Federal Reserve to create money to finance the deficits, hence causing inflation, or worry lenders into charging higher interest rates to finance the deficits. The United States has run large deficits for some years and neither has happened. For nearly three decades, the Federal Reserve has been determined to keep inflation low and stable, it has been perfectly free to do that (financing as much of the deficit as it deems wise), and it has done just that. Deficits have come and gone, but the Fed has been able to keep inflation on track.

As for bondholders, there has been speculation that they would insist on higher long-term bond rates as deficits rose, but this really hasn't happened either. Long-term rates are well-behaved right now—indeed, former Fed Chairman Greenspan referred to their low levels as a conundrum—and most reasonable forecasts expect them to remain so in the near future. We could worry that high deficits will cause high interest rates, but that would be, well, crying wolf.

So we are left with the termite argument, the one I favor. As the chart shows, deficits do lower national saving—of that there seems little doubt. When national saving declines, it is a mathematical truism that one of two things must happen:

a. domestic investment in capital equipment must decline, lowering America's long-term rate of productivity improvement;
b. domestic investment does not decline but the country borrows the difference in the form of higher current account deficits in the balance of payments.

This choice is not an assertion; it is true by definition. I could show a new set of charts here, but most of you know what happened. So far domestic investment has held up well, and the nation has made up the difference between saving and investment by borrowing from foreigners.

I think most of you would accept the fact that if the deficit-induced decline in national saving were to erode domestic investment, that would be a bad thing. It is a competitive world out there and our nation has to invest in new equipment, keep new techniques coming on-stream, and maintain its economic strength. The harder part of the argument is on the foreign side: if foreigners persist in lending us whatever we need to keep investment high, why worry?

My colleague, Edwin Truman, will address this issue in depth, but let me make one simple point. How do we know that foreigners will keep on lending to us? And at a more basic level, why should the United States put itself at the mercy of foreign lenders? One would think we should manage our affairs to keep national saving as high as we think it should be, from an optimizing standpoint. If foreigners lend to us, our own investment will be that much higher. If not, we are protected against a decline in investment by our own national saving. The basic problem with letting national saving fall is that the country becomes vulnerable.

There is also an important time dimension to the budget problem, stressed by Chairman Bernanke in his testimony to the Senate a few days ago. Soon the large baby boom cohort in the United States will hit retirement ages, and when that happens, projected entitlement spending rises rapidly. The Social Security trust fund contributes a cash surplus to the budget now, but that cash surplus will be gone in a little more than a decade and ultimately will become a big cash deficit. Simultaneously, health care spending is likely to be rising rapidly. The time to take matters under control, to get our deficits down and national saving up, is now.

Looking at this issue another way, presently the nation has a little more than three workers per retiree. In 2030, there will be about two workers per retiree. If those workers are to support the rising number of retirees, they will need more capital. They can only get capital through higher national saving. That is exactly what we should be doing today—saving at higher rates. Instead, we have let the budget deficits erode national saving.

So this is the argument, Mr. Chairman. Deficits are not like a pussycat, with no effect. Nor are they likely to huff and puff and blow our house down. But they do either erode investment or force the nation to borrow the difference, and in that way, they eat away at the foundation. Moreover, demographics is going to make the deficit problem much worse in the future than now. The time to act to get deficits under control is now.

Politics is never far away from such discussions, so I can hardly campaign against deficits without commenting on whether they should be changed on the tax or expenditure side. Basically, as a macroeconomist, I don't think it matters much. It is often argued that it is necessary to keep tax rates low. In truth, the United States has probably never had a better macroeconomic decade than the 1990s, following tax increases at the beginning of the decade. There have been other eras when good performance followed tax cuts. When national tax rates get very high, there is a theoretical argument against letting them increase further, but at present moderate rates I do not think it matters much whether the budget adjustment is made on the tax or expenditure side of the ledger.

Putting this challenge differently, some politicians may like to keep taxes lower. Fine, no problem, but these same politicians must then commit to keep spending lower, making the necessary cutbacks in spending. Some politicians may like a larger and more expansive government. Fine, no problem, but these politicians must then be willing to assess higher taxes. Deficits can be fixed on one side of the budget or the other, but from a long-term economic management point of view, they should be fixed.

The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders.

Other Publications by the Authors

- Edward Gramlich