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The Parties' Flip-Flops on Deficit Spending: Economics or Politics?

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Summary

Not long ago, Republicans were trying to pass a balanced budget amendment to the constitution. Democrats were skeptical, overwhelmingly Keynesian, and believed that deficit spending had ended the Great Depression. Under Rubinomics the positions began to switch: Democrats became the defenders of fiscal orthodoxy. Now Bush has cut taxes for the rich and caused huge deficits. Is the flip-flop just politics?

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Not long ago, Republicans were trying to pass a balanced budget amendment to the Constitution. Their worry was that large deficits would hamper growth and prosperity.

At the same time, Alan Greenspan, Chairman of the Federal Reserve, preached deficit reduction too. He saw it as the solution not only to the country's economic downturn, but also to its more long-term economic problems.

Meanwhile, Democrats were skeptical. They believed that deficit spending had brought the country out of the Great Depression, and Democratic economists were overwhelming Keynesians. As such, they feared that raising taxes and lowering government expenditures to try to balance the budget in the face of an economic downturn would have disastrous effects.

Then, in the Clinton years, the parties appeared to switch positions. The Democrats' Rubinomics attempted to rebuts claims of fiscal irresponsibility with the pre-Keynesian Wall Street mantra of balanced budgets. The New Democrats became the defenders of fiscal orthodoxy.

And Rubinomics seemed to many to be working: When the economy recovered and experienced what were its perhaps most fabulous decade, the deficit reduction got at least part of the credit.

When Bush put forward his agenda of tax cuts for the rich, and when those tax cuts led to massive deficits, Republicans and their economic advisers *now* claimed that deficits did not matter. (And in supporting the first tax cut, Greenspan seemed less worried about deficits than about the potential surpluses that would mount if taxes were not cut.)

What explains the parties' flip-flop? The cynical answer is that they are opportunistic. The real motivating force behind economic policy, on this view, is political — not economic. The hired guns bend with the wind, attacking and defending deficits according to whether they serve political ends.

Such cynicism is understandable. But it is also wrong.

When Economists Agree Deficit Spending Works: To Correct Lack of Demand

Indeed, this cynicism ignores a half-century of economic science — one result of which has been that there is an overwhelming consensus among economists about a few basic propositions. And one area of such consensus involves the key circumstances when deficits matter, and when they do not.

Suppose the economy is operating below its potential — say, because of a lack of aggregate demand. In that case, an increase in aggregate demand can help the economy. And deficits normally increase demand. That's because the government is spending more money, or because low taxes encourage increased consumer spending — or both.

Keynes made this point clear a long time ago — and he is still correct. No wonder, then, that the IMF's imposition of fiscal stringency in East Asia and Latin America — when those countries already faced a downturn — was a disaster. The IMF policy had the predictable consequence of making the economic downturns worse, turning downturns into recessions, and recessions into depressions. The right prescription for the affected countries was not balancing the budget, but running a temporary deficit to stimulate the economy — as Keynes knew.

When Economists Agree Deficit Spending Hurts: Demand Is Already Sufficient

Now suppose, however, that demand *is* sufficient to maintain the economy at full employment. In those circumstances, deficit spending *may* have adverse effects.

In the long run, the growth of the economy is limited by its potential — the supply of labor and capital and the advances in technology, what are broadly called "supply side factors." Deficits can hurt because they mean that government expenditures may crowd out private investment. What happens to growth then will depend on how government spends its money. If the money is wasted — or even if it were efficiently spent on, say, military expenditures in Iraq — then growth will be hindered; if the money is spent on high return public investments, such as in education or research, then growth will be enhanced.

Of course, globalization means that America can borrow what it needs from abroad to finance government deficits. Presumably, then, government borrowing need not crowd out private investment. But deficits still make the country poorer, in the long run, than it would otherwise have been. For more of what the country produces will have to be sent abroad, to repay principal and interest on what is borrowed.
Even if the country's GDP — what we produce — is not lowered, our standard of living will be compromised.

Why the 1993 Recovery Doesn't Disprove These Basic Points

But does America's recovery of 1993 disprove these views about deficit spending? Not at all.

The official argument was that deficit reduction allowed lower interest rates; lower interest rates led to more investment; and the increased investment spurred the recovery. But that is unconvincing — largely because it implies a false connection between deficit reduction and lower interest rates.

As the last few years have shown, Greenspan had considerable room to lower interest rates *with or without deficit reduction*. So while lower interest rates may have spurred the recovery, deficit reduction did not. (Indeed, to the contrary, it may have been the case that the economy was already on an upturn, and deficit reduction only slowed the recovery down.)

Attempts to link deficit reduction to the ability to lower interest rates are unconvincing. Some may suggest that without deficit reduction, it would have been impossible to lower long term interest rates even if the Fed had lowered short term interest rates, and impossible to let interest rates remain low. But presumably, the Fed could have intervened more directly, by buying up long term government bonds, rather than just buying Treasury bills, as it customarily does.

Of Course, Not All Deficit Spending is Effective — And Bush's is One Example

Of course, some forms of deficit spending are more effective than others. As we noted, the effect of deficits on growth depends on what gives rise to the deficits. Put another way, when borrowing creates deficits, the question is: Where is the borrowed money going?

Under President Bush, it's gone to a 2001 tax cut for the rich, and increased military expenditure. But that stimulates the economy much less than other options *both in the short run, when there is an insufficiency of aggregate demand, and in the long, when there is not.*

The proof is in the pudding: Bush's huge tax cut for the rich, in fact, had little effect. (Interestingly, the converse is also true: The Clinton experience showed that raising taxes on the rich does not have the adverse effects that the critics claimed.)

And, really, why should anyone have ever expected the Bush tax cuts to stimulate the economy? Is it realistic that a CEO whose take-home pay is reduced from $50 million to $45 million will work fewer hours, putting at risk his company's well being? Will he appeal for compassion from his Board of Directors as he explains that he could have averted the downturn in the firm's fortune, had he only worked a little longer, but that loss of $5 million changed his mind?

And while he may spend some of the extra $5 million dollars on enhancing his collection if Picasso paintings or European vacations, the fraction of his income that he will spend on goods produced in America is likely to be limited.

That's why tax cuts which increase CEO take-home pay won't have much of an effect. But tax cuts for the poor, conversely, easily could. Now imagine the worker who takes home $50,000, not $45,000, due to a tax cut. The poor — and middle-class — spend more, and save less, than the rich. That means tax cuts for them stimulate the economy more.

And tax cuts for the poor were not the only option Bush ignored. Had his deficit meant increased spending on education, or research, the effect might have been very different.

What happens in the long run, when there is presumably no insufficiency of aggregate demand, if the deficit arises as a result of tax cuts for the rich? Won't they recycle those dollars into investments, and won't that mean that "fears" of deficits crowding out private investment are exaggerated? Not generally. What has held back investment during the past three years is not lack of funds—indeed interest rates have been at an all time low. And even if those getting the tax breaks were to decide to spend more on investment, in our globalized world, there is no reason for them to limit their investments to

America. Investors will look where returns are highest—and in the judgment of many investors, this appears to be in China and elsewhere in the developing world.

The real long term worry with our long run deficit that has been generated by tax cuts for the rich is that the deficit will also crowd out public investment, such as in education and technology.

The Key to Deficit Spending: Is it Justified Under the Circumstances?

The three basic rules of deficit financing are still true: Run a deficit when there is insufficient demand; try to get the biggest bang for the buck — the most stimulation for the economy for each dollar of deficit spending; and try to spend the money in ways which enhance long term growth and address the country's basic social needs.

Currently, in the U.S. economy, demand is still insufficient, so deficit spending may be warranted. But not *Bush's* kind of deficit spending. The kind of deficit spending associated with Bush's tax cuts does not increase the country's long term economic strength. Rather, it saps it. But other, more constructive forms of deficit spending can be a boon, rather than a burden, to the economy.

All this analysis leads to one easy choice, and one hard one. Here's the easy choice: Repeal the tax cut for the rich. It isn't helping the economy — either in theory or in practice.

Here's the hard choice, though: When the tax cut is repealed, what should be done with the extra money?

Unless that money is spent in well-chosen ways, the economy may not thrive. There are a number of options, and which to put into the mix is a difficult question.

Certainly, some of the money should be spent on R&D and education, and some should go to tax cuts for the poor — who have fared so badly during the past few years. The result would be to stimulate the economy, and lay the foundations for long term growth.

Some money should also probably go toward reducing the deficit. But until demand has rebounded, it would almost surely be a mistake to eliminate it.

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