The Government Budget and the Public Debt

• Introduction: The Debate over the U.S. Budget Deficit
  – The long-run aspects of fiscal policy
    • Monetary policy should be used in stabilizing GDP at the desired level of output
      – Short-run stabilization focus
    • Fiscal policy is responsible for the level of real interest rates
      – Long-run economic growth focus
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• Long-Run effects of Fiscal Policy on Economic Growth and Welfare
  – Introduction
    • The key link between fiscal policy and long-run growth comes through the effect of a persistent budget deficit in reducing the national saving rate
    • A key aspect of this is society’s rate of time preference

• Long-Run effects of Fiscal Policy on Economic Growth and Welfare (continued)
  – Raise Saving or Do Nothing?
    » Figure 11 - 1
    • Deciding on current versus future consumption
    • An economy saves too little if the rate at which individuals discount future consumption is less than the rate of return on private investment
    • Real rate of return approximately 12%
      – Real interest rate approximately 4%
    » Implications for stock and bond markets
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- Long-Run effects of Fiscal Policy on Economic Growth and Welfare (continued)
  - National Saving, Economic Growth, and the Government Budget Deficit
    - National saving is the sum of private and government (dis)saving
      - Private saving is relatively stable
      - Government (dis)saving is highly volatile
    - Government deficits reduce national saving
      - Which reduces investment and economic growth
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• Long-Run effects of Fiscal Policy (con’t)
  – National Saving, Economic Growth, and the Government Budget Deficit (continued)
    • How the deficit is reduced is just as important as whether it is reduced
      – In reducing deficits, policy-makers must be careful not to also reduce private saving
        » Consumption taxes not income taxes
      – In reducing deficits, policy-makers must be careful not to also reduce investment
        » Public vs. private investment

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• The Future Burden of the Government Debt
  – Introduction
    • Any burden of extra government debt depends on whether it is financing government expenditures on investment goods or for consumption goods
    • How do we classify defense expenditures
    • Government investment projects should be financed by deficit spending
      – Those who receive some the future benefits will help pay some of the costs
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• The Future Burden of the Government Debt
  – True Burden of the Debt
    • The true burden on future generations is created by government deficit spending that pays for goods that either
      – yield no future benefits, or
      – yield benefits less than their social opportunity costs

• Debt Owed to Foreigners
  – International financing of domestic debt does not change the burden analysis
    » Although short-term stimulus to the economy is less

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• Will the Government Remain Solvent?
  – Introduction
    • The key is whether the debt-to-GDP ratio is stable
      – \( \frac{D}{P \times Y} \)
      – How large can the deficit be to keep this ratio constant?
    • The growth of the debt-to-GDP ratio must be 0
      \[ d - (p + y) = 0 \]
      or
      \[ d = p + y \]
      or
      \[ d \times D = (p + y) \times D \]
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• Will the Government Remain Solvent?
  – Introduction (continued)
    • The Debt-to-GDP ratio remains constant if the deficit is equal to the outstanding debt time the growth rate of nominal GDP
      – Defines the “allowable deficit”
    • Is there an optimum debt-GDP ratio?

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• Will the Government Remain Solvent?
  – The Solvency Condition
    • Can the government finance its interest bill by increasing its deficit?
      – The government can meet its interest bill through debt financing without increasing the debt-GDP ratio only if the economy’s real growth rate equals or exceeds its real interest rate

  – The Real-World Solvency Condition in the 1990s
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• CASE STUDY: Historical Behavior of the Debt-GDP Ratio Since 1790
  » Figure 11 - 2
  – Wars and Depressions
  – The New Regime of the 1980s and 1990s
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• Sources of the Deficit and the Debate over the Size of Government
  – Do Official Deficit Measures Exaggerate the Problem?
    • The real burden is less than the nominal burden
    • One time deficit financing events
    • Combined with state and local government budgets
    • Current versus capital budget

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• Sources of the Deficit and the Debate over the Size of Government (continued)
  – Behavior of Revenue and Expenditure Ratios
    » Figure 11 - 3

  – Categories of Spending
    » Figure 11-4
Figure 11-3
Federal Government Revenues and Expenditures as a Percent of GDP, 1960–96

EXPENDITURES CREPT UP BUT REVENUES DIDN’T KEEP PACE

Figure 11-4
Components of Federal Government Expenditures as a Percent of Natural GDP, 1959–96

THE COMPONENTS OF FEDERAL GOVERNMENT EXPENDITURES AS A PERCENT OF GDP, 1960-96
The Government Budget & Public Debt

• Alternative Views of Fiscal Policy: Supply-Side Economics
  – Supply-Side Arguments for Reagan Tax Cuts
    • Introduction
      – Tax rates are too high
      – Government sector is too large
    • Three important claims
      – Income taxes reduce incentives to work and save
      – Increasing the after-tax rewards to work and save will create significant increase in work and saving
      – Significant increase in work and saving will reduce the budget deficit

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• Alternative Views of Fiscal Policy: Supply-Side Economics (continued)
  – Supply-Side Arguments for Reagan Tax Cuts
    • Response of Work Effort and Saving
    • Response of Productivity Growth
    • The Laffer Curve
      » Figure 11 - 5
      » Shape and peak is completely arbitrary
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- Alternative Views of fiscal Policy: The Barro-Ricardo Equivalence Theorem
  - Introduction
    - Assumes rational expectations
    - Discretionary fiscal policy is completely ineffective because tax cuts will be offset by higher savings rather than increased consumption
    - Higher future taxes are seen as completely equivalent to lower current taxes
      » This is why it is called the equivalence theorem
    - Inter-generational transfers
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• Alternative Views of fiscal Policy: The Barro-Ricardo Equivalence Theorem
  – Criticism of the Equivalence Proposition
    • Decision horizons
    • Discount rates
  – Evidence from the 1981 Tax Cuts

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• Pros and Cons of a Balanced Budget Amendment
  – The Case for Budgetary Balance
    • Basic economic argument: boost economic growth
      – However, only about 20% of the reduction in the deficit will result in increase private investment
        » Some decline in private savings
        » Some decline in foreign investment
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• Pros and Cons of a Balanced Budget Amendment (continued)
  – The Case for Budgetary Balance (continued)
    – Channel for boost economic growth
      » Lower interest rates (although small)
      » No effect on inflation; monetary policy stabilizes GDP
      » Economic growth accelerates (but not by much)
    – Cost to deficit reduction
      » Reduced government spending and/or
      » Higher taxes

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• Pros and Cons of a Balanced Budget Amendment (continued)
  – The Case for and Against an Amendment
    • The Case for an Amendment
      – The political process is incapable of delivering a balanced budget
    • The Case against an Amendment
      – Eliminate automatic stabilization
      – Benefits are minimal
      – Likely boost government consumption at the expense of government investment
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• Conclusion: The Debate between the Termites and Pussycats
  – Termites believe the deficit is insidious
    • Higher interest rates
    • Less investment
    • Slower productivity growth
  – Pussycats believe the deficit is benign
    • Government spending is beneficial
    • Debt-to-GDP ratio can be stabilized
    • Provides restraint on government spending