COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET Fiscal Roadmap Project

Good Deficit / Bad Deficit
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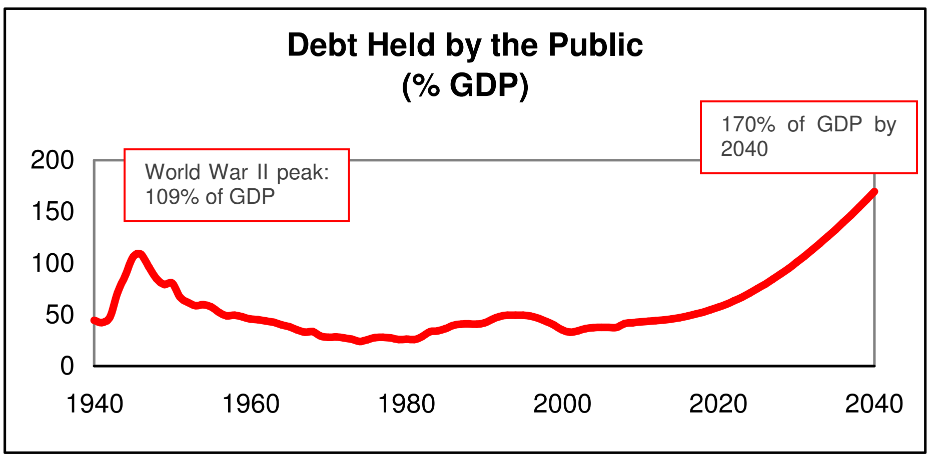
The United States is on an unsustainable long-term debt path. Debt held by the public will likely amount to more than 50 percent of GDP this year, the highest rate in more than 50 years. The debt burden is then projected to head into uncharted territory, with the debt burden projected to reach 170 percent of GDP by 2040 — over one and a half times the World War II peak of 109 percent.[1] Such increases in debt create an enormous burden on future generations and will ultimately lead to a lower standard of living.

Fig. 1: Our Future Government Debt Burden Is Unsustainable



Source: 2008 Financial Report of the United States Government.

Nonetheless, many experts support the use of heavy borrowing to help manage the current economic and financial crisis. Trillions of dollars have already been authorized for increased spending and lower taxes, for the Troubled Asset Relief Program (TARP), and for other activities to help bolster the economy and the financial system.[2] In all likelihood, even more money will be spent before the economy and financial sector recover.

Determining when deficit financing is appropriate is a key component in developing a responsible fiscal policy. This paper examines why a large temporary increase in the deficit is necessary now, but running large, permanent deficits will be dangerous in the medium to longer run as the economy recovers.

"Good Deficit": Why an Increase in the Fiscal Deficit Is Necessary Now

The Need to Address the Economic and Financial Crisis. The economic and financial challenges facing the United States are severe.

- Now in its sixteenth month, the U.S. recession has already lasted longer than the average postwar recession (ten months) and has tied the postwar record of 16 months.[3] Many economists expect the downturn to be the longest since the Great Depression.[4]

- More jobs have been lost than at the worst point in nearly all other postwar recessions, including the tough 1981–82 and 1973–75 recessions.[5] According to the Congressional Budget Office (CBO) and the March edition of the Blue Chip Economic Indicators, this is expected to be the most severe recession since World War II, and the risks are seen to be on the down side.[6]

- As with the Great Depression, at the heart of the crisis are negative feedback loops between a collapsing financial sector and depressed economic activity, set in motion by a sharp decline in asset prices. We have already seen a vicious cycle at work, as the spillover of financial sector problems into economic activity lowered employment, which in turn reduced income, leading to increased foreclosures, resulting in lower-valued mortgage-based assets spread throughout the global system, which led banks to reduce credit, and so on, thus perpetuating the cycle.

- Economic recessions driven by systemic financial crises are deeper and more protracted than "typical" recessions.[7] Recoveries from such crises are also usually

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[1] *2008 Financial Report of the United States Government*, which does not reflect the impact from the February 2009 stimulus package, p.2, http://fms.treas.gov/fr/index.html.
[2] See Stimulus Watch at www.USBudgetWatch.org/stimulus.
[3] The U.S. recession officially began in December 2007, according to the Business Cycle Dating Committee of the National Bureau of Economic Research, the official arbiter of U.S. business cycle dates. The two other longest postwar recessions to date (1973–75 and 1981–82) each lasted 16 months. See http://www.nber.org.
[4] If it persists through May, the recession will break the postwar record. Many forecasters are expecting that the downturn will continue through mid-2009. See Blue Chip Economic Indicators, "The Longest, Deepest Recession Since World War II," March 10, 2009 issue, p.1.
[5] Measured as a percentage of total nonfarm employment from the start of the recession. See Federal Reserve Bank of Minneapolis, *The Recession in Perspective*, at http://www.minneapolisfed.org.
[6] See Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook*, (Washington, DC: CBO, March 2009), p. 19; and Blue Chip Economic Indicators, "The Longest, Deepest Recession Since World War II," March 10, 2009 issue, p.1.
[7] See, for example, Stijn Claessens et al., *What Happens During Recessions, Crunches and Busts?* IMF Working Paper, WP/08/274, (Washington, DC: International Monetary Fund, December 1, 2008), at http://www.imf.org/external/pubs/ft/wp/2008/wp08274.pdf; Carmen M. Reinhart and Kenneth S. Rogoff, *The Aftermath of Financial Crises*, NBER Paper No. 14656 (National Bureau of Economic Research, January 2009), at http://www.nber.org/papers/w14656.

weaker than "normal" recoveries since normal economic adjustments cannot take place when markets are not functioning well. The absence of normal credit channels means that the financial sector cannot perform its basic activity of linking saving and spending; monetary policy does not have its usual stimulative effect on the economy; and creditworthy citizens and businesses cannot get funding for productive economic activity.

- There is also a global dimension to the situation. A majority of the world's economies are in recession. According to World Bank President Robert Zoellick, global output is likely to shrink by 1–2 percent this year.[8] This makes a trade-based recovery for the United States more difficult.

The Turn to Countercyclical Fiscal, Financial Sector, and Monetary Policies to Tackle the Crisis. To address the severity of the crisis, unprecedented countercyclical policies in the fiscal, financial, and monetary areas have been undertaken. Special initiatives to target the troubled housing sector and mortgage market have also been adopted. These actions involve the deployment of substantial resources to stimulate the economy and repair the financial system. Many — but not all — of the activities will increase the fiscal deficit over the next few years, thereby adding to the federal debt.

Fiscal Policy. Policymakers have increasingly turned to massive borrowing through active countercyclical fiscal policy as the economic situation deteriorated, conventional monetary policy tools became exhausted, and stimulus provided by automatic stabilizers[9] was not considered sufficient. Since early 2008, a series of fiscal stimulus bills have been adopted to address the deteriorating economic situation. The Economic Stabilization Act of 2008 (ESA), passed in February 2008, was intended to boost consumer spending through a direct tax rebate. The Housing and Economic Recovery Act of 2008 provided a housing tax credit to stimulate the housing market. In February 2009, as the crisis accelerated, Congress passed the American Recovery and Reinvestment Act (ARRA), the "largest peacetime economic expansion program" in U.S. history.[10]

Particularly with respect to the ESA and ARRA, the economic rationale for the stimulus packages was to offset the enormous decline in the economy's aggregate demand driven

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[8] Robert Zoellick, President, World Bank, "World Bank Says Global Economy to Shrink 1–2 %," interview, *Daily Mail*, quoted in "Headlines for March 12, 2009," http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/.

[9] Automatic stabilizers have accounted for part of the short-run deterioration in the fiscal deficit. In January, CBO estimated that automatic stabilizers would account for $250 billion (1.8 percent of GDP) of the expected change in the deficit between 2008 and 2009. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009–2019* (Washington, DC: CBO, January 2009), p.4.

[10] Lawrence Summers, "Responding to an Historic Economic Crisis: The Obama Program," remarks at The Brookings Institution, Washington, DC, March 13, 2009. p.5.

by massive wealth losses from lower asset prices (mainly for stocks and housing). In order to counteract the large loss in demand, many policymakers and economists agreed that it was appropriate to stimulate economic activity by increasing government spending and lowering taxes. With a boost in demand through temporary deficit financing, economic activity was expected to recover sooner rather than later, thereby limiting employment and output losses.

How much deficit spending by the government is appropriate to address our crisis? In the context of a fiscal stimulus package, economists start by determining the amount of increased demand required to fill the output gap, which is the difference between expected growth and potential growth (the output that would be produced under full employment). Steps taken to minimize output and employment losses for the economy are considered particularly important when the output gap is estimated to be large.

The CBO projected that in the absence of fiscal stimulus from ARRA, output would have been, respectively, 7.4 percent and 6.3 percent below potential in 2009 and 2010.[11] According to CBO Director Douglas Elmendorf, this would have been the largest shortfall in the country's output relative to its potential in terms of both length and depth since the Great Depression.[12]

The second step is to determine the size and composition of stimulus measures required to achieve the desired increase in demand. The larger the multipliers of specific initiatives, the more powerful the impact on demand will be for any given level of expenditure or tax reduction. However, there is a wide range of views among economists on the estimates of specific fiscal multipliers.[13]

While attempting to determine the amount needed to close a given output gap, responsible budgeters must also pay close attention to trade-offs between size and longer-run costs from higher debt service costs, and between size and efficiency. (The

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[11] Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (Washington, DC: CBO, March 2009), p.30.

[12] Douglas Elmendorf, Director, CBO, "The State of the Economy and Issues in Developing an Effective Policy Response," testimony before the Committee on the Budget, U.S. House of Representatives, January 27, 2009, p.1.

[13] In contrast to the larger multipliers used by CBO and the Administration, "rational expectations" economists expect that multipliers will be closer to zero, based on the view that people will lower their spending in the short run because they understand that larger deficits now will mean higher debt and taxes later. Monetarist economists also estimate very low multipliers based on their view that economic activity responds to other factors. For additional background, see CBO, "Estimated Macroeconomic Impacts of the American Recovery and Reinvestment Act of 2009," letter to the Honorable Charles E. Grassley, March 2, 2009; CBO, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook*, March 2009, pp. 21, 29; and Christina Romer and Jared Bernstein, "The Job Impact of the American Recovery and Reinvestment Act," paper, January 9, 2009, at http://otrans.3cdn.net/45593e8ecbd339d074_l3m6bt1te.pdf.

government can spend only so much money quickly and effectively.) Proper management of substantial new spending will also be an enormous challenge. Budgeters must also be concerned that long-term interest rates may rise if a temporary increase in deficit financing is perceived by investors to be a permanent large increase in the debt. From this perspective, it is very important that stimulus measures not become permanent unless the government is able to finance the additional debt.

Worries that increased government borrowing will crowd out productive private investment in the short run are not considered applicable now, because interest rates are so low, the credit markets are "dysfunctional,"[14] and private investment demand is very weak. However, this situation is expected to change dramatically when the economy begins to recover and head toward full employment.

As Figure 2 illustrates, ARRA is expected by the CBO to increase the fiscal deficit by $787 billion over 10 years, with the largest impact on the deficit in 2009–11 ($718 billion). Seventy-four percent of the total is estimated to be spent in the first year and a half. With large but temporary increases in the fiscal deficit as a result of the stimulus package, the output gap is estimated to be smaller: GDP is projected to be between 3.9 percent below potential (high effect case) or 6.1 percent below potential (low effect case), with either case representing an improvement from the baseline (7.4 percent below potential).[15]

Fig. 2: ARRA's Impact on the Fiscal Deficit and the Output Gap (Fiscal Year)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2009–2019
Fiscal Deficit Change[a)] (billions)	$185	$399	$134	$36	$28	$22	$5	-$7	-$8	-$6	-$4	$787
Output Gap Baseline	-7.4%	-6.3%	-4.1%	-2.2%	-0.7%	-0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	-
- Low Effect	-6.1%	-5.3%	-3.7%	-2.0%	-0.6%	-0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	-
- High Effect	-3.9%	-3.2%	-2.9%	-1.7%	-0.5%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%	-

Source: Congressional Budget Office.
[a]Increase or decrease (-) in the fiscal deficit.

Whether the borrowing under ARRA reflects responsible fiscal policy critically depends on the extent to which a temporary increase in the fiscal deficit now is seen to be worth the cost of future debt in the long run. So far, the risks of not acting quickly and aggressively enough to limit the severity of the recession and/or to prevent a

[14] Martin Feldstein, *Rethinking the Role of Fiscal Policy*, NBER Working Paper 14684, January 2009), p. 6, at http://www.nber.org/papers/w14684.
[15] Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook,* March 2009, p. 30.

deflationary spiral have been seen by many as greater than the risks of higher debt in the future. However, responsible fiscal policy also means that the run-up in debt now to address the recession should be paid for once the economy has recovered.

Financial Sector Stabilization Policy. It is widely recognized that economic stimulus will not be effective unless steps are taken at the same time to fix the financial sector. Until credit channels start to function more normally again, a boost in aggregate demand will not be sufficiently powerful to jump-start the economy. Addressing problems in the mortgage market is also considered to be critical.

On this basis, the Treasury Department, the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) have taken numerous aggressive actions to rescue the financial sector. Financial sector stabilization measures have required more borrowing to date than the conventional fiscal stimulus measures. The largest single initiative so far has been the Treasury Department's TARP.[16] Of the $700 billion authorized for the purchase or insuring of troubled assets under TARP, the Administration estimates that outlays this fiscal year will be $247 billion on a risk-adjusted net present value basis. It includes a placeholder in its FY 2010 budget blueprint for $250 billion in additional spending to "support financial stabilization" that may occur this year.[17] (This placeholder will not be in the budget resolution however.) Other financial market initiatives have involved guarantees, which are not reflected in the fiscal deficit estimates so far. However, as CBO Director Elmendorf stated, "[t]he ultimate costs of the actions taken in response to the turmoil in financial markets are uncertain, but they could be quite large."[18]

Monetary Policy. During most other postwar recessions, monetary policy was the main countercyclical tool used to stimulate economic activity. However, the effectiveness of conventional monetary policy in the current recession has been limited. The Federal Reserve has aggressively reduced interest rates since September 2007,[19] but this has had little impact on interest-sensitive sectors (most notably, housing, autos, and capital goods) because normal credit channels are blocked and structural problems (especially for housing) cannot be solved by lower interest rates. With interest rates now close to zero, conventional monetary policy has very little effect. As a result, the Federal Reserve has increasingly turned to nontraditional monetary policy initiatives by expanding its own balance sheet to provide considerable liquidity and credit for the economy. It

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[16] The Emergency Economic Stabilization Act of 2008 (P.L.110-343), adopted October 2008.

[17] Office of Management and Budget, *"A New Era of Responsibility,* "FY 2010 Budget Blueprint," table S-2 (Washington, DC: OMB, February 2009), p.115.

[18] Douglas Elmendorf, Director, CBO, "Addressing the Ongoing Crisis in the Housing and Financial Markets," testimony before the Committee on the Budget, United States Senate, p.21.

[19] The Federal Reserve reduced its federal funds target rate from 5.25 percent in September 2007 to 0 – 0.25 percent as of December 2008.

recently announced its decision to buy long-term Treasury securities in an unusual move known as "quantitative easing."

The Federal Reserve's actions have not had a direct fiscal impact on the federal budget so far, even though the Fed is providing considerable stimulus for the economy and financial system. Its actions are only reflected in the federal budget through the remittances it provides to the Treasury Department. The Fed typically remits between $20 billion and $30 billion annually to the Treasury Department, based on earnings from its wide range of activities (such as securities and foreign exchange market operations and fees paid for check clearing services).[20] If the Fed's balance sheet losses from the considerable risks it has assumed in the crisis prove to be larger than anticipated, its remittances to the Treasury Department could be lower.

"Bad Deficit": Why Fiscal Deficits Are Bad Later

In contrast to the special economic and financial crisis we currently face, large fiscal deficits are negative – not positive - factors for economic activity in the longer run. If the large deficits taken on to tackle the current economic and financial crisis are not reversed once the economy recovers, they will make an already challenging debt situation even more difficult, leading potentially to a fiscal crisis following upon the economic and financial crisis we are in today.

The Medium-run Outlook Points to Fiscal Problems Ahead. According to both the Obama administration and the Congressional Budget Office, the baseline fiscal deficit is expected to be over $1 trillion for the next few years, improve slightly and then increase again to over $1 trillion by 2019 (the administration). As a percentage of GDP, the baseline deficit is expected to rise to a postwar high this year (11.9 percent, according to the CBO; 10.6 percent, according to the administration), to be sustained at a high rate for the next few years, improve modestly, and then start to rise again in 10 years. The Congressional Budget Office expects that the debt held by the public as a percentage of GDP will be as high as 62 percent in 2011 and will remain above 50 percent over the next 10 years. Outlays for net interest are projected by CBO to rise steadily as a percentage of GDP over the next 10 years, from 1.2 percent of GDP this year to 2.7 percent in 2019. Given the enormous volume of borrowing expected during those years, CBO's long-run interest rate projections (5.6 percent for 2017–19) may be too optimistic and, therefore, its estimates of net interest costs may be too low.

Sustained budget deficits harm the economy in a number of ways:

• Crowding out effects: an ultimately lower standard of living. As the economy recovers

[20] Douglas Elmendorf, Director, CBO, "Addressing the Ongoing Crisis in the Housing and Financial Markets," testimony before the Committee on the Budget, United States Senate, January 28, 2009, p.22.

and heads toward full employment of labor and productive capacity, private investment will be "crowded out" by substantially higher government debt. As competition for economic and financial resources increases, interest rates will rise and start to choke off investment and growth. Without sufficient investment, productivity growth will slow and the country's standard of living will ultimately be lower.

- Limited room for new spending and tax priorities: debt service and entitlement spending increasingly take over the budget. Interest payments to service public debt are projected to become a large share of spending. As a result, limited discretionary resources will make it increasingly difficult to fund other priorities, such as replacing outdated infrastructure or increasing environmentally friendly investments. Discretionary spending will also be limited by the increasing proportion of budgetary resources taken by Medicare, Social Security, and Medicaid, which are projected to increase from the current 44 percent of non-interest spending to 65 percent over the next 20 years.[21]
- Our reliance on global savings. We also have a financing gap problem. Because the U.S. has relatively low domestic savings, we must rely heavily on global savings for the financing of our debt. As we increase our debt, unless we raise our domestic savings, we will have to increase our reliance on foreign savings to fund our "financing gap." The risk is that our creditors could decide to reduce their holdings of U.S. debt instruments due to a shift in portfolio preferences, the perception of greater financial risk, or even political concerns. Capital outflow from the United States can occur gradually or rapidly, with the risk that adjustment takes place in a disorderly fashion. A negative economic impact will probably result either way, as interest rates will adjust to a lower supply of capital. Experts do not know with any certainty whether or how the situation will develop, but many are very concerned that the risks of dramatic, rather than gradual, change are heightened by the imbalance between savings and investment.[22]

Our Unsustainable Future Debt Situation. In the longer run (or perhaps even the medium run), our future debt situation is unsustainable. With public debt levels rising sharply as we attempt to meet our budgetary commitments, we will need to devote an increasing, and ultimately unrealistic, amount of resources to service the debt. Eventually it will become impossible to do so.

Creditors will increasingly perceive that the United States is unwilling or unable to service its enormous debt, and anticipate higher U.S. inflation or outright default. To compensate for greater expected risk, they will demand high interest rates. At some

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[21] *FY 2008 Financial Report of the U.S. Government, Management Discussion and Analysis*, p.9.

[22] See, for example, Robert Rubin, Peter Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," paper presented at AEA-NAEFA Joint Session, Allied Social Sciences Association Annual Meetings, San Diego, Ca., January 5, 2004, at http://www.brookings.edu/views/papers/orszag/20040105.pdf.

point, it is expected that creditors will decide that the risk is not worth the return. Shifts out of U.S. financial instruments could well be large and dramatic, resulting in a global financial crisis.

If the United States tries to inflate its way out of repaying its debt, an increase in inflation would lead to a rise in interest rates. Because such a large proportion of our debt (over a third) must be financed every year, higher interest costs would tend to offset attempts at reducing debt service in "real" (inflation-adjusted) terms. Moreover, if we try to inflate, experience shows that we would not be able to sell our long-term debt, which is particularly sensitive to inflationary expectations.

Intergenerational Fairness. Unless we reduce our debt so that it can be financed on a sustainable basis, we will pass on an enormous burden to the next generation. Our children will have to pay higher taxes and will receive fewer public goods and services in order to close the fiscal gap they inherit.

Recommendations

In order to stabilize the economy, substantial borrowing is appropriate to finance economic stimulus and the rescuing of the financial sector. We are in the midst of an economic and financial downturn that many think is the most severe since the Great Depression of the 1930s. Running large deficits now to stimulate aggregate demand will contribute to economic and financial recovery in order to minimize employment and output losses. However, fiscal stimulus measures should not be permanent. Long-term interest rates may rise if a temporary increase in deficit financing is perceived by investors as a permanent large increase in the public debt. Fiscal stimulus measures should also reflect trade-offs between size and longer-run costs from higher debt service, and between size and efficiency. Proper management of any additional spending is critical, as well.

The debt being run up now should be repaid when the economy is on stronger footing.[23] While critical now, massive borrowing will add to future debt and make an already difficult situation worse. When the economy has recovered, it is important that we have a credible mechanism or set of policies to ensure that the country pays back the massive debt accumulated during the recession. It is not too soon for policymakers to start the serious policy discussion on what should and can be done to unwind the huge amount of debt we are accumulating now. They should take steps very soon to put a medium-term strategy in place.

[23] See Maya MacGuineas and Marc Goldwein, *Paying for the Stimulus*, Issue Brief (Washington, DC: New America Foundation, February 6, 2009), http://www.newamerica.net/publications/policy/paying_stimulus.

It is critical that we address our long-term entitlement challenges sooner rather than later. Even though we are devoting resources and political energy to tackling the current economic and financial crisis, we must start to confront our longer run fiscal challenges. With the aging of the population, the Medicare, Medicaid, and Social Security programs are expected to be unsustainable without a change in policies. The first wave of baby boom retirees is upon us, and greater pressure on entitlement resources can be expected in the next decade as a result. Making changes sooner rather than later is preferable than waiting for a crisis in the future. Policymakers must start the serious work of tackling these policies now.