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Is It Sometimes Good to Run Budget Deficits? If So, Should We Admit It (Out Loud)?

Neil H. Buchanan

George Washington University Law School, neilhbuchanan@gmail.com

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IS IT SOMETIMES GOOD TO RUN BUDGET DEFICITS? IF SO, SHOULD WE ADMIT IT (OUT LOUD)?

*Neil H. Buchanan**

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* Associate Professor of Law, The George Washington University Law School; Visiting Professor of Law, New York University School of Law. J.D., University of Michigan; Ph.D. (economics), Harvard University. I would like to thank Sarah Lawsky for very helpful suggestions on a late draft of this article, Ketan Pastakia for his continued willingness to provide feedback on ideas and drafts of this and other articles, and Samuel Roe for excellent research assistance.

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I. INTRODUCTION

There are bad deficits and there are good deficits. What makes a fiscal deficit good or bad depends on both the context in which the deficit is run and the reason that the deficit is rising.¹ The belief that it is unquestionably foolish to adopt policies that directly or indirectly increase the government's annual borrowing on the financial markets — which is what it means to run a budget deficit² — is not the universal truth that the current conventional wisdom might imply. Budget deficits are potentially dangerous and must be monitored carefully, but they are not always, inevitably, completely, and irreversibly horrific. Far from it. For example, just as families can sensibly take out mortgages to buy homes and float student loans to finance higher education, so too can governments borrow money to finance investments that will produce greater returns to society than their costs.

Knowing that deficits are not evil incarnate raises some difficult questions, however, most notably whether it is dangerous for policy makers or economists to admit publicly that deficits might sometimes be the result of wise policy choices. While there is always a danger that such knowledge can be distorted and misused, I argue in this article that we have a responsibility to adjust our public discussion of budget deficits to admit that there are good deficits as well as bad. Enhancing the discourse requires us to remind ourselves what it is about budget deficits that can make them harmful, both in the long term and the short term, as a necessary step in understanding when deficits can be beneficial. Only then can we have a full and honest discussion of our taxing and spending policies.

A. Our Political Fixation on the Government's Budget Deficit

To say that American politicians and policymakers are interested in — one might even say frequently preoccupied with — budget deficits is to state the painfully obvious. For decades, political debate

¹ See *infra* Parts II.A and C for descriptions of the conditions under which it is arguably wise to run a fiscal deficit.

² See Neil H. Buchanan, *Social Security, Generational Justice, and Long-Term Deficits*, 58 TAX L. REV. 275, 289 (2005) [hereinafter Buchanan, *Long-Term Deficits*].

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has prominently included concerns about the level of the federal government's annual budget deficit.³ Prior to Bill Clinton's presidency, there was a partisan divide on the issue, with Democrats mostly showing less concern for deficits and Republicans focusing on the issue as evidence of their opponents' fiscal irresponsibility.⁴ Since the early 1990s, however, both parties have aligned in their stated beliefs that the budget deficit is a serious problem that must be solved.⁵ Each party, naturally enough, attempts to blame the other for what are thought to be high deficits;⁶ and though it is sometimes politically expedient for the party in power to downplay either the size of deficits or their importance, it is safe to say that both major political parties in the United States are now united around the idea that deficits are a scourge that must be stopped.⁷

This unity of opinion in the political arena has been largely replicated in the world of policy analysis and public opinion. Nonpartisan think-tanks and advocacy groups (such as the Center on Budget and Policy Priorities,⁸ Citizens for Tax Justice,⁹ and many others) include fiscal policy as a major part of their focus and regularly express the opinion that budget deficits are a burden on the future.¹⁰ The "National Debt Clock" in Times Square, which has been

³ Linda Feldmann, *Summit on Budget Deficit Called for by Greenspan*, CHRISTIAN SCI. MONITOR, Aug. 2, 1983, at 2 (discussing Alan Greenspan's warning that the federal budget deficit posed a long-term threat to the economy).

⁴ David Hoffman, *Reagan Takes His Tax Bill on Sales Trip to the West*, WASH. POST, Aug. 12, 1982, at A1 (describing Reagan's claim of "[forty] years of [Democrat] fiscal irresponsibility").

⁵ Kenneth N. Gilpin, *Clinton's Economic Plan Finding Respect from Corporate America*, N.Y. TIMES, Mar. 1, 1993, at A1 (describing Clinton's leadership in handling the "problem" of federal budget deficits).

⁶ Carolyn Lochhead, *Laying Blame for the Budget Deficit*, SAN FRANCISCO CHRON., July 24, 1992, at A1 (discussing President George H. W. Bush's plan to blame Democrats for budget deficit in order to deflect blame from himself).

⁷ Scott Cox, *One of the Hottest Elections, On the Campaign Trail . . .*, DAILY BUDGET BYTES, Oct. 16, 2006, available at www.gallerywatch.com (follow "Services" hyperlink) ("Doubtless, some Members [of Congress] will want to raise the issue of large budget deficits as a way of tarring their opponents or of stressing the need for fiscal responsibility."); Jim VandeHei, *Democrats Will Try a Hybrid of Old, New Policies*, WASH. POST, Feb. 15, 2004, at A01 (describing Democrats' plan to reduce the federal budget deficit faster than it would be reduced under President George W. Bush's plan).

⁸ See Center on Budget and Policy Priorities, <http://www.cbpp.org> (last visited Dec. 14, 2006).

⁹ See Citizens for Tax Justice, <http://www.ctj.org> (last visited Dec. 14, 2006).

¹⁰ JAMES HORNEY & RICHARD KOGAN, CTR. ON BUDGET & POL'Y PRIORITIES,

running since 1989,¹¹ purports to show the up-to-the-minute aggregate national debt and the share of that debt borne by individual families.¹² Some have used these figures to calculate the portion borne by each citizen.¹³ Indeed, at least one major policy organization, the Concord Coalition,¹⁴ was founded specifically in response to concerns about the deficits experienced in the 1980s. Notably, the Concord Coalition was founded by two former senators, the conservative Republican Warren Rudman and the late liberal Democrat Paul Tsongas, in part as an effort to demonstrate that deficit reduction should be a nonpartisan effort.¹⁵

Unsurprisingly, the press in general and the business press in particular have also largely reported the deficit story as being uncontroversial in terms of good and bad. Deficits are bad and deficit reduction is good.¹⁶ Certainly, the press will print stories on the politically charged nature of the budget debate at any given time; but journalists seem to accept as simple fact that deficits are always bad and must be reduced.¹⁷

In opinion columns, the rhetoric can become colorful even from nonpartisan journalists. One of the business reporters for *The New York Times* began an “Economic View” column as follows: “Never mind the movie. This was the real Mission Impossible. Could three dozen ordinary American adults . . . reach agreement on how to prevent a fiscal train wreck?”¹⁸ The column described a focus group

DON'T POP THE CORKS — CBO OUTLOOK FOR THE FEDERAL BUDGET IS STILL BLEAK (Aug. 17, 2006), <http://www.cbpp.org/8-17-06bud.htm>; see also CITIZENS FOR TAX JUSTICE, 99% OF AMERICANS ARE NET LOSERS UNDER BUSH TAX AND SPENDING POLICIES (June 29, 2006), <http://www.ctj.org/pdf/debtus.pdf> (“[F]or all but the very wealthiest United States residents, the Bush tax cuts between 2001 and 2006 are outweighed by a dramatic increase in the burden of debt on American families.”).

¹¹ See Niall Ferguson, *Reasons to Worry*, N.Y. TIMES MAG., June 11, 2006, at 46.

¹² *Id.*

¹³ See Ed Hall, *U.S. National Debt Clock*, http://www.brillig.com/debt_clock/ (showing Outstanding Public Debt of \$8,533,492,821,033.24 and concluding that “each citizen’s share of this debt is \$28,491.78”) (last visited Dec. 14, 2006).

¹⁴ See The Concord Coalition, *About Us*, <http://www.concordcoalition.org/about.html> (last visited Dec. 14, 2006).

¹⁵ *Id.*

¹⁶ *Are Bush and Congress Truly Ready to Slash Deficits?*, KIPLINGER LETTER, Mar. 4, 2005 (stating that big entitlements have to be reined in to make a serious dent in deficits).

¹⁷ See, e.g., *id.*

¹⁸ Edmund L. Andrews, *Public’s Deficit Fix May Stun Politicians*, N.Y. TIMES, July 30, 2006, § 3, at 4.

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put together by the Brookings Institution, the Heritage Foundation, and the Concord Coalition that brought together a diverse group of citizens to “explor[e] public attitudes on the gap between taxes paid and promises made.”¹⁹ Reportedly, “[v]irtually no one needed to be persuaded that the federal budget is on an unsustainable path. . . . The federal deficit is likely to be ‘only’ about \$300 billion this year, but deficits over the next [ten] years could total more than \$2 trillion if policies remain unchanged.”²⁰ Indeed, the point of the column was apparently to express amazement that regular folks are much more sensible about making the “tough choices” on deficit reduction than are their elected representatives: “So if there was a message, it was not that people wanted to dodge tough choices. It was that they wanted good ideas from their leaders.”²¹

The political preoccupation with budget deficits also affects policy discussions even when budget effects are far from the central focus of analysis. For example, a recent law review article examining the use of affirmative action in an auction process used by the Federal Communications Commission was titled: *Deficit Reduction Through Diversity: How Affirmative Action at the FCC Increased Auction Competition*.²² The article, which is quite insightful in describing some counter-intuitive results of a bidding process that included credits for businesses owned by minorities and women, is certainly not focused on “the deficit.” Indeed, the authors conclude that the use of affirmative action in a 1993 auction increased total revenues from the auction by “nearly \$45 million.”²³ To put this number into perspective, the federal budget deficit in 1993 was \$255.1 billion,²⁴ making the \$45 million in revenues from the auction less than 0.02% of the budget deficit.

The authors, in fact, do not claim that \$45 million is a significant contribution to deficit reduction, but they instead argue that politicians might look more kindly on a program that does not cost money: “The revenue-enhancing effect, however, shows that affirmative action may cost the government less than previously

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² Ian Ayres & Peter Cramton, *Deficit Reduction Through Diversity: How Affirmative Action at the FCC Increased Auction Competition*, 48 STAN. L. REV. 761 (1996).

²³ *Id.* at 763.

²⁴ CONGR. BUDGET OFFICE, HISTORICAL BUDGET DATA (2006), available at <http://www.cbo.gov/budget/historical.pdf>.

thought. Demonstrating that such measures need not drain the treasury might be imperative for garnering legislative support. . . . [T]he revenue effect . . . may establish a necessary condition for politically justifying [affirmative action].”²⁵ This might well be true. Even so, it is noteworthy that, rather than simply saying that a seeming subsidy ends up being a net revenue raiser for the government — a fact that would be interesting no matter what the rest of the budget looked like — the authors chose to describe this program as one that results in “deficit reduction,” not only in the text of the article but as the first two words of its title.²⁶ The authors obviously knew what their target audience was likely to find exciting, even if deficit reduction was decidedly beside the point.

Again, that budget deficits are a focus of concern is not news. However, any time that there is such a broadly-held consensus about a public policy issue — particularly a public policy issue that is very technical and that few citizens, journalists, or politicians are actually likely to understand — at least two possibilities arise: first, everyone is right; or second, everyone believes the same thing because it is intuitively appealing (and maybe also simply because everyone else seems to believe it). This article explores the premise of the latter possibility — that is, I take seriously the idea that the conventional wisdom that deficits are always bad is an incomplete or inaccurate description of the state of economic knowledge. It is not my purpose here to explain how mass opinion is formed or to discern why virtually everyone seems to believe a half-truth. Instead, I directly confront the propositions that the fiscal deficit is a bad thing and that actions must be taken immediately to prevent the fiscal disaster that so many people apparently believe is surely coming.

B. Opposing Deficits versus Opposing Bad Fiscal Policies

As an initial matter, it is important to set aside one category of arguments, specifically whether failing to be “against the deficit” automatically means that one approves of a particular policy that happens to raise the deficit. In fact, a person could well believe that deficits (at least at their current levels and at the levels that are actually likely to exist in the future) are not the problem that they are made out to be, yet still believe that some changes in our current fiscal policy mix are necessary. For example, repealing all or part of the

²⁵ Ayres & Cramton, *supra* note 22, at 764.

²⁶ *Id.*

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various tax cuts enacted during the current President Bush's terms in office would certainly reduce the deficit; but reducing the deficit is hardly the only reason to favor repeal of those tax cuts. Concerns about income distribution, perverse incentives, and bad tax administration, for example, can all motivate calls for repeal of those specific tax bills as well as proposals for other changes in tax and spending policy.

Any change in tax or spending policy affects the level and future path of deficits, of course, but intent matters. If it turns out that the deficit is not always the problem that it is so often made out to be, that removes one argument from the arsenal of those who propose tax changes that reduce the deficit; and it removes one hurdle from those who disagree. That does not by any means end the debate. If, as I believe, the Bush tax cuts were a terrible mistake for reasons beyond their effects on deficits, then they should be repealed. Having the additional argument that the deficit is a bad thing, of course, strengthens the case. As it happens, the analysis in this article implies that while deficit spending is in some circumstances beneficial to the economy, the Bush tax cuts do not fall into that category and are thus damaging both because they are "bad deficits" and for other reasons as well, most prominently that they are profoundly unjust. It is thus consistent to argue that deficits are not always bad but that *these* tax cuts — in addition to their other defects — lead to the bad kind of deficits.

C. The Approach in this Article

In an earlier article,²⁷ I addressed the issues raised by long-term deficits from a more orthodox perspective.²⁸ In that article, I reviewed some of the basic issues in the measurement of fiscal deficits,²⁹ described how the long-term prospects of the Social Security system interacted with the rest of the government's fiscal prospects,³⁰ and finally assessed a relatively new method of computing long-term fiscal deficits (or the "Fiscal Gap") known as "Generational Accounting" that attempts to forecast the net present value of all deficits into the infinite future.³¹ I concluded that Generational Accounting was a fatally flawed approach to trying to predict the long-term fiscal path of

²⁷ Buchanan, *Long-Term Deficits*, *supra* note 2.

²⁸ *Id.* at 286–98.

²⁹ *Id.* at 285–98.

³⁰ *Id.* at 298–306.

³¹ *Id.* at 306–22.

the U.S. economy.³²

Rather than simply arguing that the Generational Accounting approach to forecasting long-term fiscal deficits was fundamentally flawed, though, my argument looked at the alternatives to that approach to see if there was something better that could guide policymakers.³³ My conclusion was that more traditional deficit measures such as ten-year deficit forecasts, though still highly imperfect, were at least adequate to guide policymakers who were concerned about the possible harms that deficits might visit on the economy and — even more importantly — were not subject to the shortcomings that make Generational Accounting far too easy to manipulate.³⁴ In short, it was not just that Generational Accounting was flawed but that those flaws were sufficiently serious that it was comparatively worse to use Generational Accounting than to rely on ten-year deficit forecasts.³⁵

This article extends the analysis from my earlier article in two ways. First, in my earlier article I basically accepted for the purposes of argument that deficits are *per se* harmful. While it would hardly be surprising if my skepticism about the underlying idea that deficits are generally a bad thing came through to readers, the analysis was focused on how best to measure deficits to guide policy and not on whether policy should be aimed at deficit reduction in the first place.³⁶ I analyzed the harms of deficit spending through the traditional lens of “crowding out,” which (as I describe in Part II below) is the idea that deficits reduce future economic growth by reducing the amount of private investment in a given year.³⁷

In this article, by contrast, I describe why deficits might not always be harmful after all, or more accurately, why they are harmful in certain circumstances but not in others. Perhaps surprisingly, it is not difficult to find economists who have argued against the idea that all budget deficits should be eliminated.³⁸ While virtually everyone

³² *Id.* at 325–26 (concluding that Generational Accounting is “based on highly contestable assumptions, makes questionable analytical choices, and is inherently incapable of providing the useful baseline that its proponents promise”).

³³ *Id.* at 285–86.

³⁴ *Id.* at 325–26.

³⁵ *Id.* at 285 (describing the choice between ten-year budget deficits and Generational Accounting as “[t]he [i]mperfect vs. [t]he [f]undamentally [f]lawed”).

³⁶ *Id.* at 325–26.

³⁷ *Id.* at 296.

³⁸ Alan S. Blinder, *Is the National Debt Really — I Mean, Really — A Burden*, in *DEBT AND THE TWIN DEFICITS DEBATE* 209 (James M. Rock ed., 1991) (describing

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would agree that it is possible to run deficits that are so large that they harm the economy, the question is whether our current and plausible future policies require a commitment to significant and immediate deficit reduction. I conclude that deficits can be harmful but that the harms need to be balanced against the benefits; and I suggest that our obsession with deficit reduction causes us to run the distinct risk of reducing deficits in ways that are far worse than not reducing them.

Second, even if we believe that there are situations in which deficits are acceptable (or are even a very good idea), I raise the possibility that we should nonetheless engage in a “noble deception,” that is, that we should agree not to talk about the possible benefits of deficits in order to prevent the public and policy makers from jumping to the unwarranted conclusion that if deficits are not always bad, then there is no reason to worry about deficits. This is a very real concern, given the sound-bite-driven nature of current political discourse. Ultimately, however, I conclude that deceptions — perhaps especially noble deceptions — are unwise and can ultimately cause more harm than good. It should be possible to discipline policy debate to allow us to be honest about the choices we face without being doomed to make foolish choices based on half-truths.

The fiscal choices that we make today affect our lives today, our lives in the future, and the lives of generations yet unborn. Understanding what is — and what is not — harmful and helpful about budget deficits is essential for policymakers and the public at large. The budget deficit matters, but it matters in ways that are too often poorly understood. The result of such misunderstanding can cause us to enact well-meaning policies that move us in the wrong direction. Greater understanding of all of the issues raised by budget deficits is thus essential to good governance and prudent fiscal stewardship.

II. ARE DEFICITS ALWAYS HARMFUL? IS DEFICIT REDUCTION ALWAYS GOOD?

Because of the generally low level of economic knowledge in the population at large and (perhaps especially) among politicians, it is at

himself as a “middle-of-the-road, middle-class, middle-aged economist,” *id.* at 209, and describing a former congressman’s apparent surprise when three out of four economists testifying at a congressional hearing — one of whom was Professor Blinder — stated that they “would vote for \$15 billion in additional spending on public infrastructure, if that spending would add \$15 billion to the budget deficit,” *id.* at 222).

least possible that the near-universal aversion to deficits is based on little more than gut reactions to the idea that borrowing is bad (“neither a borrower nor a lender be”³⁹) or that governments should be forced to “live within their means” just like any family must do.⁴⁰ If those or similar concerns motivate anti-deficit feelings, though, then the argument is not that deficits are harmful to the economy but that deficits are simply immoral or irresponsible no matter whether they have any effect on living standards. The argument ends there, because it is not really an argument but a matter of moral certitude.

Another source of popular concern about the deficit might arise from some “very old-fashioned arguments that were based mostly on myths and misunderstandings [and that] are still an important part of the popular folk wisdom.”⁴¹ The economist Alan Blinder, a former vice-chair of the Federal Reserve and a prominent fiscal policy analyst, puts these arguments quickly to rest. One argument is that “[i]f we borrow too much, the nation will go bankrupt,” an argument that may be true for some smaller economies but “not for the United States.”⁴² Because our deficits are financed by issuing debt that is denominated in dollars, “we can always print as many dollars as we need.”⁴³ While this may be “wise or foolish,”⁴⁴ any “fear of default is simply a red herring in the U.S. case.”⁴⁵

Furthermore, any concern that deficits must necessarily be inflationary, even if such a concern might once have been plausible, “sounds silly now.”⁴⁶ As Blinder points out, the experience of the 1980s demonstrated that one could have a simultaneous increase in the annual budget deficit and a decline (and near-disappearance) of inflation.⁴⁷ The U.S. experience in the decade-and-a-half since Blinder wrote his article further demonstrates the lack of any connection between the level of the deficit (which rose and fell

³⁹ WILLIAM SHAKESPEARE, *HAMLET* act 1, sc. 3.

⁴⁰ Robert W. Hahn, *The Cost-Benefit of Budget Cutting*, L.A. TIMES, May 6, 2006, at B17 (“Our government should not only live within its means”). Of course, this argument ignores the increasing frequency with which many families live beyond *their* means. Fiscal rectitude is surely easier to preach than to practice.

⁴¹ Blinder, *supra* note 38, at 218.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 218–19.

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dramatically over that period⁴⁸) and inflation (which mostly stayed at the low levels reached in the 1980s⁴⁹).

Thus, two of the more widely cited reasons to believe that budget deficits are harmful are based on one tautologically incorrect argument and on another empirically discredited one. Of course, many economists and well-educated policy analysts know full well that these arguments are simply wrong, but they have much more substantial concerns that cause them to advocate deficit reduction. That some people can oppose deficits for foolish reasons does not mean that others lack better reasons. The remainder of this section addresses the mainstream view of deficits and then describes some arguments offered by economists who emphasize the value of public investment and thus suggest that the presence of deficits does not always justify the adoption of contractionary fiscal policies.⁵⁰

A. *The Standard Deficit Story: “Real” and Financial*⁵¹

What has become the standard analysis of budget deficits is quite powerful and deserves to be explained fully and sympathetically. The story can be told either from a “real” or “financial” perspective. In the real perspective, the focus is not on the dollars that are borrowed or saved but on the production of goods and services and the use of underlying economic resources that are affected by fiscal policy decisions. “Real” is thus a term of art used to identify analyses that

⁴⁸ CONGR. BUDGET OFFICE, HISTORICAL BUDGET DATA, tbl. 13 (2006), available at <http://www.cbo.gov/budget/historical.pdf> (showing budget deficits as high as 4.5% of potential GDP and budget surpluses of as much as 2.5% of potential GDP since 1991).

⁴⁹ BUREAU OF LABOR STATISTICS, CONSUMER PRICE INDEX (2006), available at <ftp://ftp.bls.gov/pub/special.requests/cpi/cpi.txt> (showing average annual inflation from 1992 through 2006 ranging from 1.6% to 3.4%).

⁵⁰ Expansionary policies include tax cuts and increases in government spending, both of which result in greater demand for goods and, if the economy is not at capacity, an expansion of the economy. Contractionary policies include tax increases and cuts in government spending.

⁵¹ Because the standard story of deficits is so widely espoused, examples of it are commonplace. See Blinder, *supra* note 38, at 219–21 (describing the standard story); see also ROBERT EISNER, THE GREAT DEFICIT SCARES: THE FEDERAL BUDGET, TRADE, AND SOCIAL SECURITY 3–28, 57–58 (1997) [hereinafter EISNER, DEFICIT SCARES]; BENJAMIN M. FRIEDMAN, DAY OF RECKONING (1988) (providing a good book-length analysis of the standard story); Neil H. Buchanan, *Taxes, Saving, and Macroeconomics*, 33 J. ECON. ISSUES 59 (1999) (describing the standard story). The standard story also includes a distinction between long-run and short-run analysis which is not relevant to the discussion here.

abstract from financial market effects and focus only on quantities of resources and how they are used. The government's decision to run a deficit changes the use of resources in the economy, in turn changing the composition and (possibly) the quantity of goods and services produced. These changes can have long-term effects by changing the way the current economic output is used to create future increases in productivity and output. In the financial perspective, on the other hand, the focus is on the amount and use of saved funds in the economy, with an emphasis on how those funds are deployed to finance investment in future productivity and output. Both perspectives suggest that deficits can be very harmful to the economy, especially in the long run.

The ultimate purpose of the analysis from both perspectives, therefore, is to ask how our current deficits might affect future prosperity. Looking at each perspective separately, however, turns out to lead to unique insights that are not obvious from one perspective alone.

1. The "Real" Perspective on Budget Deficits

In any given time period, there is a limited amount of productive inputs available in an economy. The number of workers is not literally fixed, because it is always possible to allow greater immigration and to bring citizens into the work force who are not currently working (as well as increasing the hours worked by currently-employed citizens). Similarly, the amount of productive land, technology, factories, and machines is never fixed. Still, the analysis usually proceeds from the simplifying assumption that there is some maximum amount of resources available to be employed in the production of goods and services.

When a government decides to purchase goods and services or to produce them itself, it might be doing so because the resources of the economy are not being fully utilized, which means that the government can put people to work without affecting the rest of the economy. This was clearly the idea behind the New Deal policies during the Great Depression, where there was no serious concern that the government's hiring of workers would do anything but help those workers and, ultimately, the economy as a whole.

If the economy is not in a depression or a recession, however, any resources that the government commands for its uses would, by assumption, be hired by some private entity. This necessarily implies that a government's purchase of goods and services (or its direct

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employment of workers) will result in fewer goods and services being available for purchase by non-governmental actors, or at least that the composition of the economy's output would be altered by the government's choices. For example, workers who might have been employed to provide catering services to private citizens could instead be employed by the government to work in its cafeterias. Or private companies that might have produced steel rails might instead produce military equipment that sits unused.

It is the latter possibility — the diversion of resources from productive investments — that most concerns those who argue against budget deficits (and against government spending in general). Government actions that reduce spending by private citizens on consumption items like food preparation involves choices about the current composition and distribution of goods and services — choices that involve important questions of policy and politics to be sure, but not the kind of thing that obviously has any longer-term effects. Making a mistake today is bad for today, but its effect is forgotten tomorrow. By contrast, if the government decides to divert resources that would have been used to create capital goods (that is, goods and services that can be used to increase future output), then mistakes today last into the future.

The term “crowding out” is commonly used to describe the problem of government use of resources in a way that reduces the nation's annual investment in capital goods (commonly called simply “investment”). This decrease in investment in turn implies a lower standard of living for future generations as a result of our decision today to use resources for something that will not contribute to further increases in economic growth.

Hence, the real perspective highlights the impact of government decisions that redirect resources out of uses that would lead to more economic growth and into uses that simply result in more current consumption. Efforts to reduce the deficit are in essence attempts to prevent the government from decreasing future living standards by making such myopic decisions.

2. The Financial Perspective on Budget Deficits

The real perspective, however, begs the question of why it is budget deficits that harm the future prospects of the economy and not simply government spending itself that does the harm, no matter whether that spending is financed by raising taxes or by borrowing money and issuing debt. If the problem is the government's use of

resources, why is that not simply another argument for smaller government? The financial perspective brings out the difference that this choice of financing creates.

In the financial perspective, the focus of analysis is on the pool of saved funds available to be borrowed by private firms, private citizens, foreign governments, and the domestic government. Saved funds represent the voluntary decisions by private actors to command fewer resources (that is, to buy fewer goods and services) than their incomes would allow them to command in a given year. If a person earned \$100,000 in a year and spent \$90,000, the remaining \$10,000 would be a problem if it were not spent, because that would mean that private companies would receive in the aggregate fewer dollars than they have paid out in salaries and other forms of income.

Fortunately, the financial markets exist to cycle the saved funds back into the spending stream. The aggregate amount of saving (except for the trivial amounts that end up under the proverbial mattress) is lent out to willing borrowers at market rates of interest. The pool of savings that is available annually is thus divided up among willing borrowers, with the interest rate acting as the price of borrowing.

Just as the real perspective assumed that when the economy is not in a recession the government's decision to command resources necessitated their redirection from some other use, the financial perspective assumes that when the economy is not in a recession the total amount of savings cannot be increased. Therefore, the pool of savings is roughly fixed, and the government's decision to command savings necessitates their redirection away from some private would-be borrower who now finds it impossible or too expensive to borrow the funds.

This is the connection to deficits that is not obvious from the real perspective. When the government runs a balanced budget, it does not need to borrow money, so it is not involved in the market to lend out private savings. When it runs a budget deficit, though, it must finance its spending by borrowing private savings. Fewer savings remain to be borrowed by private actors, and the interest rate must rise by an amount sufficient to discourage some potential private borrowers to cancel or delay their plans to use the money that they now can no longer afford to borrow.

In the financial perspective, therefore, the budget deficit determines the total amount of funds that the government must borrow, and crowding out means that the government has prevented private companies from borrowing money that they otherwise could

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have spent to invest in capital goods.

This picture is complicated a bit by the existence of foreign trade. If there is a roughly fixed pool of private savings from which to borrow, and if the government is going to borrow a certain amount of funds, domestic private borrowers might avoid the necessity of reducing their spending by borrowing from abroad. Alternatively, the government itself might simply borrow from foreign lenders rather than domestic lenders, leaving the pool of domestic money available for domestic borrowers. Either way, total domestic spending by private actors and government combined is larger than it could otherwise have been.

The possibility of borrowing from abroad, however, does not mean that there is no crowding out in an important sense. True, the government's borrowing has not forced domestic borrowers to reduce their borrowing and spending. However, the obligation to repay the foreign lenders means that some of the future income of the economy is now pledged to be paid to foreign actors. The two outcomes — reduced domestic investment or increased obligations to foreign lenders — are equivalent in terms of future living standards, for a somewhat subtle reason.

When private investment falls, that means essentially that domestic companies are building fewer factories than they otherwise would build (and they are buying fewer machines to place in their factories). The output of the economy is thus lower than it would otherwise be. By borrowing from abroad, it is true that those factories can be built, but to what end? The output from the factories will, in the aggregate (and under some technical assumptions that are not germane here), be equal to the amount of money that domestic borrowers must pay to foreign lenders.

In other words, a government deficit results in either a reduction of the future productive capacity of the economy or, in a larger future economy, a reduction in the amount of the economy's output that domestic citizens can keep and enjoy. In the standard view, then, so long as the government's deficit does not generate a compensating increase in domestic private saving, future living standards are compromised by government borrowing. Obviously, then, in the standard story on budget deficits, it is important to reduce deficits and certainly to avoid policy choices that would increase the deficit from its current level.

B. Rejecting versus Amending the Standard Story

The standard story of how fiscal deficits affect the economy is appealing in many ways. It comports with the “no free lunch” logic at the core of economic thinking, and it forces policy analysts to think seriously about the possible costs of running a larger deficit. Surely, many unfortunate decisions could be avoided by taking seriously the possibility of crowding out. The standard story provides a powerful argument — perhaps a sufficient one, but surely not a necessary one — against the current President Bush’s tax policies. Given the highly regressive composition of the various Bush tax cuts, the standard story highlights the nature of the tradeoff implied by the Bush-era fiscal policies: tax cuts today, overwhelmingly benefiting a small, highly affluent minority of currently-living Americans, will ultimately result in lower standards of living for everyone in the future.⁵² If one wanted to advocate the repeal of those tax cuts, this is powerful ammunition.

The apparent applicability of the standard story in this context does not mean, however, that it is complete. One of the profound dangers of the widespread acceptance of the standard story (or, worse, of the continuing belief by some people in the “popular folklore” arguments noted earlier) is that deficit reduction can be seen as *per se* good policy. The discussion below includes some specific examples of the damage that flows from such a presumption. Some macroeconomists, therefore, emphasize that the standard story is theoretically incomplete if it does not explicitly include a discussion of public investment.

Before looking closely at a few of those non-mainstream views, though, it is necessary to acknowledge that there is a virtual subculture of what might be called “deficit doubters” who combine conspiracy theories with misleading arguments (and often simply false factual assertions).⁵³ Like “gold bugs,” who argue that every

⁵² TAX POLICY CTR., TAX POLICY: FACTS AND FIGURES (Oct. 2006), available at <http://www.taxpolicycenter.org/publications/template.cfm?PubID=901006> (“Assuming [the Bush tax cuts] are either financed with spending cuts or a combination of reduced spending and progressive tax increases, more than 70 [%] of households will be net losers; only those in the top income quintile will, on average, benefit.”); cf. *Blinder*, *supra* note 38, at 221 (noting that the deficits of the 1980s financed a “consumption binge,” or “a party, to which . . . the wealthy were especially invited”).

⁵³ To avoid conferring any credibility on these fringe groups by citing them — even critically — in an academic article, I will not name any here. The interested reader can easily find websites for such groups by using any standard search engine on the internet.

economic problem would be solved by a return to the gold standard,⁵⁴ or tax protesters, who claim among other things that the entire U.S. tax system is a hoax and that only income earned abroad may be taxed,⁵⁵ or any of a number of other single-minded conspiracy theorists, there are those who reject the standard view of deficits for reasons that defy description. This article is clearly not devoted to cataloging the claims of such fringe elements. Their very presence, though, unfortunately undermines those who can take issue from solid logic and evidence with some of the particulars of the standard story of the budget deficit.

A clear step up from such groups are those who argue that the budget deficit is not a problem but who make such arguments by reference to theories that — while clearly not in the mainstream — have some measure of credibility. So-called supply-side economists arguably fit into this category. There are certainly respected politicians who have advocated the theory that tax cuts matter more than budget deficits (if, indeed, budget deficits matter at all),⁵⁶ and that view continues to be heard in 21st century policy debates, such as Vice President Dick Cheney’s reported argument that “Reagan proved that deficits don’t matter.”⁵⁷

The economics profession has, however, generally been unkind to such views. Before he became chairman of the Council of Economic Advisors under President Bush from 2002–04 (and thus found himself in the possibly uncomfortable position of working in an administration with notable sympathy for supply-side arguments), Harvard’s Greg Mankiw “ridiculed the supply-side tax policies of President Ronald Reagan as the work of ‘charlatans and cranks.’”⁵⁸

⁵⁴ *Id.*

⁵⁵ *Cf.* INTERNAL REVENUE SERV., THE TRUTH ABOUT FRIVOLOUS TAX ARGUMENTS (Nov. 30, 2006), available at http://www.irs.gov/pub/irs-utl/friv_tax.pdf (explaining that federal courts have repeatedly held that all tax protesters’ arguments are baseless).

⁵⁶ See Edmund L. Andrews, *A Pragmatist at Treasury*, N.Y. TIMES, Dec. 10, 2002, at A1 (discussing supply-side Republicans, noting that “Jack Kemp [is] a former cabinet secretary and an ardent advocate of tax cuts,” and quoting Stephen Moore, another supply-sider, who criticized a likely nominee for White House economic advisor as being “hypersensitive about budget deficits”). See generally JACK KEMP, AN AMERICAN RENAISSANCE: A STRATEGY FOR THE 1980S (1979).

⁵⁷ Jonathan Weisman, *Reagan Policies Gave Green Light to Red Ink*, WASH. POST, June 9, 2004, at A11 (discussing RON SUSKIND, THE PRICE OF LOYALTY (2004)).

⁵⁸ Edmund L. Andrews, *Economics Adviser Learns the Principles of Politics*, N.Y. TIMES, Feb. 26, 2004, at C4 (referring to a comment in N. GREGORY MANKIW, PRINCIPLES OF MACROECONOMICS (1st ed. 1998)).

Even to those who largely disagree with supply-siders, such a characterization comes across as rather unfairly putting supply-siders in the same category as the conspiracy theorists noted above. The reason that supply-side economics must be rejected, after all, is not that its basic theoretical assumption is perverse or illogical. Indeed, it could have turned out to be true that cutting tax rates encouraged people to increase their economic activity so much that tax revenue overall would have risen when rates were decreased.⁵⁹ It is the continued belief that such an outcome is certain — even in the face of continuing evidence to the contrary — that earns the derision of economists like Mankiw. Because of this, supply-side believers are a breed apart from the academic mainstream.

By contrast, the economists who point out that the standard deficit story overlooks the importance of public investment are highly respected within the economics community; and while some of their fellow economists would surely disagree on the specifics of various proposals for public investment, there is no serious argument that public spending can never be productive. The discussion below thus describes not a different theory of deficits but simply the too-often-forgotten side of the theory behind the standard story of deficits.

C. Public and Private Investment

While the standard story of how deficits harm the future prospects of the economy through crowding out commands a great deal of understandable respect, the story as told above (and as usually described in textbooks) elides a very important assumption. Specifically, while the story above suggests that the amount of crowding out due to a deficit is exactly equal to the government deficit itself (that is, a \$300 billion deficit causes a \$300 billion reduction in investment), the likelihood is that the dollar amount of the budget deficit actually represents the upper limit on the actual amount of private investment that will be crowded out (and the lower limit is zero).

⁵⁹ See, e.g., Danny Hakim, *Rival Tax Relief Plans Reflect Stark Differences Between Spitzer and Faso*, N.Y. TIMES, Oct. 19, 2006, at B1 (describing as “classic supply-side economics” the belief that “tax cuts will reinvigorate the state’s economy and bring people, jobs and revenue back to the state”). Note, however, that tax revenue must rise in the aggregate as a result of the tax cuts for this to be a classic supply-side argument.

1. Is Private *Investment* Being Crowded Out?

The crowding out story says, in essence, that people and firms will reduce their investment in capital goods when they are unable to borrow as much as they would have liked in the financial markets. It is true that they will borrow less than they might otherwise have wished to borrow, but not everyone was necessarily going to borrow exclusively for the purpose of financing the purchase of capital goods. If the government's borrowing causes someone not to borrow to finance a consumption item, then the future is not harmed. Again, the government *is* causing a redistribution of goods and services, but the effect is immediate and has no long-term consequences.

Similarly, some of the items that are called "investment" in the usual statistical compilations might not be particularly productive capital goods in real life. The theory, of course, implies that private firms will choose to finance only those investments that are expected to have a rate of return that exceeds the borrowing rate of interest. Thus, the market on its own should police the use of funds for unproductive purposes. Theory, as always, has only an imperfect connection to reality; and there are far too many examples of gross over-investment in capital goods that turn out to be useless (empty office buildings and strip malls, to name two prominent examples) simply to assume that every dollar of investment that might be crowded out would have been spent on capital goods that would pay a high rate of return.⁶⁰

Finally, this last point raises the possibility that an economy can be at a saturation point when it comes to private investment.⁶¹ At an extreme, there is a point where increases in the stock of capital goods have such a low payoff that they are not worth it even from the standpoint of paying to maintain those same capital goods. In such a case, the government's policymakers should not be locked into a view that presumes that more private investment is and must always be the goal of fiscal policy. More generally, fiscal policy should at least take

⁶⁰ See, e.g., EISNER, DEFICIT SCARES, *supra* note 51, at 66 n.25 (1997) ("Resources may well have been wasted on half-empty shopping centers and office buildings, on misguided investment in steel capacity, and on nuclear power plants that proved uneconomical.").

⁶¹ David M. Cutler et al., *An Aging Society: Opportunity or Challenge?* BROOKINGS PAPERS ON ECON. ACTIVITY 68 (1990) (noting commentary by Robert Gordon that, at that time, there was adequate saving — even after taking account of budget deficits — to keep the United States from suffering declines in living standards).

account of the possibility of private investment being misdirected into unproductive ventures.

2. Is Government Spending Really Worse than Private Spending?

In addition to the question of whether the private spending that is crowded out by a budget deficit would have raised future living standards, there is an even more central question of whether the government has purchased productive capital of its own. This possibility, which is at the core of the view of deficits that focuses on public investment, highlights the other hidden assumption behind the view that a \$300 billion deficit crowds out \$300 billion of investment.

As the discussion above noted, it is unclear that a deficit automatically results in the government borrowing money from private entities who would have spent it on capital goods — or if they would have spent the money on capital goods, that those capital goods would necessarily have been productive. Even if the spending that was crowded out would have resulted in productive private investment, though, it could still be better for the government to run a deficit if the government's spending would result in investment that was even more productive than the private investment that it crowded out.

To illustrate, if the government's borrowing prevented private businesses from engaging in buying items that would have had a healthy rate of return of, say, 5% per year, the government could invest in something that has a higher payoff. Public investments in early-childhood health and nutrition, next-generation technologies (medical and industrial), alternative energy systems, and improved public education (both pre-college and university level), among others, are all likely to have very handsome long-term payoffs,⁶² with the possibility of double-digit annual rates of return.⁶³ If so, then there is not only no harm from running a deficit to spend money on

⁶² William T. Dickens et al., *The Effects of Investing in Early Education on Economic Growth*, in BROOKINGS POL'Y BRIEF 153 (Apr. 2006) (describing a universal preschool program and a model of its effects on GDP if adopted nationwide, estimating an increase in GDP in 2080 of over \$2 trillion (in 2005 dollars) — an increase of about 3.5 % — and that in 2080, predicting that the program will generate a net fiscal surplus of \$341 billion for the federal government).

⁶³ ART ROLNICK & ROB GRUNEWALD, FED. RESERVE BD. OF MINNEAPOLIS, EARLY CHILDHOOD DEVELOPMENT: ECONOMIC DEVELOPMENT WITH A HIGH PUBLIC RETURN 9, tbl. 1B (Mar. 2003), available at <http://www.mpls.frb.org/pubs/fedgaz/03-03/earlychild.cfm?js=0> (showing a total estimated real internal rate of return of 16% for the a universal preschool program).

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such things, but actually a net benefit to ourselves and to future generations. Future economic output due to the government's investment will actually be higher than it would have been if there had been no crowding out of private investment.

This possibility has long been well understood by macroeconomists. Blinder, for example, notes that "*government investments . . . entail expenditures today in order to reap returns tomorrow*,"⁶⁴ referring to evidence that the United States has underinvested in public infrastructure capital such as "roads, bridges, airports, and waste treatment facilities" and that such investments have high rates of return.⁶⁵ He also noted that "prenatal care, postnatal care, and preschool education have very high rates of return [but] the benefits come *much* later."⁶⁶ Similarly, Robert Gordon has argued that the "real problem for policy . . . is the lack of public investment."⁶⁷

Of course, the government might not invest in high-return projects and it might not even invest at all. Certainly, there are plenty of examples of government waste, including the now-infamous "Bridge to Nowhere" in Alaska, which was financed by Congress — notwithstanding extensive public ridicule — at a cost of \$223 million in 2005, even though it would benefit fewer than fifty people.⁶⁸ This hardly provides reassurance to those who suspect that the process by which government spending decisions are made is fundamentally broken.

Moreover, even government spending projects that are not wasteful (in the strict sense of providing little or no benefit to anyone) might simply not be an investment in the future, such as paying slightly more to subsidize higher-quality meals at an employee cafeteria for a government agency. Such spending can be defended as something better than sending Congressmen to play golf abroad, but it should almost certainly be paid for with current tax revenues rather than with borrowed funds that might otherwise be spent on productive private investments.

Even if one is skeptical of the government's ability to restrict itself to high-productivity investments, though, the situation may not be

⁶⁴ Blinder, *supra* note 38, at 221.

⁶⁵ *Id.*

⁶⁶ *Id.* at 222.

⁶⁷ Cutler et al., *supra* note 61.

⁶⁸ Rebecca Claren, *A Bridge to Nowhere*, SALON, Aug. 9, 2005, <http://archive.salon.com/news/feature/2005/08/09/bridges> (citing \$941 million cost of controversial projects for Alaska, of which \$223 million was earmarked for that particular bridge).

symmetric. That is, even if most spending *increases* do end up buying wasteful or low-productivity items, that does not mean that spending *decreases* as part of deficit reduction plans will only (or even mostly) cut the worst items first. The same pork-barrel mentality that creates the waste in the first place can also protect it — and once it is in place, it is arguably more difficult to end a program upon which some people can now claim to be relying. Cuts in spending might therefore come not from eliminating the waste but from reducing spending that helps the politically weak.

As the discussion below demonstrates, at least the latter concern is very real. A general atmosphere in which political points are earned by cutting the deficit can lead to harmful cuts in public investment. Because of this possibility, a more nuanced view of government spending and deficit reduction is necessary.

3. Government Spending on Basic Research

Barry Bluestone, an economist at Northeastern University, has described how former President Clinton's fiscal policies elevated deficit reduction over what he viewed as intelligent spending on future productivity.⁶⁹ Discussing Clinton's deficit reduction policies, Bluestone took issue with the idea — based unmistakably on the standard story of budget deficits, or what Bluestone and his frequent co-author Bennett Harrison called “the Wall Street–Pennsylvania Avenue Accord” — that deficit reductions in the 1990s were the cause of the economic prosperity during that decade (a decade that saw the longest uninterrupted economic expansion of the post-World War II era).⁷⁰ Bluestone characterized Clinton and his advisors as having concluded that “if reducing deficits is good, cutting them to zero must be better, and running outright surpluses must be best of all.”⁷¹

Bluestone pointed out that productivity growth had actually bottomed out in the 1981–82 recession and that it had risen from the low reached during the Carter years (0.8 % per year), reaching a higher average growth rate under each succeeding presidential administration: 1.6% under Reagan, 1.7% under George H.W. Bush, and 2.1% under Clinton.⁷² Under President George W. Bush's

⁶⁹ Barry Bluestone & Jonathan Chait, *Clinton's Bequest Reconsidered*, 11 AM. PROSPECT 18, 19 (2000) (disagreeing, in an exchange between the co-authors, on the causes of economic prosperity during the Clinton years).

⁷⁰ *Id.* at 18.

⁷¹ *Id.*

⁷² *Id.*

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administration, even with the return to annual deficits, productivity growth has averaged 3.2% per year for the first half-decade of this century.⁷³ With improvement occurring during periods in which the deficit both rose and fell,⁷⁴ Bluestone argued that is difficult to see a clear correlation between Clinton's policies and economic growth — a correlation that is just as difficult to discern, if not more so, from the statistics for the years since Bluestone wrote.

Notably, Bluestone agrees with the broad conclusions of the standard story of budget deficits: “Of course, if we had continued to pile up deficits in excess of 4 % of GDP, the escalating debt would have eventually stymied growth.”⁷⁵ Nevertheless, he argues that the typical crowding out story reverses cause and effect: “High productivity growth . . . begets lower interest rates,”⁷⁶ not the other way around. “With or without the fiscal conservatism of the [Clinton] administration, the economy would be in pretty good shape today.”⁷⁷

What, then, causes high productivity growth? Rather than being the result of low budget deficits or low interest rates, Bluestone suggests that the prosperity of the nineties was due to policies that had been adopted in previous decades, in particular those policies that had enabled the breakthroughs in information technology that were beginning to be felt in the economy most strongly in late 1990s.⁷⁸ While there is an inevitable delay between the introduction of a “startling new technology” and its payoff in productivity growth, “[t]he full-scale productivity premium is only just now being realized.”⁷⁹

The explosion in information technology had begun in university laboratories and private companies, but “much of the initiative and funding for this research came from the government.”⁸⁰ Unfortunately, as part of the focus on fiscal conservatism, the federal

⁷³ BUREAU OF LABOR STATISTICS, PRODUCTIVITY & COSTS, *available at* http://www.bls.gov/schedule/archives/prod_nr.htm#2006 (showing annual productivity growth in the business sector from 2001 through 2005 of 2.2%, 4.3%, 4.1%, 3.1%, and 2.3%).

⁷⁴ CONGR. BUDGET OFFICE, HISTORICAL BUDGET DATA tbl. 13 (2006), *available at* <http://www.cbo.gov/budget/historical.pdf> (showing highly variable deficits in 1980s, 1990s, and 2000s).

⁷⁵ Bluestone & Chait, *supra* note 69, at 18.

⁷⁶ *Id.* at 18–19.

⁷⁷ *Id.* at 19.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

government under Clinton slashed funding for basic research, public infrastructure, education, and training.⁸¹ The federal share of spending on research and development continued its drop from roughly 50% in 1979 to 26.7% in 1999.⁸² This share bottomed out in the year 2000 when Bluestone's article was published,⁸³ but by 2004 the share was still slightly below 30%.⁸⁴

More broadly, Bluestone argued that "the single most important factor behind long cycles of prosperity is the level of technological advance"⁸⁵ and that research that leads to long-term technological advances is so speculative and so hard to finance that "only the federal government has the means and the patience to do this."⁸⁶ He concluded that "Clinton's larger legacy has been to paralyze public investment."⁸⁷

In short, Bluestone's concern was a version of the "baby with the bathwater" phenomenon. He would gladly have the federal government eliminate waste and maybe raise taxes to move closer to budget balance, but he deplored the loss of public support for the government's funding of basic research that accompanied Clinton's obsession with deficit reduction.

4. Correct Measurements and Public Investment

Starting in 1984, the late Robert Eisner (and a frequent co-author, Paul Pieper) wrote a series of articles that attempted to describe the shortcomings of the government's methods of deficit accounting and that argued for a general reduction in public hysteria about budget deficits.⁸⁸ Although much of the work was technical, Eisner's major

⁸¹ *Id.*

⁸² *Id.*

⁸³ NAT'L SCI. FOUND., NATIONAL PATTERNS OF R&D RESOURCES tbl. 2, available at <http://www.nsf.gov/statistics/nsf06327/pdf/tab2.pdf> (showing the federal share of research and development spending at 24.8% in 2000).

⁸⁴ *Id.* (revised figures showing that in 2004, the latest year available, the federal share of research and development spending was 29.9%).

⁸⁵ Bluestone & Chait, *supra* note 69, at 19.

⁸⁶ *Id.* at 19–20.

⁸⁷ *Id.* at 20.

⁸⁸ Robert Eisner & Paul J. Pieper, *A New View of the Federal Debt and Budget Deficits*, AM. ECON. REV., Mar. 1984, at 11; see also EISNER, DEFICIT SCARES, *supra* note 51, at 3–28, 57–58. For a list of Eisner's other papers on this subject, see Neil H. Buchanan, Debt, Deficits, and Fiscal Policy: Three Essays 101–02, 153–54, 220 (Aug. 5, 1996) (unpublished Ph.D. dissertation, Harvard University) (on file with author) [hereinafter Buchanan, *Dissertation*].

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point was that there was no reason to believe that the best fiscal policy was to balance the annual budget.

In particular, Eisner pointed out that “balance” has many different meanings, and in the context of debt, the most appropriate way to assess balance or imbalance would be to look at the debt as a percentage of national income.⁸⁹ Balance would then best describe a situation where a government’s debt as a percentage of its national income remains unchanged from year to year, such that a growing economy can be in balance if the government’s debt grows at the same rate as national income grows.⁹⁰ The annual deficit, in such a situation, would be positive, but the budget would be “balanced” in the sense that the debt-to-income ratio would be stable from year to year.

As Eisner noted, there is nothing about any particular debt-to-income ratio that recommends it over any other.⁹¹ His point was that there is no persuasive reason to worry about balancing the annual budget with a zero deficit, since that actually implies a shrinking debt-to-income ratio over time. There is, moreover, nothing special about zero total government debt as a goal. It, too, is arbitrary.

Eisner was also prominent in advocating the use of a deficit measure that adjusts each year’s deficit to account for the health of the economy. Because an economy in recession is likely to cause an increase in the budget deficit,⁹² fixation on the deficit can lead to perverse spirals in which a recession causes an increase in the deficit, the government cuts spending and raises taxes to attack the deficit, and those contractionary policies in turn worsen the recession and lead to further deficits.⁹³

For the purposes of long-term analysis, of course, transitory shifts in budget deficits due to economic cycles are beside the point. Over time, it is the trends in the economy that matter. On this point, Eisner agreed with the economists cited above about the importance of public investment. “Capital of all kinds — public and private, physical

⁸⁹ His justification for the proposal is that the size of the economy determines the ability of the economy to carry its debt burden, much as a bank will lend larger sums of money to higher-income borrowers. EISNER, DEFICIT SCARES, *supra* note 51, at 9.

⁹⁰ *Id.* at 9–10.

⁹¹ *Id.* at 12.

⁹² An increase in the budget deficit would be caused by the reduction in tax revenues when workers lose their jobs and the increases in government transfer payments to those former workers.

⁹³ *Id.*

and intangible, human and nonhuman — contributes to future production. If deficits add to our stock of productive capital, they actually help secure the future — for our children and grandchildren.”⁹⁴

Eisner agreed that “[p]ublic investment can also be misguided, although there is increasing evidence that, in general, the largely public investment in infrastructure and particularly in human capital has had a high payoff.”⁹⁵ Like Bluestone, he argued that “[d]eficit paranoia and budget balancing mania can be dangerous, extremely dangerous, to our economic health.”⁹⁶

Eisner’s contributions to our understanding of deficits, therefore, reinforce and extend the arguments discussed above. Correcting the measurement errors would allow us to see more clearly the effects of our policies, but the big policy message remains that public investment must not become a casualty of deficit cutting policies.⁹⁷

Attempts to focus attention on public investment, therefore, do not amount to a claim that “deficits do not matter” but rather to a call for greater clarity in what we are really arguing about. Government borrowing for unproductive projects is harmful to future generations, but we cannot simply assume that deficit reduction by any means necessary will lead to an increase in net investment and thus in future prosperity.

D. What Do We Owe Future Generations?

Finally, the discussion above has accepted for the sake of argument that it is always bad to enact policies that reduce the living standards of future generations. The rhetoric of fiscal stewardship easily lends itself to this assumption, as it would feel odd indeed to argue that there is nothing irresponsible about reducing the wealth of our children and grandchildren.

Nevertheless, if we are thinking about a choice between doing something that benefits people living today (even something undeniably frivolous) or denying ourselves that choice in order to benefit our progeny, we need to think very seriously about how to

⁹⁴ *Id.* at 27.

⁹⁵ *Id.* at 66 n.25.

⁹⁶ *Id.* at 28.

⁹⁷ *See also* Dickens et al., *supra* note 62, at 6 (“Because most of these benefits [of public investment] are longer-term while the costs of mounting the programs are more immediate, the political system tends to be biased against making such investments.”).

balance the interests of present and future generations. In a future article, I will describe in much more detail the philosophical literature regarding intergenerational justice and will offer a proposed approach to balancing present and future interests.

For present purposes, however, it is perhaps sufficient simply to emphasize that discussion of this question is almost entirely absent from the policy literature on budget deficits. Eisner and others regularly argue that their policies are the best for truly guaranteeing the prosperity of future generations,⁹⁸ yet there is little if any discussion of why we must do so. Eisner at least raised the issue and questioned seriously whether it is right to engage in policies (especially reductions in benefits for elderly Americans) that will benefit future generations, particularly when those future generations are likely to be much wealthier than we are.⁹⁹ The rhetoric of “future generations,” though, permeates discussions of long-term deficits.¹⁰⁰

Similarly, I raised the intergenerational equity issue briefly in a working paper in early 2004,¹⁰¹ to which Daniel Shaviro responded briefly later that year.¹⁰² I included a very brief discussion of the issue in a subsequent article, including a response to Shaviro.¹⁰³ Despite these very scant acknowledgements of the issue, the glaring fact is that this question of intergenerational equity in fiscal policy remains highly under-theorized. The discussion in this article should be viewed in that light, with my full acknowledgement that I (like almost everyone else who discusses budget deficits) am accepting the normative standard that “harming future generations” should be avoided — even if any harm that we might cause would still leave the living standards

⁹⁸ “Capital of all kinds — public and private, physical and intangible, human and nonhuman — contributes to future production. If deficits add to our stock of productive capital, they actually help secure the future — for our children and grandchildren.” *Id.* at 27.

⁹⁹ EISNER, DEFICIT SCARES, *supra* note 51, at 57–58.

¹⁰⁰ See, e.g., Buchanan, *Long-Term Deficits*, *supra* note 2, at 322–25 and sources discussed therein.

¹⁰¹ Neil H. Buchanan, *What Is Fiscal Responsibility? Long-Term Deficits, Generational Accounting, and Capital Budgeting* 38–43 (Rutgers Univ. (Newark) Legal Working Paper Series, Apr. 7, 2004), available at <http://law.bepress.com/rutgersnewarklwps/fp/art8> (hereinafter Buchanan, *Fiscal Responsibility*).

¹⁰² Daniel N. Shaviro, *Reckless Disregard: The Bush Administration’s Policy of Cutting Taxes in the Face of an Enormous Fiscal Gap*, 45 B.C. L. REV. 1285, 1330–33 (2004). Shaviro does not cite my unpublished article, but the issues he raises are found in that piece.

¹⁰³ Buchanan, *Long-Term Deficits*, *supra* note 2, at 323–24.

of future generations much higher than today's living standards.¹⁰⁴ In future work, I will explore in detail the philosophical and practical questions of intergenerational justice, focusing in particular on how to balance the interests of unborn generations with those of currently living human beings.¹⁰⁵

III. A NOBLE DECEPTION?

If the discussion above is persuasive, it would suggest that we should immediately change our policy rhetoric and openly discuss the possibility that increases in deficits (or the refusal to take certain measures to decrease deficits, such as cutting valuable research funds) are wise public policy. If, after all, it is possible to borrow money at rates of 5% or 6% and spend the money on a project with a 16% rate of return,¹⁰⁶ it would seem perverse not to borrow the money and to make the investment.

A very real danger, however, lies in a possible response by the public and politicians upon learning that deficits really are not always a bad thing. If believed, this news could plausibly lead to a relaxation of our collective vigilance against the bad kind of deficits. What if, say, we engage in new public investments that would together raise future GDP by 10% in 2017 but, in so doing, we open the door to bad investments that crowd out enough private investment to decrease GDP by 20% over that time period? We would clearly have been better off to pretend that there never were any attractive public investments for which we might have borrowed.

While such thought experiments are useful, they of course cannot be tested. Should prudent, well-meaning analysts nevertheless conclude that the risks are too great — that our public discourse should proceed without acknowledging the potential benefits of good deficits as a defense against the unleashing of too much bad deficit spending? I am not responding here to a specific proposal; I can cite no serious analyst who has directly articulated in print an argument that we should consciously deceive people about the availability of

¹⁰⁴ Neil H. Buchanan, *Social Security and Long-Term Deficits: When Should We Worry?* 92 CORN. L. REV. 257, 266 (2007) (hereinafter Buchanan, *Social Security*) (showing that even pessimistic assumptions result in estimated real standards of living in 2080 being 131% higher than in 2005).

¹⁰⁵ The leading philosophical exploration of questions of intergenerational justice is DEREK PARFIT, *REASONS AND PERSONS* (1986); see also TIM MULGAN, *FUTURE PEOPLE* (2006).

¹⁰⁶ See *supra* note 89 and accompanying text.

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public investment.¹⁰⁷ I raise the point here simply because it is the only remaining plausible argument against debating publicly the value of deficits. If opportunities to spend public money productively exist, and if our current policy debate largely proceeds as if those opportunities do not exist, then we must either change the debate or explain why we choose not to do so.

There is plenty of room for reasonable people to disagree on such an inherently difficult judgment call, of course, but I am ultimately persuaded that we should simply proceed honestly. First, this is hardly a matter about which the facts are difficult to find. The citations in this article are just a handful from the extensive literature on public investment that exists and that is available to any interested party.¹⁰⁸

It would thus not be plausible for tax policy scholars, economists, or indeed anyone with an interest in affecting fiscal policy to sustain a public posture that borrowing to finance public investment is never a good idea. If directly challenged about that posture, the most that one could say is that, yes, there are most likely productive public investments available, but we should not avail ourselves of them. If that is the nuanced conversation that we must have, though, then it would be far better simply to say that we *are* going to look for good public investments and that we must also be ever vigilant not to

¹⁰⁷ Proposals to account specifically for public investment have, however, been met with skeptical resistance, not because public investment projects are unavailable but because of a concern that a system that allows government spending to be classified as “investment” is dangerously open to abuse. See, e.g., Karen Pennar, *Beware of Accounting Magic Tricks, Mr. Clinton*, BUS. WEEK, Jan. 18, 1993, at 55. Along similar lines, economist Paul Krugman recently suggested that, even though he is in favor of reducing budget deficits, it would be better for Democrats to spend any savings or tax increases that they can find rather than reducing the deficit. The better path, he suggests, is to act as if we do not care about reducing the deficit because other politicians might one day squander whatever savings the current Congress might find. Paul Krugman, *Democrats and the Deficit*, N.Y. TIMES, Dec. 22, 2006, at A35 (“Deficit reduction . . . might just end up playing into the hands of our next irresponsible president.”).

¹⁰⁸ In earlier unpublished work, I described in theoretical terms the concept of public investment and some attempts to measure the amount of public investment that is undertaken by the federal government. See Buchanan, *Fiscal Responsibility*, *supra* note 101, at 38–43; see also Buchanan, *Dissertation*, *supra* note 88, at ch. 1; Douglas Holtz-Eakin, *State-Specific Estimates of State and Local Government Capital*, 23 REGIONAL SCI. & URBAN ECON. 185 (1993). In future work, I will analyze the broader literature on public investment as a step toward advocating that the federal government adopt a system of accounts that would allow public investment to be financed without increasing the reported deficit.

borrow money for foolish reasons. If we cannot maintain the pretense that deficits are unmistakably bad, then we gain nothing by pretending otherwise.

Consider the attempt by former presidential candidate Al Gore in 2000 to describe the surpluses in the Social Security trust funds as a “lock box” in which our future retirement security was safeguarded.¹⁰⁹ The problem was that this was “an accounting gimmick,”¹¹⁰ and it later became possible for President George W. Bush to attempt to secure public support for his misbegotten plan to create private accounts in Social Security by claiming that “[t]here is no trust ‘fund’ — just IOUs.”¹¹¹ While all analogies are imperfect, and while Bush’s attempt to use the Democrats’ misrepresentation of the trust funds to rally support for his privatization plan failed, this at least suggests that the consequences of well-meaning deceptions are at best unpredictable and at worst corrosive to public policy discussion.¹¹²

Finally, the distributive consequences of forsaking public investments ultimately make the noble deception appear far less noble. As suggested above,¹¹³ some of the best existing and prospective public investments most directly benefit the young, the weak, and the poor before ultimately benefiting the entire economy. Choosing not to make those investments means quite deliberately choosing not to help those vulnerable populations in the name of avoiding some possibly bad choices that we should try to avoid in any case. While it is imaginable that the net crowding out of private investment that could result from poor policy choices could end up being as or more harmful to the politically weak as it would be to fail to invest directly in their futures, there are no apparent reasons to think that those possible consequences are as large or as direct as are the losses from failing to undertake the direct public investments that would clearly benefit them.

In short, we should not deny or ignore the evidence that there are

¹⁰⁹ Robert Kuttner, *Getting Over the Lock Box*, in THE AMERICAN PROSPECT (online edition), Sept. 2, 2001 (“Politically, Gore’s strategists thought that by putting the Social Security reserves off budget, and forcing George W. Bush to take the “lock-box” pledge, they would make it impossible for Bush to eat into the surplus with a large tax cut.”).

¹¹⁰ *Id.*

¹¹¹ Associated Press, *Bush: Social Security Trust Fund “Just IOUs”* (Apr. 5, 2005), <http://www.msnbc.msn.com/id/7393649>.

¹¹² For a discussion of the Social Security trust funds and the long-term health of the Social Security system, see Buchanan, *Social Security*, *supra* note 104.

¹¹³ *Supra* Part II.C.2.

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and will continue to be opportunities to make wise public investments using borrowed funds. We gain nothing in the public debate by pretending otherwise, and we risk harming those whom we should least wish to harm.

IV. CONCLUSION

The political fascination with budget deficits in the United States has led to a great deal of posturing and confusion about the nature of our fiscal obligations and the best approach for advancing the interests of future generations. We have reached a point where, with occasional strategic exceptions, the bipartisan default position is that all deficits are bad, all the time. Any good economist knows that that is false.

The standard story about how deficits affect the economy through “crowding out,” of course, does suggest that budget deficits *can* harm the economy, under certain conditions — but it also contains (or is at least not inconsistent with) an alternative story in which deficits are beneficial to the long-term health of the economy. The most important way in which reality deviates from the standard story is in the composition of private and public spending. Crowding out is harmful when a government spends its money on items that would fail to raise future productivity while preventing private parties from buying such productive items. This does not mean, though, that budget deficits are always bad. It simply means that we should be sure that the deficit *is* used to finance public investments that will increase future productivity. Conversely, we should be especially vigilant to prevent budget cuts (motivated by a “deficits are always bad” mentality) from resulting in the elimination of government spending on important investments, such as supporting education and basic research and providing assistance to vulnerable populations like very young children at risk of malnutrition or disease.

Recognizing and discussing these opportunities for public investment does, however, raise the risk that the policy discussion will become dangerously muddled. Having opened the door to claims that *some* deficits are good, there is at least a possibility that this could become an opening to justify further increases in the deficit that are harmful. Ambiguity can be the enemy of sustained political will. Despite this risk, the arguments in favor of deficit-financed public investment are too well known, and the consequences of deception too great (especially for the politically vulnerable members of our society), to justify a strategy of pretending that the benefits of budget

deficits do not exist.

Budget deficits matter, but they matter in ways that differ importantly from the conventional wisdom. We must make sure that any attempts to measure or reduce budget deficits do not mislead us into taking actions that might actually make things worse both for us and for our progeny.