A Debate on the Deficit

Per Gunnar Berglund and Matias Vernengo

As a new presidential term begins, the federal budget deficit is reaching enormous levels. Dealing with it will necessarily be a priority of the next administration. We present a comprehensive, engaging roundtable discussion on the issue among four economists with different views. An introduction sets the historical stage for the debate that follows.

Political views on the effects of fiscal deficits have changed over the years. The Great Depression marked a period of transition from sound finance to Keynesian principles, as enshrined in the Kennedy-Johnson tax cut of the mid-1960s. The 1960s were the culmination of the prosperity of the post–World War II period, now known as the Golden Age of capitalism. Rates of growth in the western world were the highest on record, unemployment rates were historically low, and although great inequalities still existed, the gap between the rich and the poor narrowed, both within and between countries. This period in the Western world can be seen, in part, as the result of a tacit accord between social classes according to which progressive taxation financed an expanding welfare state and a set of social rights, which in turn translated into a relatively low degree of social confrontation.

The tacit social agreement was a fragile one. The increasing social

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tensions of the 1960s, associated in the United States with civil rights and the Vietnam War, led to a change in the social balance that had supported the tacit agreement. Prior to this period, wages had increased hand in hand with productivity. While full employment and expanding social benefits gave workers the upper hand in wage bargaining, the brisk pace of investment in new technology, of rationalization and automation, provided a countervailing force that kept inflation in check.

In the late 1960s, all this began to change. Steadily rising taxes, an unanticipated slowdown of productivity, shock increases in raw-materials prices, a weaker dollar following upon the breakdown of the Bretton Woods system–all these factors combined to unleash the vicious wage-price spiral and to bring about the hitherto unseen combination of economic stagnation and rising inflation. Discontent and social tensions rose as distributive conflict over the proverbial "pie" intensified. By the mid-1970s, the days of the tacit accord were definitely over.

The stagflation of the 1970s broke the camel's back. Significant budget deficits reappeared along with the stagnation and became endemic as inflationary forces and increasingly restrictive monetary policies pushed interest rates ever higher. Moreover, the escalating inflation and interest rates meant significant losses for those holding financial assets, particularly government bills and bonds. The preparedness, on the part of the wealthier classes, to foot the bill for the welfare state under the new terms was then greatly diminished.

A fiscal revolt became visible in America during the 1970s. Proposition 13 in California, which greatly reduced property taxes, was one of the landmarks of the movement, which culminated with President Reagan's tax cuts. A theoretical revolution was also taking place that would eventually justify the new, reinvigorated resistance to taxes among the wealthy. Politically the tax revolt was justified under the banner of "supply-side economics" (later referred to as "voodoo economics" by Bush senior). The accumulated deficits of the Reagan era, and the backlash against Keynesian ideas and policies, meant that during the recession of the early 1990s, monetary policy was seen as the only effective instrument to combat the downturn. Fiscal policy was all but dead.

Further, the Keynesian belief in the positive effects of deficits, at least in the short run, was turned upside down in some circles. The argument was that fiscal consolidation could be expansionary provided that the cuts in government spending led to a perception of permanently lower taxes. That is, if the government decided to spend less, then taxpayers would have to pay less in the future, and, realizing this, they would increase both consumption and investment in the present. If the increase in consumption and investment was large enough to outweigh the decrease in government spending, then higher levels of current activity and income would result. The recent American experience with fiscal consolidation during the Clinton years, and the relative prosperity that ensued, led many to believe that the Treasury and Fed exchange of fiscal adjustment for lower rates of interest was the prime mover behind the Clintonian expansion.

However, reasonable estimates of the effects of deficits on interest rates cast serious doubt on whether the exceptional growth of the late 1990s was caused chiefly by fiscal consolidation. Further, measures of fiscal consolidation must be adjusted for the impact of cyclical fluctuations in the economy. Appropriately adjusted measures show that a good deal of the increase in revenue was caused by the economic expansion, not least by colossal capital gains made on booming asset markets. The deficit reduction during the Clinton presidency was, unsurprisingly, in large part a consequence of the economic boom itself. Also, as is now clear, a good part of the boom was the result of an inflated bubble in the stock market. Increasing debt and unrealistic expectations about future earnings, rather than the perspective of permanently lower taxes, fueled the surge in consumption and investment. The reversal of the boom is then related to the frustration of expectations, with lower-than-expected earnings, and with high and perhaps unsustainable levels of indebtedness.

The 2000 recession and the three rounds of tax cuts implemented by George W. Bush had at least two important effects. First, the paradoxical switch on fiscal positions between Democrats and Republicans became explicit. The first Bush tax cut was not directly related to the objective of stimulating the economy, since it was a campaign promise that preceded the actual recession. However, the subsequent tax cuts were defended as instruments against the recession in Keynesian fashion. Democrats, on the other hand, have been stalwart defenders of balanced budgets and "fiscal responsibility." Al Gore famously argued for balanced budgets even in the face of recessions during the 2000 campaign, sounding more like a Hoover Republican than an Eisenhower one, as Bill Clinton was sometimes referred to.

More important, the 2000 recession brought fiscal policy back to the fore. It was clear that with interest rates at historical lows, the only effective way to counteract the recession was fiscal activism. This, however, does not mean that there is a renewed consensus on fiscal matters. It seems clear, though, that the majority of economists and politicians would agree with the old Keynesian canon that fiscal policy is effective in the short run. We are not suggesting that there is consensus on the effectiveness of Bush's tax cuts, which mainly targeted the wealthy. It seems reasonable, however, to suppose that alternative expansionary fiscal packages would have been more effective in providing short-run stimulus to the economy.

The effects of fiscal policy in the long run are far more contentious, and the issues at stake cannot be more important. One of the main sticking points is the long-run sustainability of government finances. It appears that most economists agree that the ratio of government debt to gross domestic product (GDP) must somehow be stabilized in the long run. There is, however, little agreement about the level at which to stabilize it.

Some argue that there exists a ceiling beyond which it would be unwise to push the debt ratio for fear of jeopardizing the government's creditworthiness and risking the specter of "state bankruptcy." Another line of argument is that an, in some sense, excessive government debt implies losing the option of using fiscal policy—namely, actively raising the deficit—as a means to combat recessions. A third story is concerned about the effects of government debt on long-term interest rates and the potential for the interest burden to "crowd out" other, more socially beneficial expenditures. Although all these arguments gravitate toward the same conclusion—namely, that government debt should be limited relatively to GDP—opinions differ widely on the adequate size of the debt ratio.

In contrast, economists in the "functional finance" tradition argue that a high debt-to-GDP ratio, at any rate as long as the borrowing is done internally in the country's own currency, does not imply any appreciable risk for "state bankruptcy." Nor does it limit the scope for active, countercyclical policy measures in any relevant sense. Moreover, some argue that wealth effects—through which public debt fuels private spending—tend to spontaneously establish a certain level to which the debt-to-GDP ratio converges in the long run. In this view, therefore, the debt problem takes care of itself in the long run, and there is little cause for concern.

Disagreement tends to be centered on the long-run issues. Diametrically opposed conclusions can be drawn, depending on the analytical perspective taken. The presence—or the absence—of sustained fiscal deficits, as well as their "quality" in terms of their use, may potentially endanger several social rights acquired over long struggles during the twentieth century. At the dawn of the twenty-first century, economists and politicians have rediscovered that fiscal policy may still be a means to prosperity. Fiscal responsibility is not about permanent balanced budgets but about the quality of the deficits, and whether the public debt accumulated is sustainable.

The roundtable that follows, organized during the meetings of the Eastern Economics Association in Washington, DC, last February by Matias Vernengo, are part of a broader discussion on the effects of the current fiscal policy stance and the ironic shift in stance between Democrats and Republicans. The views on the switch on fiscal policy are varied, but all hypotheses suggest that short-term political gain and a bit of naïveté or cynicism are involved. More significantly, it is clear that a wide spectrum of the profession—from the liberal to the conservative end—is concerned about Bush's tax policies and is hoping for change.

Matias Vernengo: The topic of the roundtable is the political economy of the federal budget deficit. The topic is broad enough to encompass several issues, but the most important from our perspective are the policy consequences of the current fiscal stance, in particular the results in terms of the limitations and possibilities it opens for social policy. In other words, fiscal policy is crucial for promoting a minimal government, in the conservative-libertarian tradition, as well as projects with a progressive bent that would want to extend the welfare state. In that respect, the future of social security and the possibilities of funding a national health program would be part of the debate. Also, the apparent paradox that Democrats and Republicans have switched sides on fiscal policy is crucially important, and will be discussed.

We have a distinguished panel to discuss these issues. Barbara Bergmann is at American University and emerita from the University of Maryland. She was on the staff of the Kennedy Council of Economic Advisers and was the president of the Eastern Economic Association. Professor Jeffrey Frankel is the James W. Harpel Professor at the JFK School of Government at Harvard. He was a member of Clinton's Council of Economic Advisers and directs the International Finance section of the National Bureau of Economic Research. Dr. William Niskanen, the chairman of the Cato Institute, was acting chairman of Reagan's Council of Economic Advisers and also taught at Berkeley and UCLA. The final member of our panel is Professor Laurence Seidman, who is the Chaplin Tyler Professor at the University of Delaware. We will start with a general presentation from each panel member in alphabetical order, and then have a general discussion at the end.

Barbara Bergmann: Being invited to this session on fiscal policy caused me to remember my childhood, when I took lessons on fiscal policy from Alvin Hansen at Harvard. In those happy days, the correct size of the deficit was defined as the "full-employment deficit," which was the deficit necessary to bring the economy to full employment. A major question of that day was the size of the multiplier—the amount of GDP that an extra dollar of government expenditure would engender. It was taken to be the reciprocal of the marginal propensity to save and was thought to be somewhere between two and ten.

However, more recent developments bring us to realize that we have to be concerned with what you might call the quality of the deficit, as well as its size. A deficit of a given size can have a different effect depending on how it is incurred. For example, sending money to rich people might not have too big an effect on aggregate demand. I am lucky enough to be married to a rich guy, so the tax refund that President Bush is sending me is going right into my checking account. I doubt I will even increase my stock portfolio as a result. So the multiplier for that bit of the deficit is zero.

Then there is all the money going to defense. Presumably what's going to buy replacement helicopters will have a multiplier. But the money that's going to buy fuel from Kuwait for Iraq is going to have a multiplier close to zero. However, some of that may come back to the United States as either profit or stockholders in Halliburton or—probably more likely—higher salaries for people who work for Halliburton. They probably have enough yachts, so that part of the deficit is not going to do us much good in terms of aggregate demand.

Since the days of Alvin Hansen, the American economy has become much more open. These days, if you give tax cuts to the middle class, they are going to go right down to the store and buy some clothing made in China. That again makes for a low multiplier.

We can think of expenditures, including tax expenditures, that would produce a greater level of aggregate demand than our current deficit does. I would include things like increased spending on mental health, on child care, on education, on public transport, and so on. So to sum up, the mere size of the deficit is no longer a good measure of the expansionary effect of the government budgetary position. We need to pay attention to the components of government expenditure and how each component contributes to aggregate demand. We have to do the same for the tax cuts.

Another aspect of fiscal policy is the usefulness of the things that the extra government expenditure buys, as well as the usefulness of what the recipients of a tax cut spend the money on. Keynes said that it was worthwhile in a depression for the government to hire people to dig holes in the ground and fill them up again. But we have a lot of unfilled needs for public goods, and for private goods for people of very low incomes, so we cannot afford to be so cavalier about what kind of expenditures and tax cuts we make when trying to boost aggregate demand.

I would suspect that in the future we are going to have a bigger employment problem than has been true in the immediate past. Many American workers now are competing on the world labor market, and the world labor market is not a very cheery place to compete in, as we all know. I worry that the theory of factor price equalization will come true after all. And if wages here don't fall fast enough toward Mexican or Chinese levels, unemployment will be the result. As jobs are lost, other jobs may very well be created. But they will not be as well paid.

You have to be amazed by the Democrats, who are badmouthing deficits, while the Republicans are saying, "Don't worry about it!" In this case the Republicans would be right, if only the deficits were of a better quality—if their expenditures were going for something better than the war in Iraq and if their tax cuts were reductions in the payroll tax.

Alvin Hansen used to say, "We owe it to ourselves." Well, that wasn't true even then. The national debt was owed to the rich people who directly or indirectly held the bonds. Now a lot of it is owed to people abroad. But that should not stop us from having a high-quality deficit and a high enough deficit to get us to a reasonable level of employment.

Jeffrey Frankel: My title is "The Bush Budget Bungle," which is not an entirely nonpartisan title. I told the organizers of this session that we needed to get someone from the Bush administration to defend the budget, but they tried and tried and couldn't find anybody. I think that is understandable, given how hard it is to do this job of defending the budget. They should have outsourced to Bangalore—should

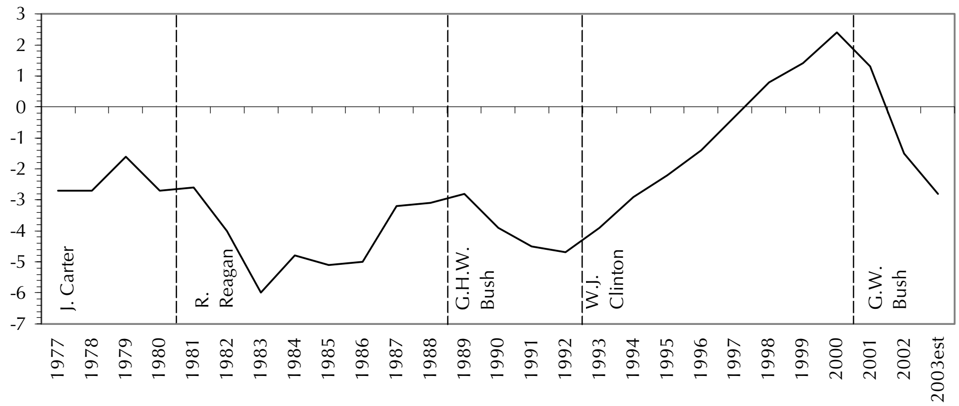

Figure 1. Spending and Budget Balance as % of GDP (current US$)

have got someone on a speakerphone, with a good English accent, to defend the budget, since they couldn't find anyone in town to do it.

Proposition 1: When a Republican president comes in, the budget balance plummets. It may sound surprising, but here it is, in Figure 1. Ronald Reagan becomes president in 1981—the budget deficit plummets. George Bush I takes office in 1989—the budget deficit plummets. George Bush II arrives in 2001—the budget deficit plummets. Now, you might think this pattern was entirely because of Republican tax cuts and Democrat tax increases. If you fell for the line that the Republican Party is the party of small government, then that's what you would expect. But the striking pattern in budget deficits is not entirely, or even primarily, due to taxes. Figure 2 shows federal spending, by presidential term. When a Republican becomes president, spending increases sharply. It was true when Ronald Reagan became president, when George Bush I became President, and when George II became president—1981, 1989, or 2001.

When a Republican president comes in, the budget plummets.

Is the deficit pattern due to Democratic tax increases and Republican tax cuts? Not entirely. Spending is at least as important.

During the Clinton administration, 1993–2000, the pattern was just the reverse: falling deficits, consisting in large part of spending falling as a share of GDP. How did it happen during the 1990s that we were able to eliminate these record budget deficits and achieve a record

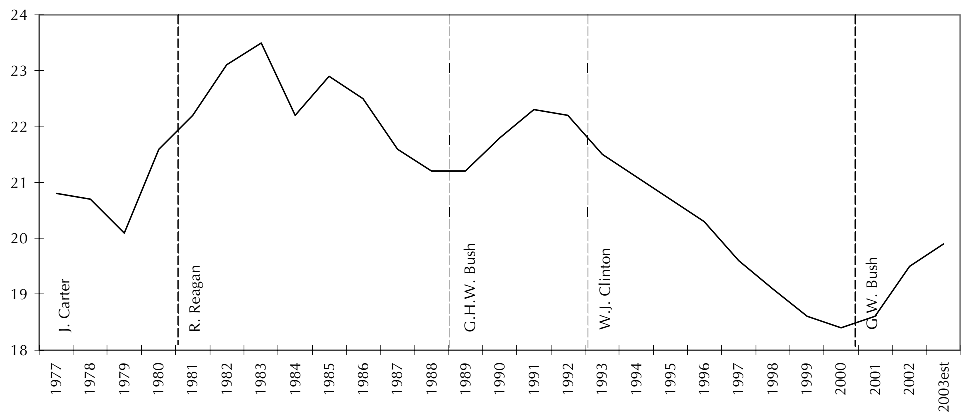

Figure 2. Spending as % of GDP (current US$)

budget surplus by the year 2000? Obviously the strong growth in the economy played a big role, and the stock market played a big role, but there are some specific policy actions that played a big role as well, and I would like to identify three.

The first important step, to give George Bush Sr. credit, was the Budget Enforcement Act of 1990, which raised taxes and legislated a combination of spending caps and the PAYGO rule. The PAYGO system (pay-as-you-go) said that anyone proposing future tax cuts or spending increases had to say how they would pay for them. The package probably cost Bush the election because it was a reversal of his "no-new-taxes" pledge. But it deserves a lot of credit for putting the economy on a path to a future of declining budget deficits.

In 1993, when Clinton came in, he decided to give top priority to addressing the deficit (thereby postponing some things he had talked about in the election campaign: a middle-class tax cut and investment spending). He renewed the spending caps and the PAYGO system and set a path for tax revenue and government spending such that gradually, in the course of time, as the economy grew, the paths would cross, and we would return to a surplus.

The third step that I think was important came when surpluses did emerge in 1998. There was tremendous pressure to spend them—the Republicans in Congress wanted tax cuts; the Democrats (and some Republicans too) had all kinds of projects to spend money on. The

White House succeeded in holding the line with the stratagem of “Save Social Security First.” In the State of the Union address in 1998, Clinton offered that as a slogan. It generated a bipartisan consensus, which lasted three years, to save the social security surplus—not use it to fund the rest of the deficit. You know about the retirement of the baby boom generation. The surpluses were not enough money to pay for it entirely, the upcoming cost of social security and Medicare. But the policy was at least “let’s save the surpluses until we put social security on a firm footing”—no tax cuts, no big spending increases.

What the mechanisms of the 1990s—spending caps, PAYGO, and “Save Social Security First”—have in common is budget neutrality as a criterion for future changes relative to the baseline. The strategy comes from the logic that to achieve budget balance, we need what I will call “shared sacrifice.” It is the idea that “If I **<<do you mean “I will”?>>** forgo my spending increases if you forgo your tax cut.” The only way you ever get budget discipline in the long run is a common spirit along the lines of “I would like to get my pork-barrel project funded for my constituents, but I will hold back if everybody else is holding back.” The 1990s showed that the principle of shared sacrifice works.

There are other proposed mechanisms to implement the principle of shared sacrifice in a more rigid way: The Gramm-Rudman legislation that was tried in the 1980s, the Balanced Budget Amendment (BBA) that was proposed in the United States ten years ago, the Stability and Growth Pact (SGP) in Europe. Those mechanisms are all pretty crude. We rejected the balanced-budget amendment, in large part because governments should have flexibility to run deficits in recessions. The Europeans are having troubles with their SGP. Not only is it not sufficiently flexible, it lacks any credibility. (In part it lacks credibility because the cost of rigid adherence is sufficiently high that people don’t believe governments will abide by it, even sincere, responsible governments.) There are proposals for a BBA or SGP that allows cyclical adjustment of the deficit targets while maintaining a balance of zero on average. But if you allow more flexibility in the form of cyclical adjustment, then you will lose even more credibility:

governments will always claim that their budget shortfalls are due to temporary bad luck in the economy. The proposal I like is a formalized version of an institution that Chile now has. The rule is a cyclically adjusted budget surplus of zero (actually 1 percent, in Chile's case). But you appoint an independent fiscal authority or commission of experts, by analogy with the Fed and other independent central banks, and they are the ones who have the responsibility for saying what constitutes deviations from potential output, for computing the cyclically adjusted budget, and for announcing whether this year's budget satisfies the rule. The rest of the government still has the responsibility for allocating spending and taxes within the total, as it should in a democracy.

Short of major political reforms that are improbable in the United States, I think the shared-sacrifice mechanisms of the 1990s worked pretty well. The problem, of course, is that they expired in 2001 and that there has been no effort to restore them, at least not from the White House.

I have discussed how we, or Clinton, achieved a surplus. How was Bush able to achieve such big deficits? The 2001 recession helped. And it is always easier to give away money than it is to collect money—that is an important principle of political economy. But there is a third factor; namely, that the government made predictably overly optimistic forecasts of future budgets. This enabled it to say, "Look, we can afford these huge tax cuts." That was part of the mechanism that allowed this fiscal mess to come about. They release their budget forecasts twice a year, and, until now, every time they have been forced to admit that last time they were wrong. And then, every time, they have done it again—"they" being both the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB). (Two qualifications: 1. The CBO has little choice but to base its projections on current legislation; 2. The OMB forecast for 2004 may, for the first time, be on the pessimistic side, which will allow it for once to say the budget came in better than expected.)

When the new administration came in, in January 2001, they boosted the revenue estimates (the CBO raised the predicted share of income going to wages, a subtle way to achieve this effect), helping them claim that we were going to have record surpluses rising as far as the eye could see. In May 2001 they admitted that the surpluses weren't going to be quite as big as they had said, but still substantial surpluses, and still rising. In January 2002, the same thing: that the surplus was small now, but it was still positive and still rising in the future. (This is after the recession on September 11, now.) Then in August—whoops!—we were in deficit after all, but that was going to go away gradually in the future. And then they continued, each time, to be forced revise.

It is surprising that the press goes on reporting these forecasts, largely at face value. Here is what the government is still forecasting (the CBO forecast, since the OMB has decided to stop forecasting at the ten-year horizon). Yes, we are going to have deficits for the next few years, but we're on a path to surplus by 2013. That is still overly optimistic, for a lot of reasons.

Some of the original sources of bias in the forecasts have gone away. The original budget forecasts were overly optimistic on the economic assumptions, but that's no longer true—they **<<who, the administration?>>** are now being realistic on their economic assumptions. The current official budget forecast, although they have revised way down and they admit to $2 trillion of budget deficits cumulating over the next ten years, is still way overly optimistic on the revenue side. The trick of making estimated future tax revenue look good through the pretense of sunsetting tax cuts is still there. The administration is still proposing to make the tax cuts permanent and is proposing new tax cuts after 2009. Also they are not proposing a way of dealing with the alternative minimum tax, which is going to cost, maybe, $700 billion spread over ten years. Various estimates of the cost of those omissions on the tax side are about $2 trillion over the next ten years if you add it up.

The over-optimism on the spending side is, if anything, is as bad as ever. They **<<the administration?>>** claim that they are going to limit overall spending. But they are going to let military spending grow rapidly, which implies cutting nondefense discretionary spending by

15 percent over the next five years. How could anybody believe that? Just like Ronald Reagan before them, they have never made specific proposals to slash agricultural subsidies or the manned space program or much of anything else—quite the opposite. Also, they are not allowing anything in the budget for spending in Iraq or Afghanistan after September 1. They are planning on asking for a supplemental to cover it, which means they are going to pretend to be caught by surprise by the need to continue spending money there. They do have in the budget an estimate of the cost of the Medicare drug benefit program that they supported for the votes. But—notoriously—they suppressed the realistic estimate from the relevant expert in order to make the budget look artificially good.

If spending rises along with GDP, then the outlook is $1.6 trillion worse than last year's CBO forecast. If it rises in the future at the same rate that it has over the last five years, which is approximately 10 percent a year (7 percent last year; more than 10 percent in the previous three years), then the outlook for the budget over the next ten years is over $3 trillion worse than what CBO has been forecasting. Figure 3: As of 2004, the long run forecasts are still too optimistic **<<what is this, out of place? Does it belong on previous page?>><<please cite figure 4>>**

But let's be very conservative. Let's assume that real spending increases only along with population, not as a share of GDP, but let's add in a conservative estimate of the Medicare drug cost and add in the tax corrections. These figures are from a new book by Alice Rivlin and Isabel Sawhill at Brookings.[1] Goldman-Sachs has done something pretty similar and gotten the same answer. Far from getting better, the budget deficit as a share of GDP would stay approximately as bad as it is today. That is the middle line in Figure 3, as opposed to the official upper line. The difference is about $4.6 trillion relative to what is officially forecast. Thus, overall, the forecast is about $6 trillion of debt over the next ten years. That implies a rising ratio of debt to GDP. And, of course, real interest rates are very low today. If they start rising sharply, we could fall into the sort of explosive debt path with which Argentina is familiar.

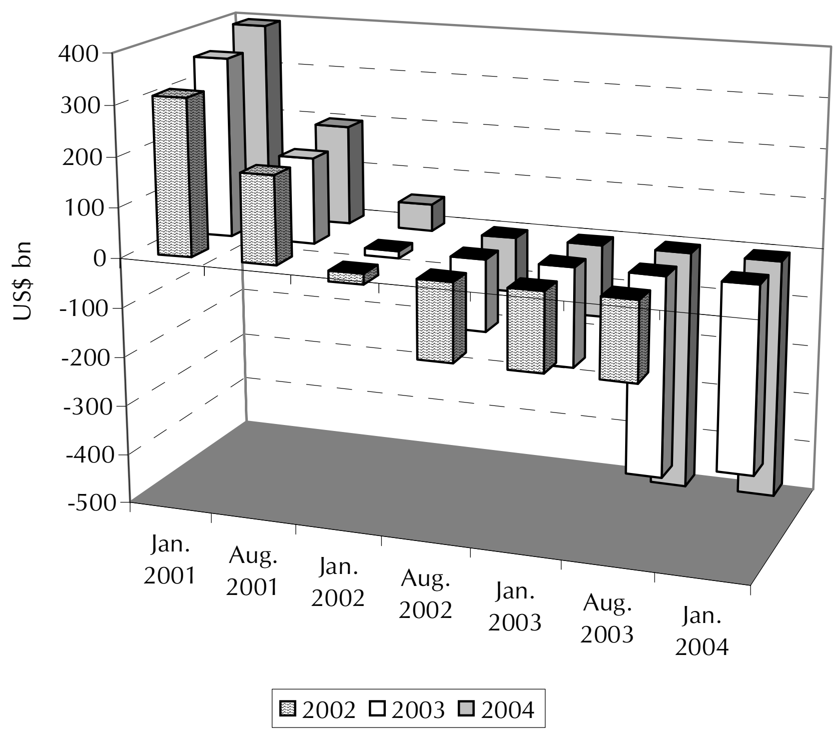

Figure 3. Forecasted Annual Budget Balance

Bill Niskanen and I overlapped in the first Reagan administration. (You may be surprised to hear that I was there. I was on the staff of the Council of Economic Advisers in 1982 and 1983, not a politically appointed member, as Bill was then and as I was in the Clinton administration.) In 1981 Ronald Reagan complained that he had inherited $1 trillion of national debt. He gave a number of speeches where he said that in terms of thousand-dollar bills stacked up, the debt would reach sixty-seven miles high. I had thought he also said that if you put the thousand-dollar bills end to end, they would reach the moon. It is a true statistic—but I haven't been able to find in the archives that he said it. I wonder if Bill remembers Reagan saying that. I wish I could find the line about the thousand-dollar bills reaching to the moon, because then I could say, "George Bush is going to Mars."

What happened in the 1980s? Reagan fiscally did pretty much what

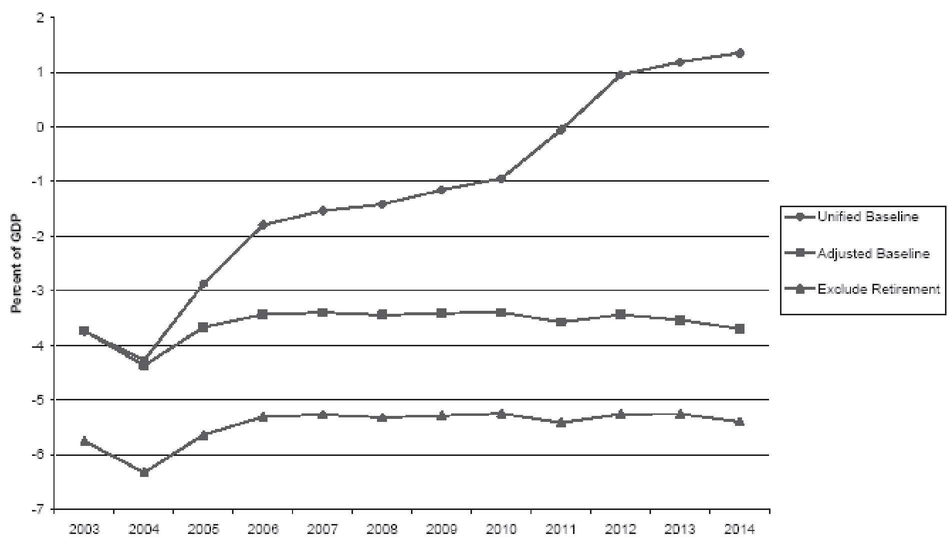

Figure 4. Baseline and Adjusted Outcomes as Percentage of GDP, 2003–2014

Source: Alice M. Rivlin and Isabel Sawhill, ed., "Restoring Fiscal Sanity: How to Balance the Budget," Brookings Institution, Washington, DC, January 13, 2004, authors' calculations (www.brookings.edu/es/research/projects/budget/fiscalsanity.htm); and Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2003). Reprinted with permission.

Bush is doing, which is to say increase military spending rapidly and cut taxes sharply. Over his term, and his second term, and the term of the first George Bush, they each added $1 trillion, so that by the time the Republicans left office in 1993, the national debt was $4 trillion. In each of their three terms, they added more debt than the previous thirty-nine presidents of U.S. history had added. But if the second George Bush gets another term, he will add roughly as much to the national debt as did his father *plus* Ronald Reagan *plus* the thirty-nine previous presidents added together.

Those statistics, everything I have told you so far, do not take into account the fact that they are raiding the social security surplus to pay for this. If you take out the social security surplus, then that's another $200 billion per year—that is the lower line in Figure 3, approximately another 2 percent of GDP. I am also not counting the recent White House proposals to expand tax-deferred saving accounts, which is another time bomb designed specifically to lose its money outside the reported budget window.

What does this administration think it is doing? What is its goal? If you take literally the name of the Jobs and Growth Act, you might think the goal is to stimulate economic demand during the recession. It had some effect it that direction, but I think it is poorly designed to provide fiscal stimulus, for some of the reasons that Barbara Bergmann mentioned. True, you cannot blow $6 trillion without having *some* stimulative effect of the economy, and I think it has had that. But it is as if they are trying to minimize the "bang for the buck," to make this as expensive as they possibly can, with as little stimulus as they can possibly get out of it—partly because it is specifically going to things like eliminating the estate tax in the year 2010, which is not going to do anything for the economy today. It is not designed to boost the economy today.

Clearly some of the features are designed to move toward a tax system that promotes saving. Apparently the goal, eventually, is to reform the corporate income tax or perhaps to abolish taxes on capital altogether. We can argue the pros and cons of that, but I would say that this is not a sound pro-investment tax reform program, not good public finance economics. One knows what a good tax-reform program looks like: It worries about budget balance, and it tries to avoid driving up interest rates.

Some observers, particularly some economists associated with the University of Chicago, say that what the Bush administration has in mind is a clever, deliberate political strategy to reduce the size of the government. This is the starve-the-beast theory: if you cut taxes, the government will be forced to cut spending. They say, "Congress can't spend money it doesn't have," evidently never having watched Congress in operation. This is an argument that was trundled out by the first Reagan administration after two or three years of record deficits, in other words, after the Laffer curve and Ricardian equivalence and the other rationales for big tax cuts had failed to work. They switched to the starve-the-beast theory. Here is one piece of evidence that this wasn't what they had in mind from the beginning. Bill Niskanen got into trouble with the White House in 1981 for saying, "Don't worry that much about the deficit." At that time, they were still arguing that they needed to eliminate the deficit.

I don't think that it's right, the idea that the Bush White House really wants to cut spending but they are just not able to because Congress won't go along. It doesn't make sense. Who is going to cut the spending for them? Do they think the "big spending" Democrats are going to do it? The Republicans haven't even tried to cut spending in any serious way. They only want to talk about cutting spending, not actually to do it.

I have already mentioned what I consider to be the competing alternative hypothesis of political economy: the way to establish fiscal discipline is a regime of shared sacrifice. "I will give up my pet spending increase or tax cut if you give up yours." Remember what worked in the 1990s: spending caps and PAYGO. This legislation constituted a mechanism so that a given congressman felt constrained that if he gave money away, that is, if he increased spending, he would have to pay for it somewhere else, and his constituency would get mad at the tax increase. That succeeded in restraining spending in the 1990s.

It's quite different from the principle of starve-the-beast. The first is "I will give up the tax cut I want if you give up the spending you want." The second is "I will take the tax cut I want, and in return you give up the spending you want." Which one sounds like a more politically plausible route to a deal in Congress?

The starve-the-beast approach says that the way to restrain spending is to create huge deficits so that people worry so much about the national debt that they will come complaining to their congressman: "I'm worried about raising taxes on my grandchildren." Maybe people will worry about the national debt, about taxes on their grandchildren. But surely they don't worry more about such uncertain prospective future taxes (as in starve-the-beast logic) than they worry about *certain taxes today* (as in shared-sacrifice logic, under which changes have to be paid for today). So as a political economy argument, starve-the-beast just doesn't work, if the alternative is the preceding regime. I don't think it describes the original motives behind the Bush administration fiscal policy, as opposed to an ex post rationalization that it is convenient to use in some circles and not in others.

So what, then, describes their motives? Getting reelected is the most obvious argument, particularly if you look at how they also abandoned Republican principles on trade policy, agricultural subsidies, and lots of other things. It seems to make sense, that they just want to get reelected. But people say that Karl Rove is the political genius behind the Bush administration, and they say that he is out to create a Republican domination of this country well beyond two presidential terms. Well, if so, what is he thinking?

Bush—if he is reelected—maybe can try to put off the fiscal day of reckoning for another four years. But 2008 is when the baby boom generation starts to retire. At that point, the fiscal problem will be so obvious to the financial markets, and even to the electorate, that it will become hard to continue postponing adjustment, no matter how irresponsible they want to be. So that means that, if they do get another term, they will have to deal with the consequences of this, of creating a fiscal crisis. So in answering the question of what they think they are doing, I have to say that I don't know what they are doing, and I worry that they don't know what they are doing either.

Finally, let me say a little about economic effects of the deficits. For you who were here in the previous session, there seems to be a consensus that, in the short run, fiscal expansion is expansionary. But, at the same time, expectations of being on a path of a rising debt-to-GDP ratio in the future could put a lot of pressure on long-term interest rates today, and that in itself is contractionary. The two effects go in opposite directions—the contemporaneous expansionary effect and the contractionary effect via long-term interest rates. In practice it is hard to separate the two out. Actual moves toward fiscal discipline are usually required in order to influence expectations and achieve credibility. Table 1 reports regressions for the United States and five other countries, where the effects of expected future debt seem to show up in determining long-term real interest rates today.

Table 1

Expected Budget Deficits and the Determination of Long-Term Real Interest Rates

	U.S.	Germany	France	Italy	Spain	UK
Constant	–0.001	–0.122***	–0.022	–0.081	–0.043*	–0.034
	(0.008)	(0.038)	(0.027)	(0.041)	(0.023)	(0.030)
Inflation	1.00	1.00	1.00	1.00	1.00	1.00
Debt ratio	0.060**	0.182***	0.027	0.109	0.031	0.067
	(0.019)	(0.047)	(0.040)	(0.062)	(0.051)	(0.044)
Expected change	0.144**	0.112***	0.177**	0.324**	0.289***	0.066
in debt ratio	(0.061)	(0.032)	(0.073)	(0.106)	(0.048)	(0.110)
Output gap	0.388**	0.608**	0.252	0.297	0.218	–0.316
	(0.174)	(0.219)	(0.202)	(0.484)	(0.223)	(0.324)
Foreign int. rate	0.096	1.529***	0.923***	0.390	1.204***	0.815**
	(0.122)	(0.327)	(0.241)	(0.446)	(0.145)	(0.348)
N	15	15	15	15	15	15
Adj.R^2	0.32	0.51	0.82	0.77	0.82	0.55
DW	2.24	2.50	2.47	1.70	2.47	1.44

Source: Jeffrey Frankel and Menzie Chinn, "The Euro Area and World Interest Rates." Conference proceedings, Center for Economic Policy Research, London, October 15, 2003. **<<source correct? >>**

Notes: OLS regression using annual data, in levels.
(Newey-West robust standard errors in parentheses).
Percentage variables defined in decimal form.
* denotes significance at the 10 percent level
** denotes significance at the 5 percent level
*** denotes significance at the 1 percent level

Table 2 is a stylized account of recent fiscal history in this light. It covers four presidential terms, two for Clinton, one for Bush, and a fourth that will be heavily influenced by the Bush legacy of debt whether he is the president again or not. The effects of contemporaneous fiscal stimulus appear in the first Clinton column and the first Bush column. I would say that Clinton's mildly contractionary fiscal policy had a mildly contractionary effect contemporaneously, and Bush's expansionary fiscal policy had a modest positive stimulus contemporaneously.

But now let's talk about expectations, the effects on the economy of expected future fiscal paths, which come through long-term inter-

Table 2

<<title?>>

	Clinton administration		**Bush administration**	
Effects on growth	**First term: 1993–96**	**Effects in second term, 1997–2000 and beyond**	**First term, 2001–4**	**Effects in second term, 2005–8 and beyond**
As, over time, the numbers show the promises of fiscal responsibility . . .		To be increasingly credible		To be less and less credible
(1) Effect of contemporaneous fiscal stance, via demand	Mild contraction	Mild contraction	Positive stimulus	Approx. neutral
+ (2) Effect of expected future fiscal path, via long-term interest rates	Mild expansion	Strong positive effect	Mild contraction	Strong negative effect
= Overall impact of fiscal policy on growth	Approx. neutral	Positive	Weakly positive	Strongly negative

est rates. They are illustrated in the second and fourth columns. Both Clinton and Bush claimed to be on a good long-term path. Initially it wasn't entirely credible on either part. But Clinton even in his first term got some credibility benefit. In the second term, when the markets saw that these promises were coming true, interest rates declined, the stock market rose, investment boomed, and the economy grew.

Clinton set goals by the end of the first administration to cut the deficit in his second administration. These claims of fiscal responsibility became increasingly credible, so cut the long-term interest rates (with accommodation from the Fed).

I think that in the second term of Bush, if there is one, or the Democratic candidate, we are going to see the emergence of the deficit numbers that I gave you, which have not been properly absorbed by the public and the markets. Interest rates are going to go up, and that is going to start to have a negative effect on the economy.

Of the adverse consequences of growing deficits, interest rates are perhaps the most debated. The concern, of course, is crowding out investment and slowing growth. Glenn Hubbard, George Bush's first Council of Economic Advisers chair, responded to interest rate concerns in two forms, one for political audiences and one for a professional audience. He wrote a proper phrase for the White House: "Interest rates do not move in lockstep with deficits." Superficially that sounded to be in support of the proposition that there is no connection. We got that trick right away in academia; deficits aren't the only thing that affects interest rates. Monetary policy does too, for example, but, you know, big deal. It is like saying, "Who wins in a ballgame doesn't move in lockstep with who hits the more home runs." I guess that's true, but if you hit more home runs, you are better off! Similarly, bigger deficits mean higher interest rates *other things equal*. As a defense, it is true, but practically empty of content.

Then there is the response Glenn gave for his economist peers. This was a calculation that said, yes, the budget deficit would affect interest rates, but the effect would be small. Though his calculation gave a smaller number than would many others, it was based on a perfectly respectable economic model. Do you know how he got his estimate? He assumed that increased debt causes one-for-one crowding out of investment, and asked what magnitude is that as a fraction of the total capital stock, and what does that do to the marginal product of capital? That is the effect on the real interest rate. In other words, the exercise is to compute what increase in the interest rate you need to accomplish the crowding out. He got a relatively small number. I don't much care. The reason we are worried in the first place is because of crowding out. If we have a given amount of crowding out, then whether that's accomplished through a small increase in interest rates, or a big increase in interest rates, or a fall in the stock market, or some other channel, I don't really care. It's a crowding out of investment and the trade balance that are the problem.

If the Democrats are trying to pin the blame of the recent recession on Bush, I don't think that's right. Rather it's the next recession that is going to be his fault. I don't know when that will be. But when it comes, we are not going to have the ability to use fiscal policy, to cut taxes, the way they did in 2001. Next time, tax rates will already be low, and the fiscal policy option will be gone.

William Niskanen: My role in this panel is that of a scoundrel who sees things as they are, rather than as they ought to be. I want to share with you two intriguing findings about what drives federal spending. In a prior exploratory article, I found that federal spending as share of GDP from 1981 through 2000 was a *negative* function of federal revenues as a share of GDP.[2] In a separate article, I found that the rate of increase in real federal spending since World War II was lower in administrations in which at least one of the two houses in Congress was controlled by the other party.[3] My new paper presents separate estimates of each of these relations.

First let me talk about what has been called the starve-the-beast hypothesis. Over nearly three decades, many conservatives and libertarians have argued that reducing federal tax rates, in addition to an increase in long-term economic growth, would reduce the growth of federal spending by "starving the beast." This position was recently endorsed, for example, by Nobel laureates Milton Friedman and Gary Becker, in separate *Wall Street Journal* columns in 2003.[4]

The problem with this hypothesis is that it is *not* consistent with the evidence, at least since 1980. My article presented evidence of the relative level of federal spending over the period 1981–2000, where coincidentally the relative level of the burden of federal taxes went in the opposite direction. In other words, there was a strong *negative* relation between the relative levels of federal spending and tax revenue. Controlling for the unemployment rate, federal spending during this period increased about one-half of 1 percent of GDP for each percentage point decline in the relative level of federal tax revenues.

What is going on here? The most direct interpretation of this relation is that it represents a "demand curve" for federal spending. Demand for federal spending by current voters declines with the amount of this spending that is financed by current taxes. Future voters will bear the burden of any resulting deficit but are apparently not effectively represented by those making the current fiscal choices.

One implication of this relation is that tax *increases* may be among the most effective policies to reduce the relative level of federal spending. On this issue I would be pleased to be proved wrong.

Second, for the divided government hypothesis, my brief 2003 article presented evidence that the rate of growth of real federal spending in the years after World War II was lower during the administrations in which at least one house of Congress was controlled by the other party. The only two long periods of fiscal restraint in the sample were during the Eisenhower and Clinton administrations, during which the opposition party controlled the Congress in the last six years of each. Conversely, the only long period of unusual fiscal expansion was the Kennedy–Johnson administration, which brought us both the Great Society and the Vietnam War, with the support of the same party in Congress.

One reason for this condition is that the prospect for major war has been substantially higher under unified government. I recently went back over history and found that American participation in *every* war in which the ground combat lasted for more than a few days—beginning with the War of 1812 to the current war in Iraq—was initiated by a unified government. A more general reason for this effect of unified government is that each party in a divided government has the opportunity to block the most divisive issues proposed by the other party.

My judgment is that our federal government may work better, or less badly, when at least one house of Congress is controlled by a party other than the party of the president. American voters, in their unarticulated collective wisdom, have voted for a divided government for most of the past fifty years. Divided government is not the stuff of which legends are made, but the separation of powers is probably a better protection of our liberties if the presidency and Congress are controlled by different parties.

I have updated both of these tests. On the starve-the-beast hypothesis, the test equation is the spending share of GDP as a function of the federal revenue share of GDP in the *prior* year, the current unemployment rate, and a first-order autoregressive term. The other thing that I have done is to test the same relationship for the period 1949–1980, to see whether the relationship I had found for the post-1980 period would also fit the period prior to 1981. It does not, as it turns out.

The first conclusion from this test is that both the relative level of federal revenues in the prior year and the unemployment rate had a significant positive effect on the relative level of federal spending in the sample 1949 to 1980. This finding is consistent with the starve-the-beast hypothesis during this period.

The more important conclusion, and the more perplexing conclusion in a way, consistent with my prior estimates of this equation, is that there is a strong negative relation between the relative level of federal spending and the relative level of federal revenues in the sample 1981 to 2000. Controlling for the unemployment rate, federal spending during this period increased again about one-half of 1 percent of GDP for each percentage point of relative decline of federal revenues in the prior year. The first three years of the current Bush administration were not in this sample, but they are consistent with this relationship. During the period that conservatives and libertarians promoted the starve-the-beast hypothesis, the developing evidence was strongly contrary to this hypothesis.

Finally we are left with a puzzle. Why was the relation between the relative **<<is this what you mean? Or delete “relative”?>>** level of federal spending and federal receipts strongly negative in the period 1981 to today, but positive and significant during the period from 1949 to 1980? What happened in federal fiscal policy that might explain this substantial difference in the estimates from these two samples? I do not know. But I suspect that it is the growing influence from the “supply-siders,” who have a good case that high marginal tax rates substantially reduce economic growth. Their influence undermined the influence of the traditional conservatives’ commitment to a balanced budget. This is only a suggestion.

My new test of the divided-government hypothesis does three things. One is that I test these effects year by year rather than administration by administration; second, I add the years 1949–1952 to the sample; and third, I do a formal difference-of-means test to test the significance of the difference between these. What I found is that during periods of unified government, all the way from 1949 to today, the mean rate of growth of real per-capita federal expenditures was 3.8 percent per year, whereas in divided government, the mean annual change in real per-capita federal expenditures was 1.27 percent. So the rate of growth during unified government was basically three times that during divided government. Then doing a difference-of-means test, the difference of the means was 2.53 percent per year, and with a standard deviation of this difference of means of 1.32, I get a t-ratio of roughly 2, so it does look like there is a significant effect.

Again we are left with a puzzle. Much of the annual variance in total federal spending per capita in the short run is due to changes in defense spending. But if most of the variance in defense spending is exogenous, it may be only a coincidence that the largest increases in total real federal spending per capita had been under a unified government, and the lowest increases under a divided government.

My judgment, however, is that a large part of the variance in real defense spending has been a function of domestic political conditions. I find it hard to dismiss the implications of a nearly 200-year pattern in which American participation in *every* war involving more than a few days of ground combat was initiated by and under a unified government. Divided government may have the lowest rate of growth of real federal spending in part because it has been an important constraint on American participation in war.

In conclusion, each of these tests has produced an intriguing finding about federal spending. Each, however, is a test of a single possible explanation of federal expenditures without controlling for the condition addressed by the other tests, or for other conditions that may also affect federal spending. And each of these tests has left us with a puzzle to which the answer is not apparent, at least not to me. My hope is that this presentation has planted some ideas that others may develop.

Laurence Seidman: What I would like to do is set out a way to run fiscal policy both in the short run and in the long run—and to take both into account simultaneously. My position is intermediate between two extremes. One extreme says, "Always worry about budget deficits, every year." The other view is, "Never worry about budget deficits, this year, next year or the year after." In a normal economy over the long run, we want balanced budgets and fiscal discipline, and I will get into the details about how to do that. But when the economy goes into a recession, we want temporary short-run fiscal stimulus. In a recession, run the deficits as a fiscal stimulus, but in normal economies over the long run, have tight fiscal policy and fiscal discipline. If you don't normally have fiscal discipline, you can't run this fiscal stimulus with temporary deficits in the short run that you may need. John Taylor, of the famous Taylor rule, who was on the Council of Economic Advisers in the first Bush administration during the 1991 recession, admitted that it was very difficult then to propose short-term fiscal stimulus, because during the 1980s they had run up such budget deficits, and therefore debt, that people were afraid of it—financial markets were afraid of it—and their hands got tied about using it in the emergency of the recession.

So if you want to use it in the emergency of recession, you need to—I think Larry Summers may have been the one to use this phrase—"reload the fiscal cannon" in good times. When the sun is shining, do Rubinomics, or whatever you want to call it, have tight budgets, surpluses if possible, and keep a low debt-to-GDP ratio, so that if we get into trouble in a recession, we can temporarily run deficits, and it is acceptable to the public and the financial markets. Let me first talk about the long run. My proposal for the long run is really an old idea. For half a century, economists have advocated it. It is the full-employment balanced budget rule. There are some little wrinkles in it, so I will change the acronym to NUBAR, "normal unemployment balanced budget rule." Congress should be under a statute (I would not try to put it in the Constitution) that says the following: Each year Congress should enact a budget, a planned budget for the coming fiscal year, that technicians estimate will be balanced next year if next year's unemployment rate is normal. This is the old full-employment balanced budget rule idea, except it avoids the debate on "What is full employment?" I would just say, take normal unemployment. We might define that as the unemployment rate of the last ten years, to get realistic—on average, that is really what happens—and try to avoid a debate about "What is really full employment?" Conceptually, it is exactly the same. It focuses on the planned budget. Technicians, probably at the CBO, would be the ones who would have to sign off on it. Once you get into the next year, and the economy drops into a recession and the revenues drop, you won't have to do anything because this is about the planned budget, not about the actual budget. So it avoids the danger that we could get into with the old, classical rule of a balanced budget all the time, through which a recession could turn into a depression. But the new rule would put pressure on Congress and the president every time they are planning a budget. To liberals it would say, "You want to raise spending—fine. But are you willing to raise taxes?" To conservatives it would say, "You want to cut taxes—fine. But you have to be willing to plan a cut in spending." So it would impose some discipline on the politicians, whether liberal or conservative.

Having a tight fiscal policy has other benefits. In the old days they used to call it the "tight fiscal, easy monetary mix," which would promote long-run economic growth, as Bob Solow, Paul Samuelson, and others emphasized. The composition of the pie would be more investment with a low interest rate and less consumption with a tight fiscal policy, so that, over time, you would have faster capital accumulation and growth, and improve the standard of living at a faster rate. Another reason for keeping fiscal discipline in normal times is to keep the confidence of financial markets. If financial markets feel that there is no fiscal discipline, as Jeff [Frankel] pointed out, the markets will expect interest rates to rise in the future, so immediately you get a rise in long-term interest rates, and you get harm to investment and capital accumulation in the short run. And you certainly don't want to test out how far you can go with running up your debt-to-GDP ratio. Look at Japan! Whenever some of us say, "Japan needs fiscal stimulus," we quickly are given the argument that their debt-to-GDP ratio has now gone over 100 percent, and everybody is worried—"We can't do it." Well, I think that can be debated, but the practical answer is, "In normal times, get that debt ratio low, have fiscal discipline, so that when you get into trouble and need stimulus, you've got the means to do it."

Now, what about the stimulus in the short run? This is where some economists have gotten pessimistic about whether, in practice, Congress can, in a timely and effective manner, get the stimulus out. I think we have to push, in our textbooks, in our public debate, for making fiscal stimulus automatic in a recession. Just to quickly sketch it: It should be automatically triggered when the unemployment rate, for example, rises above a given point in a given quarter. Automatically, transfers would be sent out to households. It could be done with purchases or with cash transfers to state governments, but I am going to concentrate on the transfers to households like the $600 tax rebate in 2001, which I think was a step in the right direction. It was too small, it wasn't repeated, but it was a start. The key is to have this pre-enacted. Our textbooks and our courses should spend some time saying that a missing ingredient in current macro policy is Congress's pre-enactment of a fiscal policy package that would be triggered automatically when the unemployment rate jumps above a threshold and is de-triggered automatically when the unemployment rate comes back down below that threshold, so that it is clearly temporary. **<<sentence was hard to follow, is edit OK??>>** This is the key missing ingredient.

The latest evidence suggests that consumption does respond to cash transfers—not as much as, say, in the early Keynesian view that, if you give them $1,000, they will spend $900 immediately, but the permanent-income and life-cycle views are overly pessimistic in saying that people would spread it out over the rest of their lives. The reality is something in the middle. Greg Mankiw did a nice review of empirical work in the 2000 *American Economic Review*, saying it is somewhere in between.[5] If you then look at the numbers and run some simulations, you will find that if you trigger a tax rebate twice as large as the 2001 rebate ($1,200 instead of $600), but keep repeating it every quarter as long as you are in a high-unemployment-rate period, you could chop roughly a full percentage point off the unemployment rate. That's a lot of jobs, that's a lot of well-being of the people and the economy, which I think would occur.

During this debate in the last few years, there were very few economists publicly saying, "We need to have this on the books, an automatic policy like this, triggered and de-triggered." Once again, we got **<<have?>>** to cover that, in the long run, and over the normal economies, you are running tight fiscal discipline. **<<sense? Please clarify>>** By the way, I think the methods that Jeff [Frankel] emphasized in the nineties, about pay-as-you-go—that anytime you propose a spending increase, you have to propose a tax increase; anytime you propose a tax cut, you have to propose a matching spending cut—that's exactly right, that's the discipline you want to press on them in normal times. And you also need to have an administration—as Secretary Rubin exemplified—saying to the public, "We are worried about fiscal discipline in normal economy and in the long run. We temporarily want to stimulate, but we are not going to do this on a permanent basis." We haven't had that in this country in the last several years. And we still don't have it coming loud and clear from the economics profession. Part of the economics profession believes monetary policy alone can handle a recession. Well, it can handle some but not all recessions. So that is my proposal as set out. Stimulus in a recession, but discipline in normal economies and for the long run, and make the stimulus in a recession automatically triggered.

Barbara Bergmann: I would like to talk a little bit about the slogan President Clinton chanted in his State of the Union messages: "Save Social Security Now." Those who want to destroy social security are pretending it is going to go bankrupt, and they are telling the public they are going to lose their contributions and never get the promised pensions. Clinton made a terrible mistake pretending that social security needed saving—his slogan plays right into the hands of the people who want to destroy the public system. There are plenty of relatively minor changes that can be made by the time the baby boomers retire. We can, of course, increase taxes, particularly on the part of income not now taxed, and we can reduce scheduled benefits. So I think it is terrible to give the false impression that the social security system is like a private insurance company, which does not have the power of increased taxation or the power to cut its obligations.

William Niskanen: I think President Clinton was right. In order to maintain the current promised benefits, payroll taxes have to be increased from 12.4 percent to about 18 percent—that is the level of increase in the payroll taxes that is necessary to meet promised benefits, and that doesn't correct for the several biases in the system against young workers, those who have a shorter expected life, and two-worker families.

Barbara Bergmann: The public has shown itself willing to take hefty tax increases when it is told that the proceeds will go to social security.

William Niskanen: That's right, but you would have to increase revenues by the equivalent of a 6-percentage-point increase in the payroll tax in order to meet promised benefits. One way or the other, the government will either have to break promises or will have to impose a substantial tax increase to make Social Security sustainable.

Now that is overwhelmed by the problems of Medicare. The Medicare expenditures are going to take something like 12 percent of GDP, up from about 3 or 4 right now, in the next forty to fifty years. The current estimate is that if we keep the increase in medical expenditures to no more than 1 percent above the growth of GDP, Medicare expenditures will grow up to about 12 percent of GDP. Now I want to warn you that in the past forty years, medical-care expenditures have been increasing 3 percent per year faster than GDP, so 1 percent is very optimistic. I think that it is irresponsible to claim that there is "no problem" for social security or, for that matter, for Medicare. In the absence of a major reform of these two programs, the only way these problems are going to be solved is for the government to break promises.

Everybody who has been promoting, in one form or another, a privatization of social security would maintain the full benefits for people who are now retired or who are about to retire. There would be no reduction of promised benefits for them, or for those who choose to stay in the social security system. All these proposals give people an *option* for a private account, maintaining the full benefits of those who have retired or are about to retire.

So I think it is irresponsible to ignore what is a looming crisis. The Ponzi game is over. There is no longer any politically viable way to save social security and Medicare.

Jeffrey Frankel: Barbara [Bergmann] is right that it is not bankrupt. We are not going to have to cut social security or Medicare benefits to zero. Sometimes people get overly alarmist about it, so that is correct. But that observation doesn't take you very far, and I agree with everything Bill [Niskanen] said. There is a serious problem there. One could have imagined, three years ago, being on a path where we could have got through this with relatively minor adjustments in benefits or taxes. I can't imagine that now. We are looking at, probably, drastic cuts in benefits, breaking promises, together with pretty steep tax increases. If we got started on it right away, then maybe we could have only a moderate breaking of promises and moderate tax increases, but if we put it off much longer, then the necessary adjustment will be more extreme. The idea that we are going to get through it without any adjustment is now out of the question. Even if the White House were to achieve a fantasy projection of the growth rate, we are not going to get there.

But I have a second question. Barbara [Bergmann], presumably the reason you don't like Clinton's "Save Social Security First" strategy is because you think it has limited the ability to increase domestic spending. But why won't you give us some credit for having for three years held the line against the Republicans, who wanted to give away money in tax breaks? That was the more likely danger, which I can assert with confidence because that's what actually happened the moment Bush II came in.

Barbara Bergmann: Wouldn't a better way to fend off tax cuts be to call attention to the fact that we are the only country that doesn't have national health insurance? That we need more government subsidies for child care? That we need more housing assistance for working-poor families? More help with college expenses? Part of the reason the Democrats are out of office is that they haven't done enough to educate the public on the nation's needs. The Republican Senate Majority Leader Bill Frist said we can't afford national health insurance. We're the richest country in the world, and we're the only ones who don't have it. How come we can't afford it?

Instead of this "Save Social Security Now" business, we could have told the country what it needs and tried to promote it. That is the most essential thing that the Democrats have to do. The Clinton administration was traumatized by Hillary Clinton's bungle of national health insurance. But we will never make progress unless we get the public to stop believing that the government is a big bad evil thing that can't do anything good for us. The Democrats' failure to do that is part of the reason that they ended up out of power.

Let me remind Bill Niskanen that the privatization of social security would not be free. It would cost, perhaps, $2 trillion of extra money. There has been a suggestion that the way to finance that transition is to borrow it. Guess what? To increase the debt some more!

William Niskanen: It does take some increase in the explicit debt to allow people a private option. But that increase in the explicit debt reduces the implicit debt, which is many times the explicit debt. Our explicit debt that is not owned by the Fed is now about $4 trillion. But the implicit debt for social security alone is in the order of $12 trillion. So the privatization or social security choice options reduce the implicit debt because people opt out of social security, and increase the explicit debt to fund the transition. So it does require an increase in the explicit debt or other taxes or spending cuts, but you should look at the sum of the explicit debt and the implicit debt, and that goes down with this proposal.

Laurence Seidman: If I could just comment here. I am sitting right between Bill [Niskanen] and Barbara [Bergmann] on this, but actually I am right where Jeff Frankel's view is. We have a serious long-term problem with social security, but it doesn't mean you have to go to privatization, it does mean that you need to build up surpluses. I wrote a book a few years ago called *Funding Social Security: A Strategic Alternative.*[6] One of the best things that we have done is that in the 1980s, a bipartisan commission led by Alan Greenspan, before he went to the Fed, began to build up the Social Security Trust Fund. That is important. By the way, it is real, it is going to be able to be cashed in when we start drawing it down. We need to build it up more, and build it up better, and it is not painless, because you have to raise taxes or slow benefit growth in order to do it. We don't have to go to privatization. We have to go to building up in advance, and I think that's what President Clinton meant by saying "Save Social Security First" and transfer some of the funds. Anyway, before I let Barbara [Bergmann] grab this, I want to let her know that I agree with some of what she said earlier.

Barbara Bergmann: The effect of this attempt to prepay social security has been nil for social security. All it has done is to make the tax system more regressive by financing the defense budget through the payroll tax. And I disagree that the trust fund is a "real" thing. The money collected in the form of extra social security taxes has gone over to the Pentagon. All we have out of it now is a fleet of used fighter planes, and that is not going to help us buy bread for the older citizens.

Laurence Seidman: Now this is the beginning to a long debate. I just want to tie this in with what I said earlier. When you have a full-employment balanced budget rule, or normal unemployment balanced budget rule–and one wrinkle I didn't point out is that we need to separate social security and Medicare off-budget. The balanced-budget rule applies to the rest–social security and Medicare need to build-up surpluses. Bill [Niskanen] would say, “Privatize it!” but I don’t agree with that—they need to build up surpluses and pre-fund them. Barbara [Bergmann], you are right. If the rest of the budget is running larger deficits while you are building up the surplus, you are offsetting it. But if you have discipline in the rest of the budget and build up the surpluses in social security and Medicare, then you accomplish something.

Barbara Bergmann: Surpluses in the Social Security account are sent to the Treasury, which in return sends bonds, which we can think of as going into a drawer at the social security agency. If the agency ever needed to make an expenditure that could not be covered by current social security taxes, it could get money from Treasury by presenting those bonds to the Treasury and asking for repayment. To make the repayment, the Treasury would have to raise taxes, or lower expenditures, or run a deficit. But it could do these things and send the proceeds to the social security agency whether or not the agency had bonds in its drawer. So the presence of those bonds has no meaning. The Social Security Trust Fund is fictional.

William Niskanen: I would like the audience to know and remember that we have finally heard something on which Barbara [Bergmann] and I agree! [Audience laughs . . . applause.]

Jeffrey Frankel: We have been listening here to an interesting debate on the question of privatizing social security, between Bill Niskanen who is a principled conservative of a libertarian bent, and Barbara Bergmann, who is a principled liberal, and Larry [Seidman] in the middle. And we could have debates like that about the proper scope of the government when it comes to the environment or inequality or lots of issues—how to pick a balance, an optimal point on the tradeoff between those values versus the desirability of efficiency and laissez-faire, efficiency and growth.

But my problem is that, in this country, we are not having any kind of optimal tradeoff like that. We have a government that is composed not of honest conservatives, but rather of people who talk the rhetoric of discipline and small government and laissez-faire and free trade, and then do exactly the opposite every time they think it will get them votes. We are not on the optimal production possibility frontier between maximizing real growth in GDP and these other objectives. And I think that if we economists continue to debate as if it is all honest liberal vs. honest conservative, then we are missing the picture.

Any time you want to know what an honest conservative position would be, look up Bill Niskanen's numbers. But he is in a minority. The people in the public debate, who push most of the proposals to privatize social security, or others like the flat tax, tend to jimmy the numbers. They pretend that we can get something for nothing; they don't depict an honest tradeoff.

So we first have to focus attention on the dishonesty and the truth of the tradeoff before we can talk about where we want to be on it. Over the last five presidencies, it seems to me, Democrats have actually looked honestly at what the tradeoffs are, and Republicans have been in "never-never land."

William Niskanen: I don't know of any social security proposal that assumes that there are no costs. There are a variety of tax-cut proposals out there that assume it can be done without cost, but I don't know of any social security proposal that assumes that you can do it without costs.

There are several proposals that would give everybody a default portfolio of 60 percent equity and 40 percent bonds of a very widespread amount of securities. Only after they have accumulated a good bit in their accounts would they have greater freedom in choosing their portfolios. All proposals also have a safety net. We are proposing 120 percent of whatever is the then poverty line as a safety net. So we have a first line of defense in that we should have a conservative, broadly based portfolio, and then a safety net.

The numbers we are using come from the government, from the social security actuaries, so we are not using numbers that are any different than the numbers that go into social security's own calculations.

I blame the Republicans indirectly for the fact that we do not have a substantial social-security-choice proposal in place. In 1998 Clinton had half-a-dozen town meetings around the country to talk about this issue. We had a major White House conference in December 1998, in which four Cato people participated. He was very close to endorsing a social-security-choice proposal in the State of the Union message in 1999.

What happened in the meantime was the impeachment period, and the Democratic left made it clear to Clinton that their support in the impeachment hearings was dependent upon his backing away from this social security proposal. So I think that the impeachment process, which was an absurd process and wholly unnecessary, destroyed the possibility or the probability that we would otherwise have had a social security reform system in place already.

Matias Vernengo: I would like to intervene at this point, since we are approaching the end, and ask all of you to give a final round of comments on the Democrat/Republican switch on fiscal policy matters.

Laurence Seidman: I think it is sort of who is on offense. In the 1960s, the Democrats were on offense with the presidency and Congress; they wanted to raise spending for domestic programs. The Republicans said, "If you are going to raise spending, which we don't want you to do, you've got to raise taxes and balance the budget." The Republicans, on defense, preached a balanced budget. The Democrats said, "Don't make such a big deal out of deficits." Now, in more recent years, Republicans are on offense, they want to cut taxes, and Democrats say, "All right, if you want to cut taxes, which we don't want you to do, you've got to cut spending, and we've got to have a balanced budget."

Just one other point, though: In the short-run stimulus in these last few years, just to connect to your point, if we have slogans such as "Deficits Matter" or "Deficits Don't Matter," we are going to really be in trouble. We need to say, "In a recession, run deficits. But in normal circumstances, have fiscal discipline." You've got to have that degree of complexity in the message.

Look at the debate in the last two or three years. The problem with the Bush administration's approach is not deficits in the short run. The problem is permanent long-run deficits. And the problem was that tax cuts for the wealthy were a very inefficient and inequitable way to provide stimulus. Both parties agreed to $600 for everybody. But the Bush administration said, "For more stimulus, there have to be many more dollars for the upper-income groups," and that was very divisive, very unfair, and very inefficient in terms of the marginal propensity to spend. They could have gotten stimulus that was efficient and equitable, but they went for their own distributional priorities instead.

Jeffrey Frankel: Let me elaborate on my claim that the Republicans and Democrats have switched places regarding responsible economic policy. I am talking about the performance of the actual presidents, not candidates during the campaign, and not Congress. And I am talking about what the presidents actually do, not what they say. My claim is that the pattern is not just Clinton vs. Bush, but that it goes back twenty-five years. The Republicans have become the more irresponsible party, not just on budget deficits, where it is very striking as in the graphs I showed, but also on trade policy, on subsidies for agriculture and other special interests, on attempts to strong-arm the Fed into easier monetary policy. I have heard Bill Niskanen say in the past that Ronald Reagan and the current President Bush have been more protectionist—certainly more than Bill Clinton—but also more than any president in the postwar period. So this is a very general puzzle, why the two parties have switched places. Here is the best I can do at a hypothesis.

If you are out of Washington and pride yourself on being an "out-of-Washington," and your whole mindset is anti-government and anti-

Washington, you fall into the habit of thinking that it is very easy to cut back government—that all you have to do is cut back waste and abuse, give some speeches. It's evil bureaucrats who are expanding government. There doesn't have to be any pain for the public. It is just a matter of standing up to the bureaucrats. But it's not like that. For a pork-barrel project, there are people who benefit from it and can make a good-sounding case for why they deserve it. It is a difficult business to tell people that they can't have their import protection or their pork-barrel project. If you come into office thinking it is easy, you are completely unprepared to make the real compromises, the political tradeoffs, and the difficult calculations that you have to make. So you give speeches instead. I think that describes Ronald Reagan and that it describes the current president.

Barbara Bergmann: The reversal in rhetoric on the deficit results from truly evil behavior on both sides. On the Republican side is their desire to shovel money to the rich, their desire to increase without rational limit or need the money spent on fancy weapons, and their macho desire to establish permanent American hegemony in the world, starting with an expensive Iraqi adventure. On the Democratic side is their pusillanimous failure to try to explain to the American public that there are times when deficits are helpful (to the extent that they increase aggregate demand when that is needed, which the current deficit does poorly), and times when we would do better to balance the budget, or pay off past debt. Instead they are trying to get political mileage out of accusing the Republicans of a "crime" that the Republicans in olden days falsely propagandized the public to believe should never, ever, be committed. It's a sad spectacle.

William Niskanen: Seldom do I have an opportunity to have the last word, but it is appropriate on this issue. For I believe that the change in the major party positions on fiscal policy has been tactical and temporary, not structural and enduring.

For the past several decades, the Republican perspective on fiscal policy has been shaped primarily by supply-siders who have promoted a politically attractive but inconsistent free-lunch perspective about tax cuts:

1. A reduction of marginal tax rates would significantly increase long-term economic growth, a position that I share and that has been confirmed by the accumulation of empirical studies.

2. An increase in the deficit has no significant short-term economic effects (other than on the current account deficit), a position that I may have been the first to defend and has also been confirmed by subsequent empirical studies.

3. A reduction of marginal tax rates would not increase the deficit, a position that is both implausible and inconsistent with the evidence.

4. A reduction of marginal tax rates would increase the deficit, but that is a desirable effect because it would "starve the beast," a position that has not been consistent with the evidence since 1980.

My guess is that most Republican members of Congress would revert to their more traditional position about the deficit (if the president is a Democrat and tax cuts are not on the agenda) as an argument against spending increases. For the most part, this was their position during the Clinton administration.

The recent Democratic position of fiscal policy was also tactical and is probably temporary. "Rubinomics" was clearly an ex post attempt to explain the long boom of the 1990s as the result of some policy that Clinton had proposed and that was approved without Republican support. The 1993 tax increase was the only major policy change that met those conditions. From that came a revived Hooveresque claim that tight fiscal policy increases economic growth, primarily by reducing interest rates, although, in fact, interest rates increased until the Republicans won control of Congress in 1994. My guess is that this perspective would not survive the election of a Democratic president because, so far, the spending increases proposed by the Democratic presidential candidates are a good bit larger than the increased revenues from their tax proposals.

The sad fact is that neither party has an institutional commitment to a responsible fiscal policy. My guess is that the federal government will continue to have a substantial deficit until we are disciplined, probably, by a balance-of-payments crisis.

Matias Vernengo: Let me thank everybody, the panelists and the audience, for an enlightening and entertaining session. Although it is clear that there is no consensus on what optimal fiscal policy should be, in particular regarding the long-term effects of deficits, it seems that a wide range of the profession—from the progressive liberals to the conservative libertarian—would agree that the current fiscal stance is problematic. Irrespective of the electoral results, it is patent that important challenges lie ahead.

Notes

1. Alice M. Rivlin and Isabel Sawhill, ed., *Restoring Fiscal Sanity: How to Balance the Budget* (**<<City?>>:** Brookings Institution Press, 2004).

2. William A. Niskanen, "Comments," in *American Economic Policy in the 1990s*, ed. Jeffery A. Frankel and Peter Orszag (Cambridge: MIT Press 2002). **<<page nos?>>**

3. William A. Niskanen, "A Case for Divided Government," Cato Policy Report, January/February 2003.

4. Gary S. Becker, Edward O. Lazear, and Kevin M. Murphy, "The Double Benefit of Tax Cuts," *Wall Street Journal*, October 7, 2003. Milton Friedman, "What Every American Wants," *Wall Street Journal*, January 20, 2003. **<<page nos?>>**

5. N. Gregory Mankiw, (2000), "The Savers-Spenders Theory of Fiscal Policy," *American Economic Review* 90, no. 2. Papers and Proceedings of the 112th Annual Meeting of the American Economic Association **<<city?>>**, May, pp. 120–25.

6. Laurence S. Seidman, *Funding Social Security: A Strategic Alternative* (Cambridge and New York: Cambridge University Press, 1999).

For Further Reading

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