

# Fiscal Deficits

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Econ520

September 8, 2022

# Topics

In this section you will learn:

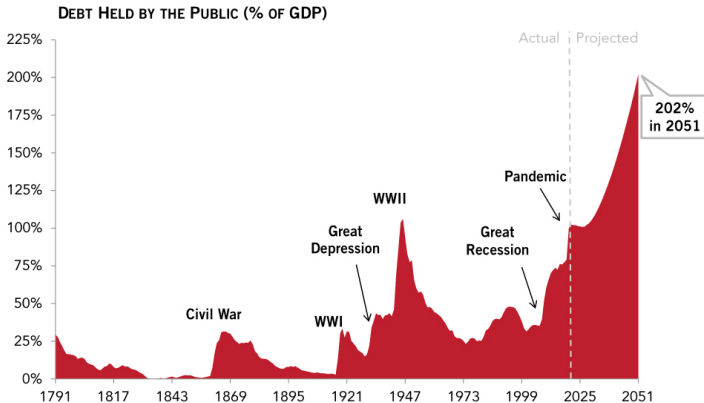
1. what the outlook for the U.S. government budget looks like
2. what deficits do

# Public Debt is Rising



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Federal debt is on an unsustainable path



SOURCES: Congressional Budget Office, *The 2021 Long-Term Budget Outlook*, March 2021, and *The Budget and Economic Outlook: 2020 to 2030*, January 2020.

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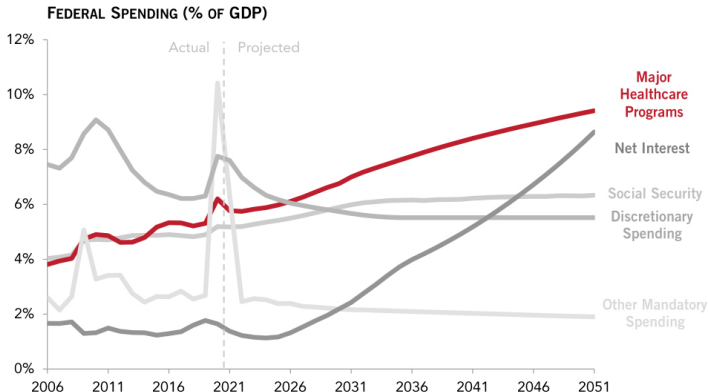
PGPF.ORG

Source: PGPF, 2021

# Main Driver: Health Spending



Spending for the major healthcare programs will continue to climb rapidly over the long term



SOURCE: Congressional Budget Office, *The 2021 Long-Term Budget Outlook*, March 2021.

NOTE: The major healthcare programs include Medicare (net), Medicaid, the Children's Health Insurance Program, and spending to subsidize health insurance purchased through the marketplaces established under the Affordable Care Act and related spending.

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[PGPF.ORG](https://pgpf.org)

Source: PGPF, 2021

Rising fraction of older people + rising health care prices.

# Policy Options

1. Cut spending
2. Raise taxes
3. Print money

# Cut Spending

2020 budget:

- ▶ spending = \$6.6 trillion
- ▶ discretionary spending = \$1.6 trillion
- ▶ much of federal spending is entitlements (medicare, medicaid, social security, “welfare”)

## Summary: Facts

1. There are manageable short-term problems.  
largely a consequence of crisis spending
2. There are hard to solve long-term problems  
mainly the rising cost of health care
3. Your taxes will rise and your entitlements will be cut  
the only question is how soon

The government budget constraint



# Government Debt

What does government debt do?

How much debt is sustainable?

How worrying is the situation?

## Two views

### *THE NATIONAL DEBT IS ON AN UNSUSTAINABLE PATH*

*CBO estimates that federal debt, which is already at high levels, will climb significantly over the next 30 years. In CBO's latest projections, debt is expected to climb from 77 percent of GDP in 2017 to 150 percent of GDP in 2047, based on current law.*

*Debt at those levels would be unprecedented. – Peterson Foundation, 2017*

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*Low interest rates also create numerous opportunities. They expand the scope for expansionary fiscal policy, make the debt more sustainable and increase the scope of public investments that will pay for themselves over time. – Furman and Summers (2020)*

# The government budget constraint

$$\underbrace{G_t + Tr_t + iB_t}_{\text{spending}} = \underbrace{T_t + \Delta M_t}_{\text{income}} + \underbrace{\Delta B_t}_{\text{borrowing}} \quad (1)$$

Sources of funds:

- ▶ Tax revenues:  $T$
- ▶ New bond issues:  $\Delta B_t = B_{t+1} - B_t$
- ▶ Seignorage:  $\Delta M = M_{t+1} - M_t$

Uses of funds:

- ▶ Government spending on goods and services:  $G$
- ▶ Transfer payments:  $Tr$
- ▶ Interest payments on bonds:  $iB_t$

# The government budget constraint

Government income:  $Y_t = T_t + \Delta M_t$

Government spending:  $X_t = G_t + Tr_t$

Saving:  $S_t = Y_t - X_t$

Budget constraint:  $B_{t+1} = (1 + i)B_t - S_t$ .

This is intuitive ... and the same holds for a household or firm.

# Intertemporal budget constraint

The budget constraint is accounting.

It says nothing about how much spending / debt is sustainable.

To see how much debt is sustainable, we need to look at the **intertemporal** budget constraint.

Then we will find:

$$\text{Present value of income} = \text{Present value of spending} + \text{initial debt}$$

Present value:

- ▶ sum of all future values
- ▶ discounted by cumulative interest factors
- ▶ e.g.,  $Y_t + Y_{t+1}/R + Y_{t+2}/R^2 + \dots$

▶ Derivation

## $R$ versus $g$

How much debt is sustainable depends on the race between

- ▶ interest accumulation (governed by interest rate  $R$ )
- ▶ GDP growth (governed by growth rate  $g$ )

$R/g$  determines the rate at which debt/GDP grows over time.

Traditional view:  $R > g$

Output growth  $g$ : perhaps 3% p.a.

Real interest rate  $R$  (on stocks!): averages about 7% p.a. over that last 100 years.

**If the government has debt today, it needs to save (enough).**

Otherwise the interest share of the government budget keeps growing without bounds.

Not sustainable.

## Traditional view

**If the government borrows today, it has to save in the future.**

This is true even though

- ▶ government debt can grow without bounds
- ▶ the government never has to repay its debts

The constraint simply comes from the need to keep debt-to-output finite.



# Implications

1. If the government borrows today, taxes will be higher in the future (or spending must be cut)
2. The longer the government waits before stabilizing the debt, the higher taxes must rise
  - 2.1 because the debt grows due to accumulated interest
  - 2.2 but the present value of the tax collection does not depend on when the debt gets repaid

## Low Interest Rates: $R < g$

Now output grows faster than the interest burden on debt.

- ▶ Even if the government rolls over all interest

The government can keep borrowing forever.

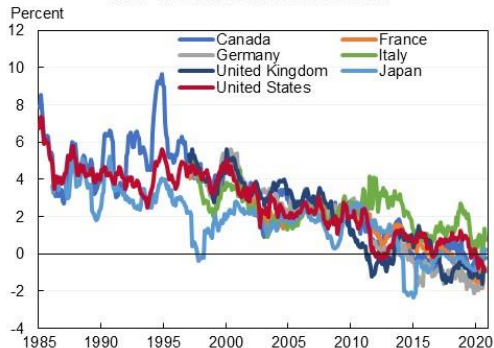
The debt-to-output ratio does not blow up.

The government can invest in future growth without having to worry too much about debt repayment.

- ▶ The opportunities that Furman & Summers have in mind.

# Low Interest Rates

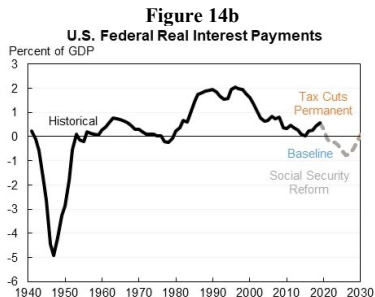
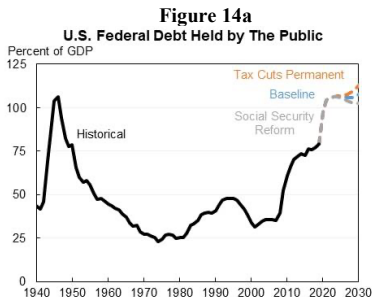
**Figure 1**  
**Real Ten-Year Benchmark Rate**



Source: Furman and Summers (2020)

Real interest rates have been falling for a long time (why?).

# Interest Payments



Source: Furman and Summers (2020)

## Key point

It's not the size of the debt that matters, its the size of interest payments relative to output.

Does this mean that government debt is a free lunch?  
Should the government borrow a lot?

## The Effects of Deficits

# What Do Deficits Do?

- ▶ Does a higher deficit imply that interest rates rise?
- ▶ Does government borrowing crowd out private investment?

## Crowding out

- ▶ Start from the NIPA identity

$$Y = C + G + I + EX - IM$$

- ▶ Rewrite as

$$\underbrace{Y - T - C}_{\text{private saving}} + \underbrace{T - G}_{\text{public saving}} + \underbrace{IM - EX}_{\text{foreign saving}} = I$$

- ▶ Everything else equal, higher government deficits reduce investment.
- ▶ But everything else is not equal...

# Crowding out

- ▶ There are reasons to believe that private saving rises when government deficits rise.
- ▶ Which ones?



# Ricardian Equivalence

- ▶ The government budget constraint implies
  - ▶ a current tax cut + borrowing does not change the present value of taxes collected
- ▶ The household budget constraint implies
  - ▶  $\text{present value of consumption} = [\text{present value of income}] - [\text{present value of taxes}]$
- ▶ Households “should” not change consumption in response to deficits + tax cuts
  - ▶ what should they do?
  - ▶ what is then the effect of a deficit?

## Deficits and Private Saving

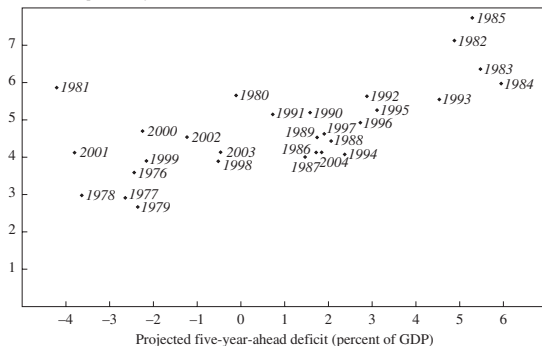
- ▶ The evidence suggests: a \$100 increase in the deficit leads to
- ▶ a \$25 increase in private saving
- ▶ a \$25 capital inflow from abroad
- ▶ a \$50 reducing in U.S. investment (Sinai et al. 2004).

$$\underbrace{Y - T - C}_{+\$25} + \underbrace{T - G}_{-\$100} + \underbrace{IM - EX}_{+\$25} = \underbrace{I}_{-\$50}$$

# Deficits and Interest Rates

**Figure 8. Forward Ten-Year Real Treasury Rates and Projected Deficits, 1976–2004<sup>a</sup>**

Interest rate (percent a year)



Source: Gale and Orszag (2004)

Best estimates suggest: increase in government deficit by 1% of GDP raises interest rates by 0.3 to 0.6%.

## Debt Raises Borrowing Rates

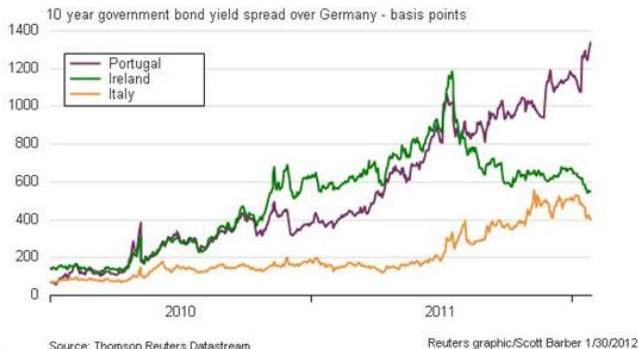
- ▶ Investors worry about runaway dynamics (Greece and Italy)
- ▶ Holding debt stable requires a primary surplus that pays the interest on the debt:

$$B_{t+1} - B_t = rB_t - ( \underbrace{T_t - G_t - Tr_t}_{\text{primary surplus}} ) \quad (2)$$

- ▶ If investors start to doubt the government's ability to roll over the debt,  $r$  rises (risk premium)
- ▶ That makes it harder to stabilize debt
- ▶ A possible self-fulfilling prophecy

# Debt Raises Borrowing Rates

## Portugal, Ireland, Italy bond spread



# Is Today Different?

Does it look like crowding out is a major concern today?

One view: Furman and Summers (2019).

## Other Effects of Deficits

1. Higher inflation - why?
2. Currency depreciation - why?

## Appendix: Derivations



## Two period example

The world lasts for  $t = 1, 2$ .

The economy starts with debt  $B_1$ .

There is no money (or  $M$  is constant)

Budget constraint for  $t = 1$ :

$$B_2 = RB_1 - S_1 \quad (3)$$

Budget constraint for  $t = 2$ :

$$B_3 = RB_2 - S_2 \quad (4)$$

$$= R[RB_1 - S_1] - S_2 \quad (5)$$

where  $R \equiv 1 + i$ .

## Two period example

Combine the 2 budget constraints (substitute out  $B_2$ ):

$$B_3 = R^2 B_1 - R S_1 - S_2 \quad (6)$$

In words...

Rearrange

$$\frac{B_3}{R^2} = B_1 - \frac{S_1}{R} - \frac{S_2}{R^2} \quad (7)$$

The present value of debt at the end equals the present value of borrowing (“primary deficits”) in all periods.

This is very general (not limited to examples with a few periods)

## Many periods

We still have

$$\frac{B_{T+1}}{R^T} = B_1 - \frac{S_1}{R} - \frac{S_2}{R^2} \cdots - \frac{S_T}{R^T} \quad (8)$$

$$\frac{B_{T+1}}{R^T} = B_1 - PV(S; R) \quad (9)$$

$PV(S; R)$  is the present value of saving (“primary surpluses”) discounted at  $R$ .

In words:

The increase in the present value of debt equals the present value of all dissaving (“primary deficits”).

## Case 1: Finite Horizon

E.g., a person who cannot die in debt:  $B_{T+1} = 0$

Consider the case of  $B_1 = 0$ .

- ▶ Any deficit must be offset by savings of equal present value.
- ▶ If the agent borrows now, they must save later.

With initial debt, just add repayment of the debt to  $t = 1$  spending.  
But this does not apply to governments (or firms)!

## Case 2: Infinite Horizon

Now what is the constraint on the present value of future debt  $B_{T+1}/R^T$ ?

The depends on the path of output

- ▶ because tax revenues and spending rise with it.

Write output shares as lower case:  $b_t \equiv B_t/Y_t$ .

Assume output grows at a constant rate:  $Y_t/Y_1 = g^{t-1}$ .

## Case 2: Infinite Horizon

Then we have

$$\frac{B_{T+1}}{R^T} = \underbrace{\frac{b_{T+1}}{R^T} Y_{T+1}}_{b \equiv B/Y} = \underbrace{\frac{b_{T+1}}{R^T} g^T Y_1}_{Y_{T+1} = g^T Y_1} = \frac{b_{T+1}}{(R/g)^T} Y_1 \quad (10)$$

Apply the intertemporal budget constraint (divided by  $Y_1$ ):

$$\frac{b_{T+1}}{(R/g)^T} = \frac{B_1}{Y_1} - \frac{S_1/Y_1}{R} - \frac{S_2/Y_1}{R^2} - \dots - \frac{S_T/Y_1}{R^T} \quad (11)$$

$$= b_1 - \frac{s_1}{R} - \frac{s_2}{R^2} \frac{Y_2}{Y_1} - \dots - \frac{s_T}{R^T} \frac{Y_T}{Y_1} \quad (12)$$

$$= b_1 - \frac{1}{R} \left[ \frac{s_1}{1} + \frac{s_2}{(R/g)^1} + \dots + \frac{s_T}{(R/g)^{T-1}} \right] \quad (13)$$

$$= b_1 - (1/R) \times PV(s; R/g) \quad (14)$$

This uses  $S_t/Y_1 = (S_t/Y_t) \times (Y_t/Y_1) = s_t Y_t/Y_1$ .

Note: the race between interest and output growth!

## Case 2: Infinite Horizon

Assume that  $s_t \equiv S_t/Y_t$  is constant at  $\bar{s}$ .

Then

$$\frac{b_{T+1}}{(R/g)^T} = b_1 - \frac{\bar{s}}{R} \sum_{t=0}^{T-1} (R/g)^{-t} \quad (15)$$

Recall that

$$\sum_{t=0}^{T-1} (R/g)^{-t} = \frac{(R/g)^{-T} - 1}{(R/g)^{-1} - 1} \quad (16)$$

Then

$$b_{T+1} = (R/g)^T \left[ b_1 - \frac{\bar{s}}{R} \frac{(R/g)^{-T} - 1}{(R/g)^{-1} - 1} \right] \quad (17)$$

Now what happens depend on  $R$  versus  $g$ .

Traditional view:  $R > g$

$R/g > 1$  and therefore  $(R/g)^t$  grows over time.

For large  $T$ :  $(R/g)^T \rightarrow 0$ .

$$b_{T+1} = (R/g)^T \left[ b_1 - \frac{\bar{s}}{R} \underbrace{\frac{0-1}{(R/g)^{-1}-1}}_{>0} \right] \quad (18)$$

The government must save to prevent debt/GDP from exploding.



## Low Interest Rates: $R < g$

Now  $(R/g)^T \rightarrow 0$  over time.

$$b_{T+1} = \underbrace{(R/g)^T b_1}_{\rightarrow 0} - \frac{\bar{s}}{R} \underbrace{\frac{1 - (R/g)^T}{(R/g)^{-1} - 1}}_{\text{finite}} \quad (19)$$

Now output grows faster than the interest burden on debt.

The government can keep borrowing forever.

The debt-to-output ratio does not blow up.

# Reading

Blanchard (2018), ch. 23

Also useful:

- ▶ Time to Worry Less about Federal Budget Deficits? (Timothy Taylor's summary of Furman & Summers)
- ▶ Jones (2013), ch 13.

# Advanced Reading

- ▶ Ball and Mankiw (1995): informal. Ideas
- ▶ Gale and Orszag (2004): summarizes the evidence of the effects of deficits on interest rates
- ▶ Rubin et al. (2004)  
[http://www.brookings.edu/papers/2004/0105budgetdeficit\\_orszag.a](http://www.brookings.edu/papers/2004/0105budgetdeficit_orszag.a)
  - ▶ nice summary of possible consequences of budget deficits.

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