

Why do people hate deficits?

By Dylan Matthews, Updated: April 8, 2013

People really don't like deficits. Polls measuring national priorities [tend to find](#) that the deficit/debt is the second most important issue to voters, after "the economy" generally and ahead of health care, guns, foreign policy and immigration.

Politicians don't like deficits either. Both President Obama and the Republican leadership in the House pay lip service to wanting to reduce the national debt burden, and almost all their fights to date have centered on how best to do that.

But hold on a second. Why do we hate deficits? "Balancing the budget" sounds really nice, but what reason do we have to believe it's actually valuable? There are a number of reasons to think it might be good for the debt load to be smaller rather than larger, but almost all of them are controversial among economists, and some more so than others. Here are the common reasons for balancing the budget you hear, and what the evidence says about each.

You can't just run deficits *forever*. Surely the money has to come from somewhere.

No, really, you actually can run deficits — of a manageable scale — forever. "A balanced budget is an extreme outcome. The real question is how big a deficit you can run forever," Joe Gagnon, an economist at the Peterson Institute, tells me. "Economists like to talk about primary budget deficits, which is the budget deficit not counting interest payments, and that's a lot easier to balance." A balanced primary budget, in other words, is one where revenues match total *new* spending, excluding interest payments on money you've spent in the past.

When interest rates are close to the rate of economic growth, Gagnon continues, you can run a budget deficit forever as long as the primary deficit is balanced. The debt load as a share of the economy won't increase over time. And if interest rates are lower than the pace of growth — as they are now — the load will actually shrink while you run those smaller deficits. "Yes, the national debt is the sum of all previous deficits, but it's being compared to a moving target, since the question is how big it is relative to the economy," Gagnon concludes.

That doesn't mean that there's no such thing as too much debt, of course, and the U.S. does probably need to slow the pace at which it's increasing its debt load. But that's a far cry from the U.S. needing a balanced budget year after year.

It's unconscionable to load so much debt on to our grandkids.

We at Wonkblog aren't generally in the business of making judgments as to what is and isn't unconscionable, but it's worth noting that a lot of this debt is going to result in more payments to your grandkids. That's because a whole lot of U.S. debt is owned by

Americans, who thus receive the ensuing interest payments. About [two thirds of our debt](#) is owed domestically. So that's money that the U.S. government, either over the next year or over a longer period of 10 or 30 years, will pay back to its citizens or to itself.

So yes, higher debt burdens might mean tax increases or spending cuts for your grandkids. But it could mean more moolah from bonds, too, and more money to programs like Social Security and Medicare with trust funds.

We'll be in debt to the Chinese! Think of the national security risks!

The other third of U.S. debt, it's true, is held outside the country. U.S. debt is considered a very safe asset so foreigners like to buy it. But [the idea](#) that this itself is a national security threat is rejected by the Defense Department, the Heritage Foundation, and just about everyone in between.

There are a number of reasons for this. One is that China has been selling a great deal of its U.S. bonds. We actually like that, since it means China is doing [less currency manipulation](#); every bond they buy that's dollar-denominated reduces the value of the yuan relative to the dollar.

The nightmare scenario is a massive sell-off of U.S. debt. But that would hurt China much more than it would the U.S. "The likelihood that China would suddenly reduce its holdings of U.S. securities is questionable because doing so could have a significant negative impact on the Chinese economy," a CRS report [concluded](#), noting that a sell-off would lead to a collapse in Chinese exports to the U.S. and would lower the price of U.S. debt, reducing the value of what dollar-denominated debt China still had.

If you want to worry about Chinese power, in other words, worry about it getting aircraft carriers. It doesn't really have leverage through the debt.

We're broke! America is going to be bankrupt!

We're really not. The U.S. Treasury never has to default on any of its debts. That's because we control our own currency. If we owe debts and don't have the tax revenue to pay them, we can always just print the money and hand it over. That may not be the best approach, and in the very worst-case scenario this leads to hyperinflation so bad that defaulting is the less-bad option. But we're so far from that situation today that worrying about it doesn't seem worthwhile. "Higher debt burdens sometimes cause bad things," Gagnon said. "You can imagine that they will eventually if we don't slow our rate of debt increase, but it just seems so far from an issue now for the U.S."

Deficits will give us inflation!

Under most macroeconomic models, this ought to be true. The theory is summarized well by the University of Chicago's John Cochrane [here](#): "Inflation results when the government prints more dollars than the government eventually soaks up in tax payments." In the near-term, the government can also soak up dollars by issuing bonds, but those are backed with a promise of higher taxes to pay for the interest in the future. If investors start to believe that the U.S. isn't going to raise taxes to pay off that interest, then they won't buy bonds. They'll buy real assets like stocks and corporate bonds instead. But unless there's a huge increase in the supply of those assets, the price has to rise. That

means inflation.

However, as IMF chief economist Olivier Blanchard and Bank of Israel governor Stanley Fischer once [wrote](#), “A common criticism of this stress on the budget deficit is that the data rarely shows a strong positive association between the size of the budget deficit and the inflation rate.” Indeed, the [best empirical work](#) on this suggests that there’s a strong, non-linear relationship for developing countries or countries with high inflation to start with, but not for developed countries with low inflation.

Given that the U.S. has extremely low inflation at the moment, and is a developed country, that would seem to predict little inflation resulting from deficits going forward. Indeed, the history of the past decade, in which deficits have exploded with no commensurate rise in inflation, would seem to confirm that finding.

At some point, deficits get large enough that it’s worth worrying about inflation getting out of control. But we’re just not there yet.

Every dollar lent to the U.S. government is a dollar not lent to private companies.

This is the “crowding out” argument. If U.S. deficits grow large enough, investors will start to doubt that they’ll be paid back, or else predict inflation resulting from the deficits will erode what value their interest payments have. Both of these concerns would lead to investors demanding higher interest rates on U.S. bonds. If those interest rates get high enough, investors looking for a good return will start to look to government debt as opposed to corporate debt, which will make it harder for businesses to raise capital for investments. That’s bad for growth in the long-run.

This has happened in the U.S. in the recent past. In the early 1990s, interest rates were [quite high](#) in nominal terms, though high inflation lowered the real interest rate a bit. But it’s not happening now. Again, real interest rates are negative. No one looking for a good return is going to be putting their money in treasuries. There just isn’t a crowding out problem yet.

Countries with debt over 90 percent of GDP enter a danger zone.

The 90 percent figure comes courtesy of Harvard economists Ken Rogoff and Carmen Reinhart in their paper [“Growth in a Time of Debt.”](#) They found that debt loads above 90 percent were associated 1 percent lower growth rates. That’s pretty bad. But there are a lot of potential pitfalls in this analysis. “If one reads their paper carefully, it is clear that Reinhart and Rogoff picked the 90% figure almost arbitrarily,” Yale’s Robert Shiller has [written](#). “They chose, without explanation, to divide debt-to-GDP ratios into the following categories: under 30%, 30-60%, 60-90%, and over 90%. And it turns out that growth rates decline in all of these categories as the debt-to-GDP ratio increases, only somewhat more in the last category.”

Shiller, [John Irons and Josh Bivens](#), and [Mike Konczal](#) have also noted that it’s much more likely that causality runs in the other direction. That is, countries have high debt-to-GDP ratios because they have slow growth, rather than the other way around. This makes sense. Slow growth means lower tax revenue, greater social service payouts, and a whole lot of other factors that contribute to increased deficits and debt. It’s possible to tell

a story where high debt hurts growth, but it's much less intuitive and only holds when interest rates are high and choking off private investment.

The Rogoff-Reinhart theory also ignores that countries' past track records with debt repayment have a huge impact here. "They don't talk about the government's past record of behavior," Gagnon says. "If it's defaulted often, 90 percent is huge, and if it hasn't, then it's not."

Reinhart dismisses these criticisms as wishful thinking. "We're quite aware that you have causality going in both directions," she says. "But please point out to me what episodes from 1800 to the present have we had advanced economies who carried high levels of debt growing as rapidly or more rapidly than the norm." Belgium after World War I, she says, fits the bill, but that's basically it. "It's not about some exotic magic threshold where you cross the Rubicon," she says. "But high debt levels are like a weak immune system."

So even Reinhart doesn't think that 90 percent is a hard-and-fast cutoff. She simply believes that larger debt loads cause more and more of a problem for growth. That's a contested issue, but even the economists being cited as supporting a point-of-no-return figure of 90 percent don't believe that.

Deficit-spending in good times makes it harder to do so in bad ones.

This is probably the best argument for keeping deficits low, if not nonexistent. Governments almost by necessity have to run deficits during recessions. Tax revenue tanks, payments through programs like food stamps increase, and so forth. So you want room to run deficits of an appropriate size to stave off the recession. That's easier to do when investors are willing to lend you money, and insofar as behaving in a fiscally prudent manner keeps them interested, it's valuable.

Larry Summers and Brad DeLong note that holding a large structural deficit increases the cost of expansionary fiscal policy measures like the stimulus package as well. "Clearly, the risks of short run fiscal stimulus having adverse effects on long-run credibility will be greater in settings where government debt already carries a significant risk premium," they [write](#).

The U.S. debt does not currently carry a significant risk premium. But medium-term debt reduction to ensure that no such premium presents itself may make it easier to combat recessions in the future. "Japan was hit with an earthquake, a natural disaster," Reinhart explains. "Can you imagine what it would have done if their debt, instead of being 240 percent, was 50 percent of GDP? Their ability to react to that shock would be much greater."

Not balancing the budget means borrowing more, which adds to the national debt.

This one seems almost tautological on first read. Obviously, if you're borrowing money every year, that adds to the overall debt burden, right? It turns out to be more complicated than that. The reason is that interest rates paid out by the Treasury are now negative in inflation-adjusted terms. That is, investors pay us money for the privilege of owning Treasury bonds.

That blunts the impact of deficits on the overall debt considerably. Economists Carmen

Reinhart (now at the Kennedy School) and Belen Sbrancia (at the University of Maryland) have [argued](#) that ultra-low interest rates from 1945 to 1990 had the effect of reducing U.S. debt by 3-4 percent of GDP every year, or 30-40 percent over the course of a decade. For comparison, U.S. debt is around 100 percent of GDP at the moment. A 30-40 percent reduction in the debt is a pretty big deal!

Reinhart explains that, for repression to work, you need both negative real interest rates (got 'em) and a captive audience willing to buy low-yield debt. We have that too, in the form of foreign central banks that use U.S. debt to set the value of their currencies, not to mention domestic pension funds and other low-yield investment vehicles.

All else being equal, of course, the debt burden is increased the bigger the deficits we run. But the interest rates matter too, and at the moment we're adding onto a debt load that's decaying over time. Reinhart notes that for repression to work you really need to be reducing the debt load through that lever faster than you're adding to it through new spending, and we're not doing that quite yet, but she agrees it's an important part of any budget solution. "I think the U.S. is sooner or later going to have to come to terms with its budget on both the expenditure and the revenue side," she tells me. "I think also helping debt dynamics will be financial repression, sustained negative real interest rates, and we have a bit of room still to maneuver there."

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