Re: Budget Deficits Lead to lower or higher GDP?

Source: http://sci.tech−archive.net/Archive/sci.econ/2004−10/1083.html

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Date: 10/18/04

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Date: Mon, 18 Oct 2004 03:13:04 GMT
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Matt Fuerst wrote:
> *Hello all,*
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> *I am in my first semester of Macroeconomics at a local community college. I*
> *have thus far found the subject to be fascinating so outside of my*
> *coursework I have read Heilbroner's 'Worldly Philosophers' and am currently*
> *reading Heilbroner and Thurow's 'Economics Explained'. Our assigned textbook*
> *is Mankiw's 'Brief Principles of Economics'. From my understandings and*
> *readings Mr. Mankiw and Heilbroner would have two very difference stances on*
> *how Government should interact with an economy and I think I've come across*
> *some readings that left me a little puzzled.*
>

Yes they would. I am not sure if you are to point of discussing
differing theories of macroeconomics yet. However, I can say Mankiw is a
Neo−Keynesian while I believe Heilbroner is not. The toughest part about
a macroeconmics course is sorting out the theories. The one semester
course often makes this harder because you get a little macro and a
little micro.

> *Mankiw's 3rd Policy is when a Gov't runs a budget deficit. Mankiw states*
> *that since the market for loanable funds includes both the private savings*
> *(households and firms) as well as Gov't public savings, this would have the*
> *effect of lessening the supply of loanable funds on the market. The supply*
> *curve would shift negatively, interest rates would rise and net amount of*
> *savings would decrease. He takes this policy to the next logical step where*
> *the effect of lessened investment in the economy leads to lower GDP as*
> *investment allows for innovation, new growth, etc...*
>
> *Last night I read through Heilbroner's take on Gov't spending in 'Economics*
> *Explained' (again, Chapter 8 of his book) and I must say it strikes me as*
> *quite different. Heilbroner essentially states that the Gov't is terms of*
> *spending is much like a private firm, except it's investments lead to*
> *returns for everyone in the country as opposed to just a corporation making*
> *an investment. Heilbroner proposes that an expanding deficit is reasonable,*
> *and uses Exxon as an example. Heilbroner says that Exxon had a deficit of*
> *$170M in 1929 and had a deficit of over $10B as of ~1998. Heilbroner says*
> *this all very reasonable, Exxon has used those funds to expand it's business*

> *and those expansions (investments) generate returns and profits for the*
> *business. There is no meaningful expectation that Exxon will repay those*
> *debts, in fact it's reasonable that when some come due Exxon will simply*
> *issue new bonds to cover the debts and likewise (at least I take it that he*
> *implies) it's reasonable for a Gov't to act in the manner.*
>
> *So, I'm not sure which way to take it. I imagine there is empirical evidence*
> *on both sides of the argument, I was just wondering if anyone wanted to jump*
> *in here and throw in their $0.02 to enrich the debate.*
>

The first argument is what economist call crowding out. The negative effect on savings causes an in interest rates and a decrease in investment. In the long run this could mean lower growth rates due to the increased interest rates. This is a common argument for those who oppose deficits. To this point I have seen few empirical studies that explore the crowding out effect. It is difficult to test because the effect is ceteris paribus. This means other factors such as the Fed can offset the effect.

Heilbroner's argument assumes the government is spending on investment. That is the funds are going into roads, airports, education, etc. This is not neccesarily the case. Government investment need not occur. For instance National Defense spending, transfer payments, etc are not investment. What Heilborner argues is that the deficit is not a big deal. Unlike a household the government and often corporations do not have credit limits. So borrowing today could be financed in the future by more borrowing. This is a possibility. Bonds can be financed by bonds for some time. There is a limit interest compounds exponentially while GDP grows in a linear fashion. If the governement continued to run deficits forever at some point the interest payments would exceed GDP and they would have to default. So at some point the deficits have to be paid. The same could be said about Exxon the debt issued compared to assets affects the credit rating. If Exxon borrowed too much the market would fear default and no one would buy bonds.

That being said Heilborner does have a point. Deficits can continue for quite some time if the Fed acts to offset the interest rate effect. In general tax raises in the future would need to less to pay the debt. As the population grows then the debt is spread out among more tax payers. For example if the government has 10 tax payers and borrows $100, then it has to raise an average of $10 per person to pay back the debt. If the tax payers expand to 20 the government only has to raise $5.00 for a person. So if the debt is kept steady over time due to inflation and population growth it becomes easier to pay. Inflation means the government recieves more revenue. So deficits may not be a big deal.

The analysis from Mankiw really stress the effects on the business cycle and growth when deficits occur. They can have economic effects if they are not offset by Fed policy. The Heilborner argument states the fallacy that there need be a massive increase in taxes at some time to repay the deficit and that deficits will cause the government to go bankrupt. They can cause the government to default but it takes high deficits for extermely long periods to do so. It also counters the idea that budget should always be balanced. Borrowing can help the economy grow if the expenditures are placed correctly. Some of government expenditures do go to maintaining and improving infrastructure which does help the country grow but not all expenditures.