

Re: Budget deficits and GDP

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- *From:* The Trucker <mikcob@xxxxxxxxxxx>
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On Tue, 27 Nov 2007 22:14:48 -0800, Lysander wrote:

On Nov 26, 10:18 pm, dekka <eddiepy...@xxxxxxxxx> wrote:

Hope this is the right board:

Could someone with an economics degree explain to me academically how a budget deficit hurts the economy (especially GDP)? I've taken a few international economics courses, so feel free to get technical.

Thanks!

The following stuff from lysander is (surprisingly) somewhat correct. I am shocked.

There are differing effects of budget deficits in the short and long run. For the short run I will give you the theory then some potential problems with the traditional theory. At least since Keynes, Economics has shown that budget deficits are a useful tool at fighting unemployment. The traditional Keynesian view is that due to imperfections in the labor market, mainly nominal wages being sticky downward, the cost of living effects employment. This means pure price effects such as inflation and deflation have real effects on output.

The traditional view is that recessions are caused due to Aggregate demand shocks. These can be from people deciding to spend less, the marginal propensity to consume dropping, or due to expectations causing less investment in the economy. Demand for investment goods are part of Aggregate demand. Foreign exchange rates can affect AD as well as exports add to aggregate demand and imports decrease demand.

(not bad... not actually correct, but not terribly wrong either)

Re: Budget deficits and GDP

In a demand side recession, that is AD decreases, the appropriate policy is to increase demand to where it was before. This can be done with monetary policy or tax and spend.

Actually, the Keynesian position is that monetary stimulus (dropping interest rates) has little effect. Absent the government spending to increase AD, no one is going to borrow money to invest. It is like "pushing on a string".

If using tax and spend you want to create a deficit.

It is spend only that effects demand. The tax part may or may not serve well depending on how the taxes are assessed and collected.

You increase government expenditures which in turn pays people who buy goods which pay more people who buy goods. As the dollars continually turn over consumption also increases and raises AD. You can cut taxes as well which gives people more take home pay so consumption rises.

True..... If you cut taxes on the low and moderate incomes then consumption (demand) will rise. This does not hold true if you cut taxes on the high incomes.

In an inflationary period you would want to cut deficits and run surpluses. This deficits make inflation worse. The traditional Keynesian view is run surpluses during inflation to pay for deficits in recession so the budget is balanced over the cycle.

Tax collections are a direct cure for inflation in that money is removed from the economy just as it would be if the Fed raised interest rates and/or Treasury started selling bonds like crazy. The difference is that appropriate taxation need not curtail investment. The increased tax collections must be in the middle income range as opposed to the high range to achieve the opposite effect of the tax cuts that would have stimulated consumption.

The problem comes from how deficits are financed. In order to finance a deficit, the government must issue bonds. People buy these bonds and the government uses the loaned money to make up the difference between taxes and expenditures. The Fed may also buy bonds if they wish to increase the money supply.

Re: Budget deficits and GDP

This is where the effect of deficits becomes questionable and potentially harmful to the long-run. There should be exist equal returns, adjusted for risk among assets, this means all assets are equal attractive in equilibrium. As the government issues bond, the supply of bonds rises. The price of bonds fall as the government "floods the market" with debt instruments. This causes the yield on bonds, the interest rate, to rise. The yield on a bond is a function of the price when the bond cost less you get a higher yield. The rise in interest rates filters into other markets as the interest rates must rise to be competitive. The result is higher interest rates and less investment. The drop in investment causes the increase in consumption to be offset.

This is harmful in the long run because investment in new capital is part of the engine of economic growth. High interest rates cause less capital to be bought and can slow down the rate of growth for the nation.

The other harm comes if the Fed wants to target a certain interest rate. As the interest rates rise the Fed must expand the money supply to keep interest rates at the current rate. This is called monetizing the debt. The Fed goes in and buys bonds to offset the increase in supply. The interest rate is not affected and crowding out does not happen. This is why detailed analysis is necessary to show crowding out. If one only looks at the correlation between interest rates and deficits they may not see the effect because the Fed's action cancel out the interest rate effect. You have to control for money supply changes before the data show the result. Anyway, the problem is the increase in the money supply may increase AD more and cause inflation.

Deficits have an inflationary component that is made worse when the debt is monetized to keep interest rates low.

The good effect from deficits is less unemployment, if u/e is above the natural rate.

The bad effects are more inflation and decreased economic growth.

Time for the major intrusion on this theoretical stuff: Increased government spending is what stimulates the economy --- NOT DEFICITS. It is entirely possible to increase government spending AND TAXES so as to spend more and actually _cause_ more consumption and investment without ever having a deficit. The latter day neoeconomist assumes that government must increase or decrease taxes across the board as opposed to varying what or who is taxed. Keynes seems to have made the same silly assumption. In addition Keynes assumed that money was gold and that borrowing and taxation were the only mechanisms by which spending could be financed. It is as though the notion of monetization never did intrude on Keynes. We

Re: Budget deficits and GDP

buried the gold standard but the Republicans don't seem to be able to BENEFICIALLY use what that created. The same neoeconomists that would have us believe that all taxes are equivalent would also have us believe that all government spending is equally stimulative and equally problematic in the long run. And none of these assumptions should ever be valid unless you have totally brain dead Republicans advised by neoclassical economists from Cato running the government.

There is also the public choice case that argue that deficits are bad because uncontrolled spending gives lobbyist too much power. The average voter has little information and little influence. The lobby can use its influence to seek rents and get spending. Allowing any level of deficit allows lobbyist free reign. By requiring balance budgets lobbyist influence is much more limited. There is a limited amount of funds to fight for and lobbyist must compete which lowers their power.

If you tax the hell out of rent then there will be a lot less rent seeking. But I admit there will be a lot of lobbyists seeking to convince government to not tax rent. And they will be paying lots of money to the Cato institute also.

There are some papers out now that are indicating the doctrine of starve the beast does not work.

Now???? Most rational people knew that was total crap in 1982.

That is cut taxes and not give government enough money to expand. They do that anyway. One member of CATO has noted that divided government is the best tool to fight spending.

Well certainly! Government spending (except for spending on imperialism and occupations of other nations of course) is the Wicked Witch of the North. Especially if it is spending on infrastructure or general welfare.

When the party in the white house differs from the party that controls congress spending is limited the most. This holds at least back to Eisenhower. When the Republicans took over under Clinton spending dropped. When the Democrats slightly took over the Senate under Bush spending dropped. It lead to the comment "as a conservative I hope for divided government, I do not care as to the way it comes about." Meaning it doesn't matter if a democrat is President and

Re: Budget deficits and GDP

Republicans control the legislature or a Republican is president and the Democrats control the legislature. The result is likely a lot less spending.

What actually matters, of course, is the beneficial or harmful nature of the spending. The CATO people and those who fund and who listen to CATO do not want ANY government at all. And they will do all they can to make damned sure that government cannot to do anything worthwhile.

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"I know no safe depository of the ultimate powers of society but the people themselves; and if we think them not enlightened enough to exercise their control with a wholesome discretion, the remedy is not to take it from them, but to inform their discretion by education." – Thomas Jefferson
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