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Why Now Is the Wrong Time to Increase the Deficit

In a growing economy, the federal government should shore up its long-run fiscal position, not blow it out.

By Alan S. Blinder

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My last column prompted more than 1,500 comments from Wall Street Journal readers. Few were friendly. Many objected to this sentence: "The tax cuts blow a large hole in the federal budget, and most Americans think the deficit is already too large." Since I was an outspoken supporter of President Obama's fiscal stimulus in 2009, which increased the deficit, some readers argued that I was inconsistent to oppose President Trump's tax cuts on the grounds that they would also increase the deficit.

These comments reminded me that the budget deficit is frequently misunderstood. So let me try to explain why it is perfectly consistent to support a larger budget deficit under some circumstances while arguing for a smaller deficit under others.

Start with the basics: A balanced budget has no inherent claim to being the "right" fiscal policy. In fact, as long as our economy grows, it is normal for the government to run a budget deficit of some size. With GDP growing larger, it is natural for household debt, business debt and, yes, government debt all to rise year after year. Not in unlimited amounts, of course—families, businesses, and governments can, and sometimes do, go overboard with debt.

So how much is too much? The analog, in a growing economy, to a balanced budget in a no-growth economy is a national debt that grows at the same rate as gross domestic product. These days, for the federal government, that means an annual budget deficit in excess of $600 billion. (Yes, it's a big country.) Perhaps by coincidence, that's close to where we are today. Projections, however, show the debt-to-GDP ratio rising in the years to come, which is cause for concern.

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That said, borrowing for productive purposes is perfectly sensible. Students borrow to finance their educations; businesses borrow to invest. As long as the projects they finance with debt generate income flows large enough to pay the interest and principal—and leave over some surplus—borrowing makes them better off. It's the same for governments. Debt acquired to build, say, schools and highways often generates payoffs that exceed the costs—leaving society better off.

Every business owner knows where to draw the line between debt that is sensibly rather than foolishly acquired: Borrowing makes good sense where the rate of return on the investment exceeds the interest rate paid on the loan.

This last point is why, for example, state and local governments have lots of outstanding debt despite legal requirements to "balance their budgets." At first blush, that seems to defy the laws of arithmetic. If a state balances its budget every year, how does it go into debt? The answer is that state balanced-budget requirements, unlike the oft-proposed balanced-budget amendment to the U.S. Constitution, generally apply only to operating budgets. Capital expenditures are financed by issuing bonds.

But there is a more important difference between federal and state budgeting: The national government has responsibility for the health of the nation's economy; states don't. So, for example, when the Great Recession began in December 2007, many states saw their tax receipts shrink and reacted with spending cuts—which made the recession worse.

But the federal government is not hamstrung by a balanced-budget requirement. It also has huge borrowing capacity—as today's low Treasury rates attest. And should it ever need to pay back its debt, Washington has much greater taxing power than the states. So the responsibility for stabilizing the economy with fiscal policy naturally falls to the federal government, not to the states.

Concretely, this means spending more, not less, when a recession starts, thereby administering a double whammy to the deficit: Spending rises while tax receipts fall as the economy sags. It may also mean cutting taxes further. Finally, it probably means helping the cash-strapped states by increasing federal grants for such items as Medicaid, education, highways and unemployment insurance. All these things and more were done in the 2009 stimulus package. It was sensible fiscal policy, and we would have suffered through a worse slump without it.

The general lesson is clear: In a recession, the federal government should make its budget deficit bigger—deliberately.

But today we are back to full employment, or perhaps beyond it, and economic growth looks solid. The economy doesn't need fiscal stimulus. Further, as we look to the future, we see an aging population putting great pressure on government budgets, especially for health care and pensions. And all this is happening at a time when federal revenue as a share of GDP is below its 50-year average—even before the Trump tax cuts kick in.

So, unlike 2009, this is a particularly bad time to cut taxes—or to do anything else that worsens the government's long-run fiscal position.

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