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Livin' Large

President Bush just sent Congress a budget that calls for $2.4 trillion in spending and a $521 billion deficit in 2005. Although there is little evidence that large deficits harm the economy in the short term, over the longer term they add to the Federal debt and force future generations to pay the bill for today's spending.

In the first three years of his administration, President Bush made tax cuts the centerpiece of his domestic policy. He cut income tax rates, increased the child tax credit, reduced the marriage penalty, cut the taxes on capital gains and dividends to well below the rate on ordinary income, and began to phase out the estate tax.

Since he took office, the Federal tax burden has fallen sharply. In fiscal year 2003, the government collected nearly $1.78 trillion in receipts. That is about $240 billion *less* than it collected in 2000, the year before Bush took office. Federal receipts have fallen in each of the past three years—something that has not happened since the 1920s. And in relation to the size of the economy, receipts are now at the lowest level since Eisenhower was president (see Chart 1).

This decrease in taxes hardly means that "the era of big government is over." Reducing the tax burden is not the same thing as shrinking the size of government. That requires cutting spending, or at least slowing its growth.

Far from doing this, President Bush has greatly increased government spending. Last year the government spent nearly $2.2 trillion, or 20 percent more than it spent in President Clinton's last year. During every year of the Clinton administration, Federal spending decreased as a percentage of Gross Domestic Product (GDP). During every year of the Bush administration, it has increased.

The result has been an extraordinary swing in Federal finances. The budget went from a surplus of $236 billion in 2000 to a deficit of $374 billion last year, and official projections suggest that the deficit will be even larger this year. The Congressional Budget Office says it will be $477 billion and the White House says it will be $521 billion.

The return to deficit spending is, in a sense, a return to standard practice in Washington. For most of modern American history the government has run deficits. In the nearly 60 years since the end of World War II, there has been a budget surplus just 12 times. And even though last year's deficit was the highest ever in nominal terms, it was smaller than the deficits of the 1980s in relation to the size of the economy (see Chart 2).

Economists have long warned that large deficits will lead to higher interest rates and slower economic growth. Their arguments are persuasive. The trouble is, there is no evidence that this has actually happened.

In the postwar era, the worst period for the American economy was the 1970s and the early 1980s. The rate of price inflation accelerated to double digits, unemployment soared, and there were two severe recessions. Conditions were so bad that economists invented new terms to describe them ("stagflation" and the "misery index"). But all this happened *before* the Federal deficit soared. During the period 1982-1993, the deficit was higher, relative to GDP, than it had ever been except during times of war. But price inflation moderated, interest rates decreased, and the economy experienced a record expansion followed by a reces-

Chart 1: **Federal Receipts and Outlays as Percentages of GDP**

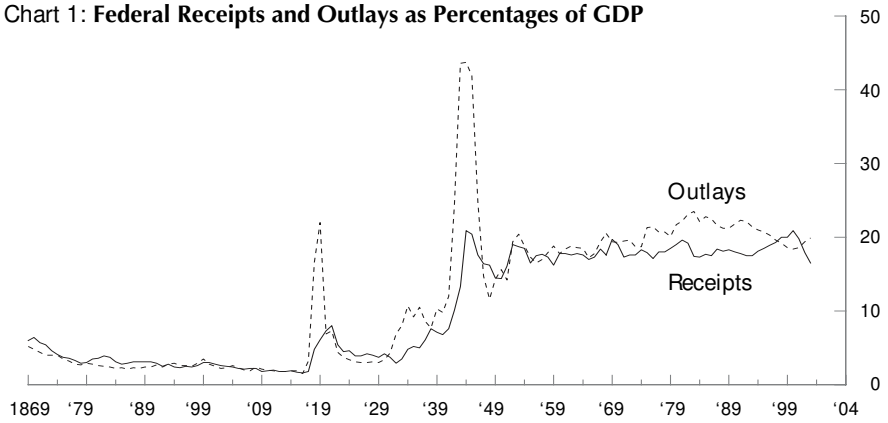
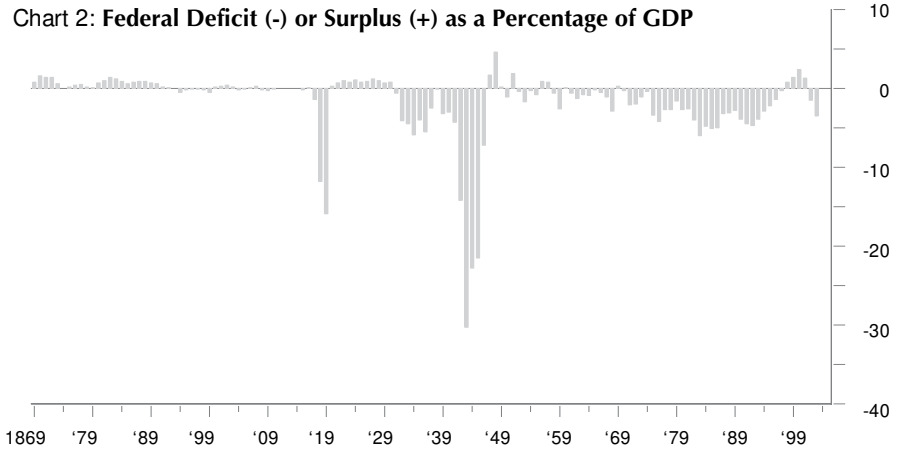


Chart 2: **Federal Deficit (-) or Surplus (+) as a Percentage of GDP**



sion that, by historical standards, was brief and shallow.

In short, the relationship between Federal deficits and the economy has turned out to be less predictable and less rigid than many economists thought. To the extent that economic problems did emerge in the wake of large deficits (e.g., the recession of 1990-91 or the brief spike in price inflation in the early 1990s), it was impossible to determine whether deficits played a key role or other factors were more important.

Do Voters Care?

The political impact of budget deficits also is unclear. In a new book by Ron Suskind, *The Price of Loyalty*, former Treasury Secretary Paul O'Neill says that when he met with President Bush to discuss plans for another major tax cut, he warned the president that growing deficits threatened the economy. Vice President Cheney responded with the comment "Reagan proved deficits don't matter. We won the midterms. This is our due."

In political terms, Cheney was right. Reagan was re-elected in a landslide in 1984, even though the deficit had soared to then-record highs (and was much higher in relation to GDP than it is today). The deficit *was* a political issue in the 1980s, and there were various legislative efforts to reduce it. But when it came time to vote, people cared more about other issues.

However, deficits *did* matter for the first President Bush. Public concern over the exploding deficits of the early 1990s helped Ross Perot get an extraordinary 19 percent of the vote in the 1992 election. The deterioration in fiscal finances was one reason that George H. W. Bush lost his bid for re-election.

So it seems that sometimes deficits matter politically and sometimes they do not. If people are optimistic about the economy, they may not care much about it. But if they think the economy is in trouble, as many did in 1992, they may blame the deficit for those troubles.

Now, twenty years after the deficit first soared to unprecedented peacetime levels, there is another factor to be considered. The shock value of huge deficits has worn off. The country has been down this road before, and things turned out better than many people expected. (Virtually nobody predicted that the deficit would disappear in the late 1990s). In dollar terms, last year's $374 billion deficit was the largest ever, and this fact alone still carries some shock value. But the bar may have been raised on the level of deficit spending that people consider unacceptable, and it might not become a potent political issue again unless the economy develops serious problems that voters believe are linked to how much the government borrows.

In this regard, the aging of the baby boomers remains the great cloud on the horizon. The fiscal imbalance that will appear when large numbers of this generation start collecting Social Security and Medicare benefits promises to dwarf the current deficit. The baby boomers will begin turning 62, becoming eligible for early retirement benefits, just four years from now. It is getting late to introduce measures that will make it easier to deal with this demographic burden. Even so, the problem remains a remote one in many people's minds, less urgent than national defense, health-care reform, education, or other issues.

Are Deficits Necessary?

Some observers think that the return to deficit spending is a necessary step toward eventually reining in the growth of government. The notion is that deficits act as a brake on spending, because they force Congress to cut spending in order to keep the deficits to a "manageable" level. In this view, perpetual deficits are acceptable if they are large enough to keep a lid on spending but small enough to keep the Federal debt from growing faster than the economy.

The problem with this scenario is that the deficit could get much larger, and add much more to the national debt, before political pressures build enough to cut spending. At its peak in the 1980s, the deficit was six percent of GDP. In today's economy, that's $650 billion. As a result of those large deficits of the 1980s and early 1990s, the size of the Federal debt held by the public doubled as a percent of GDP.

Moreover, President Bush has not yet done anything to limit spending. In dollar terms, Federal outlays have grown twice as fast each year under his administration as they did under President Clinton.

Increased spending on defense and homeland security are major factors, of course. (Prior to September 11, the share of GDP spent on defense had fallen to its lowest level since before World War II.) However, outlays for a wide range of other programs such as Medicare, Medicaid, Social Security, education, and agriculture also have increased more rapidly than they did in the 1990s. The president did not propose any serious spending cuts during his first three years in office and he has yet to veto a single spending bill. Although his latest budget proposal calls for slowing the growth of spending, it remains to be seen whether this will happen during an election year.

Nor have the Bush tax cuts "starved the government" of revenue. There has indeed been an extraordinary decrease in revenues since the president took office. But the tax cuts are only one factor and many of them have yet to be phased in. The other factors are the recession and the end of the stock market boom.

The market boom of the late 1990s generated an astonishing increase in tax revenue tied to income from capital gains and stock options. This extra revenue helped push total Federal revenues to their highest level, in relation to GDP, since the middle of World War II (see

The Incumbent's Edge

Conventional wisdom has it that the state of the economy could make or break President Bush's bid for re-election. However, in the current situation the advantages of presidential incumbency may prove overwhelming. Only eight elected incumbent presidents have been turned out of office in U.S. history. These were John Quincy Adams, Van Buren, Cleveland, Benjamin Harrison, Taft, Hoover, Carter, and George H. Bush.

In this century, absent a third-party challenge that split the vote, every incumbent president who stood for re-election except Herbert Hoover was returned to office. Teddy Roosevelt split the vote in 1912, John Anderson split the vote in 1980, and Ross Perot split the vote in 1992. President Hoover, of course, faced re-election during an economic depression. Compared with that episode, the recession of 2001 was a mere blip in business activity. President Bush also "got his recession over" early in his presidency, and it appears that his re-election campaign will be shifting into high gear just as the employment outlook has begun to improve. Barring a successful challenge from within his own party or an independent candidacy, the defeat of an incumbent president in such circumstances would be virtually unprecedented.

CONSUMER PRICE CHANGES IN 2003

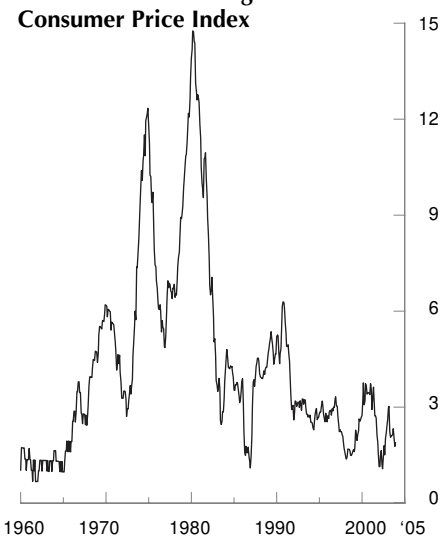
The Consumer Price Index for all urban consumers increased by 1.9 percent last year, down from 2.4 percent the previous year.

The rate of price inflation remained relatively low last year. But, as always, the increase in the CPI masks widely different trends in the prices of the hundreds of goods and services included in the CPI basket. The price of beef soared by over 20 percent during the year, due in part to the popularity of Atkins-type diets and to the banning of beef imports from Canada after the first confirmed case of mad cow disease was detected there last spring. Other items with larger-than-average price increases include eggs (up 30 percent), college tuition (9.8 percent), health care services (the price of inpatient hospital care rose 5.7 percent) and energy (fuel oil prices increased 7.8 percent and gasoline prices rose 6.8 percent).

At the other extreme, the prices of hi-tech goods continued to plummet, led by personal computers and peripheral equipment (down 17.8 percent) and televisions (down 14.3). The prices of used cars and trucks also fell, as did apparel prices.

The continued moderation in price inflation is encouraging. It also stands in sharp contrast to the longer-term trend. Since 1990, the general level of consumer prices has increased by nearly 50 percent. It is *nine* times higher than it was at the end of World War II. Whether the recent moderation marks a lasting reversal of that trend or merely a temporary interruption of it remains to be seen.

Annual Percent Change in the Consumer Price Index



Percent Changes in Selected Consumer Price Indexes
December 2002 – December 2003

Expenditure Category	*Percent Change*
All Items	1.9
Food and Beverages (16% of expenditures)	3.5
Food	3.6
Food at Home	4.5
Breakfast Cereal	0.5
Bread	2.1
Cookies	0.7
Meats	14.0
Beef and Veal	23.5
Pork	5.2
Bacon, breakfast sausage, and related products	4.3
Pork Chops	5.4
Poultry	4.7
Fish and Seafood	2.7
Eggs	30.1
Milk	6.9
Cheese and related products	2.3
Ice cream and related products	0.2
Fresh fruits and vegetables	4.5
Apples	3.2
Bananas	-1.5
Citrus fruits	1.9
Potatoes	-3.5
Lettuce	38.1
Tomatoes	-1.5
Canned fruits and vegetables	-2.7
Frozen vegetables	2.7
Candy and chewing gum	0.3
Butter	2.9
Salad dressing	2.2
Peanut butter	0.3
Nonalcoholic beverages	-0.4
Juices and carbonated drinks	-0.6
Coffee	0.7
Soup	0.9
Food away from home	2.3
Full service meals and snacks	2.2
Limited service meals and snacks	2.3
Alcoholic beverages at home	1.7
Beer and ale	3.0
Wine	-0.5
Distilled spirits	1.5
Housing (41% of expenditures)	2.2
Shelter	2.2
Rent of primary residence	2.7
Owners' equivalent rent of primary residence	2.0
Hotels and motels	3.1
Fuels and utilities	6.5
Fuel oil	7.8
Electricity	2.6
Utility natural gas service	17.4
Water and sewerage maintenance	4.7
Garbage and trash collection	4.2
Household furnishings and operations	-1.8
Floor coverings	-1.7
Window coverings	-1.5
Bedroom furniture	-0.3
Living room, kitchen, and dining room furniture	-2.3
Major appliances	-3.7
Clocks, lamps, and decor items	-9.1
Dishes and flatware	-2.3
Tools, hardware and supplies	-1.7
Outdoor equipment and supplies	-3.1
Housekeeping supplies	-0.9
Household operations	2.3
Gardening and lawncare services	1.3
Repair of household items	3.4
Apparel (4% of expenditures)	-2.1
Men's apparel	-1.7
Suits, coats, and jackets	0.7
Shirts and sweaters	-3.1
Pants and shorts	-6.1
Boys' apparel	1.1
Women's apparel	-1.6
Outerwear	-1.1
Dresses	0.1
Suits and separates	-2.7
Girls' apparel	-4.0
Infants' and toddlers' apparel	-4.9
Watches	0.1
Jewelry	-4.6
Footwear	-1.8
Transportation (17% of expenditures)	0.3
New cars	-2.1
New trucks	-1.5
Used cars and trucks	-11.8
Car and truck rental	3.2
Gasoline	6.8
Motor vehicle maintenance and repair	2.4
Tires	-0.5
Motor vehicle insurance	4.5
Motor vehicle fees	6.8
Public transportation	1.3
Airline fare	-0.1
Ship fare	-10.3
Public transportation within city	10.3
Medical care (6% of expenditures)	3.7
Medical care commodities	2.1
Prescription drugs and medical supplies	2.5
Over-the-counter drugs	1.4
Medical care services	4.2
Physicians' services	2.3
Dental services	4.4
Eye glasses and eye care	1.5
Inpatient hospital services	5.7
Outpatient hospital services	6.6
Nursing homes and adult daycare	5.8
Recreation (6% of expenditures)	1.1
Video and audio	0.1
Televisions	-14.3
Cable television	3.8
Video cassettes and discs	-2.1
Rental of video tapes and discs	-0.2
Audio equipment	-5.4
Pet food	2.0
Veterinarian services	5.4
Sporting goods	-0.7
Photography	-2.2
Toys	-4.2
Sewing machines, fabric and supplies	0.5
Music instruments and accessories	-1.4
Recreation services	3.5
Club membership dues and fees	2.7
Admissions	3.4
Fees for lessons or instructions	6.3
Newpapers and magazines	1.7
Recreational books	-0.5
Education and communication (6% of expenditures)	1.6
Education	7.2
Educational books and supplies	6.0
College tuition and fees	9.8
Elementary and high school tuition and fees	6.5
Child care and nursery school	4.1
Communication	-3.9
Postage and delivery services	0.2
Telephone services, local charges	2.6
Telephone services, long distance charges	-10.0
Cellular telephone services	-1.3
Personal computers and peripheral equipment	-17.8
Computer software and accessories	-9.7
Other goods and services (4% of expenditures)	1.5
Tobacco and smoking products	-0.4
Personal care	2.1
Cosmetics and related products	0.8
Haircuts and other personal care services	2.3
Legal services	5.0
Financial services, incl. tax returns	2.6
Funeral expenses	4.2

Chart 1). But this revenue bubble burst along with the stock market in 2000; last year the share of GDP that Americans paid to the Federal government was the smallest since 1959.

This share is likely to increase if the economy continues to expand and employment increases. But even if all of the Bush tax cuts were repealed, it is unlikely that revenues would return to the peak level of the 1990s. That was a product of extraordinary stock market gains, not tax policy.

Democrats have criticized both ballooning deficits and the Bush tax cuts, but there is no indication that they want to repeal the cuts in order to shrink the deficit. They want to use the extra revenue to pay for their own spending initiatives.

The Federal Debt

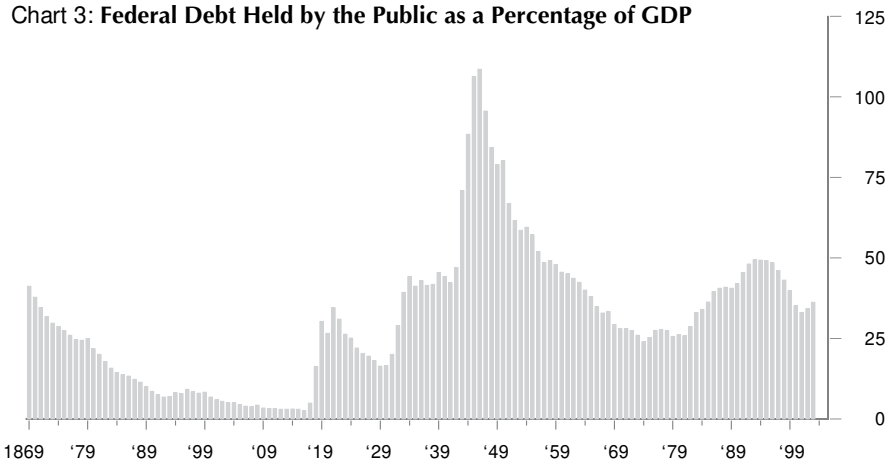
There are different ways to measure the government's obligations. The Federal debt, which now stands at $7 trillion, is the sum of all the annual deficits the government has ever run *plus* the debt that is held by various government agencies and trust funds such as the Social Security trust fund. This figure understates the government's liabilities, however, because it ignores most of what the government has promised to pay in future Social Security and Medicare benefits. If these unfunded liabilities were included, the Federal debt would be trillions larger. But because it is difficult to measure the future cost of these programs, they are excluded from traditional measures of debt.

Even the standard $7 trillion measure of debt is somewhat misleading, because about $2.8 trillion of it is "non-marketable securities" held by the government trust funds. These IOUs are essentially book-keeping entries. The government owes the debt to itself, and the interest paid by the Treasury (as borrower) goes right back to the Treasury (as lender) which counts it as income on the assets held in the funds.

The rest of the Federal debt—the portion held by the public—is the only debt that is marketable. That is, it is held in the form of Treasury bonds, notes, and bills that are sold and traded freely in the financial market, where the government must compete with private businesses and other borrowers (such as state governments) to attract investors' funds. This debt is the best measure of how much money the government has drained from the private sector to cover its budget shortfalls over the years. It currently amounts to about $4 trillion.

Although this is the largest debt ever in dollar terms, by other terms the Federal debt was much higher a half century ago. As can be seen in Chart 3, the Federal debt exceeded 100 percent of GDP during World War II. This ratio declined to just 26 percent by 1981. Throughout this period the government ran deficits and the dollar amount of Federal debt increased. However, the ratio of debt to GDP declined because the economy grew faster than the debt.

Chart 3: **Federal Debt Held by the Public as a Percentage of GDP**



Prior to the 1980s, the debt generally increased in relation to GDP only during times of war. But during the 1980s and early 1990s the debt ratio doubled, reaching 50 percent of GDP by 1995. It decreased when the government ran surpluses from 1998 to 2001, but it is now rising again.

Currently the Federal debt held by the public equals 36 percent of GDP. This is not high by historical standards or even by comparison with the debt ratios of other developed countries, such as Japan and Italy. In short, even if this ratio increases further (as seems likely) it is not clear at what point it will become "unsustainable" or "unsafe."

Last year the Treasury paid $153 billion in net interest on the debt. That's about $90 billion *less* than it paid in 1997, even though the debt is higher now. About seven cents out of every dollar the government spends is used to make interest payments—but this is less than the 15 cents it paid in 1997. The share of the economy's output that is used to service the debt is now about 1.5 percent of GDP, half of what it was when this ratio reached a postwar peak in the early 1990s.

The key factor keeping interest payments down, of course, is the exceptionally low interest rates that have accompanied the recent increase in government borrowing. Investors apparently are confident that the U.S. government will repay its debts, and in dollars that have not lost much of their purchasing power. If they did not believe this, presumably they would demand higher interest rates.

This confidence could erode if the budget outlook continues to deteriorate. There is little risk that the government would default on its debt. It has no reason to do so because, unlike private borrowers (or state governments), the Federal government has the power to print money. However, investors might eventually worry about the government's ability to service its debt and meet all of its other obligations without printing excess money and thereby reducing the purchasing power of the dollar.

The larger the deficit, the more the Federal debt increases, and the more likely that investors will begin to worry. Faster economic growth could ease the need for the government to borrow, but it is unlikely to fix the longer-term budget problem. To avoid large and chronic deficits, Americans will have to decide whether they prefer a higher level of taxes or a lower level of spending. The most expedient thing to do, of course, is simply to keep on borrowing and leave the difficult choices to the next generation. ❑

PRICE OF GOLD

	2002	*2003*	—— *2004* ——	
	Feb. 7	*Feb. 6*	*Jan. 29*	*Feb. 5*
Final fixing in London	$299.50	$375.80	$405.70	$399.55

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