Discussion of "Consequences of Government Deficits and Debt"

Alberto Alesina
Harvard University

1. Introduction

I am very pleased to participate in this conference in honor of Benjamin Friedman, for two reasons. One is to celebrate his immense contribution to our profession, especially in the areas of monetary and fiscal policy. The second one is my debt towards him: he has been my mentor from the moment I walked into the Economics Department at Harvard as a first-year Ph.D. student in September 1982. It is also a pleasure to discuss this fine paper by Glenn Hubbard, which very cleverly points out the costs of large deficits and public debts.

2. The Cost of Deficits and High Debts

Not since the end of WWII have public finances of industrial economies been in such disarray as they are today. While robust growth in the quarter century after WWII allowed a fairly rapid reduction of debt/GDP ratios, this is not likely to happen now. The current high public debt levels in the United States and Europe are not going to disappear soon thanks to vigorous growth. In addition, the aging of the population is going to significantly add to the current fiscal problems induced by the Great Recession. Major discretionary policy intervention will be needed on both sides of the Atlantic in the next several years. The paper by Hubbard identifies clearly the costs of deficits. Together with the work by Reinhart and Rogoff (2009), observations about the costs of debt burden on growth, Hubbard reminds us of the seriousness of the situation. Ben Friedman himself, in his *Day of Reckoning* volume (Friedman 1988), warned about the evils of excessive debt of the eighties.

2.1 Interest Rates

One of the costs of excessive deficits is their effects on interest rates. We can classify the latter into two such effects. One occurs even when there is no default risk, and it has simply to do with the increase in quantity of Treasury bonds offered in the market. Currently interest rates on "safe" public debt are low, but they can only increase. The second source of problems comes from default risk. For the first time in decades, some forms of default or restructuring have been openly discussed for several OECD countries—Greece, Ireland, Italy, Portugal, and Spain. Even the United States has lost its triple-A status. Default risk can trigger a dangerous spiral. The more the markets fear a default, the higher the interest rate premium they ask; the latter makes the solvency of the government in question even more problematic, inducing markets to require even higher interest rate premiums.

This problem has been aggravated by a very late awakening of markets in Europe. For the first decade of the euro, the interest rates on public debts in Europe converged almost fully to those of Germany. Greece, Portugal, and Spain were borrowing large quantities of funds at very low rates, contributing to creating large imbalances. Suddenly, after the financial crisis, markets woke up to the idea that Greek debt was not German debt! Currently the interest differentials between countries in Europe are large.

2.2 The Tax Burden

Large public debt implies a large interest rate burden. To the extent that the interest rate burden is financed by tax revenues, the distortionary costs of taxation induced by large public debts become relevant. European countries and (to a lesser extent) the United States have high tax rates, and the top of the Laffer curve may be appearing on the not too distant horizon. For countries with debt levels approaching 100 percent of GDP, even relatively small increases in rates, holding primary spending constant, would lead to a significant increase in distortionary tax rates.

2.3 Rigidity of Fiscal Responses

When a country has accumulated a high debt, it loses the necessary flexibility for responding aggressively with deficits if a recession occurs. Even allowing automatic stabilizers to "do their job" may become overly costly because of a dangerous debt dynamic. Thus, high-debt countries may have to contain deficits even during recessions, leading to dangerous vicious circles: the deeper the recession, the larger the deficits; the larger the latter, the more stringent the budget constraint for highly indebted countries and the higher the pressure to reduce deficits, aggravating the recession.

3. How to Reduce Deficits

We are currently witnessing a lively debate on the issue of how and when to reduce deficits. Two critical questions are as follows:

(i) What are the short-run costs of a fiscal tightening?

(ii) How does one minimize the costs of fiscal adjustments?

On both questions we, as economists, do not know as much as we would like or perhaps we should. The issues are complicated, because of very difficult "identification" problems. Suppose we observe that the ratio of spending of GDP goes down while GDP goes up. What causes what? How do we disentangle the issue? Also, fiscal policy experiments—in particular, large fiscal adjustments—are accompanied by a host of other policies, such as more or less loose monetary policy, exchange rate devolutions, and structural reforms. Therefore it is often difficult to isolate the effects of fiscal policy from everything else.

A lively debate is alive today in the profession. This is not the place for a full review of the recent literature on fiscal policy, but the following points represent my readings of the results.

- Spending multipliers (i.e., the effect of one dollar of discretionary spending on GDP) are estimated between roughly 0.8 and 1.5. Some estimates fall outside of that range, but most fall within it.

- The effect of government spending on employment has weakened in the latest recessions.
- Tax multipliers are (much) larger than spending multipliers.
- Spending multipliers are slightly larger in recessions.

Overall these results should give pause to those who hold a textbook Keynesian view of public finance. According to the latter, spending multipliers should be larger than tax multipliers, and spending multipliers should be (much) larger than one. The wide range of estimates does not allow us to draw firm conclusions on how much one should use discretionary government spending as a countercyclical tool, but they certainly are not an endorsement of a very proactive stand. In addition, those estimates do not deal with two additional issues. One is the "long and variable lags" and the effect on deficits. That is, by the time an expansionary fiscal package is designed, approved, implemented, and spent, it may take so long that it may reach the wheels of the economy when it is too late, i.e., in the wrong part of the cycle. In addition, deficit spending (including the effect of automatic stabilizers) should be compensated by surplus during expansions. But often, for political reasons, it is not, and deficit spending during recessions accumulates in large debts, because they are never compensated.

Therefore my reading of this evidence is that one should be careful in using discretionary spending as a countercyclical fiscal policy tool, above and beyond automatic stabilizers.

Let's now turn to the second issue, namely how costly it's going to be to reduce deficits. Virtually everyone would agree that in the medium run, having a solid fiscal position facilitates public policies and growth. The most hotly debated issue is what are the short-run costs of the kind of large deficit-reduction policies that are needed both in several European countries and in the United States. Once again, this is not the place for a survey of the rather vast literature on these issues.

Much of this literature, starting in the early nineties, has studied several examples of large fiscal adjustments that have occurred in OECD countries. My reading of the results is as follows:

- Spending based on adjustments is less costly in terms of short-run recessions than tax-based adjustments.

- Only spending-based adjustments are likely to lead to a long-lasting stabilization and reduction of the debt/GDP ratio. This is because without putting a break on programs which automatically grow, tax revenues cannot keep up with spending increases, especially with an aging population. Which programs are better candidates for cuts vary across countries but typically include pensions, health spending, and various other types of subsidies. In many European countries, government employment is overextended and public-sector wages have grown more than private-sector ones.
- In some cases, spending-based adjustments have been much less costly than a standard Keynesian model would predict, and in fact they have been accompanied by expansionary effects on the economy.
- In these cases, a swift response of private-sector investment (in addition to private consumption) has "crowded in" aggregate private demand.
- These "expansionary" fiscal contractions are helped when they are accompanied by a structural reform package that indicates a "regime change."
- In small open economies, exchange rate devaluations helped in the short run.

These results are sometimes labeled as "non-Keynesian effects" of fiscal policy, namely the possibility that a fiscal adjustment does not bring about a deep recession even in the short run. Several non-Keynesian channels that could counteract the standard effects of spending cuts on aggregate demand have been discussed in the literature.

The first one goes through an expectation effect. A spending-based adjustment today indicates a decreased need for a bigger one tomorrow and reduces expectations of future tax increases. This may have some positive effects on expected profits for firms and expected disposable income for consumers. Stabilization of the budget may also bring about positive effects on confidence for investors. The removal of uncertainty about the future stance of taxes and regulatory policy may bring about a boost of confidence. This is an issue that deserves further study.

An additional effect may come from interest rates, current and future. Countries that are paying a significant premium on their financing needs because of default risk may see significant reduction in their interest burden, which would facilitate the adjustment and have positive effects on private demand.

Another especially important channel in European countries with unionized labor markets has to do with cuts in the size and the rate of growth of wages of public employees. Wage moderation in the (large) public sector induced by the fiscal adjustment has implications for wage moderation in the private sector as well.

More generally, a sharp fiscal adjustment may offer a political opportunity for introducing pro-growth reforms, like privatizations, deregulation of certain sectors, and labor market reforms. This is indeed the case in Europe at the time of this writing. The political bet for several countries in Europe is to adopt spending cuts and pro-growth reform in order to act on both the numerator and the denominator of the debt/GDP ratio.

4. Conclusion

How to deal with the costs of large public debt and how to reduce it will be the critical questions for many OECD economies in decades to come. As economists, we need to understand more and better the effects of alternative fiscal policy. What we have learned from Ben Friedman will help us a great deal.

References

Friedman, B. M. 1988. *The Day of Reckoning: The Consequences of American Economic Policy Under Reagan and After*. New York: Random House.

Reinhart, C., and K. Rogoff. 2009. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton, NJ: Princeton University Press.