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Reducing long term deficits☆

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1. Introduction

The most serious long-term challenge for the economic policy of the U.S. Federal government is the explosive growth of the national debt that will occur unless there are specific policy actions. The ratio of the federal government debt to the GDP has doubled in the past decade from a level of less than 40% that prevailed for many years before the recent recession to 75% of GDP now. According to the most recent report by the Congressional Budget Office (2016), the debt ratio is already beginning to rise.

The CBO projects that with current policies the debt to GDP ratio will reach 86% within 10 years and the federal debt will be on its way to 155% of GDP by the year 2045. I suspect that even this disturbing forecast is too optimistic because a debt trajectory like that is likely to cause portfolio investors in the United States and elsewhere to conclude that the U.S. government has lost control of its fiscal policy. If that happens, interest rates on U.S. government bonds will rise faster, bringing with it an even larger deficit and a more rapid growth of the national debt.

There are of course other important economic problems facing the United States that need to be fixed. High on my list is that the education system for most K through 12 students falls short of global standards and that we also fail to provide useful education and training for many high school graduates. But these are primarily the responsibility of the state and local governments.

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Of course, in thinking about the problems that we face we should not lose sight of the great advantages that have raised the standard of living in the United States and that will continue to do so in the future: an entrepreneurial spirit that generates new businesses and new products, a financial system that supports that entrepreneurship, great research universities that contribute to that process, and a labor market that does well at matching job seekers and jobs without the barriers of regulations, state owned enterprises, and labor unions that impede the labor markets in other countries.

But we could do better, especially relative to our own recent performance. Looking ahead, the Congressional Budget Office (2016) predicts that the growth of output in the nonfarm business sector will slow from a growth rate of 3.5% during the past half century to just 2.5% in the next decade. The CBO attributes half of that decline to the slower growth of potential working hours (resulting from the aging of the population and the end of the surge of female labor force participation). The rest of the projected slowdown is attributed to lower capital accumulation and a slower increase of total factor productivity, perhaps a false distinction because greater capital accumulation would bring with it improvements in total factor productivity.

The reduction in capital formation is one of the serious direct effects of a large fiscal deficit. It is important therefore to understand the nature of capital formation in the American economy and of the role of the fiscal deficit in reducing capital formation.

But before looking at the impact of the budget deficit on capital formation, it is useful to recognize the three other ways in which a rise in the national debt is a serious problem for the American economy (Feldstein, 2011). First, servicing the debt requires raising taxes and those taxes impose efficiency costs on the economy. Second, with more than half of the national debt held abroad, paying interest on that debt requires a lower real value for the dollar, reducing U.S. living standards by worsening our terms of trade. Third, a higher debt reduces the government's room to raise spending in case of a military problem or an economic downturn.

It is important therefore to reverse the upward path of the debt to GDP ratio. The good news is that this requires only a relatively small shift in the annual deficit to GDP ratio. If the future nominal growth rate of GDP is 4%, an annual deficit of 4% of GDP will cause the debt ratio to rise to 100% of GDP. But if the annual deficit is cut to 2% of GDP, the debt ratio will gradually decline to just 50%.

2. The new nature of capital formation

I return now to the adverse effect of the fiscal deficit on capital formation. The traditional textbook view of the role of capital formation is that increased capital per worker means more and better equipment, leading to higher productivity and therefore higher real wages and a higher standard of living. That continues to be true but it is only a very limited part of the story about the potential role of increased investment in businesses today.

The national income account data teach us that investment in industrial equipment is just a small share of the investment that firms do today. Last year, total business investment, other than inventory investment, totaled $2.3 trillion. Only 10% of this investment was spending on industrial equipment ($233 billion). Firms spent nearly 50% more on information processing equipment ($323 billion) and more than three times as much on software and other intellectual property products ($730 billion). So capital formation in the current information intensive age is very different from the traditional investment in plant and equipment.

Companies need resources for all of this spending, and also for investing in upgrading the skills of production workers and of managers, a form of spending that is not counted as investment but