

Budget Deficits and Interest Rates

BY AARON STEELMAN

During the late 1990s, the federal budget went into the black for the first time in more than two decades. Indeed, mounting surpluses were projected for as far as the eye could see. But in 2002, as revenues began to flow into Washington more slowly and expenditures continued to rise, those black figures turned red. No one knows for sure, of course, when this will change. But it seems likely that federal budget deficits will be the norm for at least the near future.

Changing fiscal conditions have reignited a debate among economists: Do budget deficits cause long-term interest rates to rise? Unfortunately, there is no consensus on this issue.

“Despite a long history of analysis of fiscal policy, there is much less solidly based knowledge than one would like about the effects of government deficits on the economy,” notes Gerald Dwyer Jr. in an article in the *Journal of Money, Credit and Banking*.

For years, the conventional view was that government debt leads to increases in long-term interest rates, which decrease capital formulation, which ultimately leads to lower real income. How might public debt fuel higher long-term interest rates? The relationship “seems a trivial application of supply and demand,” Dwyer writes. “If the deficit increases, the supply of government bonds increases; everything else the same, the price of government bonds falls and the interest rate rises.”

There is some evidence to support the claim that deficits do, in fact, raise long-term interest rates. In a recent paper, Thomas Laubach, an economist at the Federal Reserve’s Board of Governors, wrote that the “estimated effects of government debt and deficits on interest rates are statistically and economically significant: a 1 percentage point increase in the projected deficit-to-GDP ratio is estimated to raise long-term interest rates by roughly 25 basis points.”

But the positive correlation between budget deficits and higher long-term interest rates doesn’t always hold up under empirical testing. “There are three periods during which the federal deficit has exceeded 10 percent of national income. In none of these periods did interest rates rise appreciably. Regression analysis applied to data from these three periods has not uncovered a positive association between deficits and interest rates,” writes Paul Evans in a paper published in the *American Economic Review*. “There also appears to be no evidence for a positive association between deficits and interest rates during the postwar period. I conclude from this survey that the con-

cerns of the popular press and many economists may be misplaced.” Likewise, Charles Plosser has been unable to find a positive correlation between public debt and higher interest rates in two papers for the *Journal of Monetary Economics*.

The reason why some researchers have been unable to find such a correlation might be explained by the “Ricardian equivalence” theorem. This theorem is based on the notion that people are far-sighted and view deficits as simply postponed tax liabilities, which they will eventually have to pay.

“The Ricardian equivalence theorem can account for the tenuousness of any relationship between government debt and

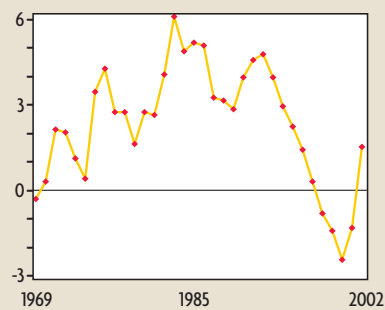
the interest rate. Under certain conditions, an increase in the supply of government debt that is not acquired by the Federal Reserve and that finances a nondistortionary change in taxes does not affect the current and expected future opportunity sets of private agents,” writes Dwyer. “Hence, private agents’ current and expected future consumption are unchanged, the increase in private saving exactly equals the increase in the deficit, and the increase in the demand for government securities exactly equals the increase in the supply of government securities.”

Robert Barro has become perhaps the leading proponent of the Ricardian equivalence theorem, first in a 1974 paper for the *Journal of Political Economy* and now in his textbook, *Macroeconomics*.

None of this means that we should necessarily stop worrying about budget deficits. First, as Laubach’s paper demonstrates, the evidence isn’t as clear cut as proponents of the Ricardian equivalence theorem might claim. Second, even if budget deficits do not lead to higher interest rates, they are often the result of unwise government spending — spending that itself can produce distortions in the economy. Such spending should be avoided, no matter its effects on interest rates.

In the end, the issue of whether it may be desirable, under certain circumstances, to run budget deficits involves more important questions than how those deficits will affect interest rates. It involves setting national priorities. For instance, we may, as a country, be willing to tolerate budget deficits in order to finance an important military campaign, as we did during World War II. Likewise, we may decide that it is desirable to run up some debt to pay the transition costs necessary to privatize the Social Security system. These are issues on which economics can shed some light. But they can’t be answered by economic analysis alone. **RF**

Federal Budget Deficit as a Share of Gross Domestic Product*



*Includes “off-budget” items, such as Social Security
SOURCE: Office of Management and Budget