

## **How harmful are fiscal deficits?**

There has been much criticism of the Bush administration's economic policy. Some would describe the accumulation of large fiscal deficits as reckless, particularly following on from the Clinton administration which worked so hard to bring restore discipline to the US public finances. Today's conventional wisdom might well agree. The belief is that high public deficits lead to higher interest rates and a crowding out of business investment. Because it is business investment that is the driver of long term productivity growth, and hence GDP, high deficits are felt to be damaging.

There are alarm bells ringing. The US deficit is forecast to grow as a proportion of GDP meaning that interest liabilities will absorb more and more real resources. In the last fiscal year the US budget deficit was \$412 billion or 3.6% according to the Congressional Budget Office. The Brookings Institute predict that if the deficit remains around 3.5% of GDP over the next decade, by 2014 the debt to GDP ratio will be around 55%, and if current trends continue it will rise to 139% by 2030.

The Keynesian perspective though may not fully agree which these prognoses. If the economy is not fully employed then an expansive fiscal policy can employ factors of production - labour and capital - that otherwise would have lain idle. Consequently the economy grows faster, and as a result GDP may grow faster than the accumulation of liabilities. Although in levels terms deficits and debts may grow significantly, as a proportion of GDP the impact could be far more moderate.

Support for this view may come from a comparison with Japan and Germany (see figures 1 and 2). Although the US fiscal position has clearly deteriorated in recent years, the fiscal situation in Japan and Germany has been worse. As table 1 highlights, the economic performance of these nations have been relatively poor, with high fiscal deficits largely the consequence of low growth- which in turn generates low tax revenues and higher social security spending. Spending your way out of a recession might not appear so reckless when considering the fiscal consequences of a recession.

Table 1: Averages 2001-2005

	<u>Growth (%)</u>	<u>Unemployment (%)</u>
USA	2.56	5.46
Germany	0.7	8.98
Japan	1.2	4.94

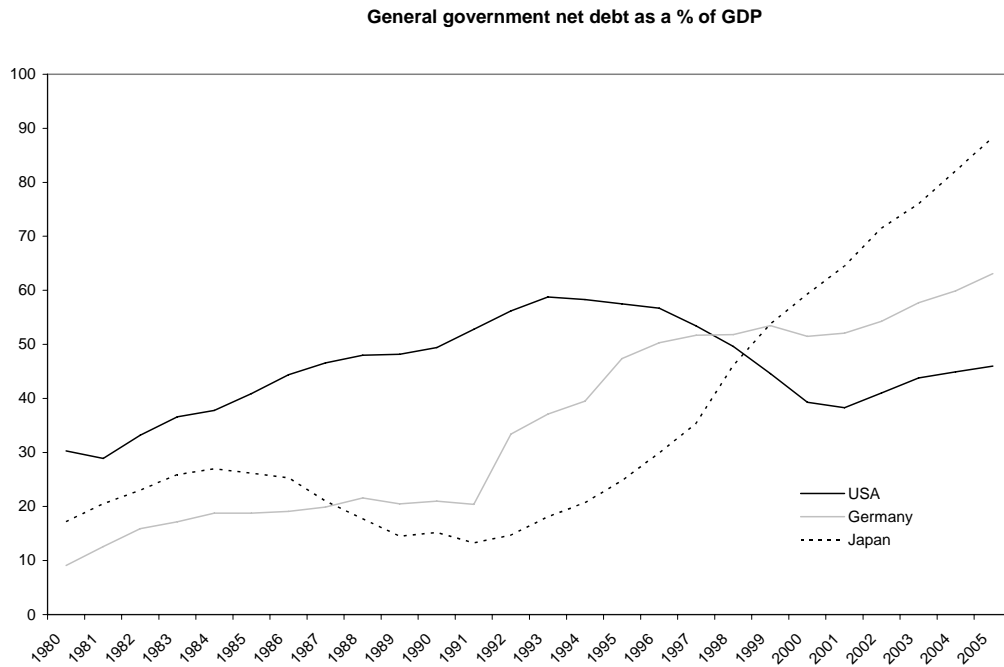


Figure 1: IMF World Economic Outlook database

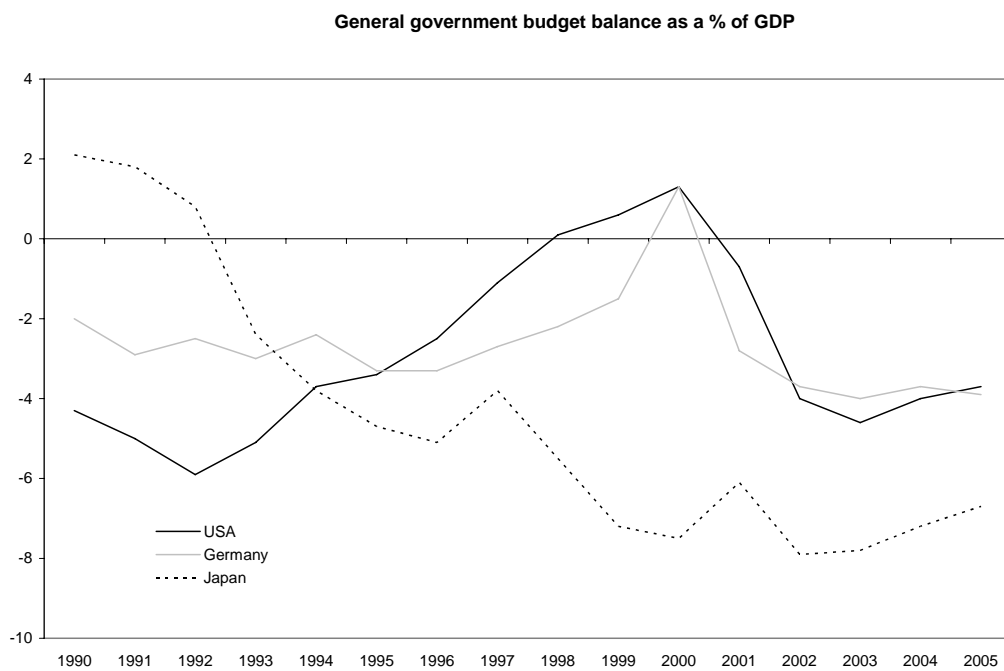


Figure 2: IMF World Economic Outlook database