Where Have All the Keynesians Gone?

Do big deficits increase interest rates? There is a strange debate on this question going on between the Brookings Institution and The Wall Street Journal editorial page. The context, of course, is President George W. Bush's proposed $674 billion tax cut.

The Journal, the temple of supply-side economics and advocate of the Bush plan, insists that deficits don't affect interest rates. Their editorials point to the Reagan years in the 1980s, when deficits were high and rates low. Supply-siders believe that reduced taxes on capital energize investment and growth--generating enough tax revenue to pay for the deficit. The Journal accuses Brookings of practicing "Rubinomics," after the former Treasury Secretary under Bill Clinton, Robert Rubin, who made budget surpluses a fiscal Holy Grail.

The objects of the Journal's scorn are two Brookings economists, William Gale and Peter Orszag, authors of the recent influential paper The Economic Effects of Long-Term Fiscal Discipline. Gale and Orszag contend that increased deficits must hike interest rates. Despite their disclaimer that they're not troubled by short-term deficits, Gale and Orszag are essentially resurrecting the old "crowding out" theory. Under that premise, government borrowing competes with private investment for a fixed supply of capital. Keynesians add that it all depends on whether the economy is at full employment.

But crowder-outers believe that government borrowing increases the overall demand for money; hence, the price of money--interest rates--must rise, too. Higher rates, according to Gale and Orszag, then raise the cost of capital, neutralize the benefit of the tax cut and actually reduce the net growth rate.

What's bizarre about this debate between the Journal and Brookings is the absence of a third party--those who believe in Keynesian economics. As several generations of Keynesians have pointed out, the actual effect of government deficits on interest rates depends on how slack the economy is and on what the Federal Reserve does. In a weak economy, government borrowing can energize consumer demand and economic growth without putting upward pressure on prices. Without a crystal ball that tells you consumer and investor confidence and Fed policy, you can't predict how deficits will affect rates, much less with the precision that Gale and Orszag suggest in their work.

The Keynesian dynamic still applies, but whatever happened to its champions? Here the story shifts from economics to politics. Moderate Democrats such as Rubin and Clinton were won over to the "crowding out" theory because it fit the fiscal and political circumstances of the 1990s, when the budget was still suffering from the immense deficits bequeathed by Reagan and George Bush I. Rubin had an implicit deal with the Fed to trade lower deficits for lower rates. Centrist economists also saw the big surplus as insurance for Social Security's solvency.
Today, however, the economy is soft. Since Bush II took office, the U.S. has shed 2.7 million jobs. We have a jobless recovery. Consumer borrowing is about at its limit. State budget deficits, now approaching a collective $80 billion, will require hikes in taxes and cuts in services, further reducing consumer demand. An Iraq war will not generate much stimulus. And Bush's proposed tax cut delivers little stimulus this year.

In this political and fiscal climate, the Brookings view is not so much wrong as unhelpful. It is axiomatic that large permanent public deficits are damaging. But it should be just as axiomatic that weak economies need significant, temporary pump priming that results in big deficits. Although Gale and Orszag concede as much, their passion is reserved for deficit reduction, and their paper is ammunition for the view that cutting deficits is virtuous policy in all seasons. Paradoxically, this leaves President Bush and the Journal editorial page in the anomalous role of pseudo-Keynesian apologists for deficits.

We are at precisely the phase of the business cycle when large deficits are needed. In fact, you can indeed grow your way out of huge public debt. The U.S. did it after World War II, and interest rates stayed low. But contrary to Bush's premise that tax cuts on dividends will energize capital spending, the overhang of surplus capacity suggests the need for a Keynesian recovery led by public and private spending that stimulates demand.

In the current circumstance of stalled job creation, tapped-out consumers, and capacity overhang, the Bush/Journal/supply-side view is fanciful, and the Gale-Orszag resurrection of "crowding out" is irrelevant. We need serious deficit spending this year--not tax cuts that favor dividends but spending that gives relief to consumers and state budgets and energizes demand. This is the debate Brookings should be prosecuting. Yes, the long-run fiscal effects of Bush's tax cuts would be economically dubious, but as the master himself famously said: "In the long run, we're all dead."

By Robert Kuttner