Private Deleveraging and Large Government Deficits

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- Members of the general public are deleveraging—reducing their debt—and the federal government is running substantial deficits, effectively undoing some of the private deleveraging.
- A standard Keynesian analysis indicates that such government deficits can reduce adverse effects of deleveraging on output and employment.
- The ability to counteract possible negative effects on output and employment presupposes that the general public either is unaware that higher deficits today are likely to be associated with higher taxes in the future or else is unable to respond to that realization.

Should the federal government be running deficits to offset some of the adverse effects of households' deleveraging? On September 30, two serious arguments were published—one in favor of substantial government deficits and the other opposed. The titles of these articles summarize the themes well: "The IMF's foolish praise for austerity" by Martin Wolf (2010a) and "Why a deficit-financed stimulus leads nowhere but to stagnation" by Jerry L. Jordan (2010).

How can these two arguments reach such diametrically opposing conclusions? Neither can be dismissed as simply uninformed, since both authors have impressive credentials. Wolf is the widely honored chief economics commentator at the *Financial Times*. Jordan is a well-known economist who has been president of the Federal Reserve Bank of Cleveland and a member of the Council of Economic Advisers. Why the difference?

Wolf's argument

Wolf berates the International Monetary Fund (IMF) for its emphasis on austerity. In his blog post with the paradoxical title "We can only cut debt by borrowing," he lays out the underlying reasons for his conclusion. His argument has a few basic elements.

> *While it would be possible to let the economy operate with reduced output and employment, Wolf argues that the government could run a larger deficit and spend more and increase output today.*

First, can everyone reduce leverage at the same time? Leave aside saving for the moment and suppose that everyone wants to reduce their leverage immediately. People can sell assets, such as second houses, to reduce their debt. If everyone wants to sell second homes to reduce leverage, then the prices of the homes have to fall to induce others to buy the homes. These falling prices reduce the value of households' assets. In addition, a reduction in debt by one person requires a reduction in lending by another. While the debt is a liability for the borrower, it is an asset for the lender. In sum, large-scale deleveraging involves significant adjustments in other parts of the economy.

If an economy is a part of a larger world, though, people can deleverage by selling some assets to foreigners and reducing borrowing. But Wolf argues that selling assets internationally is not likely for the United States and Europe today because countries with trade surpluses such as China are unlikely to acquire even more assets in the rest of the world.[1]

Over time, people can reduce their debt by spending less than their income and use the difference to increase their assets and pay off debt. Wolf argues that this resolution is not desirable because the reduction in consumption will reduce the economy's income, output, and employment. These negative effects of increased saving on output and employment apparently are inferred from a standard Keynesian analysis.[2]

While it would be possible to let the economy operate with reduced output and employment, Wolf argues that a better alternative is available. The government could run a larger deficit and spend more, and this spending can replace the reduced private consumption spending and increase output today. An increase in government securities pays for the spending, and these securities can be acquired by members of the public, thereby accomplishing the deleveraging the public wants. Because output and investment are higher today, the economy's capital stock can be higher in the future.

While the government debt might seem to create problems later, there is an increase in output today and in the future resulting from the higher investment today. This increase in output can be large enough to more than pay the future interest on the debt, although that outcome is not inevitable.

Given this analysis, it seems that that running government deficits to accommodate deleveraging is an excellent idea. But is it? Others, including Jordan, are not so sure.

Jordan's argument

Wolf's argument makes a couple of crucial assumptions. For one, he ignores the possibility that people pay attention to the government's deficits and the implications for their own future incomes and consumption.

A choice between financing spending by taxes and debt really is a choice between taxes today and taxes in the future.

As Jordan (2010) emphasizes, forward-looking people are likely to realize that their attempt to deleverage is being reversed by government deficits. Such behavior is called "Ricardian equivalence." The famous economist David Ricardo first noted that taxes paid today and taxes plus interest paid in the future can be pretty much the same thing to taxpayers. He compares taxes paid at the start of the year and taxes paid at the end of the year. Government collection of taxes at the start of the year and collection of taxes at the end of the year plus interest are equivalent to a producer. What if the government engages in spending at the start of the year? Then it has to issue debt to pay for the spending at the start of the year, and it owes the amount borrowed plus interest at the end of the year. More generally, if government debt is used to finance spending today, that debt implies higher taxes in the future. So a choice between financing spending by taxes and debt really is a choice between taxes today and taxes in the future.

[1] This argument seems inconsistent with news about Chinese acquisitions, but Wolf might counter that the acquisitions are not in the United States and Europe.

[2] In a principles of economics class, the analysis of an increase in saving leading to lower output often is encountered as the "paradox of thrift." The reduced output and employment are not inevitable and rely on investment that depends only on current output combined with wages and prices that do not adjust to changed circumstances.

What happens if households want to deleverage and the government is issuing an offsetting amount of government debt, as Wolf suggests they do? Households recognize the implied future tax liabilities from the increased debt and realize that they are not deleveraging at all. Instead, households are merely reducing their private indebtedness and future debt payments while their future tax payments on government debt are increasing. If households want to reduce their total indebtedness, they will increase their private saving by more to offset the higher government debt.

Jordan's analysis goes further, arguing that a policy of large government deficits can lead to stagnation. Why stagnation instead of the higher output envisaged by Wolf? The stagnation envisaged is lower output due to higher tax rates in the future. Higher taxes require higher tax rates on income, consumption, or assets, and these higher taxes will depress economic activity in the future.

Which argument is correct?

The primary underlying dispute is over whether households perceive that higher deficits today indicate higher taxes in the future. Wolf apparently assumes that people pay no attention to the effects on their future taxes. Jordan assumes that people realize that larger government deficits today are likely to be associated with higher taxes in the future.

The outcry among the general public about the current deficits and their effects on future spending suggests that at least some households are aware that larger deficits today are likely to be associated with higher tax bills in the future. Not all households are likely to be so forward looking as to see the link between deficits today and taxes in the future. Still, it also is hard to imagine that members of the general public who are aware of that link are few and far between. The weight of the economics literature seems consistent with responses to deficits today that reflect higher taxes in the future.[3]

[3] Seater (1993) summarizes the arguments and the literature.

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Thomas Cunningham provided helpful comments.

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