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Most American liberals are now fiscal conservatives. But not all

LIKE all the fiercest debates in American politics, the fight over the budget deficit has its hawks and its doves. But on fiscal matters, it is now the American left that brandishes talons and the right that carries an olive branch in its beak.

One exception is James K. Galbraith, of the University of Texas, Austin. “A card-carrying member of the Texas left”, he is also the whitest of fiscal doves. That makes him a rare bird indeed these days. He shares not only his famous father's initials, but also his sharp pen and his passion for the economics of John Maynard Keynes. In a recent pamphlet* on the budget deficit, Mr Galbraith argues that members of the present Republican administration are unwitting disciples of the Cambridge master.

That administration ran a deficit of $412 billion, or 3.6% of GDP, in the most recent fiscal year. The deficit this year will narrow to $331 billion, according to the Congressional Budget Office. But under some plausible assumptions about congressional budget-making, America's deficits will average about 3.5% of GDP over the next decade, estimate William Gale and Peter Orszag of the Brookings Institution.† By 2014, they project, America's public debt will amount to 55% of its GDP. By 2030, on present trends, debt could reach 139% of GDP.

How much will this matter? Messrs Gale and Orszag think that chronic deficits will eat away at the pillars of American prosperity like “termites in the woodwork”, as Charles Schultze, former chairman of the Council of Economic Advisers, once put it. The coming decade of big deficits will reduce national saving by 2-3% of GDP. As a result, American households will accumulate fewer assets, yielding $1,500-3,000 less income a year.

The deficits serve only to divert resources from investment to consumption, they argue. When taxes are cut, households spend up to 80% of the proceeds, they find. But this extra consumer demand must compete with other claims on a fully employed economy. In their view, extra household spending crowds out investment, dollar for dollar.

Ah, a Keynesian might ask, but what if the economy is not fully employed? Then, says Mr Galbraith, a budget deficit adds to demand in the economy, bringing into play labour and capital that might otherwise have lain idle. These resources might not be put to their best use, to be sure; but what matters is that they are put to some use. The economy is bigger as a result, so even if the deficit reduces investment's share of GDP, it might (at least in principle) raise the actual amount of investment that takes place.

Few could disagree with this logic: it is the basic case for a counter-cyclical fiscal expansion. Even the administration's critics concede that its 2001 tax cuts were impeccably timed (if fortuitously so), boosting consumer demand at a time when many workers were at risk of forced idleness. But as the economy nears full employment, those same critics believe, budget deficits become more damaging.

Doom or Verdoorn?

Mr Galbraith thinks otherwise. America's sustained deficits will help it outgrow the liabilities they leave in their wake, he believes. And if that fails, they will help inflate those liabilities away. As an economy approaches full employment, any fiscal stimulus is dissipated by higher prices. In this case, the stimulus may add nothing to real GDP. But, Mr Galbraith points out, it still adds something to nominal GDP. This will ease the government's debt burden, since it is out of nominal GDP that the government must repay the nominal claims held by its creditors.

Inflation, like devaluation, is a tried and tested way for an indebted government to escape its obligations. It is because it is so tempting that macroeconomic stability is so hard-won and so easily lost. It may be true, as Mr Galbraith suggests, that America would rather let its inflation rate multiply than its debt-to-GDP ratio explode. But why would anyone want either?

In fact, Mr Galbraith is confident that a sustained fiscal stimulus will yield more than just inflation. When demand is strong, innovation quickens, he argues. He cites Verdoorn's law, named after the Dutch economist Petrus Verdoorn, which holds that the pace of productivity growth picks up as the economy nears full capacity. If a government deficit adds to the demands on an economy at full stretch, the economy may find ways to stretch a little further.

There may be a grain of truth to this observation. But Mr Galbraith presumably does not believe in a world without any supply-side constraints, in which the only check on the ingenuity of the American economy is the timidity of its fiscal authorities.

In so far as there is any truth in Verdoorn's law, its practical implications are more modest. It suggests that America's policymakers must test the economy's limits before they can know precisely where they lie. The American economy might, for example, learn to cope surprisingly well with a tight labour market, as it did in the late 1990s. At that time, the Federal Reserve seemed to take the view that faster productivity growth had allowed the unemployment rate consistent with stable inflation to be temporarily reduced. More generally, the Fed knows that it cannot be quite sure exactly where America's natural rate of unemployment and its neutral rate of interest lie.

But if the Fed can be trusted to explore the economy's limits and respect them, Congress cannot. Fiscal policy is made in a spirit of political point-scoring, not macroeconomic inquiry. Given too much licence to roam, Congress would soon reach the economy's outer frontiers—and carry right on over the edge.

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* “Breaking Out of the Deficit Trap: The Case against the Fiscal Hawks”. The Levy Economics Institute. June 2005

† “Budget Deficits, National Saving, and Interest Rates”