PROJECT SYNDICATE
THE WORLD'S OPINION PAGE

BUSINESS & FINANCE

KENNETH ROGOFF

Kenneth Rogoff, Professor of Economics and Public Policy at Harvard University and recipient of the 2011 Deutsche Bank Prize in Financial Economics, was the chief economist of the International Monetary Fund from 2001 to 2003. The co-author of This Time is Different: Eight Centuries of Financial Folly, his new book, The Curse of Cash, was released in August 2016.

JAN 16, 2017

The Trump Deficit

CAMBRIDGE – It is a post-financial-crisis myth that austerity-minded conservative governments always favor fiscal prudence, while redistribution-oriented progressives view large deficits as the world's biggest free lunch. This simplistic perspective, while perhaps containing a grain of truth, badly misses the true underlying political economy of deficits.

The fact is that whenever one party has firm control of government, it has a powerful incentive to borrow to finance its priorities, knowing that it won't necessarily be the one to foot the bill. So expect US President-elect Donald Trump's administration, conservative or not, to make aggressive use of budget deficits to fund its priorities for taxes and spending.

The most accurate framework for thinking about government budget deficits in democracies was proposed in the late 1980s by the Italian scholars Alberto Alesina and Guido Tabellini, more or less simultaneously with two Swedes, Torsten Persson and Lars Svensson. While their approaches differ slightly in detail, the basic idea is the same: You give money to your friends while you can. If there is less money to go around later, when the opposition party gets its turn in power, well, that's just too bad.

One only has to recall recent US economic history to confirm the insight of the Italian/Swedish model – and to see the absurdity of claims that Republicans always aim to balance the budget while Democrats always try to spend beyond the country's means. Back in the 1980s, conservative hero Ronald Reagan was willing to tolerate enormous deficits to fund his ambitious tax-cutting plans, and he did so in an era when borrowing wasn't cheap.

In the early 2000s, another Republican president, George W. Bush, essentially followed Reagan's playbook, again slashing taxes and sending deficits soaring. In 2012, at the height of the standoff between the Republican-controlled Congress and Democratic President Barack Obama over deficits and the national debt, Republican presidential candidate Mitt Romney proffered an economic plan that featured eye-popping deficits to finance tax cuts and higher military spending.

On the other side of spectrum, Democratic President Bill Clinton, during what most academic economists consider to have been an extremely successful presidency, actually put the government into surplus. Indeed, at the end of the 1990s, some researchers actually wondered how international markets would function if the US government gradually retired all of its debt. Bush's subsequent tax cuts and unfunded wars ensured that this never became a problem.

What, then, prevents deficits from spiraling upward as parties alternate power and borrow to help their supporters? In high-functioning democracies such as the United States or the United Kingdom, there is enough collective memory of the problems caused by high debt to allow some support for periodic reduction of debt/GDP ratios. But even in the US and the UK, budget deficits are not sterile and neutral forms of economic stimulus, as in the classroom Keynesian model. Instead, deficits are almost always the product of fierce political infighting over fiscal priorities.

Of course, in a constantly changing world, the costs of carrying a large debt burden can shift over time. After falling for decades, interest rates are suddenly starting to rise.

Different attitudes toward risk are a central factor in the perennial controversy over how much stimulus is optimal. Until recently, many left-leaning economic commentators have been arguing for massive fiscal stimulus in the US, though they seem to have changed their position overnight (the night Trump was elected, to be precise). No one quite knows what a reasonable middle ground between debt and stimulus would be.

The Nobel laureate economist Thomas Sargent and others recently argued that the optimal level of debt for the US is in fact very close to zero, though he does not recommend trying to get there anytime soon, given that US government debt is now over 100% of GDP. Sargent's recommendation contradicts the view (espoused most recently in an *Economist* magazine leader) that instead of stabilizing debt, all advanced countries should be aiming to emulate Japan (where net debt is more than 140% of GDP, the highest ratio among the advanced economies).

What matters is not only the level of debt, but also how it is managed – a question I examined in a recent commentary focusing on the right mix of long-term and short-term government borrowing. Some, including Robert Skidelsky, seem to think that discussion of how the maturity structure of government debt should be managed is somehow a stalking horse for tight budgets and austerity. But if interest rates shoot up in the Trump era (as well they could), the US government will wish that it had opted for less short-term borrowing and more long-term borrowing.

If a Trump presidency does entail massive borrowing – along with faster growth and higher inflation – a sharp rise in global interest rates could easily follow, putting massive pressure on weak points around the world (for example, Italian public borrowing) and on corporate borrowing in emerging markets. Many countries will benefit from US growth (if Trump does not simultaneously erect trade barriers). But anyone counting on interest rates staying low because conservative governments are averse to deficits needs a history lesson.

http://prosyn.org/Ibf6hBQ