

# IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

*IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.*

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## **DEFICITS, TAX CUTS, INTEREST RATES AND INVESTMENT (PART II): WOULD FINANCIAL MARKET CONSEQUENCES OF TAX REDUCTION NEGATE POSITIVE EFFECTS ON GROWTH?**

For years, students of economics were taught that deficits drive up interest rates. In recent decades, some Democrats and old-guard Republicans have argued against tax cuts, even those designed to promote investment, on the grounds that cutting taxes would raise interest rates and retard investment and growth, and thus be self-defeating. In a recent budget resolution, Republicans claimed that policies to increase the budget surplus would reduce interest rates and further improve the budget outlook. The trouble is, the data don't bear out the claims.

Part of the reason people become frightened by the deficit is that the nominal deficit may be higher than the real deficit. Inflation reduces the amount of real debt outstanding. For example, if the federal debt held by the public (that is, not in federal government accounts) is \$4 trillion and inflation is 2 percent, then the real debt is falling by \$80 billion a year. There is a real deficit only when the nominal deficit exceeds \$80 billion. Even that overstates the economic and budget impact of the debt, because the Federal Reserve buys some of the debt each year as it increases the money supply, and returns the interest payments on its holdings to the Treasury (after meeting its own minimal expenses). Of course, some obligations of the federal government, such as rising future Social Security obligations, are not recorded as part of the debt, but these

obligations will be dealt with either through benefit formula changes or tax changes. Also, several trillion dollars worth of federal assets, such as land, buildings, and weaponry, are not counted as offsets to the debt either.

But let's get back to the traditional measure of the deficit and the traditional discussion of deficits and interest rates. A rise in the deficit is assumed to "absorb" more of the nation's saving, and leave less for the private sector. According to "flow of funds" analysis, the deficit increase means more "demand" for saving out of a relatively fixed "supply", so the "price" (the interest rate) must rise. This is also expressed as the notion that a higher deficit means a lower rate of national saving.

But this assumes that the supply of domestic saving is fixed, and that we have no access to world credit markets.

In fact, changes in the government deficit are significantly offset by opposing changes in private sector saving. Lower taxes, especially those that raise after-tax retained earnings (part of business saving) or that encourage saving by individuals and raise the returns to investment, primarily boost saving, not consumption. When tax cuts boost saving to match, they leave national saving unchanged. When tax cuts encourage larger increases in saving, they may boost national saving.

*For years, students of economics were taught that deficits drive up interest rates... The trouble is, the data don't bear out the claims... Numerous studies have found only limited relationships between deficits and interest rates.*

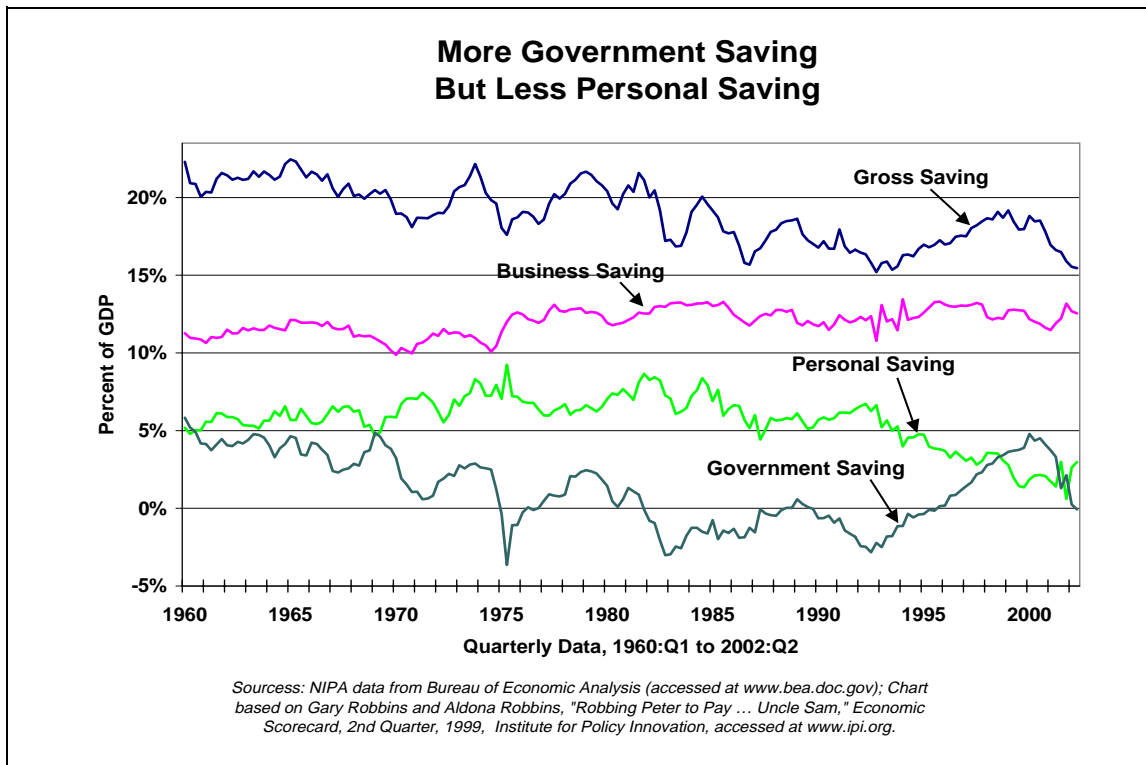
For example, suppose there were an increase in allowable deductions for IRAs. Some of the additional IRA deposits would have been saved anyway, but some will be new saving. If the percent of new saving in the amounts deposited exceeds the taxpayers' marginal tax rates, national saving will have risen (because the tax loss only equals the deposit times the taxpayers' marginal tax rates).

The following chart tracks gross national saving, "government saving" (federal, state and local surpluses), business saving, and personal saving as a percent of GDP. It shows a striking tendency for government saving and personal saving to move in opposite directions. The same is true for government and business saving (although the latter has varied a bit less than personal saving). In short, a tax increase to reduce the deficit is largely saved, not spent, and a tax increase to reduce the deficit mostly reduces private saving and hurts investment.

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Furthermore, it is wrong to measure the deficit against the annual flow of U.S. saving. The world flow of saving is much larger than the U.S. flow, and we can and do tap it. For example, in recent years, foreigners have acquired, annually about \$300 to \$400 billion more U.S. stocks, real estate, and bonds and notes than U.S. savers acquired abroad, which meant we had a large net capital inflow. Total flows of saving across the U.S. border in both directions has been running at about \$1 trillion to \$1.5 trillion annually. Even a small reduction in U.S. capital outflows (keeping a bit more of our saving at home) or a small increase in foreign inflows could accommodate a large swing in the U.S. budget deficit without affecting domestic investment or interest rates.

Even that is only part of the story. It is not just the *flow* of this year's saving that matters, but rather the whole pool of existing assets in the world, or the



**stock** of accumulated saving, that matters. Large changes in the federal budget balance would represent only a minuscule change in the roughly 100 trillion dollars of financial instruments that will be outstanding in the world capital markets over the next decade, and would have a correspondingly limited effect on world asset prices and interest rates. An added trillion dollars of federal debt over the next ten years, for example, would only increase the stock of financial assets outstanding in the world by about a percent, and would be unlikely to raise world interest rates by more than 5 to 7 basis points. To make room in people's desired holdings of securities, the added debt would have to drive down the value of existing debt instruments by the same amount in order encourage people to save that much more to replace their lost assets. Asset prices move in the opposite direction as interest rates. An added percent of world debt would need to raise global interest rates by about **a percent of themselves**, e.g. from 6% to 6.06% for long term government bonds, to depress their value by about a percent, which is a trivial change.

There is another way in which the deficit may impact interest rates, however. Changes in government spending and taxation can affect the cost of obtaining investment goods or of hiring labor, and thereby alter the rate of return on business investment, as well as altering the deficit.

Increased government spending on goods and services reduces the availability and drives up the cost of goods and services for the private sector, including the cost of equipment and structures.

Increased government employment reduces the availability and drives up the cost of labor for the private sector. Both effects reduce the rate of return on capital investment and reduce capital formation. **These effects are due solely to the government's use of the physical resources and manpower, and they occur whether the increased spending is financed by taxes or by borrowing.** Consequently, if the deficit were due to spending hikes, then there might well be a drop in national saving and investment, but that would be due to the absorption of

physical resources by the government, not credit market effects. It is not the deficit per se, but the government spending that crowds out investment and reduces its rate of return. In fact, government spending may weaken investment and thus drive down interest rates on financial assets until a shrinking capital stock raises the rate of return back to normal levels.

Conversely, lower taxes on capital income would directly raise real after-tax returns on additional capital and would increase business fixed investment. Lower taxes on labor would increase its supply and reduce its cost, thereby also raising returns on investment. Yields on associated financial instruments would rise to reflect the higher returns on physical capital, which would attract the saving to finance additional

investment to take advantage of the improved investment opportunities. The rise in returns on stocks and bonds (interest rates) would be a sign of increased profitability of investment, not a sign of a scarcity of saving that would be an obstacle to investment. Other than the benign effect of higher returns on business investment being reflected in

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financial assets, there would be little effect on market interest rates from the changed budget posture per se. The direct incentive effect of the reduction in the tax rate on capital income would boost investment and the capital stock, until the increase in the capital stock reduced returns to normal levels, and a new equilibrium was reached.

It is time to acknowledge that the United States has an "open" economy. We are part of the global economic system. U.S. interest rates and prices are set in global, not purely domestic, markets. Capital and goods are free to move across borders. If investment opportunities open up in the United States, they can be funded with domestic or foreign saving, and can be translated into additional capital formation far more quickly than if we were dependent only on our own saving or on our own capital goods industries. Not only would U.S. saving rise, but less of it would flow abroad and more foreign saving would move into U.S. assets.

Estimates of the response of capital investment to a tax change should be based strongly and directly on the impact of the tax change on the desired capital stock, and not on calculations about the flow of funds through the financial markets and the availability of domestic saving. Once additional investment is made profitable by a tax change, the global financial market will take care of the funding.

Similarly, the rate at which we add to the amount of physical capital is not restricted to the existing capacity of the domestic capital goods industry. Additional machinery and vehicles can be

put into service quickly by adding production capacity and by importing investment goods. The stock of commercial and residential buildings can be increased speedily by shifting resources into the construction trades. The real-world gains from adopting a more saving and investment friendly tax base would come quickly, not slowly, in the dynamic, integrated world economy.

Numerous studies have found only limited relationships between deficits and interest rates. See "The Effects of Deficits on Prices of Financial Assets: Theory and Evidence", The Office of the Assistant Secretary for Economic Policy, U.S. Treasury Department, Washington, DC, March, 1984. It contains some independent estimation as well as a review of the then-existing literature. See also "Government Debt" by Douglas W. Elmendorf and N. Gregory Mankiw, Working Paper 6470, National Bureau of Economic Research, Cambridge, MA, March, 1998 at <http://www.nber.org/papers/w6740>. The authors review many of the theories that bear on the issue of debt, interest rates and growth, and lay out some of the assumptions that underlie arguments for and against the traditional claims for an adverse relationship. They are critical of many studies that find little relationship between deficits and interest rates, or an adverse empirical (as opposed to theoretical) relationship between deficits and growth, but have no convincing counter to the results.

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