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How to Run Up a Deficit, Without Fear

By ROBERT H. FRANK

FEW subjects rival the federal budget deficit in its power to provoke muddled thinking.

It's a pity, because there are really only three basic truths that policy makers need to know about deficits: First, it's actually good to run them during deep economic downturns. Second, whether deficits are bad in the long run depends on how borrowed money is spent. And third, eliminating deficits entirely would not require any painful sacrifices.

Evidence for the first two propositions is compelling. The third is controversial, but as I'll explain, it's true nonetheless. Policies grounded on these propositions would greatly improve our economic prospects.

The first proposition comes from the eminent British economist John Maynard Keynes, who argued that when total spending falls well below the level required for full employment, the economy won't recover quickly on its own. Consumers won't lead the way, because even those who still have jobs are fearful they might lose them. And most businesses won't invest, since they already have more capacity than they need. Only government, Mr. Keynes concluded, has both the motive and opportunity to increase spending significantly during deep downturns.

Of course, if the government borrows to do so, the debt must eventually be repaid (or the interest on it must be paid forever). That fact has provoked strident protests about government "bankrupting our grandchildren."

It's an absurd complaint. Failure to stimulate the economy would mean a longer downturn. That, in turn, would mean longer stretches of reduced tax receipts, increased unemployment insurance payouts, and depressed private investment. The net result? Higher total public borrowing and a permanent decline in productivity compared with what we would have had under effective economic stimulus.

Once the economy is back on its feet, deficit logic changes. At full employment, extra borrowing often compromises future prosperity, just as critics say. On President George W. Bush's watch, for example, the national debt rose from $5 trillion to $10 trillion. Some of that borrowing paid for an expansion of Medicare prescription coverage and a financial bailout a year ago, but most went for a war in Iraq and tax cuts that largely just allowed for additional consumption. Our grandchildren will be forever poorer as a result.

But the reverse would be true if government borrowing were used for productive investments. After decades of neglect of the nation's infrastructure, attractive public investment opportunities abound. It's been estimated, for example, that eliminating bottlenecks on the Northeast rail corridor would generate $12 billion in benefits at a cost of only $6 billion. These are present value estimates. When government undertakes such investments, our grandchildren become richer, not poorer.

But they'd be richer in the long run if we paid for those investments with our own savings rather than with borrowed money, for that would allow our grandchildren to benefit from the miracle of compound interest. Many fiscal hawks insist that the only way to eliminate deficits and pay for additional investment is by cutting government spending. But as California's experience suggests, that approach often backfires. Government programs have constituents. Those that get the ax are often not the least valuable ones, but those whose supporters have the least influence. California's schools, once among the nation's best, are now among the worst.

To eliminate deficits, we need additional revenue. The encouraging news is that we could raise more than enough to balance government budgets by replacing our existing tax system with one that taxes activities that cause harm to others. Called Pigovian taxes by economists — after the English economist Arthur Cecil Pigou — such levies create a burden that is more than offset by the reductions they cause in costly side effects of everyday activities.

When producers emit sulfur dioxide into the atmosphere, for example, the resulting acid rain harms others. As the 1990 amendments to the Clean Air Act demonstrated, the most efficient and least intrusive remedy was to tax sulfur dioxide emissions. Doing so entailed no net sacrifice, because solving the same problem by prescriptive regulation would have been much more costly.

Similarly, when motorists enter congested roadways, they impose additional delays on others. Here, too, taxation is the best remedy. The time that congestion fees save is more valuable than the fees are burdensome.

When the transactions of financial speculators fuel asset bubbles, they increase the risk of financial meltdowns. A small tax on those transactions would reduce this risk.

When drivers buy heavier vehicles, they increase others' risk of dying in accidents. This risk would be lower if we taxed vehicles by weight. Carbon dioxide emissions contribute to global warming. Here as well, taxation offers the most efficient and least intrusive remedy.

Anti-tax zealots denounce all taxation as theft, as depriving citizens of their right to spend their hard-earned incomes as they see fit. Yet nowhere does the Constitution grant us the right not to be taxed. Nor does it grant us the right to harm others with impunity. No one is permitted to steal our cars or vandalize our homes. Why should opponents of taxation be allowed to harm us in less direct ways?

Taxes on harmful activities would be justified quite apart from any need to balance government budgets. But such taxes would also generate ample revenue for the public services we demand, quieting the ill-considered commentary about deficits.

In the meantime, however, such commentary continues to render intelligent political decisions about deficits less likely.

For example, 58 percent of respondents in a recent NBC News-Wall Street Journal poll said the president and Congress should worry less about bolstering the economy than keeping the deficit down, while only 35 percent said economic recovery was a higher priority.

If we really want to bankrupt our grandchildren, that poll charts a promising course.

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