What’s at Stake in Economic Growth This Election

A Finger Exercise

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The Republicans: Deficit Doves

Back in 1981, America’s Republican Party gave up all belief that the government’s budget ought to be balanced. The idea took hold that tax cuts should be undertaken all the time, at every opportunity, because reducing taxes supposedly raised revenue. Irving Kristol, sometime editor of the magazine The Public Interest and one of the intellectual midwives of this idea, later wrote that he was interested not in whether it was true, but in whether it was useful. Years later, he spoke of his

> own rather cavalier attitude toward the budget deficit and other monetary or fiscal problems. The task...was to create a new...conservative... Republican majority – so political effectiveness was the priority, not the accounting deficiencies of government...

The fight between Republicans who put low taxes first and the Republicans who put balanced budgets first was damaging party unity. The solution? Pretend that there was no conflict—and by so pretending throw commitment to budget balance of any kind over the side.

Now it has become clear that John McCain—he who once criticised George W Bush's tax cuts as imprudent deficit boosters, and so refused to vote for them—has succumbed to this current of thought. His proposed policies promise to swing the U.S. budget balance from a projected deficit of $200 billion on the general fund in 2013 to a deficit of some $900 billion.

What will be the consequences?

Begin by assuming that John McCain's fiscal policy is likely to be standard Republican fiscal policy. Since 1981, standard Republican fiscal policy has been to increase the ratio of gross federal debt to GDP by nearly 2% per year. By contrast, a typical post-WWII Democratic administration has reduced the debt-to-GDP ratio by more than 1% per year. This 3% per year swing in the rate of growth of the debt-to-GDP ratio is a very important difference.

Policies that ignore the level of government debt completely lead to the currency's collapse, depression (due to the resulting disruption of the sectoral division of labour), and high inflation—perhaps hyperinflation. Guilty politicians traditionally would then evade responsibility and blame the economic catastrophe on the sinister manipulations of foreigners: the Rothschilds, the "gnomes of Zurich" or the IMF. The US is far from that point: we don't (yet) have to worry about a collapse of confidence in the government and its currency, and about the severe depressions and disruptions that accompany hyperinflation.

But we do have to worry. Even in the shorter run—over the next two presidential terms—the costs of a high deficit and rapid debt growth would be substantial.

Real GDP Growth

In the first instance, a growing debt-to-GDP ratio crowds out investment, as resources that would otherwise go to fund productive investment instead support private or public consumption. Since 1981 the US has been lucky: inflows of capital from abroad have partly financed the growth of government debt. At some point, this will stop, and increases in deficits will trigger capital flight from the US. Suppose that over the next eight years larger deficits trigger neither extra capital inflows nor capital outflows.

Suppose further that the marginal social product of investment is somewhere between 10% and 15% per year—that after we add up all the profits earned by investing companies, financiers, and the savers who finance them; the taxes paid; and the extra wages earned by workers in more capital-intensive and productive firms we find that each extra dollar invested in America produces between ten and fifteen cents of extra incomes. And suppose, last of all that the alternative to a McCain presidency—a Barack Obama presidency—will not be able to match the Democratic post-WWII average in fiscal-policy prudence but will instead simply hold the gross federal debt-to-GDP ratio constant.

Then the math is straightforward. Each year, 2% of GDP is drained from the pool of savings to finance investment, and so each year America's real incomes grow between 0.2% and 0.3% slower under a McCain than under an Obama presidency. By 2017, America's productive potential is projected to be $18.4 trillion real 2009-value dollars. Subtract eight years' worth of fiscal drag and get that under a McCain presidency the 2017 level of real GDP would be lower by between $290 and $440 billion real 2009-value dollars—some $1,800 to $2,700 per worker per year. Income in 2017 that Americans could have, but won't because McCain is campaigning as and will in all likelihood govern as a deficit dove.

Most of this $290 to $440 billion reduction in real GDP would show up as lower incomes. But some would show up as fewer jobs. In a poorer America, fewer businesses would find it worthwhile to entice secondary workers from families into the labor force. With a long-run labor-supply elasticity of 0.2, some 500,000 to 800,000 net jobs that would otherwise have been there in 2017 would never appear.

Unemployment and Real Wage Growth

There are additional effects. Slower growth of the capital stock means slower growth of real incomes. A higher-debt America would see labor productivity growth slow by between 0.2 and 0.3 percentage points per year. The rate of growth of real wages depends on the level of unemployment—with a lower level of unemployment, workers are more eager and more able to demand real wage increases from their bosses. With a lower rate of productivity growth, the warranted rate of real wage growth must slow us well. Thus the unemployment rate would have to rise

to keep workers' demands for real wage increases at a level warranted by productivity growth.

The gross correlations between productivity growth and average unemployment found in the 1970's, 1980's, 1990's, and 2000's suggests that productivity growth moves one-for-one with average unemployment, in which case the growth slowdown from fiscal drag increase the economy's natural rate of unemployment by 0.2 to 0.3 percentage points, which with a moderately elastic fraction of the population in the labor forc would amount to a reduction in employment of between 500,000 and 700,000.

Inflation and Unemployment

There is yet a third effect: a higher-debt America is an America in which savers and lenders would have a justified greater fear that the government would resort to inflation in order to reduce the value of its outstanding debt. The Federal Reserve would then have to fight inflation harder—putting upward pressure on unemployment—in order to reassure savers and lenders of its willingness to guard price stability in the higher-deficit environment.

There are not even crude gross correlation-based estimates of the size of this effect, but economists believe that it is very real. Would it cost a negligible number of jobs? A quarter-million? A million?

Totals

Add all these effects up, and we have an America that would be poorer in 2017 from a McCain presidency by a substantial amount. Annual incomes would be lower by a total amount between $290 and $440 billion real 2009-value dollars—some $1,800 to $2,700 per worker. And 1,750,000 to 2,500,000 or so jobs would disappear.