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Real Money, Real Concerns

The numbers associated with the federal government's budget can seem unreal. The Congressional Budget Office, for example, reports a budget deficit of $984 billion for fiscal year 2019. And the national debt is more than $23 *trillion*. Consider: A stack of $100 bills worth $1 trillion would be 631 miles high.

Though the figures are mind-boggling, budget deficits — the subject of often heated debate on both sides of the political aisle — have a real impact on domestic programs, the global economy and more, said Benjamin J. Cohen, the Louis G. Lancaster Professor of International Political Economy at UC Santa Barbara.

As he points out, the deficit is simply the result of greater expenditures than revenues.

"In practical terms, this is no different from how all of us as individuals deal with a deficit in our personal budget," Cohen said. "Every time we use a credit card we are building up debt. If over the course of time our income fails to match the accumulation of debt, we are in deficit. Same for families; same for business enterprises; same for every level of government (cities, counties, states)."

The federal deficit, however, is more complicated than a family's budget shortfall. Over time, he said, the government's debt must be "serviced" — paying interest on the accumulated debt. The size of the deficit, he noted, matters because higher interest payments mean less revenue is available to pay for everything else, from national defense to health care.

“It’s like pieces of a pie,” Cohen explained. “The bigger the slice of pie that must go to pay interest, the less pie there will be for other programs. The impact on individual Americans will depend on what programs get cut or canceled. If farm support is cut, farmers are hurt. If food stamps are eliminated or Medicaid benefits are cut, poor people suffer. If defense spending is cut, workers in the defense sector may be laid off. That is what the budget fights in Washington are all about — whose piece of the pie is to be reduced; bluntly, whose ox will be gored.”

The impact of the deficit, he said, depends on the size of the debt and the interest rate paid for servicing the debt. Higher debt and higher rates mean less money for domestic programs. Currently, historically low interest rates mute the impact of the deficit. Payments on 10-year government bonds are at less than 2%, which means interest payments swallow about 15% of the federal budget.

Globally, Cohen said, the deficit ripples across markets. Although increased U.S. spending benefits foreign exporters, the biggest impact will manifest through interest rates that are bound to rise as government borrowing continues to grow, he noted.

“Higher interest rates will have to be offered to persuade lenders to keep buying government bonds,” Cohen explained. “This in turn will attract lending from abroad, which in turn will drive up the exchange rate of the dollar (since foreigners will have to buy dollars in order to buy U.S. government bonds); and that in turn will hurt the competitiveness of U.S. firms in world markets (since a higher exchange rate – appreciation — will mean higher prices for U.S. exports in foreign markets and lower prices for foreign goods in the U.S. market).”

If deficits can lead to trouble, why does the government run them? Cohen, author of “Currency Statecraft: Monetary Rivalry and Geopolitical Ambition” (University of Chicago Press, 2019), said they are “to a large degree, inevitable — but for political reasons, not economic reasons.”

He notes that a government could always use its sovereign power to impose taxes on its citizens. “But that is where the politics comes in,” he said. “Politicians understandably find it much easier to spend money than to raise taxes. Hence in practice almost every government runs a budget deficit. Budget surpluses are rare.”

Still, Cohen said, that doesn’t mean a deficit is necessarily undesirable. What matters, he explained, is the size of a deficit relative to the government’s ability to

service debt — what is called debt-service capacity.

“Again, this is just like all of us as individuals,” he said. “Many of us carry debt — a home mortgage or a car loan, for instance. Whether that is good or bad depends on whether our present or future income is likely to be adequate to service our debt.”

What about a government? Cohen said that a crude measure of debt-service capacity is the ratio of deficit to gross domestic product. A ratio below 3% or so is considered relatively safe. But if the ratio begins to drift higher than that, risk begins to multiply.

“Today that ratio in the U.S. stands at 4.6%, up from 3.8% just a year ago,” he said. “The rapid rise of the ratio should be a cause for concern.”

All of this raises two questions: How important is it to address the deficit, and what are the most effective ways to do so? Given the rapid rise of the deficit/GDP ratio, Cohen said, the deficit does indeed need our attention.

There are two options, he said: cut expenditures or raise taxes. The partisan divide tends to split preference. Conservatives by and large favor the former while progressives prefer the latter.

About UC Santa Barbara

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