BY ROBERT J. BARRO

It's the Spending, Stupid—Not the Deficit

A line attributed to Vice-President Dick Cheney (by Ron Suskind in *The Price of Loyalty*) runs: "Ronald Reagan proved that deficits don't matter." Whether Cheney said it or not, the line contains both truth and falsehood. The main costs and benefits from the government's budget come from how much is spent—whether on defense, roads, courts, health care, welfare, or pensions. Since I think that the benefits from most such programs fall short of their costs, I favor smaller government. Others have a different opinion. The important point is that this debate involves levels of spending, not the budget deficit.

Government outlays must be financed by taxes, and the economy performs better if the distortions from taxes are small. Examples of distortion are the negative effect of tax on work effort and investment and the time required to comply with tax laws. Taxes that distort the most are those with high marginal rates and those that fall on income from capital.

HIGH MARGINAL TAX RATES ARE BAD, since they discourage effort, capital formation, and innovation. In our federal system, high marginal rates fall on two groups: the rich, who face high marginal rates on income tax, and the poor, who lose transfer payments, such as Medicaid and food stamps, when they earn more. The tax reforms of the 1980s wisely cut marginal rates, and the 2003 tax law returned to this theme.

Taxes on capital income—such as the corporate income tax or taxes on dividends, interest, capital gains, and estates—are harmful because they tax savings. These taxes motivate people to consume more today and less tomorrow. The 2003 cut on dividend tax helped reduce the rate on capital income.

The federal income tax is not efficient: Marginal rates are high, and capital income is taxed. Social Security payroll tax (which yields almost as much revenue as individual income tax) is much less distorting because it does not tax capital income and is a flat-rate levy. Sales taxes are also efficient.

The government must decide how to tax and when to tax. By running a deficit, it shifts from collecting taxes today to collecting them tomorrow. Because a deficit does not change the total collected (in present value), there is a sense in which the deficit does not matter, as the Cheney quote argues. In fact, British economist David Ricardo laid out in 1820 (in *Funding System*, a supplement to *Encyclopaedia Britannica*) the conditions under which current taxation and public borrowing had equivalent effects on the economy. That is, interest rates, investment, and so on were the same whether the government paid for today's spending by taxing today or by borrowing. This result is called Ricardian equivalence.

Contrary to pure Ricardian equivalence, the timing of taxes does affect the economy. It is not efficient to tax labor income or consumption at 100% one year and 0% the next. A better policy stabilizes rates over time. Thus, the 2001 tax law and the Reagan reforms of the early 1980s erred by phasing in their cuts. Generally, a judicious use of deficits can help the economy. For example, borrowing in wars and recessions avoids very high tax rates during national emergencies.

The Reagan policies added a new dimension to the theory. Reagan wanted a smaller government, but he was initially more successful at halting the growth of taxes than at stopping the growth of spending. Budget deficits resulted, and the ratio of public debt to gross domestic product increased. Eventually, deficits and debt exerted enough pressure on Congress to curb spending. After trending up from the 1950s to the early '80s, the ratio of federal spending to GDP declined through the '90s. This pattern is clearest for spending outside of defense and interest. Thus, Reagan's method for curtailing government worked.

> **Huge debt often helps curb outlays. But today that isn't happening**

The current Administration learned correctly from the 1980s that deficits and debt do not matter much for interest rates, investment, and so on. However, one way to read the Cheney quote is that the Administration has gone further to infer that government expenditure itself does not matter. The Administration seems to think that deficit financing makes the spending free. This faulty perception eliminates political pressure from deficits. Reagan's idea of strategic deficits works only if concerns about debt lead to spending restraint. At present, indifference to deficits is allowing outlays outside of defense and interest to grow at staggering rates. We have to hope that a fear of deficits will return to curb the growth of federal spending. Otherwise, Washington will have to rely on some new source of discipline. ■

Robert J. Barro *is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu)*