That Was Then
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Deficit reduction worked for Clinton, but circumstances were different in 1993. Today's Democrats mustn't think they can merely mimic him.

WE LIVE IN AN UPSIDE-DOWN WORLD where Republicans defend deficits and Democrats attack them. These are seemingly opposite views. But both have led, mistakenly, to cuts in social investment as well as to needlessly slow economic growth and high unemployment.

For years Republicans tried to slay Keynesian economics, the idea that in an economic downturn, one should run deficits. During the Clinton years, they even pushed for a balanced-budget amendment to the Constitution, which would have enshrined the principles of fiscal prudence (and precluded the Bush deficits). In those years, the Democrats were accused of being fiscally irresponsible because they sensibly believed that in times of recessions, a deficit was good policy.

All of this has changed. Ronald Reagan, of course, did run huge deficits, but that was supposedly a mistake. In his "voodoo" economics, tax cuts were supposed to somehow generate more tax revenues, so there was not supposed to be a deficit. Under George Bush Senior, taxes were raised to correct Reagan's error. But George W. Bush unabashedly defends huge, endless deficits.

As a form of economic stimulus, all deficits are not created equal. The economy may be temporarily booming, but Bush's tax cuts were not designed primarily to provide an effective stimulus but, rather, to reduce taxes, mainly on the wealthy, as an end in itself. But tax cuts for the poor, or better unemployment benefits, are far more effective in stimulating the economy. Public investment-in, say, roads, airports, education or technology-would have provided much more stimulus in the short run and enhanced America's productivity in the long run.

The new Republican economic logic also insists that prolonged deficits do not produce significant increases in interest rates. This logic defies the usual laws of supply and demand, in which an increase in demand (here the demand for funds by the government) leads to an increase in price (here the interest rate). Accordingly, by this logic even enormous and structural deficits do not adversely affect growth. This view is nonsense, but Democrats make a mistake when they respond by embracing the old Republican role of deficit hawks. In a downturn, tax revenues normally decrease, so deficits increase. During a recession, therefore, it makes sense to tolerate and even to increase these deficits, to stimulate economic activity and recovery.

But the new Democratic recipe is something along the lines of, "Reduce the deficit and economic prosperity will be restored." Emboldened by the seeming success of that formula in the early 19905, and the seeming failure of the opposite strategy by Bush, many Democrats believe fiscal prudence will cure both the economy and their fiscal reputation. But, unfortunately, the wrong lessons have been drawn from both experiences.

DEFICIT REDUCTION UNDER BILL Clinton worked, both because of the peculiar circumstances of the time and because of the way it was carefully crafted. For a variety of reasons-including regulatory mistakes that contributed to the economic recession in the first place-banks had larger than normal portfolios of long-term government bonds. So the lowering of long-term interest rates-which increases the price of long-term bonds-effectively recapitalized the banking system, leading to new lending. Normally deficit reduction dampens the economy. But Clinton's carefully designed deficit reduction program was heavily backloaded (to bite after a strong recovery was well under way). Moreover, the 1993 tax increase was targeted at the rich. On both counts, aggregate demand in the short run was not reduced much.

Conversely, Bush's backloaded tax cuts, taking effect years down the road, lead the market to anticipate far larger deficits in the future, so medium- and long-term interest rates must rise relative to short-term treasury bills, partially undoing the Federal Reserve's original efforts to lower interest rates. The lesson: While deficit increases normally stimulate the economy, it is possible to design ones badly enough that they do not provide much stimulus. The economy may have a good quarter or two, but sooner or later the money markets will catch on and bid up rates. And with that, the nascent recovery may falter.

TODAY THE ECONOMY IS GROWING again, but it's not producing enough jobs. Bush's presidency will likely be the first since Herbert Hoover's with a net loss of jobs. The economy needs millions of new jobs just to keep up with the new entrants into the labor force. And it is not just that jobs are not being created; employed people are also working less. The United States is out of recession but still far from its potential. Huge amounts of resources are being wasted, and millions of people are suffering as a result.

Bush's defense is that he inherited a downturn; were it not for his tax cuts, he says, matters would have been even worse. That would be true, if Bush's tax cuts were our only choice. But they are not. Alternative policies would have helped more, making the downtown shallower and shorter and the recovery stronger. Indeed, it is hard to imagine such a large set of tax cuts that could have done less to stimulate the economy.

By early 2001, it was clear that the economy was facing a significant and potentially prolonged downturn. (This is not just a matter of Monday-morning quarterbacking; others and I wrote this at the time. I even tried to speak to Bush about it at a White House reception for Nobel laureates, but he was distinctly uninterested.)

We should have had tax cuts and expenditure increases targeted to where the money would be spent, and spent quickly: increased benefits for the unemployed, tax cuts for the poor, investment tax credits (just to those firms that make investments), and aid to the states and localities that would shortly be facing severe budgetary shortfalls, forcing cutbacks in expenditures or increases in taxes.

The badly designed tax cuts put an increasing burden on the Fed to keep the recovery going. But the Fed's rate cuts have worked mainly by inducing households to refinance their mortgages, taking on greater and cheaper debt. This has left the economy in a precarious position. The higher indebtedness may make a robust recovery all the more difficult, for normally as recovery sets in, interest rates rise. Debt burdens are manageable today only because of the low interest rates. There is a further risk that rising interest rates could not only squeeze consumption but also bring on a fall of real-estate prices, further dampening the recovery.

Had Bush's tax cuts been fairer and aimed more at stimulating the economy, the recovery would have occurred earlier and been far stronger; today the Fed would have had further room to maneuver, with fewer risks to our economic future.

WHERE DOES THIS LEAVE THE DEMOcrats? The soaring Bush deficits are an easy target. They are a cause of concern. But the danger is that the Democrats will focus excessively on deficit reduction, thereby not only impairing the ability to maintain the economy at full employment but also reducing prospects for long-term growth. The simple fallacy is that government expenditures cause deficits, deficits force higher interest rates and higher interest rates crowd out private investment, which is the key to long-term growth. But much government expenditure also underwrites investment. And if public investment is starved, growth, too, can be impaired. Studies by the Council of Economic Advisers show that the returns on public investments, such as in education and research and development, are very high-far higher than the returns on much private investment that was crowded out and certainly higher than the investments in the excess capacity of fiber optics, telecommunications and dot-coms.

The financial markets' focus on deficits is another piece of evidence of their shortsightedness-and another example of the need for better accounting. One needs to look not just at liabilities (what the government owes) but at assets. A deficit in our infrastructure can be even more harmful than a financial one. And these public investments-in education and in the environment-are necessary for sustainable growth with equity.

Some say that Bush created the huge deficits to squeeze government, to force cuts in public investments and social programs. Democrats who focus excessively on deficit reduction are falling precisely into the trap, especially when political timidity impedes reversing the tax cuts.

It is true that increasing debt burdens-both to government and to households-have put our country's future at risk, a risk for which there is little compensating reward. Our looming problems-inequality and an aging population with increasing demands on Social Security and Medicare-have only been made worse. The cure will entail a far bolder program than just another bout of deficit reduction.