

IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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DEFICITS, TAX CUTS, INTEREST RATES AND INVESTMENT (PART 1) DO LARGE DEFICITS RAISE INTEREST RATES?

Two competing policy prescriptions have been offered to combat the sluggishness of the economic recovery: a deficit reduction strategy favored by Democrats and a tax reduction strategy favored by Republicans. The question is which would best stimulate business fixed investment. Weakness in business investment was the cause of the 2000-2001 economic downturn and the continued economic sluggishness. A difference of opinion on how best to address the investment slump is at the heart of the competing proposals.

Deficit reduction approach. Former Secretary of the Treasury Robert Rubin and some Congressional Democrats have recommended freezing the remaining steps in the 2001 tax rate reductions (at least for the top brackets) to reduce projected budget deficits. They assert that higher deficits due to the tax cuts have boosted interest rates and depressed investment, and that freezing the tax cuts would lower deficits, reduce interest rates and spur business investment.

Tax reduction approach. President Bush and most Congressional Republicans believe that the 2001 tax cuts and the bonus depreciation added in the subsequent 2002 stimulus package boosted the economy and investment. They oppose any freeze of the 2001 tax cuts and, if anything, would accelerate them and make them permanent. Others would enact new tax cuts reducing the double taxation of dividends and easing taxation of capital gains. They contend that lower taxation of capital income would spur investment.

An empirical question, not a rhetorical one. Taken separately, each policy sounds reasonable, but they cannot both be right. One cannot choose between them based on the wording of the arguments. It is an empirical question whether tax cuts indirectly do more harm to investment by raising deficits and interest rates or do more good by directly increasing the after-tax returns on investment.

In this paper, we shall look at the historical evidence concerning how much deficits affect interest rates. In the next paper, we shall look at more recent data and consider some of the world capital market conditions and economic factors and behaviors that might account for the observed results. Later, we shall discuss how businesses decide whether or not to undertake investment, and how taxes and interest rates affect the decisions. In that way, we can decide which is of greater magnitude, the assumed negative effect of higher interest rates on investment or the assumed positive incentive effect of tax reductions on investment.

The historical record. Professor Paul Evans of Ohio State researched the relationship between deficits and interest rates in a number of published studies. Evans assumed that, if a relationship exists, it might be most obvious during those periods when budget deficits were very large relative to the size of the economy.

The largest budget deficits as a share of GDP in U.S. history occurred during three major wars. The

deficit reached a peak of about 15 percent of GDP during the Civil War, and exceeded 25 percent during a portion of World War I and a good part of World War II. In none of these cases did interest rates on long-term bonds increase significantly, and short-term rates, while more volatile, showed no sustained rise.

Charts 1-3 illustrate the findings of Evans's 1985 study, "Do Large Deficits Produce Higher Interest Rates?" (*American Economic Review* 75, March 1985, pp. 68-87). They graph U.S. budget deficits as a percent of GDP (the deficit ratio, DR) against the long-term railroad bond rate (RRBR) or Moody's AAA bond rate (AAA) and against the short-term commercial paper rate (CPR). Charts 1 and 2 are for the Civil War and World War I. Railroad bond yields were over 6 percent at the start of the Civil War and less than 5 percent during much of the conflict. They moved from just under 5 percent to just over 5 percent during U.S. participation in World War I.

Chart 3 shows that interest rates during WWII resembled, as Evans puts it, "the cardiogram of a rock". Some might question the significance of Chart 3 because the Federal Reserve worked to control interest rates during WWII. Therefore, in a later piece, "Are Government Bonds Net Wealth? Evidence for the United States," (*Economic Inquiry* 26, October 1988, pp. 553-566), Evans presents more clear-cut evidence, using forward interest rates. (Forward interest rates are market predictions of what interest rates will be some quarters or years ahead. They can be determined by comparing the yields of long-term bonds of maturities that bracket the period in question.) Pearl Harbor and the onset of war made it obvious to the bond markets that federal debt would be much higher for decades into the future. Yet the forward Treasury bond rate for the period 1948-1960 dipped immediately after Pearl

Harbor, from about 2.6 percent to 2.5 percent. It continued to fall over the next 5 years, reaching 2.3 percent in mid-1943 and 1.9 percent in mid-1945.

Similar results are obtained whether one looks at long-term interest rates (as in these charts) or ex post real interest rates (nominal interest rates less actual inflation over the periods). Similar findings are confirmed by statistical analyses with controls for many different influences including the business cycle and monetary policy.

Chart 4 tracks the Treasury bill rate and the deficit as a share of GDP from 1947 to 2002. Increased federal budget deficits are not associated with increased short-term interest rates. Indeed, they move as often in the opposite direction, usually as the result of the business cycle. Economic downturns are generally associated with rising budget deficits and falling interest rates.

Conclusion. Fear of deficits of the magnitude being projected for the United States is largely overblown. History offers no support to the notion that budget deficits, even those much greater relative to the size of the economy than those now forecast, would have a significant impact on interest rates. Deficits do have their drawbacks. They help disguise the full cost of government from the taxpayer/voters, and should not be maintained indefinitely for that reason. Nor should they be allowed to grow without restraint until the resulting debt service swamps the budget, as has happened recently in Argentina. But the modest deficits related to last year's recession and the current modest recovery should be no obstacle to the adoption of appropriate policies to strengthen the economy in the near and long term.

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Chart 1. U.S. Experience During Civil War

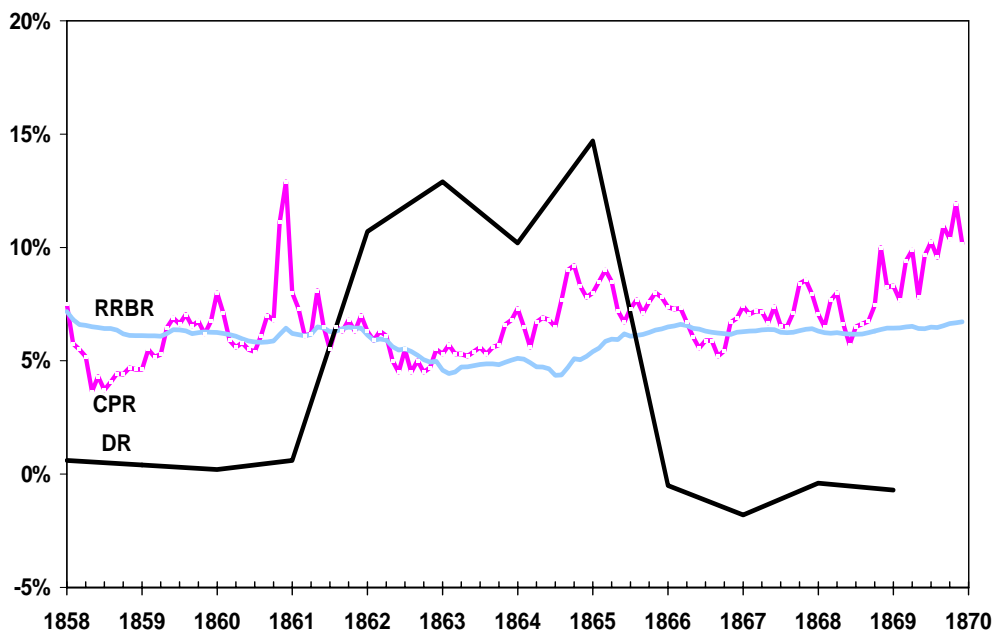


Chart 2. U.S. Experience During World War I

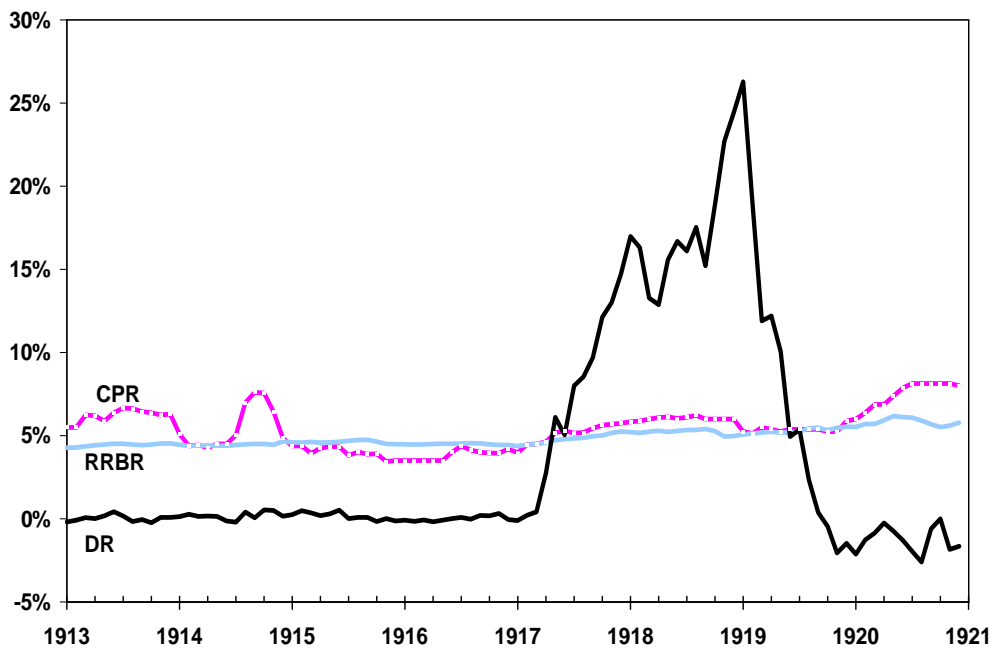


Chart 3. U.S. Experience During World War II

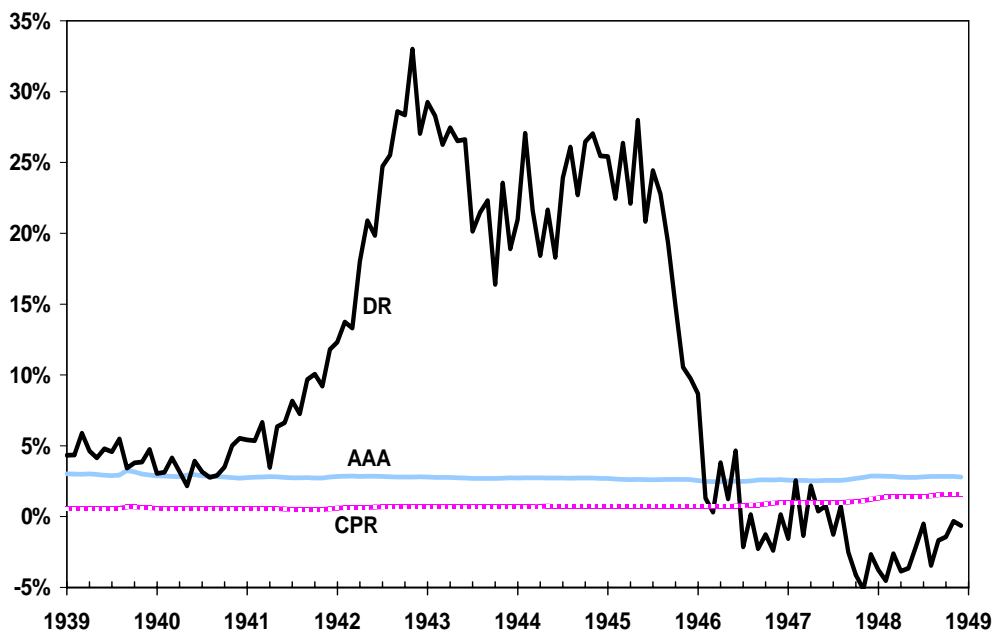


Chart 4. Three-Month Treasury Bill Rate vs. Federal Budget Deficit for the Postwar Period

