

# Tax & Budget

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## Do Budget Deficits Raise Long-Term Interest Rates?

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Prominent legislators have suggested that tax cuts to stimulate the economy should be temporary, and that tax cuts scheduled for 2004-10 should be postponed, on the theory that budget deficits raise long-term interest rates.

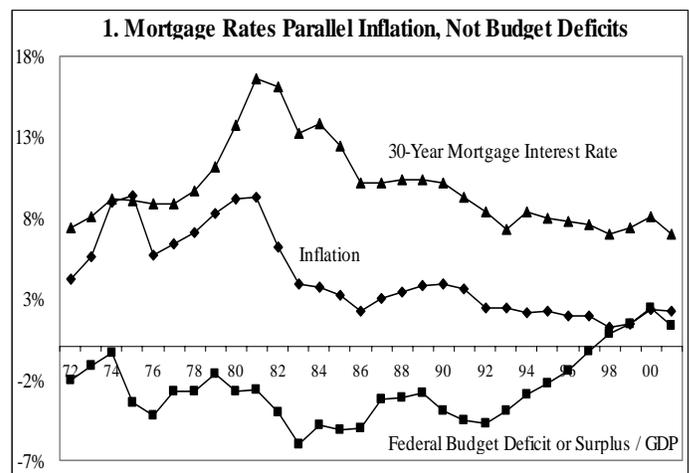
In his January 16 address, Senator Ted Kennedy (D-MA) argued for “avoiding” scheduled reductions in income tax rates and estate taxes. “Taking fiscally responsible action now,” he argued, “will actually help the economy – by leading to reductions in long-term interest rates that have remained stubbornly high because of the fear the unaffordable tax cuts will lead to growing federal deficits throughout the decade.”

These concerns come at a time when long-term interest rates are low by any reasonable definition. Chart 1 shows that 30-year mortgage rates have trended downward since the early 1980s, despite the federal budget deficit both rising and falling during the period.<sup>1</sup> During the past year, the budget moved from a surplus to a deficit while long-term interest rates remained low. The new Congressional Budget Office (CBO) projections show a \$4 trillion reduction in the ten-year budget surplus compared to last year’s estimates, and yet the CBO’s outlook for long-term interest rates is virtually unchanged.

Certainly, Senator Kennedy’s concerns are not new. The belief that high tax rates please the bond market has been around since at least 1932 when President Hoover persuaded Congress to triple tax rates to “maintain public confidence.” This remained standard Republican doctrine long before it became the new Democratic orthodoxy. In the 1968 *Republican Papers*, President Eisenhower’s former chief economist Raymond Saulnier urged “a temporary tax increase” to “prevent further escalation of interest rates.”

But is there any evidence that long-term interest rates rise because of budget deficits? In the 1980s, economists began to examine the facts.<sup>2</sup> What they found, as Robert Barro reported in his 1987 *Macroeconomics* textbook, is

that “this belief does not have evidence to support it.”<sup>3</sup> A 1985 analysis by Paul Evans found that historical periods of high budget deficits in the United States did not coincide with high interest rates.<sup>4</sup> A 1993 survey of



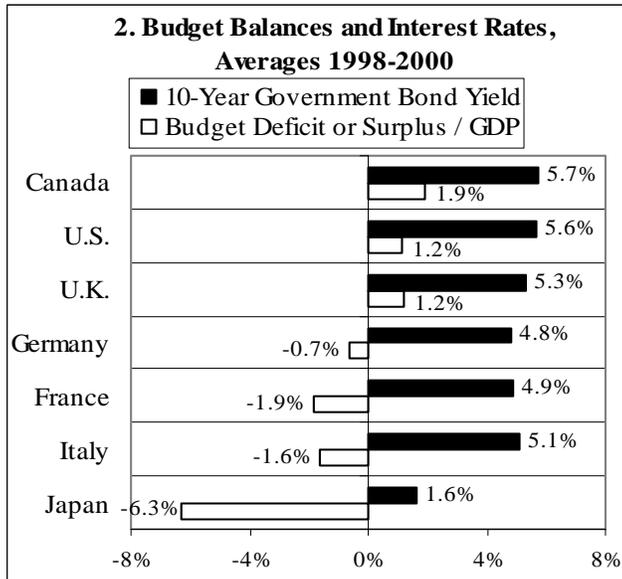
academic studies by John Seater concluded that, “they are inconsistent with the traditional view that government debt is positively related to interest rates.”<sup>5</sup>

Confronted with this evidence, some began to say that it was not nominal interest rates that were driven up by deficits, but *real* interest rates. But the only way deficits can raise real rates without raising nominal rates would be if deficits caused inflation to fall, which does not make sense.

Note that with regard to tax policy, tax cuts reduce the “tax wedge” built into interest rates. This wedge is apparent by observing the lower interest rate on tax-exempt municipal bonds than regular taxable bonds. As a consequence, tax cuts should nudge long-term interest rates downward. Examining evidence from the 1980s, Patric Hendershott and Joe Peek found that “the large tax rate reductions in the 1980s made an important

contribution to the [1986-89] reduction in real interest rates.”<sup>6</sup>

Another variation on the deficits cause high interest rates theory -- embraced by Office of Management and Budget Director David Stockman under President Reagan and by Treasury Secretary Robert Rubin under President Clinton -- says that it is budget deficits expected in the future that matters for interest rates.



However, there is no evidence that expected deficits have any different effects than actual deficits. Using a variety of statistical tests, a 1987 study by Paul Evans “found no evidence that interest rates are related to current, past, and expected future budget deficits.”<sup>7</sup>

Looking at Chart 1, mortgage rates soared around 1974 and 1980, when budget deficits were quite small and inflation was high. The deficit was much larger in 1983-87, but mortgage rates fell along with inflation. After the economy slipped into recession in 1990-91, the deficit grew substantially larger through 1993, but mortgage rates declined. The deficit then shrank steadily as the economy recovered, but mortgage rates nonetheless edged up in 1994 and again in 2000, before declining in 2001 as the surplus disappeared. In short, mortgage rates clearly move in response to changes in inflation, but neither mortgage rates nor inflation move in tandem with the budget.

Chart 2 shows data on interest rates and budget balances for the G-7 industrial countries.<sup>8</sup> It includes federal, state, and local government budget balances and

uses 10-year government bond yields. The chart covers a recent three-year period, 1998-2000, in case any single year is a fluke. The chart indicates that there is no relationship between budget balances and interest rates. As it happens, the country with the largest surplus, Canada, had the highest long-term interest rate. Japan, with the largest budget deficit, had the lowest interest rate.

Interest rates are largely determined by inflation and the expected real return on capital, not by how many bonds the government is selling or buying. What global investors are willing to bid for U.S. Treasury or foreign government bonds depends on the expected return on alternative investments. Competing investments include the world inventory of stocks, bonds, bills, bank deposits, commodities, and real estate. Adding a few more U.S. bonds into this huge pool is not like peddling wheat or corn, where selling more bushels might require slashing the price.

In conclusion, there is no clear connection between government deficits or surpluses and long-term interest rates. Certainly, balancing the budget is a commendable policy goal, but support for it must be based on other criteria than concern over interest rates. Therefore, worries regarding interest rates should not stand in the way of tax rate reductions and other pro-growth tax reforms.

<sup>1</sup> The Chart 1 inflation measure is the change in the GDP price index. Mortgage rates and inflation are calendar year; budget deficits and surpluses are fiscal year.

<sup>2</sup> Studies on this issue include Charles Plosser, “The Effects of Government Financing on Asset Returns,” *Journal of Monetary Economics*, May 1982 and Gerald Dwyer, “Federal Deficits, Interest Rates and Monetary Policy” *Journal of Money, Credit and Banking*, November 1985.

<sup>3</sup> Robert Barro, *Macroeconomics*, John Wiley & Sons, 1987, p. 403.

<sup>4</sup> Paul Evans, “Do Large Deficits Produce High Interest Rates?,” *American Economic Review*, March 1985, p. 68.

<sup>5</sup> John Seater, “Ricardian Equivalence,” *Journal of Economic Literature*, March 1993, p. 176.

<sup>6</sup> Patric Hendershott and Joe Peek, “Treasury Bill Rates in the 1970s and 1980s,” National Bureau of Economic Research Working Paper #3036, July 1992, p. 19.

<sup>7</sup> Paul Evans, “Interest Rates and Expected Future Budget Deficits in the United States,” *Journal of Political Economy*, February 1987, p. 50.

<sup>8</sup> Chart 2 data from the Organisation for Economic Cooperation and Development, *OECD Economic Outlook*, June 2001.