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Deficits Matter, but to whom?

"…**and therefore never send to know for whom the bell tolls; it tolls for thee**," wrote John Donne in 1623, long before the Deficit Marched Up and Down Again with no discharge of the War!

We know it is the political season as the rant about the deficit rises by the decibel. Despite our science, economics cannot predict, without endless equivocation, the size of the deficit, even for 2004, much less the size of the cumulative deficit for the next 10 years. The bell is tolling incessantly over the impending disasters that will befall the economy as the Deficit Marches on, growing without suitable restraint. In fact, there is more than a single bell tolling the collapse of the Republic because growth in the deficit of the size some economists now project will surely eat all of our lunches.

The clever econometricians of Goldman Sachs joined the fray once again today, despite having to admit that the fiscal 2003 deficit looks like it will fall below their earlier estimates of some $425 billion, the CBO's $401 billion baseline and the OMB's $455-billion projection. They now 'guestimate' some $380 Billion. $425 less $380 is $45 and that's billions. What do they say? A billion here, a billion there. Pretty soon you're talking about real money. Push the latest trend a bit over the next few months and maybe Congress will spend too little? Fat chance! They have the bit in their teeth.

Sensible men and women know, even if Professor Krugman writing in the New York Times does not, that predicting the size of the deficit is very dangerous however. As Ben Franklin once said about the weather: leave its prediction to fools and foreigners. Once a budget is passed and appropriations are set, we can guess the direction of the deficit in the short run since it is mostly a question of the timing of spending decisions while the revenue side of the budget hides behind the complexity of tax laws, timing decisions of economic agents and the actual course of the economy. Of course, due allowance should be made for the occasional foreign adventure!

Consider the problem posed to deficit forecasters by the vagaries of this business cycle? Since early spring, forecasters have been steadily revising upward their estimates of GDP for 2003, particularly in Q3 and Q4. Some bold hearts now say Q3 could well see GDP rise by more than 5.5% and for the second half of 2003, a figure considerably north of 4.25% is not beyond imagination. If the stock market keeps humming higher, some capital gains taxation may actually show up, albeit at the new lower rates! Remember the market bottom of early October 2002!

Of course, Congress will not lack for things to spend our tax dollars upon particularly as the President ups the ante for Iraq. While last week began with hopes that a UN resolution might bind our erstwhile allies to our cause in Iraq, if only under a blue and white flag, this week's news suggests that everyone in Europe not already in the fight hates the U.S. as much or more as they did four weeks or four months ago. If we cannot predict the budget, we certainly will have no luck predicting what the many mouths of the current French Republic may utter on this subject. The Smart Money will stay with predicting much higher U.S. expenditures for some time period forward. That leaves only the course of the economy and the timing decisions of economic agents in order to calculate possible Federal tax revenues.

But if only fools and foreigners will jump into the prediction derby concerning 2004's budget deficit, what should we term those hardy forecasters who are willing to look out for ten years upon the stormy seas of spending, taxation and the not-quite dead American business cycle?

At Passover, the parable of the Four Sons is recited each year. All of us know about the Wise, the Wicked, the

Simple and the Son, incapable of asking a question. Take your pick from the possible respondents when you ask about a ten-year forecast of the Deficit. Until someone in Washington is ready to stand up and tell the American public that U.S. demographics will simply not permit the passage of and payment for a huge expansion in medical and social security entitlements, forecasters who venture into 10-year land are incapable of even asking the right questions.

Sooner or later, having tried all incorrect policies, even the U.S. will stumble onto the right answer: there are no free lunches. In fact, considering only Medicare, prescription drug benefits and social security entitlements, it will not be a decade into the future before Congresspeople finally have to tell their Constituents that there are insufficient rich to tax to pay for unrealistic expectations. They will have to do it despite their overweening pride over their ability to obscure the obvious. When the truth becomes sufficiently unpleasant, it will be spoken.

Will this be before November 2004? Not very likely. In such a case, what can we say about a 10 year 5.5 Trillion dollar shortfall as predicted by Goldman Sachs? Our view is that the best answer is HIGHLY UNLIKELY. Even in Washington, someone will hear the bell tolling and they will reply, "It tolls for all of us!"

Until then, however, madness will prevail and excess will not be abandoned, unless as a very eminent economist said to me the other day at the recently concluded NABE convention, "maybe the Democrats and Republicans will become so outrageous in their schemes that they will fail to agree on any bill!" That may be our best hope, and given that the silly season has already commenced, it may be our only one!

If we cannot predict in any reasonable fashion what the deficit is likely to be over the next ten years, we should be wary of assessing some of the discomforting consequences cited by Goldman. Asserting that deficits will produce higher interest rates, foreigners will refuse to fund our deficits and as a result of higher interest rates, our capital stock will accumulate far more slowly than otherwise leads them to a grim warning about how fast the economy will be growing in the future. That may be true, but the connection between deficits and interest rates is not a perfect certainty. Different economic environments will produce different outcomes and ten years is a very long time to run a forecast. We should be careful about going down that road too far. Lower growth rates could happen, but that might not be the actual outcome. Our guess is that as a result of the growing incubus of current budget deficits, even the most unredeemed spenders in Washington will begin to take note of the dangerous course our public finances are beginning to assume. We don't need to give some spurious accuracy to those conjectures to be frightened. The current bell ringing may turn out to be enough even if we cannot precisely measure the dangers ahead. That's a Donne deal!

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