The era of fiscal austerity is over. Here's what big deficits mean for the economy

By Neil Irwin
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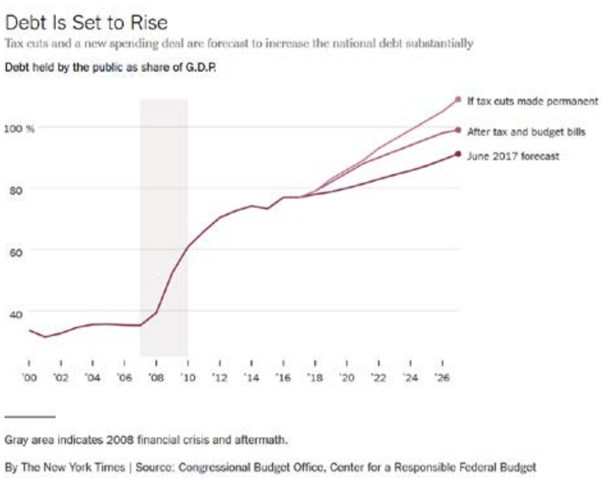
The last seven weeks amount to a sea change in United States economic policy. The era of fiscal austerity is over, and the era of big deficits is back. The trillion dollar question is how it will affect the economy.

In the short run, expect some of the strongest economic growth the country has experienced in years, and some subtle but real benefits from a higher supply of Treasury bonds in a world that is thirsty for them.

In the medium run, there is now more risk of surging inflation and higher interest rates — fears that were behind a steep stock market sell-off in the last two weeks.



In the long run, the United States risks two grave problems. It may find itself with less flexibility to combat the next recession or unexpected crisis. And higher interest payments could prove a burden on the federal Treasury and on economic growth. This is particularly true given that the ballooning debt comes at a time when the economy is already strong and the costs of paying retirement benefits for baby boomers are starting to mount.

It's hard to overstate how abrupt the shift has been.

When the Congressional Budget Office last forecast the nation's fiscal future in June, it projected a $689 billion budget deficit in the fiscal year that begins this coming fall. Analysts now think it will turn out to be about $1.2 trillion.

One major reason is the tax law that passed on Dec. 20, which is estimated to reduce federal revenue by about $1.5 trillion over the next decade, or $1 trillion when pro-growth economic effects modeled by the congressional Joint Committee on Taxation are factored in. A budget deal passed in the early hours of Friday morning includes $300 billion in new spending over the next two years for all sorts of government programs and $90 billion in disaster relief, without corresponding cuts elsewhere in the budget.

It is a stark reversal from 2010 to 2016, when congressional Republicans insisted upon spending cuts and the Obama administration insisted on raising taxes (or, more precisely, allowing some of the Bush administration's tax cuts to expire). Those steps, combined with an improving economy, cut the budget deficit from around 9 percent of G.D.P. in 2010 to 3 percent in 2016.

The near term: Strong growth in 2018

In almost any economic model you choose, the new era of fiscal profligacy will create a near-term economic boost. For example, Evercore ISI, the research arm of the investment bank Evercore, estimates that the combination of tax cuts and spending increases will contribute an extra 0.7 to 0.8 percentage points to the growth rate in 2018, compared with the policy path the nation was on previously.

Economists generally think that these policies will have a lower "multiplier" than these policies would have if they took place during a recession, when there is more spare capacity in the economy. But that doesn't mean the multiplier becomes zero.

"Some people assume that because this was a bad process and the tax bill is really regressive that it won't have a short-term growth impact, but I think that's wrong," said Adam Posen, president of the Peterson Institute for International Economics. "We shouldn't confuse whatever distaste one has for the composition of the package for totally overwhelming the multiplier effects."

Put a different way, it would be very hard for the government to pump an extra half-trillion dollars into the economy in a single year *without* getting some extra economic activity out of it.

Another potential near-term positive for the global financial system could be the effect of billions of dollars in bonds issued by the Treasury. For years the world has experienced what some analysts call a "safe asset shortage," too few government bonds and other investments viewed as reliable relative to demand.

This has arguably been a factor in depressed interest rates and sluggish growth across much of the advanced world. More Treasury bonds floating around might reduce those pressures.

The medium term: Depends on economic slack, and the fed

Over the next two or three years, things get more murky. What happens will depend on how the economy responds to the additional fiscal stimulus, and how the Fed responds to that.

The big question is whether the economy has the room to keep growing without higher inflation emerging. The unemployment rate is already low at 4.1 percent, so there aren't exactly hordes of jobless people available to be put back to work. That means there is a chance that all this extra money flooding into the economy doesn't go toward more economic output but just bids up wages and ultimately consumer prices.

If that happens, the Federal Reserve would almost certainly raise interest rates more than it now plans, essentially engineering an economic slowdown to try to keep inflation from accelerating. In that scenario, the apparent benefits of tax cuts and spending increases would be short-lived.

But there's no certainty that will happen. It may be that the United States has more growth potential than standard models suggest. Perhaps corporate income tax cuts and looser regulation on business will unleash more capital investment and higher productivity, as conservatives argue. Maybe some of the millions of prime-age adults who have dropped out of the labor force in recent years will come back in, creating more economic potential.

"The really big question mark we have is how much slack there really is in the economy," said Donald Marron, a scholar at the Urban Institute who was once acting director of the Congressional Budget Office. "If you look at conventional measures, unemployment looks really low, but on the other hand if you look back to what we used to think of the potential of the economy a few years ago, we may have some room to grow."

The long run: Higher debt-service costs and less room to maneuver

The public debt was already on track to rise relative to the size of the economy before the new tax and spending deals; now it will probably rise faster. The Congressional Budget Office projected last June that the nation's debt-to-G.D.P. ratio would rise to 91 percent in 2027, from 77 percent in 2017.

The C.B.O. hasn't updated those numbers to reflect the new tax and spending legislation, but the Committee for a Responsible Federal Budget estimates that it will turn out to be between 99 and 109 percent, depending on whether provisions of the tax law are allowed to expire as they are scheduled to.

But those numbers are just an abstraction. The question is what effects higher debt loads might have for Americans in 2027 and beyond.

Higher debt service costs are one big one. Taxpayers in 2027 were forecast to pay $818 billion a year in interest costs even before the tax cuts and spending increases, or 2.4 percent of G.D.P. That will presumably be higher, because taxpayers will be paying interest costs on more debt, and probably at higher interest rates.

And there is probably some point at which the amount of debt the government takes on crowds out private investment; to the degree that the supply of funds to borrow is finite, every dollar the government borrows is not available to be lent to a homeowner taking out a mortgage or a business looking to expand. That said, in practice, the supply of loanable funds is not finite — households may save more with higher interest rates, for example, and foreign capital might flow in.

The bigger costs of a high national debt may come in how much flexibility policymakers have to respond to a future recession or crisis. If the United States finds itself in a major war or a deep recession, its starting point in terms of debt load will be much higher than it was at the onset of the Iraq War or the 2008 financial crisis.

"It's about risk management," Mr. Posen said. "We may need that fiscal capacity for something else."