The Washington Post, July 16, 2003

Deficits And Economic Priorities

By N. Gregory Mankiw

The administration's budget update, released yesterday, shows the economic recovery is picking up steam. It also shows a budget deficit for 2004 of $475 billion. The budget deficit is a concern, and the president is determined to see that it comes down as forecast in the mid-session review. Even so, the current deficit must be kept in proper perspective. Three points are salient.

First, it is a textbook principle of prudent fiscal policy that budget deficits are appropriate in times of war and recession. Without doubt, the war on terrorism and the lingering effects of the recession continue to exert a large influence on the federal budget. To insist on budget balance in difficult times would mistakenly sacrifice the greater goals of economic growth and full employment.

Second, the deficit must be evaluated relative to the size of the economy. The federal budget deficit represents 4.2 percent of the nation's $11 trillion economy. Such a deficit is very manageable. The economy handled larger deficits in six of the past 20 years -- all in the aftermath of recessions.

Third, under the president's proposals, the deficit will shrink from 4.2 percent of gross domestic product in 2004 to 1.7 percent in 2008. The key to achieving this is more-rapid economic growth, which will bring in more tax revenue, together with restraint in the growth of government spending. Because the deficit is shrinking, the accumulated level of national debt is not expected to become problematic: In 2008 it will represent 40 percent of annual GDP, which is almost exactly the average since 1950.

Like most private forecasters, the administration expects the economy to improve. With the Jobs and Growth Economic Bill now taking effect and workers keeping more of what they earn, we project that the pace of economic growth will accelerate from approximately 2.2 percent over the past four quarters to 3.9 percent over the next four. Faster growth will translate into more jobs.

It's no mystery why the economy has been struggling. Over the past several years the United States has experienced the collapse of a high-tech bubble, corporate governance scandals, terrorist attacks, the uncertainties of the Iraq war and slow growth among our major trading partners.

These adverse shocks have been offset to some extent by expansionary monetary and fiscal policy. Although the current unemployment rate of 6.4 percent is unacceptably high, it would have been even higher without the tax cut passed in 2001. The tax cut the president signed into law this May will further stimulate growth and reduce unemployment.

Professional economic forecasters are nearly unanimous that the economy is poised to rebound. Of the 52 economists surveyed by Blue Chip Economic Indicators, all but one expect annual growth of at least 3 percent in 2004. The average of the Blue Chip forecasts is 3.7 percent -- identical to the administration's forecast.

Of course, there are still fiscal challenges ahead. Spending discipline requires policymakers to face difficult tradeoffs and make hard choices -- which the president is doing. Under the president's budget, discretionary spending will fall from 8 percent of GDP in 2003 to 6.7 percent in 2008.

A number of tax policy issues also need to be addressed, including the sunset of the tax cuts already enacted and the growing number of people subject to the alternative minimum tax. Moreover, the tax code can be improved. The president's budget calls for such action, including his proposal to simplify and expand the use of tax-preferred savings accounts.

The greatest fiscal challenge ahead is the growth in entitlement spending from the aging of the population and the retirement of the baby boom generation. The president's February budget correctly called this "the real fiscal danger."

Unless Social Security and Medicare are modernized for future generations, truly worrisome budgetary pressures will arise over the next few decades. This is one reason why the president has stressed the need for personal accounts in Social Security. And it is one reason why, as a prescription drug benefit is added to Medicare, the president has called for reform of the system to include greater choice for seniors and competition among private providers.

Yet these longer-term fiscal challenges should not blind us to the immediate goal of restoring robust economic growth and putting people back to work. The president's economic policies will do that, and millions of American families will soon reap the benefits.

The writer is chairman of the president's Council of Economic Advisers.