

ECONOMIC SCENE

It looks like red ink and the ills that can go with it are back to stay for a while.

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THE budget President Bush submitted last month should have come with the warning, "They're baaack!" Deficits are re-emerging as a major problem. Goldman, Sachs recently raised its estimate of the federal budget deficit this year to \$375 billion, and warned that it could go even higher. That works out to more than \$1,400 for every man, woman and child. With the impending retirement of the first baby boomers, the red ink is expected to last as far as the eye can see.

This dire predicament inspired the Committee for Economic Development, a nonpartisan business organization, to issue a report yesterday calling urgently for tax increases and spending cuts to put the government's fiscal house in order. Unless corrective action is taken, the group warned, investment, productivity and living standards will suffer.

Although the group's recommendation of higher taxes is unlikely to be popular, past experience with deficits suggests that tax increases are virtually inevitable before the decade is out. Even Ronald Reagan ended up raising taxes to try to make up for the big shortfall from the 1981 cuts.

Smart consumers would start tucking money away now for future tax increases. But such foresight is uncommon. In a National Bureau of Economic Research paper -- titled "What Have We Learned From the Reagan Deficits and Their Disappearance?" -- Benjamin Friedman of Harvard documents that personal savings declined as the deficit ballooned in the 1980's and early 1990's. As a consequence, government borrowing crowded out private investment and caused interest rates to rise.

Four other less obvious political-economic responses are likely now that we are back in an era of persistent deficits.

First, there will be renewed interest in indexing Social Security benefits to an inflation gauge that is growing more slowly than the Consumer Price Index, the current yardstick. Alan Greenspan, chairman of the Federal Reserve, for example, recently urged Congress to switch to the Bureau of Labor Statistics' new chained price index, which adjusts the market basket if consumers' spending patterns change. Changing the index is appealing to many politicians because it is a stealth way to curb benefits.

There may also be sound reasons to believe that -- at least under certain technical assumptions about the nature of tastes and price shocks -- the new series provides a more accurate gauge of changes in the cost of living than the old one, which reflects the cost of purchasing a fixed basket of goods. It should not go unnoticed, however, that inflation is the main indicator by which the Federal Reserve is judged, so Mr. Greenspan is not a disinterested observer. Indeed, so much intellectual firepower has gone into searching for reasons the C.P.I. might overstate inflation that one worries that factors that cause the index to understate inflation have been overlooked.

Although the traditional inflation index has its shortcomings, there is no reason to limit the debate on indexation to technical issues concerning price indexes. Why not adjust retirees' benefits so they rise in lock step with the average worker's wage? This would connect benefits to the tax base that finances the program, and one could argue that it is fair to treat retirees and workers comparably.

Also, why not consider gradually increasing the normal retirement age beyond the scheduled rise to 67 in 2027? When Social Security was enacted in 1935, life expectancy for a 65-year-old was 77; in 2035 it is forecast to be 84.

Second, with miles of red ink ahead, unfunded government mandates will become a relatively more attractive option to federal lawmakers. The need for politicians to demonstrate that they are responsive to crises like terrorist attacks or natural disasters will not diminish. Mandates on state governments will satisfy this need without showing up on the federal budget ledger. This is already happening: the Homeland Security Act and No Child Left Behind Act are quickly becoming two of the largest unfunded mandates ever. The 1995 Unfunded Mandates Act is unlikely to curb this tide.

Third, compared with spending, regulation will also become relatively more attractive. Instead of paying for more fire trucks, the government could tighten safety regulations. Of course, a major problem is that there are not enough inspectors to enforce regulations already on the books.

Finally, look for budget rules and rhetoric to change, although it is hard to predict how. If the government becomes serious about reducing deficits, it will reinstate provisions that capped discretionary spending and required offsets elsewhere in the budget for every spending increase or tax cut. These provisions helped eliminate the Reagan-Bush deficits, but have recently expired.

If the government remains in a state of deficit denial, the accounting rules applied to the budget will probably change to conceal the problem. The Bush administration, for example, provided only five-year forecasts of the unified budget in its latest documents; the practice had been 10 years. Also, don't expect to hear the term "lockbox" -- a rhetorical device that helped protect the Social Security trust fund from other uses -- from the president any time soon.

With the suddenness of a winter storm, budget surpluses were snowed under by deficits in the last two years. Because the confluence of tax cuts and spending increases is responsible for more than half the disappearance of the surplus in the 10-year budget, Peter R. Orszag, an economist at the Brookings Institution, warns that there is no reason to suspect the tide of red ink will recede as suddenly as it appeared, even if the economy improves more than expected. The official deficit projections are already overly optimistic because they exclude the costs of extending popular tax provisions due to expire, a possible prescription drug plan, and the substantial costs of any war with Iraq.

So it would be wise to prepare for another era of deficits.