TrendMacrolytics

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INTELLECTUAL AMMUNITION

The Deficit and Growth

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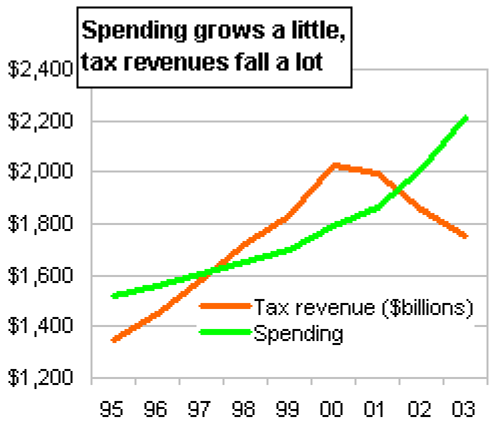
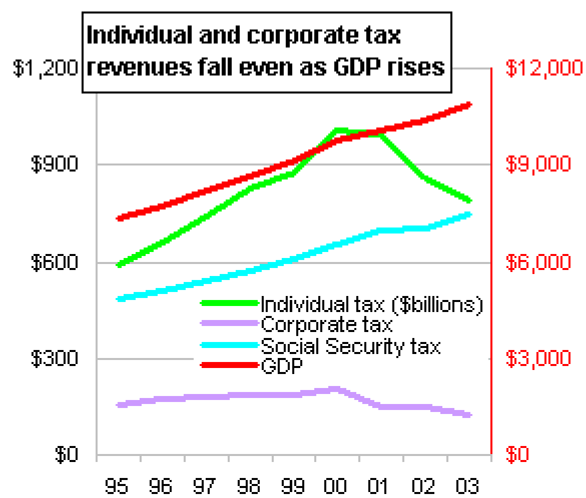
The deficit is a reflection of our performance-based economy -- slow growth was its cause, and fast growth will be its cure.

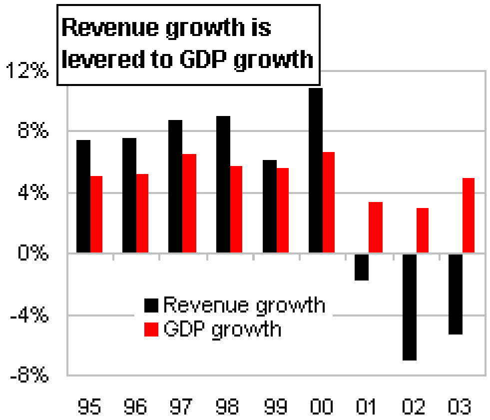


After a week in New York talking to investors, we found widespread concern that the current large federal budget deficit would be an impediment to economic recovery. Yes, inappropriate policy responses to deficits could create problems. But deficits themselves are the *result* of slow growth, not the *cause* of slow growth. Even the troubling increase in federal spending has exerted only a small influence on deficits. The chart at left reveals the deficit culprit -- the sharp fall-off in tax receipts following the end of the 1990s expansion. The implication is that a reacceleration of growth will ameliorate the deficit as quickly as the deceleration of growth caused it.



The drop in tax revenues has been out of proportion to the slowdown in economic growth. As the chart at right shows, individual and corporate tax revenues have dropped precipitously -- individual tax revenues especially so, off over 23% since the 2000 peak! -- even as GDP has continued to grow. This cannot be explained by tax-cuts (they have hardly taken effect yet). And it cannot be explained by the rise in unemployment (the unemployment rate is up since 2000 by 2%, not 23%). The explanation is that today's tax base is highly progressive, with about 40 million American workers who pay no federal taxes at all other than Social Security taxes. Today marginal tax revenues are linked to the fate of high-earning taxpayers whose incomes are directly performance-linked to the growth of the economy.

Executives compensated by stock options, or any executive or salesman whose cash bonus is linked to sales growth, will have seen their highly-taxed marginal income drop substantially over the last two years. The result is that the **US Treasury** has been put, in effect, on performance-based compensation. Thus, as the chart on the following page shows, tax revenues are now more highly correlated to *growth* in GDP than to the *level* of GDP. And they are correlated in a levered way -- small changes in GDP growth drive large changes in tax revenues. That suggests straightforwardly that, if slow growth has been the cause of today's deficits, then faster



growth will be their cure. It also suggests that tax-cuts are a "revenue cost" that will have a significant payoff when they are successful in stimulating growth.

All that said, do today's deficits nevertheless pose any threat to the very growth that could cure them? We believe that they do not, or at least not necessarily. We disagree with the often-heard arguments that increased government demand for borrowing will "crowd out" private sector borrowing, drive up interest rates, and choke off economic growth. The historical record of the relationship between deficits and interest rates simply doesn't support the "crowding out" argument (see "The Curse of Rubinomics" January 15, 2003).

Our residual concerns arise, first, from the extent to which the deficits are the result of a ramp-up in government spending. Such spending is an efficiency drag on the economy that implies lower long-term growth rates than would otherwise be achievable. And second, we cannot help but be concerned that deficits will be used in a fractious political environment as an excuse to raise taxes or impose other anti-growth measures. TM