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DEBTS, DEFICITS, ECONOMIC RECOVERY, AND THE U.S. GOVERNMENT

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Introduction

The U.S. federal deficit for the 2010 fiscal year is expected to equal about 10 percent of GDP. This seems like a large sum, and it is certainly far larger than most deficits incurred since about 1950. However, deficits need to be better understood and perhaps better measured, along with their potential benefits.

One must keep in mind that there has been panic about budget deficits before. Today, as then, deficit critics invoke the term "bankrupt"—but that adjective does not describe the United States or its government (Galbraith 2006).[1] Sovereign default (the failure of a national government to pay back borrowed money) is certainly common, but not in U.S. history. Countries with sovereign currencies, borrowing in their own currency, can never go bankrupt. At the extreme, they can be shut out of international capital markets. However, this remains very unlikely for the United States, with its currency still maintaining its role as the main international reserve currency. Indeed, most key interest rates continue to trend downward, indicating that fears of a sharp drop in the dollar (let alone a collapse) are secondary to far more immediate concerns about growth, unemployment, and poverty.

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Worries about insolvency are far more immediate for the 1.4 million Americans who declared bankruptcy last year (BDP 2010). These personal bankruptcies were mostly the result of problems that are within society's power to ameliorate, such as fraudulent financial practices, unemployment, and the cost of health care. Hence, an adequate remedy for excessive debt might include electoral reform, limits on lobbying, tighter regulation of financial institutions, and consumer-protection and -education legislation.

Yet the national debt and its size are currently very important political and economic issues. The deficit issue cannot be thought of separately from the national crises that have led to the current fiscal situation.

Indeed, in a time of such profound turmoil, one could hardly expect anything but powerful fiscal stresses and strains. For example, using postwar data from industrialized and emerging economies, Carmen Reinhart and Kenneth Rogoff (2009, 170) estimate that real public debt increased on average by 86 percent in the three years following a major banking crisis.

This raises an interesting question: how much of the current deficit is merely the inevitable result of a severe recession and financial crisis, and how much reflects freer spending by Congress and the president? The Congressional Budget Office (CBO 2010a) estimates that the recent recession and shaky recovery contributed 2 percentage points to the total 2009 federal deficit of 9.3 percent of potential GDP. Let's see how this breaks down by category. Stimulus bill spending amounted to 0.7 percent of GDP. By the CBO's definition, discretionary spending (often thought of by conservatives as the big problem) increased by only 1.2 percent of GDP from 2007 to 2009. Finally, "mandatory expenditures" (those required by Social Security rules, welfare eligibility rules, et cetera) increased by 4.5 percent of GDP. In particular, means-tested benefit programs—a category that includes the program formerly known as food stamps, as well as unemployment benefits and supplemental security income—grew by 72 percent in nominal terms between 2007 and 2009. Meanwhile, tax revenues fell from 18.5 percent to 14.8 percent of national output in that period. The stimulus bill accounts for 0.6 percentage points of this latter 3.7 percentage-point decline. In general, tax revenues are greatly affected by the state of the economy.

Overall, there have been huge changes in aspects of the budgetary situation that are traceable in one way or another to the health of the economy: tax revenues; mandatory expenditures, especially spending on means-tested programs; and discretionary spending under the stimulus bill. Nonstimulus discretionary spending is the only major category in the budget that is clearly unrelated to the recession and financial crisis, and it accounts for only a tiny fraction of overall expenditures. Moreover, total discretionary spending increased by only a bit over 1 percent of GDP from 2007 to 2009. It seems fair to conclude that charges of profligacy or radical Keynesianism are greatly overstated. The full costs of the recession will include any losses incurred by the financial rescue effort and may grow significantly over time.

The point of stating these facts is that America's current fiscal stance is part and parcel of the recession and financial crisis, and not the product of political whims. Using a historical analogy, Presidents Hoover and Roosevelt faced strong headwinds early in the Great Depression when the deficit reached then-unprecedented levels (Hannsgen and Papadimitriou 2010).

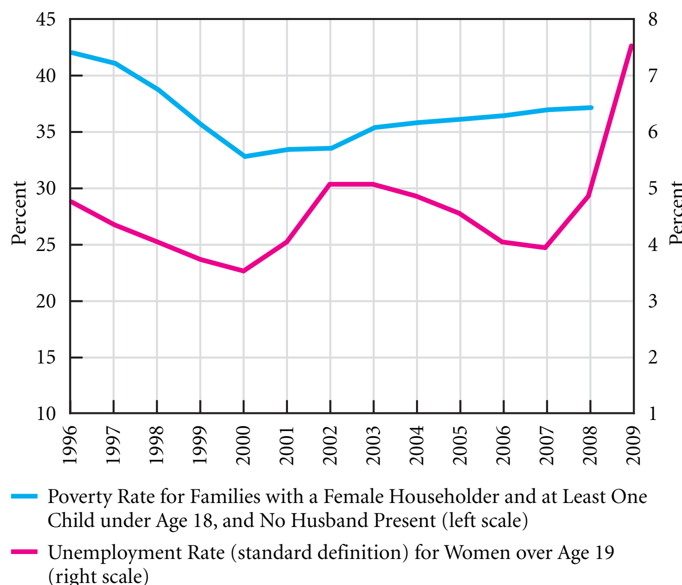
The best way to think of recent deficits is as a logical and necessary response to a severe recession, as they were in the Depression. The United States must address "jobs now and deficits later" (Mishel and Walker 2010). However, recent private sector forecasts indicate that average unemployment will remain above 9 percent in 2010 and 2011 (Willis and Scheuble 2010). We are pessimistic about employment recovery, as well.

Government Budget Deficits: Indispensible Tool for Economic Stability

A good fiscal policy takes advantage of the benefits of "automatic stabilizers" (e.g., income taxes and unemployment benefits) that automatically lead to increased deficits during recessions without special legislation, as well as "stimulus packages." Hyman P. Minsky was an early proponent of what we regard as perhaps the best automatic stabilizer: an employer-of-last-resort program, which would offer a job to anyone who met a minimal set of eligibility criteria (see Papadimitriou 1999 for more details on this idea). He also supported a universal children's allowance that would be available to all families, regardless of income (Minsky 2008 [1986], 301).[2]

A key reason for additional social spending during this time of higher unemployment and underemployment is the near absence of many stabilizers that helped in the past—for example, the Aid for Dependent Children (AFDC) program. Since 2000, poverty rates for most groups have gradually

Figure 1 **The Link between the Poverty Rate and the Unemployment Rate for a Key Demographic Group Impacted by Welfare Reform, 1996–2009 (in percent)**



Sources: U.S. Bureau of Labor Statistics; U.S. Department of the Census

trended upward, including a notable increase in poverty for families without a husband that is approaching 40 percent (Figure 1). This trend has coincided with a rise in the unemployment rate for women over age 19, from 3.6 percent in 2000 to approximately 8 percent so far this year.

Workers in the poorest groups—including minorities, those with less education, and welfare recipients—tend to be the last in line for new jobs as business improves and the first to lose them in the onset of a recession. Hence, automatic stabilizers are needed to alleviate mass unemployment.

Improving and creating programs that directly address key economic problems at the household level would not bankrupt a nation like the United States. The AFDC program in 1980 cost the federal and state governments about $30.1 billion in today's dollars (DHHS 2010). Over the life of the Troubled Asset Relief Program (TARP), the government will be providing $36 billion to assist just one corporation: the insurance firm AIG (CBO 2010b, 3). The total federal deficit for 2009 was approximately $1.4 trillion—46 times the inflation-adjusted cost of the much-maligned AFDC program in 1980.

Any deficit spending, whether oriented toward business or households, helps the private sector, which must thrive in a capitalist system to provide a tax base and the bulk of commodities. In his book *Stabilizing an Unstable Economy*, Minsky cited three main mechanisms through which fiscal policy stabilized the economy (2008 [1986], 13–37). During a recession, higher deficits increase (1) government demand for goods and services; (2) the financial *surpluses* of the private and/or foreign sectors; and (3) the stock of very-low-risk financial assets in private portfolios. Minsky documented that these three effects were among the main forces behind most postwar economic recoveries. Also, we hasten to add that Minsky generally approved of the kind of lender-of-last-resort actions taken by the Fed since 2008, though he might have objected to the specific steps that the Fed took to stabilize the financial sector during the recent crisis. The deficit cannot possibly be treated as the main problem when it is the product of a poorly functioning economy.

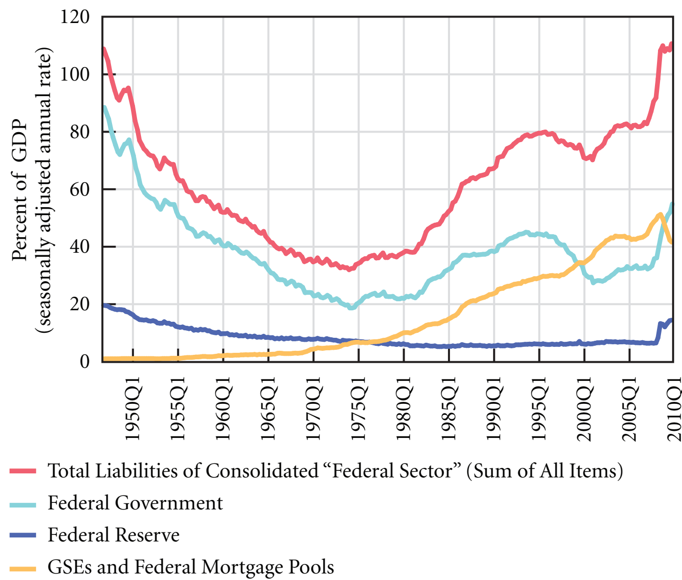
Trends in the Federal Debt and the Stock of Money: How Unpleasant?

There are many uncertainties about what deficits mean for economic performance, but perhaps the only sure thing is the government budget constraint. Roughly speaking, the government's spending in excess of tax revenues and other government receipts must equal increases in its liabilities. In the case of the U.S. government, these liabilities are mostly those of the Federal Reserve (especially paper currency and the banks' reserve "deposits" at the Fed) and Treasury securities, including savings bonds and Treasury bills. Putting such liabilities on private sector balance sheets, where they help fill holes created by the housing bust and financial crisis, is one of the three ways mentioned above that federal deficits can help fight recessions.

Figure 2 shows how the government has been using its ability to generate assets for other sectors of the economy. An entity we call the "federal sector" includes (1) the Fed, (2) the federal government, and (3) a combined entity that includes both the government-sponsored enterprises (GSEs such as Fannie Mae and Freddie Mac) and the mortgage pools that technically hold many of their assets. The top line represents a measure of the liabilities of the entire federal sector to entities outside the sector.

Some of the most important GSEs were effectively taken over by the federal government in 2008 and have received large infusions of public funds. We are not in uncharted territory,

Figure 2 **Liabilities of Consolidated "Federal Sector"*** **1947Q1–2010Q1 (in percent of GDP)**



* Federal government, Federal Reserve, GSEs, and federal mortgage pools

Notes: Data points for 1947 through 1951 are interpolated from annual observations using a linear technique. Quarterly observations are used for all other years. The term "Federal Sector" has no legal meaning.

Sources: Federal Reserve Flow of Funds Accounts; Federal Reserve Bank of St. Louis, FRED database

even considering our somewhat unorthodox inclusion of the GSEs in the aggregate federal sector. Without the GSEs, total federal sector liabilities in 2010 would be far lower than they were in 1947. However, the GSEs and their mortgage pools add 41.7 percent to federal sector liabilities, while they did not reach even 1 percent of GDP in 1947. Incidentally, we have left out the large portion of the government's debt that technically is owned by the Social Security Trust Funds.

It is reasonable that macroeconomic policy should be more stimulative than at the height of the last recession or the one before that, during which unemployment stayed below 8 percent. (Even positive, but moderate, growth will not be enough to revive tax revenues.) There is no justification for the belief that cutting spending or raising tax rates always or even usually reduces the federal deficit, let alone permits solid growth. With so many categories of spending set almost permanently, any foreseeable policy that does not encourage growth also cannot reduce the deficit.

The Fed's balance sheet has changed rapidly since the financial crisis began in earnest in late 2008. However, the eventual decision to unwind the roughly $300 billion in Treasury securities purchased since last March will only be a matter of deciding upon the best interest-rate policy for the economy—and, of course, avoiding a panic in the bond market by selling the bonds gradually. In fact, there is no reason to bother selling Fed assets unless there is a need to influence interest rates. Likewise, the mortgage-backed securities on the Fed's books are there primarily to reduce mortgage interest rates. When it comes to the Fed's other assets, such as those obtained in the rescue of AIG, the Fed's ability to shrink its balance sheet will depend upon the markets' views on the strength of those assets. The bottom line is that if the Fed loses money on these investments, the losses add to the deficit of the consolidated federal sector.

Many people believe that U.S. policymakers might be setting the stage for losing control over inflation, owing to their overconfidence in the effectiveness of interest-rate policy alone. They share the belief—common among mainstream economists—that controlling the money supply is the key to fighting and preventing inflation, but doubt that the Fed will be able to choose a slow rate of money-supply growth when huge deficits must be financed and old debts paid off or refinanced. The worst fears about recent stimulative policy and rapid money-supply growth, however, are proving to be incorrect once again.

The monetary base has grown by about 58 percent since August 2008 and there have been few inflationary reverberations, with CPI inflation remaining under 3 percent since then. In recent months, inflation has fallen well below the Fed's informal target range. Broader measures of the money supply have also been following an upward trend for a long time, though growth rates of these aggregates have been plummeting in recent months. At the same time, cash from the Fed has allowed many banks to repair their balance sheets, so that large financial institutions once facing bankruptcy are now flush with reserves. If anything, this situation again raises the question: couldn't the government solve numerous other, even more serious, problems the same way—by essentially printing money and spending it as needed?

A Proactive Approach to Controlling Expenditures: Reduce Financial Risk-taking

We need to work to prevent the emergence of another crisis by tightening regulation of the financial industry, which was weakened greatly under previous administrations. The recently passed financial reform bill may help, and in-depth research in the tradition of Minsky continues at the Levy Institute and elsewhere.

At the level of consumer protection, regulation can help prevent lenders from making loans that are likely to lead to bankruptcy. The bond-rating system should be strengthened to reduce conflicts of interest. Furtive maneuvers of various kinds to move dubious assets off the balance sheets of banks and other financial companies have caused trouble, and should be prevented. A return to the use of the discount window—to reduce reliance on the federal funds market—would help the Fed keep tabs on banks' balance sheets. In addition, the Fed could easily use the discount window to provide liquidity to markets that were about to freeze up during crises. Regulators should foster the existence of a large number of small- or medium-size financial institutions (e.g., community development banks) to reduce dependence on banks and financial conglomerates that are "too big to fail," and to address pressing needs in economically distressed communities (Minsky et al. 1993).

It is not always understood why the federal government has spent so much money on bailouts over the years, yet the financial system remains unstable. TARP and other rescue measures have favored the interests of large financial companies, but the hand of government has been badly weakened in crises; officials often have no choice but to agree to bailouts when the alternative is the collapse of major corporations and, indeed, of large segments of the financial sector. The consequences of the 2007–09 crisis would have been far worse in the event of a laissez-faire policy toward failing institutions. And it is important to notice that a firm like AIG enjoyed no formal FDIC protection yet took great risks anyway.

Political scientist James O'Connor (2002 [1973]) pointed out long ago that the impetus for fiscal crises, paradoxically, often comes from the private sector. The latest run-up in the deficit seems to fit O'Connor's theory better than most previous episodes of fiscal stimulus in U.S. history, partly because such a huge sum of money was spent on an explicit effort to rescue the financial system.

The financial fragility of the modern economy is likely to remain a major threat to government finances. Minsky argued that financial instability was a "fundamental characteristic of an economy with financial institutions such as those of the United States" (Minsky 2008 [1986], 51). On the other hand, Minsky certainly saw many potential benefits in regulatory reforms. Budget deficits, along with lender-of-last-resort actions by central banks, are necessary and effective responses to incipient crises. The financial boom-bust cycle observed by Minsky is still very much in evidence, though it has turned out that inflation is not an inevitable accompaniment to financial euphoria and large deficits. In other words, the massive bailouts and stimulus bills that have strained government finances will be hard to avoid in the future.

Of course, good policy across the board will help. A narrow focus on fiscal policy will not work, since policymakers do not have the ability to literally "choose" the best size for the budget deficit. Also, fiscal policy, while among the most highly potent macroeconomic tools, can only accomplish so much. As of now, there is still strong interest among the electorate in reining in corporate behavior. At the same time, there is similar populist sentiment among large numbers of Americans against the federal government. What seems most relevant now is finding the political will to "reinvigorate government" (Madrick 2009), as well as to maintain Keynesian macro stimulus in the face of ideological opposition and widespread mistrust of government.

Notes

1. Two interesting and recent critiques of standard objections to budget deficits are Kregel 2010 and Nersisyan and Wray 2010.
2. The details of his proposal were interesting, though. It would remake the welfare system along the lines of the current Social Security retirement program, which provides help to rich and poor alike. Also, it would be available regardless of choices about living arrangements, marriage and divorce, and participation in the workforce. Inflating Minsky's calculations to February 2010 dollars, a program of $2,000 annual child allowances for a population of 55 million children under 16 years of age would cost $110 billion per year (Minsky 2008 [1986], 301).

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