By Robert Pollin

ECONOMIC PROSPECTS

The U.S. Fiscal Deficit: Scare Stories vs. Reality

Is the United States government facing "fiscal suicide"? Are U.S. Treasury bonds "heading for the dumpster"? Such claims have been published regularly in the mainstream media following the passage of the Obama economic stimulus program, which became law in February 2009 (these particular quotes were in the *New York Times* and *Bloomberg News* in May 2009). Of course, the Obama stimulus program was implemented to counteract the economic disaster that was already at hand in February 2009 and continues to the present.

In fact, the stimulus program is too small relative to the magnitude of the crisis and too loaded with corporate tax breaks. But it is still among the most progressive pieces of economic legislation since the 1960s. Of the $787 billion in new government spending being pumped into the economy over the next two years, major funds are flowing into clean energy and traditional infrastructure investments, health care, and education, as well as unemployment insurance, food stamps, and similar measures to support people who are suffering the most severely from the crisis. Overall, the stimulus program aims to generate about 3.5 million jobs over the next two years, to compensate at least in part for the nearly seven million jobs the economy has shed since January 2008.

Good intentions aside, the Obama program will obviously not succeed if it ends up wrecking the U.S. government's financial credibility. This is why—like it or not—debates over the deficit cannot be left to technicians and Wall Street fulminators alone. Ordinary people, progressives in particular, need to maintain a basic grasp of the issues at hand.

In fact, government bonds are not really heading for the dumpster. We can see this over the short term by considering the government's forthcoming interest payment obligations. Over the longer term, the most fair and effective ways to control government deficits will entail raising taxes on the wealthy, in particular Wall Street speculators, and cutting the gargan-

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tuan sums of money that now flow to both the health care industry and the military budget.

LOW INTEREST RATES MEAN SMALL DEBT PAYMENTS

To pay for the Obama stimulus program, the U.S. fiscal deficit is projected to rise to $1.8 trillion in 2009 and $1.4 trillion in 2010. The 2009 deficit amounts to about 13 percent of projected GDP in 2009, with the 2010 deficit at 10 percent of GDP. Between 1942 and 1946, as the U.S. fought World War II, the federal deficit averaged 19.2 percent of GDP, peaking in 1943 at 30.3 percent. The 2010 deficit will be by far the largest since World War II. The closest we have come previously was in 1982, during the recession under Ronald Reagan, when the deficit reached 6 percent of GDP. For the full postwar period, the fiscal deficit averaged about 2 percent of GDP.

In assessing the fiscal burden that these deficits will create, we need to ask the same question a household would pose when taking out a mortgage, which is: how much will we have to pay every month to service our new debt? In fact, the news is very positive, at least for the next few years.

As of May 2009, the interest rate on five-year U.S. Treasury bonds averaged 2.1 percent. By contrast, when the Reagan-era deficits peaked in 1982, the government paid, on average, 13 percent for five-year Treasuries. This difference in interest rates between the Reagan-era deficits and now completely transforms the fiscal picture. Assuming the average interest rate on government debt is at the five-year bond rate of 2.1 percent, the government will have to pay about $38 billion per year in interest on the projected 2009 deficit of $1.8 trillion. If the interest rate had been at Reagan-era levels of 13 percent, the annual interest payment on $1.8 trillion would have instead been $234 billion. The current low interest rates thus reduce the government's debt burden by nearly $200 billion per year, an amount more than four times greater than the full 2009 federal allocation for education.

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Why has the U.S. government been able to borrow at such low rates during the current crisis? The answer is that the world's financial magicians of just a few years ago have now chosen to protect what remains of their wealth by buying up the safest possible assets they can find. And fiscal dumpsters notwithstanding, the former high rollers still recognize U.S. government bonds as the world's safest asset.

FIXING WALL STREET, HEALTH CARE, AND THE MILITARY

U.S. government bonds will not remain as the premier financial safe haven if anything close to the 2009-2010 deficit levels continue over time. The Chinese and other big-time U.S. creditors have already voiced concerns that Treasuries are becoming more risky, and they are starting to demand higher interest payments to buy the bonds. Few investors seriously think the U.S. will default on its debts. The more pressing concern is that inflation in the U.S. will gain momentum, which in turn would lower the value of the dollar and all dollar-based assets, including U.S. Treasuries.

How much will the deficits need to be cut to maintain a framework of fiscal stability? We can get a sense of this through considering the deficit forecasts over the next decade

developed by the U.S. Congressional Budget Office (CBO). For 2011-2019, the CBO projects that the fiscal deficit will average around 4.9 percent of GDP if our current levels for federal spending and tax rates remain largely unchanged. This is obviously a huge drop from the 2009-2010 deficits of 13 and 10 percent of GDP, and it is only modestly above the average deficit level over the full eight years of Ronald Reagan's presidency.

Transforming the U.S. health care system would yield somewhere in the range of $1 trillion in annual savings.

But it is still also far above the historic levels of around 2 percent of GDP. To get the projected deficits down from 4.9 to around 2 percent of GDP would entail either raising the economy's average GDP growth rate above what are fairly pessimistic projections by the CBO, or squeezing about $420 billion out of the deficit at the CBO's projected growth rate. The economy could come out of its current slump more robustly than the CBO anticipates, and that would itself ease the deficit burden. But at this point, the economic landscape is too littered with landmines to count on fast growth emerging soon. Yet even if we accept for now the CBO's assessment that future GDP growth will be below its historic average, we could still achieve the needed level of deficit reduction through a combination of three steps—a tax on Wall Street speculative trading as well as cuts for the health care industry and to the military budget.

Financial trading tax. This would be a small sales tax on all financial transactions. The point of the tax would be to raise costs for short-term speculative traders while having negligible effects on people in financial markets who trade infrequently. Such taxes have been a common policy tool throughout the world. In the aftermath of the 1987 Wall Street crash, the idea of such a tax was endorsed by then House Speaker Jim Wright, then Senate Minority Leader Bob Dole, and even the first President Bush.

In 1987, Speaker Wright proposed a trading tax rate of 0.5 percent for all stock sales. A viable financial system could begin from this figure, along with a sliding scale on all other financial transactions. For example, the tax on a fifty-year bond would be set as equal to the 0.5 percent rate on stocks, with the tax rates falling proportionally on bonds of shorter maturity (e.g., the tax rate on a forty-year bond would be 0.4 percent). Working within this framework, I estimate that this tax would raise approximately $350 billion per year if speculative trading did not decline at all after the tax was imposed. But even if trading declined by 50 percent as a result of the tax, the government would still raise about $175 billion annually. And it would do so through discouraging the type of hyper-speculation on Wall Street that created the crisis in the first place.

Health Care. The U.S. government is projected to spend about $750 billion in 2009 on Medicare and Medicaid, which amounts to 5.4 percent of GDP. The CBO projects this figure to rise to nearly $1.4 trillion or 6.5 percent of GDP by 2019. Reducing health care costs could obviously play a major role in bringing the fiscal deficit down closer to its historic level.

Overall—including private spending as well as Medicaid and Medicare—the U.S. spends about twice as much per person as other highly developed countries such as Canada, Japan, and those in Western Europe on health care, even while these other countries

deliver universal health care coverage, longer life expectancies, and generally more healthy populations. The problem with the U.S. health care system is that we spend far more than other countries for drugs, expensive procedures, and especially administration. We also devote less attention to prevention. Transforming the U.S. health care system so that it comes more closely into line with the other advanced economies would yield somewhere in the range of $1 trillion in annual savings for the overall economy, and $300 billion out of Medicare and Medicaid, even while creating a universal health care coverage system.

The U.S. government is not on the brink of financial ruin.

But let's allow that because of the power of the private health insurance and drug companies, the idea of bringing the U.S. health care system fully in line with other advanced economies is unrealistic. Certainly the Obama proposal for a hybrid plan, to create a government insurance company—"Medicare for All"—competing with private companies will help, but the private companies will still retain enormous market power. It should nevertheless be reasonable to expect that we could achieve at least half the level of available savings through the Obama plan, or some variations of it, now being debated in Congress. That alone would reduce the government's deficit by about $150 billion.

Military Budget. The U.S. military budget rose from 3 percent of GDP at the end of the Clinton presidency to 4.3 percent at the end of George W. Bush's. In today's economy, the Clinton level of military spending would be about $430 billion, and the Bush level would be about $620 billion—a difference of $190 billion. Almost the entire increase in the military budget under Bush was for spending on the Iraq war. Obama, of course, pledged to end the war as a top priority of his presidential campaign. For Obama to fulfill that pledge should mean a cut in the military budget by about $150 billion per year. This would still leave a level of military spending beyond where we were under Clinton, to deal with all the other issues that the administration has targeted as priorities. I strongly oppose further military adventures in Afghanistan. But the point for now is that the administration would still have more than ample funds for such an operation even if the military budget were cut by $150 billion.

Overall then, the U.S. government is not on the brink of financial ruin. In fact, the fiscal deficits for 2009 and 2010 were necessary emergency measures for countering the disaster that Wall Street speculators had already created. The low interest rates at which the government has been able to borrow make these emergency deficits manageable. Over the next decade, we can return the deficit to its historic levels—i.e., to levels well below those that prevailed under Ronald Reagan—by getting serious about controlling the health care industry, the military, and Wall Street speculation itself.