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Struggle for the Soul of U.S. Capitalism

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# AUSTERITY ECONOMICS AND THE STRUGGLE FOR THE SOUL OF U.S. CAPITALISM

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## **Abstract of Paper**

*Amid the wreckage of the 2008-09 Wall Street collapse and Great Recession, orthodox economists and political elites in both the United States and Western Europe have been strongly pushing the idea that austerity is the only viable policy option. The basis for the austerity hawks claim is that both the U.S. and European economies are being consumed by out-of-control levels of public indebtedness. Public spending must therefore be slashed before economic collapse becomes a real possibility.*

*Are the austerity hawks correct that there is simply no alternative to their agenda? In fact, the austerity hawks' arguments are wrong across the board. Focusing on the U.S. case, this paper shows that the austerity hawks claims about large deficits causing high inflation and interest rates have been consistently wrong for four years. Moreover, U.S. is nowhere near experiencing a fiscal crisis in the commonsense definition of the term, which is to say, the government is facing difficulties in meeting its commitments to creditors.*

*The paper then reviews the recent experiences of U.S. state and local governments, which show how the austerity agenda is attacking the foundations of is already a modest U.S. welfare state. It is becoming increasingly clear that many, if not most, austerity hawks view this period as an opportunity to eviscerate the public sector, labor unions, social insurance and other basic social protections. The paper closes by sketching some ideas capable of countering the austerity agenda, by both moving the U.S. economy toward full employment in the short-term and sustaining full employment in the long term.*

Amid the wreckage of the 2008-09 Wall Street collapse and Great Recession, orthodox economists and political elites in both the United States and Western Europe have been strongly pushing the idea that the only way out of the mess is to deliberately make life worse for almost everybody. Details aside, this is the basic idea behind the austerity agenda that has become the conventional wisdom in both the U.S. and Europe, regardless of which political parties happen to hold office. It has been the underlying premise for both the Democratic and Republican sides of all recent debates—on debt limits, the “fiscal cliff,” sequestration, and all skirmishes in between—concerning the U.S. federal budget.

Thus, despite Barack Obama’s reelection last November, the inside-the-beltway Democrats, including Obama, appear committed to reaching common ground with Republicans over a bipartisan austerity agenda that would entail significant cuts in Medicare, Social Security and public spending on education, infrastructure, family support and the environment. No such cuts have been agreed to as of this writing (March 2013). But Obama continues to offer them to Republicans as part of a fiscal “grand bargain” that would also include some tax increases for the wealthy beyond the modest increases enacted in January 2013. To be sure, the Obama austerity agenda is softer than the hard-right approach favored by Republicans. But it is the long-term Republican agenda to gut Medicare, Social Security and public education that continue to frame the debate.

The situation is still worse throughout Europe, where the dominant elite view is that the European welfare state is no longer affordable. Public employment, health care budgets, and pensions are being slashed, while poverty is rising dramatically. For example, *The New York Times* reported in September 2012 that 22 percent of Spanish households are living in poverty and that 600,000 have no income whatsoever. As the *Times* noted (Daly 2012), “For a growing number, the food in garbage bins helps make ends meet.”

But such human suffering aside, could the austerity hawks be correct that there is simply no alternative to forcing this bitter medicine down people’s throats? The basis for the austerity hawks claim is that, both the U.S. and European economies are being consumed by out-of-control levels of public indebtedness. Public spending must therefore be slashed before total economic collapse becomes a real possibility.

In fact, austerity hawks claims are wrong across the board: the public debt burden in the U.S. is actually at a near-historical low level, not a high; in Europe, where government debt burdens are severe, there are still clear alternatives for managing the problem that do not entail a

crushing austerity agenda; and finally, the austerity agenda actually solves nothing. Making life worse now for most people also makes it more difficult to pull the economy out of the ditch in which Wall Street has shoved it.

What then is behind the austerity agenda? Can we envision viable alternatives to austerity? The short answer is "yes," both in the short- and long-runs, as I try to show. I will focus here on the U.S. case, with which I am most familiar. But there certainly are broad parallels with the situation throughout Europe, which many others have explored insightfully (Arestis and Pelagidis 2010, Sawyer 2012, Zezza 2012).

### **U.S. REALITY: THERE IS NO FISCAL CRISIS**

U.S. government deficits—i.e. how much the government is borrowing each year—did rise sharply between 2008 – 2012. This was entirely due to the Wall Street collapse and ensuing Great Recession. To begin with, the onset of the recession itself generated a sharp decline in tax revenues, as a consequence of falling household incomes and business profits. Total federal tax revenues (in real 2012 dollars) fell from \$2.9 trillion in 2007 to 2.3 trillion in 2009, a 21 percent decline in two years. As of 2012, federal revenues are still, at \$2.5 trillion, nearly 14 percent billion below the pre-recession level.

In addition, U.S. policymakers did enact extraordinary measures to counteract the crisis created by Wall Street. These measures included financial bailouts and the Federal Reserve pushing its policy interest rate—the federal funds rate—close to zero by late 2008 and keeping it there for at least four years subsequently (as of this writing, the Fed has stated its intention to keep the federal funds rate at near-zero until the unemployment rate falls to 6.5 percent). In addition to these, the federal government passed a large-scale fiscal stimulus program that was financed by a major expansion in the federal government deficit. This federal stimulus program was the American Recovery and Reinvestment Act (ARRA), which President Obama signed into law in February 2009. This measure included \$787 billion in new government spending and tax cuts for households and businesses.

Figure 1 presents data on the federal deficit as a share of GDP from just prior to the recession in 2007 through 2012, with the projected figure for 2013. It also shows the average figure for the 63-year period 1950 – 2012. As we see, in 2007, the deficit was at only 1.2 percent of GDP, which is below the average historic figure of 2.2 percent. This is while all tax cuts enacted under President George W. Bush were fully in force and with the U.S. military heavily engaged in both the Iraq and Afghanistan wars. The deficit rose to 3.2 percent of GDP in 2008, due to the initial decline in tax revenues that resulted from the onset of the recession. In 2009,

the deficit spiked to 10.1 percent of GDP, as tax revenues fell further and ARRA spending began. The deficit then fell modestly from 2010 – 2012, with the 2012 figure at 8.5 percent of GDP. As we see, the U.S. Office of Management and Budget projects the deficit at 5.5 percent of GDP in 2013. This decline in the deficit for 2013 would result from a projected \$400 billion increase in revenues along with modest spending cuts in real dollars. As we see, the 2013 projected deficit would represent a sharp decline over the 2009 – 2012 period, though it would still keep the deficit well above the historic average of 2.2 percent of GDP.

#### FIGURE 1 BELONGS HERE

Overall, what is evident from this full 2007- 2013 period is that, regardless of the merits of the Bush tax cuts and the military spending increases devoted to Iraq and Afghanistan, these factors were not responsible for generating the historically outsized federal deficits. The large deficits were solely the result of the 2007-09 financial crisis and subsequent Great Recession.

The question we need to ask here is whether this pattern of deficit spending created a government debt crisis that can only be brought under control through austerity. This has been the claim of austerity hawks since 2009. Some of the main figures making these claims have been leading U.S. macroeconomists such as John Taylor, Alan Meltzer, Martin Feldstein, and Robert Barro.<sup>1</sup> Beginning soon after the deficit began expanding significantly in 2009, these and other austerity hawks focused, with only small variations, on three major hazards. These are:

1. *Inflation.* The large government deficits would produce significant inflationary pressures, because large-scale government borrowing is pushing liquidity into the economy much faster than the economy is producing new goods and services.
2. *Rising interest rates.* The deficits generate an aggregate increase in demand for credit much faster than the supply of credit is increasing from the overall pool of available savings.
3. *Unsustainable debt burden.* The growing deficits will produce a correspondingly sharp increase in the ratio of government debt/GDP. The government will not be able to meet its debt servicing requirements without either imposing some combination of sharp tax increases or spending cuts, or allowing inflation to rise to dangerous levels.

#### **Why Inflation and Interest Rates are Low**

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<sup>1</sup> The initial formulations of these austerity hawk positions are reviewed in Pollin (2010). See also Meltzer (2012) and Taylor (2012) .

I present basic summary data in Figure 2 on inflation and interest rate patterns since the fiscal deficit first rose sharply in 2009. As we see there, both inflation and the interest rate on U.S. Treasuries were at historic lows in the four years, 2009 – 12, during which government deficits were at their peak. Thus, the average inflation rate over the between 1953 – 2008 was 3.8 percent, while between 2009 – 12, inflation averaged only 1.6 percent. Similarly, the interest rate on 5-year Treasuries averaged 6.2 percent between 1953 – 2008, while, over 2009-12, the average rate on 5-year Treasuries was 1.6 percent.<sup>2</sup>

FIGURE 2 BELONGS HERE

Why did inflation and interest rates on government bonds reach such low average levels despite the historically large fiscal deficits? First, the lack of inflationary pressure is the direct result of the high rates of unemployment and low rates of capacity utilization. These translate into no upward pressure on wages and prices from the demand side of the economy. Indeed, the predominant effect of high unemployment and low capacity utilization is deflationary pressures, not inflation. As Martin Feldstein himself acknowledged in 2010, “sustained budget deficits...do not cause inflation unless they lead to excess demand for goods and labor.” The other factor that could have caused inflationary pressures is an oil price shock similar in magnitude to the experience of the 1970s. In fact, oil prices did indeed spike in this period. The average retail price of a gallon of gasoline rose by 115 percent, from \$1.84 to \$3.96 between January 2009 and May 2011 and remained at this higher level into 2013. The fact that this did not create broader inflationary pressures throughout the U.S. economy only underscores the strength of the economy’s deflationary counter-pressures coming from the demand side.<sup>3</sup>

What about the sharp decline in interest rates on U.S. Treasuries? Two factors have been at play. The first is that financial market investors globally became increasingly focused on reducing their risks after the financial collapse, in a dramatic reversal of their mindset during the hyper-speculative years. Since the onset of the crisis, these investors have voted strongly in support of U.S. government bonds as the single safest store of their wealth.

The second factor has been the Federal Reserve’s aggressive policies to hold down interest rates. This includes the Fed’s near-zero interest rate policy for its short-term policy target rate, the federal funds rate. In addition, under its “quantitative easing” program, the Fed has also

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<sup>2</sup> These time series data begin in 1953, since that is the first year in which figures are available for Treasury bond interest rates.

<sup>3</sup> It is notable that food prices also spiked over this same period, both in the U.S. and globally. The sharp global increases in both oil and food prices are tied to the corresponding rise in speculative trading on the commodities futures markets. For further discussion, see Pollin and Heintz (2011) on oil prices and Ghosh, Heintz, and Pollin (2012) on food prices.

successfully lowered the longer-term rates on U.S. Treasuries by buying long-term Treasuries directly in the open market.

### **Disastrous Government Debt Burden?**

Even with low inflation and interest rates, it is still the case that large fiscal deficits have led to an increasing level of accumulated government debt. Figure 3 shows the pattern of federal debt owed to the public as a share of GDP rising sharply from 2008, at 36.4 percent of GDP, to 62.9 percent in 2011, and a projected 73.5 percent of GDP for 2013. At the same time, as is also clear from the figure, the U.S. operated with a debt/GDP ratio above 50 percent from the World War II spike in borrowing in 1942 until 1956. The federal debt/GDP ratio hit a peak of over 100 percent in 1945-46. The federal debt/GDP ratio also rose sharply in the early 1980s under President Ronald Reagan, after having fallen steadily since the World War II peak. The figure for 1982 was 25.8 percent, which rose to a high of 49.1 percent in 1996.

Despite these broader historical perspectives on the current U.S. debt situation, the austerity hawks have been pounding on the idea that the rising debt/GDP ratio since 2009 is creating a massive and unsustainable burden on U.S. government finances. The leading conservative macroeconomist John Taylor of Stanford has perhaps been most vociferous on this point. Taylor has written regularly about the increase in the U.S. debt in a tone that is openly alarmist. For example, Chapter 3 in his 2012 book *First Principles* is titled "Defusing the Debt Explosion." He writes there as follows: "Nothing better signifies America's recent failure to follow the principles of economic freedom than the exploding debt of the federal government. I do not exaggerate when I use the word "exploding," (p. 101).

Taylor then presents a graph taken from the U.S Congressional Budget Office, showing total federal government debt as a share of U.S. GDP from 1850 – 2050 and beyond. Taylor observes about this graph that:

Its soaring upward climb resembles the fireworks on America's Independence Day. But rather than remind us of America's founding, it portends America's ending. I carry a version of the chart in my wallet and show it to my students, and to my children and grandchildren, because it's their future on the line," (p. 101).

What Taylor does not clarify in his discussion of this figure is that the segment of the graph that is exploding "like fireworks," is occurring well into the future, starting around 2040. This explosion represents only a long-term projection of future U.S. debt growth by the Congressional Budget Office, working from a set of highly unrealistic assumptions about U.S.

fiscal deficit spending and taxation over the next 35 years. But the fact that someone of Taylor's professional stature would write in such alarmist tones reflects the broader tenor of debate that has dominated U.S. fiscal policy debates since 2009.

What is still more remarkable about the perspective advanced by Taylor and allied austerity hawks is that they make no mention of the fact that since 2009, the U.S. government's debt servicing burden has been at *historically low levels, not historic highs*, despite the government's rising level of indebtedness. We can see this in Figure 4, showing U.S. government interest payments as a percentage of total federal expenditures. As we see there, government interest payments from 2009 through 2013 averaged 6.4 percent. This contrasts with an average figure of 12.9 percent between 1981 – 92, under Presidents Ronald Reagan and George Bush-1. That is, the government's debt-servicing burden since 2009 is *less than one-half the average under Reagan and Bush*. Moreover, the figure for 2009 – 2013 is nearly three percentage points below the 9.1 percent average figure for the full period 1940 – 2013. The explanation for this is straightforward: the low interest rates at which the U.S. has been able to borrow since 2009—the rate on 5-year U.S. Treasuries again averaging 1.6 percent from 2009 – 2013—has enabled the government to accumulate increasing debt without experiencing an accompanying heavy debt-servicing burden. By contrast, under Reagan and Bush-1, the average interest rate on 5-year U.S. Treasuries was 9.5 percent—i.e. nearly eight full percentage points higher than since 2009. This in turn meant that heavy government borrowing during the Reagan-Bush-1 era also produced severe debt-servicing burdens.

What is therefore evident from these figures on government interest payments is that, claims of austerity hawks notwithstanding, in fact, the U.S. has not been facing a fiscal crisis at all in the commonsense meaning of the term. That is, the federal government is nowhere near approaching a point where it could become unable to cover its upcoming debt obligations.

## **THE AUSTERITY AGENDA IN PRACTICE**

### **How Sequestration Cuts Favor the Military**

On March 1, 2013, the federal budgetary "sequestration" agenda was put into effect, fully in keeping with the perspectives advanced by the austerity hawks. The sequestration agenda includes \$55 billion per year in annual cuts to both social and military spending relative to previously allocated levels. When Congress and President Obama originally agreed to the sequestration plan in November 2011, it was widely understood in mainstream political circles that these measures would never actually be enacted. Rather, the broadly shared mainstream



view was that Congress and the President would reach some alternative agreement for a deficit reduction program prior to hitting the deadline for imposing the automatic sequestration cuts.

As of this writing in late March 2013, it is still possible that the President and Congress will reach some alternative agreement that will enable them to nullify the scheduled sequestration cuts. But based on how discussions have evolved since the sequestration bill was initially enacted in November 2011, and where the reports say any further discussions may be heading in the coming months, it is almost certain that any new agreement is not going to be more than marginally less committed to austerity than what would transpire through continuing with sequestration as is. For example, the Obama Administration has already made clear its willingness to accept cuts in Social Security, even though the spike in the fiscal deficits that began in 2009 had nothing whatsoever to do with funding Social Security.<sup>4</sup>

More generally, mainstream Democrats and Republicans appear to agree on reducing spending cuts for the military, and, therefore loading cuts disproportionately onto social spending. This is despite the fact that there is a basic asymmetry in the budgetary situations for military versus social spending. That is, the recent budgets for the military—which brought the military budget from 3.0 percent of GDP in 2000 to 4.7 percent in 2012—included funding to fight the Iraq and Afghanistan wars. With spending on these wars now nearly ended, there is no legitimate reason as to why the military budget should be maintained at its wartime levels. In fact, if the sequestration-based cuts in military spending are enacted in full, the net impact of these cuts would be to bring the military budget only to a level equal to that prior to Iraq and Afghanistan. That is, under full sequestration, the military budget would return to being about 3 percent of GDP as of 2017. Moreover, such calculations on the military budget also assume—hopefully but perhaps implausibly—that the U.S. does not engage in additional wars between now and 2017. If we do end up fighting more wars, the budgets to pay for them would be exempt from any spending caps. The sky would be the limit. In short, aside from winding down Iraq and Afghanistan, the defense cuts that will result through sequestration are actually modest and easily reversible.<sup>5</sup>

In contrast with this situation for the military budget, spending on education, healthcare, family support, infrastructure and the environment have already fallen sharply as a result of the Great Recession. Further cuts will deeply compromise the already modest level of welfare state

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<sup>4</sup> The Obama administration is supporting cuts in Social Security through endorsing a change in the way in which Social Security cost-of-living adjustments are calculated. Specifically, they are supporting a change to a “chain-weighted” Consumer Price Index as opposed to maintaining the current Consumer Price Index for Urban Workers (CPI-W) as the basis for cost-of-living adjustments. In practice, the shift to the chain-weighted index will mean a reduction in the annual benefits to Social Security recipients.

<sup>5</sup> See Pollin and Garrett-Peltier (2012) for further discussion on the U.S. military budget and sequestration.

provisions in the United States. We can see this clearly through considering conditions for state and local governments throughout the country.

### **State and Local Governments' Fiscal Crises**

Due to the sharp falls in incomes, spending, and property values tied to the recession, tax revenues from the two main sources for state governments—income and sales taxes—declined precipitously, and even local property taxes, after expanding continuously for decades, were flat in 2010. By 2010, state tax revenues (adjusted for inflation and population growth) had fallen by fully 13 percent relative to where they were in 2007. By comparison, revenues fell only 7 percent following the 2001 recession. Even during the 1981-82 recession, the most severe post World War II downturn prior to 2007 – 09, the decline in state tax revenues was less than 2 percent.<sup>6</sup>

Table 1 below shows the change in inflation-adjusted state tax revenues from the most recent revenue peaks in each state—those mostly being 2007—through 2011. We show figures aggregating revenue levels for all states, as well as those for six large, representative states, from different regions of the country—i.e. California, Illinois, New Jersey, New York, Texas and Virginia. As we see, overall, by the end of 2011, state tax revenues were down by 7 percent relative to the most recent peak levels. There were significant differences among the six representative states. But in the best case, New York, revenues were still down by 0.2 percent, while in the worst case, New Jersey, the revenue decline was 15 percent.

TABLE 1 BELONGS HERE

The recession also meant that people's needs for state services rose sharply. This is clear through considering the situation with Medicaid, the U.S. health insurance program for low-income families that is jointly funded by the federal and state-level governments. Four million more people received health insurance through Medicaid in 2012 relative to 2008, as a result of rising unemployment and employers cancelling health care coverage. In addition, the number of people seeking assistance from the Low Income Home Energy Assistance Program, another joint federal/state government program, rose by 53 percent between 2008 and 2011, from 5.8 to 8.9 million households. That is, as of 2011, about 8 percent of all households were receiving this assistance. The net result of the collapse of tax revenues and rising demand for state services was budgetary shortfalls of \$191 billion in 2010, \$130 billion in 2011 and \$112 billion in 2012. The 2011 shortfall was equal to 19 percent of all state spending commitments (Pollin and Thompson 2011).

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<sup>6</sup> Data are from Pollin and Thompson (2011). See also Heintz (2009) for related data and perspectives.

All states in the U.S. other than Vermont are required to maintain a balanced budget on their operating budgets every year. Without having the option of deficit spending on their current account, the states adjusted to these budgetary shortfalls through a combination of measures. The 2009 ARRA federal stimulus program, along with supplemental funds for Medicaid, did provide substantial support to help cover state and local government budget gaps. This amounted to about one-third of total budget gap generated by the recession. But that still meant that about two-thirds needed to be filled by other means. The ARRA funds also ran out by 2011.

The other two-thirds of the states' budget gaps were filled primarily through expenditure cuts. The extent of the expenditure cuts is reflected in the changes in employment for state and local governments. Table 2 presents basic figures for the United States as a whole, along with six of the large, regionally representative states, California, Illinois, New Jersey, New York, Texas and Virginia. As the table shows, between December 2007 – June 2009, state and local government employment rose slightly, by 0.7 percent, before falling by 3.1 percent from June 2009 – May 2012. The patterns of the six major states in the table are broadly reflective of this same nationwide pattern.

#### TABLE 2 BELONGS HERE

State and local governments spend most of their money on education, health care, public safety and various forms of non-health related social support, such as the home heating oil programs. The gaps in state and local governments have led to significant cuts in all these areas of public sector funding. The severity of the cuts have been exacerbated by the fact that, the population being supported by these programs has grown by approximately 12 million people, nearly 4 percent, between 2007 and 2012.

#### **From Fiscal Crisis to Attacks on the Public Sector<sup>7</sup>**

Despite the reality that the state-level fiscal crisis was caused by the Great Recession, a widespread movement emerged among powerful groupings on the political right to claim that the fiscal crisis was the result of long-term excesses in public sector programs and on compensation for public sector workers. Thus, Arthur Laffer and Stephen Moore wrote in their introduction to the 2009 *Annual Report* of the American Legislative Exchange Council (ALEC), "The real

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<sup>7</sup> This section is mainly based on Pollin and Thompson (2011).

problem facing states is the fundamental issue of overspending taxpayers dollars.”<sup>8</sup> Yet in fact, state and local spending has remained remarkably stable for decades, without having ever produced anything close to the severe budget crisis tied to the 2008-09 recession. Thus, in 2006, just prior to the recession, spending by state and local governments was 22.2 percent of total personal income, only slightly higher than the average figure over the mid-1990s of 21.5 percent. State and local government spending levels do fluctuate on a short-term basis as the overall economy alternates between phases of growth and recession. Over the longer term, state and local governments do also face rising cost pressures to cover health care expenses. But this is an economy-wide problem, with the federal government and private businesses experiencing similar pressures resulting from the excessive administrative burdens of the U.S. health-care system relative to those of other advanced economies.

It is also untrue that state and local government workers are overpaid, despite widespread claims to the contrary. One widely cited 2009 *Forbes Magazine* cover article reported that “State and local government workers get paid an average of \$25.30 an hour, which is 33 percent higher than the private sector’s \$19....Throw in pensions and other benefits and the gap widens to 42 percent.”

What such figures fail to reflect is that state and local government workers are older and substantially better educated than private-sector workers. *Forbes* is therefore comparing workers with different attributes. As John Schmitt of the Center for Economic Policy Research has shown (2010), when state and local government employees are matched up to private-sector workers of the same age and educational levels, the state and local government workers throughout the U.S. actually earn, on average, about four percent less than their private-sector counterparts. Moreover, the results of Schmitt’s properly constructed comparison are fully consistent with numerous studies examining this same question over the past 20 years.

### **Broader Attacks on U.S. Workers Rights**

Such attacks on public sector workers emerging out of the recession broadened to becoming state-level attacks on workers collective bargaining rights generally. Thus, amid the struggle over its fiscal crisis, the state of Wisconsin passed a law in 2011 curbing the collective bargaining rights of many public employees. In that same period, Indiana enacted a right-to-work law, which enables workers to receive the benefits of union contracts without having to join the union. The state of Michigan, which, since the 1930s, had been the most significant stronghold of unionism in the United States, also became a right-to-work state in December 2012. The Michigan legislation enacting the right-to-work legislation was rushed through the

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<sup>8</sup> ALEC is primarily funded by the notorious right-wing billionaire Koch brothers. See, for example, Nichols (2011).

Michigan legislature, without hearings during an end-of-year lame duck session. As a result of these and related actions, the proportion of U.S. workers who were union members fell to a 97-year low in 2012, of 11.3 percent of the U.S. workforce (Greenhouse 2013).

### **Austerity as a Tool of Class Struggle**

It is clear from the experiences of U.S. state and local governments that austerity policies have not brought the U.S. economy onto a healthy growth trajectory. This is not surprising since there is nothing in the austerity agenda that can serve as an engine of economic recovery. Indeed, since, collectively, state and local governments are the largest single source of employment in the U.S. economy, any agenda to cut state and local government employment will act as a drag on any movement toward expanding overall job opportunities.

Moreover, this pattern for the U.S. is fully consistent with the experiences with fiscal austerity in Europe since 2010. In an important January 2013 paper examining the austerity experience in Europe, IMF Chief Economist Olivier Blanchard, along with IMF colleague Daniel Leigh acknowledge that the negative effects of austerity cuts have been more severe than the IMF had originally estimated. Specifically, they found that austerity cuts in the Eurozone have led to reductions in overall output in excess of the total level of spending cuts. The IMF had previously held that austerity cuts in public spending would rather encourage more private sector spending that would offset to a significant degree the public sector cuts.

This previous IMF position was derived from the “crowding out” theory of fiscal deficits. According to the crowding out theory, increases in government deficit spending reduces the amount of affordable credit available for private investors, and thereby discourages private investment. Correspondingly, according to this approach, reducing government deficit spending will provide a larger pool of affordable credit for private sector investors. The increasing availability and affordability of funds for private investors was supposed to create a channel through which government austerity policies could promote recovery. But the overall body of evidence had never supported this crowding out position.<sup>9</sup> The most recent experiences in both the U.S. and Europe have only confirmed the conclusions of this longstanding literature.

This does raise the question: if the evidence is overwhelming that austerity policies do not promote recovery out of recessions, then why do elites in the U.S., along with those in Europe, continue to push this agenda? No doubt, there are sincere austerity hawks such as John Taylor who think—however erroneously—that there are no alternatives in the face of historically

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<sup>9</sup> Some earlier references on this debate, offering alternative perspectives, includes Eisner (1986), Friedman (1988), Heilbroner and Bernstein (1989), and Rock (1991).

high debt levels. Focusing on the U.S. again, there are also no doubt scheming Republicans who support austerity now because they calculate that it could well drag the economy down, which in turn will damage Obama and the Democrats just in time for the 2014 election. But there is also a deeper, longer-term factor at play: that elites in both the U.S. and Europe are eager to dramatically push down wages and eviscerate the welfare states in their respective countries. Their purpose is to permanently lower their labor costs and taxes, which in turn mean fatter profits and still higher incomes for the rich.

The evidence from the U.S. since the recession officially ended in June 2009 is certainly consistent with this perspective. Thus, Emmanuel Saez of UC Berkeley reports (2013) that the richest one percent of U.S. households captured an astounding *121 percent* of the economy's total income growth from 2009 – 2011, i.e. the two first years of official recovery. The bottom 99 percent of U.S. households experienced -0.4 percent income growth over 2009 – 11. This was after the bottom 99 percent experienced an average income decline of 11.6 percent during the official recession years 2007 – 09. It is precisely due to such patterns that the U.S. stock market could begin booming in early 2013, even while GDP growth for the last three months of 2012 was at a paltry 0.4 percent, and official unemployment had only edged down to 7.7 percent as of February 2013—i.e. nearly four full years since the recession had officially ended.

## **SHORT- AND LONG-TERM ALTERNATIVES TO AUSTERITY**

Coming up with alternatives to the austerity agenda in the U.S. begins with asking a different set of questions than those posed by the austerity hawks. Instead of asking how to bring down the U.S. fiscal deficit to control the economy's supposed fiscal crisis, the question we should rather ask is: how do we eliminate mass unemployment and move the U.S. economy onto a path of sustainable full employment? There is a wide range of issues to address if we want to seriously advance full employment as a serious alternative to today's dominant austerity agenda. These include issues around globalization, financialization and financial regulation, the inflation-unemployment trade-off, industrial policy, new progressive sources of tax revenues, and controlling health care costs.<sup>10</sup> For the current discussion, I focus on only two issues that I consider central to the broader discussion. These are: 1) Creating an effective overall stimulus program in the short-run; 2) Permanently expanding decent employment opportunities in the long run through investments in the green economy and education.

### **Credit Policies for Short-Run Stimulus**

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<sup>10</sup> I cover this broader set of questions in Pollin (2012A).

As we have seen, the federal government is not in a fiscal crisis. Interest payments on the federal debt are at a near-historic low of 5.9 percent of total government spending as of 2013, a figure that is less than half the average under Ronald Reagan and George H.W. Bush. Especially with interest rates for the U.S. government remaining at historically low levels, the federal government can and should expand spending on education, health care, public safety, family support, traditional infrastructure and the green economy, as well as unemployment insurance. Much of this funding can be used simply to stop and reverse the cuts we have seen in state and local government budgets. Overall, the amounts devoted to spending in these areas should be at least as large as the roughly \$400 billion per year that was budgeted through the original ARRA.

Fiscal policies such as I describe above have been widely discussed in progressive circles, including the Congressional Progressive Caucus.<sup>11</sup> I want to therefore focus on what I consider to be the equally important area of money and credit policies, where there has been much less attention paid to the possibilities for building a viable alternative to austerity.

### **Commercial Banks' Cash Hoards**

All such discussions should begin with the fact that increasingly since 2010, U.S. commercial banks are sitting on massive, historically unprecedented cash hoards. As of the most recent data from the last quarter of 2012, the commercial banks were carrying an unprecedented \$1.5 trillion in cash reserves. This is equal to nearly 10 percent of U.S. GDP. The banks obtained most of this money through the Federal Reserve having maintained the interest rate at which banks can borrow at nearly zero percent—that is, the banks have access to nearly unlimited liquid funds at no borrowing costs. The other big source of the banks' funds was the Fed's quantitative easing program, whereby the Fed purchased longer-term Treasury holdings from the banks.

Figure 5 shows how the commercial banks cash reserves have ballooned relative to pre-recession levels. As we see, as of 2007, the total cash holdings of the banks were under \$20 billion. By the end of 2011, it was \$1.6 trillion. The total since edged down slightly to \$1.5 trillion in 2102. Of course, banks need to maintain a reasonable supply of cash reserves as a safety cushion against future economic downturns. One of the main causes of the 2008-09 crisis and other recent financial crises was that banks' cash reserves were far too low. But increasing reserves to \$1.5 trillion is certainly a new form of financial market excess.

It is true that a significant fraction of these funds need to be held by the banks to carry an adequate margin of safety in the currently highly risky environment. However, as I have

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<sup>11</sup> See, for example, the Congressional Progressive Caucus's (2013).

analyzed elsewhere (Pollin 2012B), after making highly conservative assumptions about the safety requirements of the banks in the current environment, I concluded that a reserve fund of \$600 billion for the commercial banks would provide a safety margin far beyond any previous historical experience as well as beyond current needs. This means that about \$1 trillion should be available to move into the economy as productive loans.

### **Escaping the Liquidity Trap**

Of course, saying the money is available in abundance doesn't mean it is going to get channeled into job generating job-generating investments. Private businesses operate to earn a profit. As such, the fact that banks are sitting on approximately \$1 trillion in excess cash rather than lending these funds for productive purposes must mean that, at some level, they do not see adequate profit opportunities in the U.S. economy today through investments and job creation.

These conditions in credit markets over the Great Recession and subsequently are hardly unique relative to previous recessions, in the U.S. and elsewhere, and the 1930s Depression itself. Indeed, this contemporary experience represents just the most recent variation on the classic problems in recessions in reaching a "liquidity trap" and trying to "push on a string." This is when banks would rather sit on cash hoards than risk making bad loans, and businesses are not willing to accept the risk of new investments, no matter how cheaply they can obtain credit. The liquidity trap that has prevailed since the 2008-09 recession has served as a major headwind, counteracting the effects of what, on paper, had been a strongly expansionary macro policy stance through the ARRA.

How to escape this liquidity trap? Clearly, if businesses don't see investment opportunities, that means that one overarching problem in the economy is insufficient demand from consumers, businesses, and the government itself as a purchaser. In the face of inadequate market demand, a federal government austerity agenda—cutting back on government spending—would then just make the economy's demand problem worse, not better. So step one for ending the liquidity trap has to be reversing the fiscal austerity agenda, and instead getting refocused, as discussed briefly above, on a viable federal stimulus.

However, the economy has also been operating with severe credit constraints, with small businesses, in particular, having been locked out of credit markets. We therefore need to explore a range of policy approaches that can reduce the level of risk for borrowers and lenders, and/or raise the costs for banks to continue holding cash hoards. I focus here on two ideas: extending federal loan guarantees for small businesses and taxing the excess reserves of banks.



## **Combining One Carrot and One Stick**

This approach is simple, combining the use of one big carrot and one big stick to creating millions of new jobs quickly. The carrot would be measures to substantially reduce the level of risk being faced by both borrowers and lenders. This can be done through the federal government's existing loan guarantee program. In terms of practical implementation of such a program, the federal government does already operate various loan guarantee programs on a major scale. Thus, for 2012, the total level of loans guaranteed by the federal government was about \$780 billion. This equals about 2.8 percent of all outstanding debt held by U.S. households and domestic non-financial businesses. By far, the largest category of loan guarantees was housing subsidies, with about \$130 billion going to businesses. The federal government should pursue an agenda to roughly triple as rapidly as possible its overall loan guarantee program to non-housing related businesses to about \$450 billion in total, with the focus of the expansion on small businesses. That would entail an increase of guaranteed loans for small business of about \$300 billion. This would represent a major expansion of the existing federal guarantee programs, while still remaining within the scale of existing overall programs. It would also be a huge benefit to small businesses, which—as the Republicans never stop touting—do indeed create significantly more jobs per dollar of spending than big businesses.

The stick would be for the federal government to tax the excess reserves now held by banks. This should create a strong disincentive for banks to continue holding massive cash hoards. It is difficult to know in advance what the appropriate tax rate should be for this purpose—probably in the range of 1-2 percent. But any such initiative should also allow Congress to operate with flexibility, to adjust the rate as needed for channeling excess reserves into job-generating investments. For starters, the Fed needs to stop paying interest on bank reserves. It currently pays 0.25 percent on these accounts. Indeed, this whole initiative could be conducted through the Fed, as opposed to having Congress pass an excess reserve tax. The way they could do this is to establish a maximum level of reserves that they would allow banks to hold without facing a penalty for holding excess cash hoards.

One crucial feature of this combination of policies is that its impact on the federal budget will be negligible. Loan guarantees are contingent liabilities for the federal government. This means that, beyond some relatively modest increase in administrative costs, the government would incur costs from the loan guarantee program only as a result of defaults on the guaranteed loans. Even if we assumed, implausibly, that the default rate on the new loans was triple the proportion that prevailed in 2007, prior to the recession, this would still increase the federal

budget by less than one percent. Moreover, a significant share of this budgetary expense could be covered by the revenues generated by the excess reserve tax.

Austerity hawks should therefore take note: the carrot of a new loan guarantee program for small businesses and the stick of taxing the massive cash hoard now being held by commercial banks—with money they obtained nearly for free from the Fed's zero interest rate policy—would be a nearly cost-free approach to providing serious support for small businesses especially. This would enable small businesses to expand operations and begin to making the job-generating investments we need.

### **Clean Energy and Education Investments for Long-Run Prosperity<sup>12</sup>**

We can envision the path to creating a sustainable full-employment economy through considering some basic data on the job-creating effects of investing in clean energy and education relative to spending on fossil fuel energy and the military. Figure 6 shows the level of job creation in each of four sectors—clean energy, education, fossil fuels and the military—for every \$1 million in spending in these sectors. By a significant margin, education is the most effective source of job creation among these alternatives--about 27 jobs per \$1 million in spending. Clean energy investments are second, with about 17 jobs per \$1 million of spending. The U.S. military creates about 11 jobs, while spending within the fossil fuel sector, by far the weakest source of job creation per dollars, creates about 5 jobs per \$1 million.

#### **FIGURE 6 BELONGS HERE**

These figures combine three categories of job creation—what are termed *direct*, *indirect* and *induced* job creation—that result through spending on any activity. Direct jobs are those created by an activity itself, such as building a wind turbine, hiring school teachers, opening a military base in Afghanistan, or transporting oil from the Persian Gulf to Houston. Indirect jobs are those generated by businesses providing supplies to support the direct activities, such as steel manufacturers supplying a wind turbine manufacturer, or a paper company providing office supplies to a school, military base, or an oil company's corporate headquarters. The term "induced jobs" refers to the expansion of employment that results when people who are newly hired—either through direct or indirect job creation—spend the money they have begun to earn. This is also frequently termed the "multiplier effect" of direct and indirect job creation. These multiplier effects that generate induced jobs are especially beneficial in offering expanding market opportunities for small businesses, such as food service firms selling lunches at a wind-energy work site.

Two main factors account for the differences in total job creation across sectors, including all direct, indirect, and induced jobs. The first is *relative labor intensity*, the amount of

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<sup>12</sup> This section is based mainly on Pollin, Heintz, and Garrett-Peltier (2009) and Pollin and Garrett-Peltier (2011).

people, as opposed to everything else, a business utilizes in its operations. For example, a clean energy investment program utilizes far more of its budget to hire people than to acquire machines, supplies, land (either on- or offshore), or energy itself.

The second factor is relative domestic content per overall spending amount—how much of the work is done within the U.S. rather than other countries. The clean energy sector relies much more than the fossil fuel sector on economic activities taking place within the United States—such as retrofitting homes or upgrading the electrical grid system—and less on imports.

Consider an agenda in which we transfer about 25 percent of total spending in both the military (\$700 billion) and fossil fuel (\$625 billion) sectors—that is, about \$330 billion per year—in equal shares into education and clean energy? Before assessing the effect of this transfer of spending priorities on employment, we should of course also recognize their crucial and complimentary political and environmental benefits. Reducing the Pentagon's budget by 25 percent would simply return the military to its spending level prior to the wars in Iraq and Afghanistan, i.e., as discussed above, to about 3 percent of U.S. GDP. Such cuts would result if the sequestration program were carried out through 2017 under its current stipulations.

Cutting spending from fossil fuels and transferring it into clean energy of course reflects the imperative of controlling CO<sub>2</sub> emissions to fight global climate change. Indeed, if we are going to meet widely recognized minimum level of reductions to stabilize average global temperatures at acceptable levels—80 percent below our 2000 level as of 2050--we will need to reduce fossil fuel spending by far more over the coming generation. Finally, transferring approximately \$165 billion per year into spending on education would represent a roughly 16 percent increase over the current total public spending level of about \$1 trillion. An increase in educational funding of this magnitude could mean, for example, reducing average classroom sizes nationwide from 23 to 19 students per class, plus an increase in the average amount of financial aid of \$1,500 for college students, plus substantial improvements in school buildings throughout the country—or some appropriate combination of these and other priorities.

In terms of employment effects, the impact of a \$330 billion annual spending shift out of the military and fossil fuel sectors and into education and clean energy would be dramatic. It would create about 4.8 million more jobs for a given level of total spending. The job expansion would be across all sectors and activities—i.e. new opportunities for highly paid engineers, researchers, lawyers and business consultants as well as for elementary school teachers, carpenters, bus drivers, cleaning staff at hotels, and lunch-counter workers at wind energy construction sites. Note also, that I am not proposing net increases in aggregate spending at all, but rather shifts in relative levels of spending between sectors that will generate a rise in overall labor intensity and domestic content for a given amount of spending.

In the context of today's economy, the injection of 4.8 million new jobs would reduce the unemployment rate by about one-third, from about 8 to 5 percent. Realistically however, this kind of large-scale shift in spending economy-wide will not occur rapidly enough to affect today's unemployment rate, in contrast with the short-term fiscal and credit policy measures

discussed above. But this large-scale shift in the country's investment priorities is capable of transforming the employment picture over the long-term. For example, assume that the unemployment rate were to fall over the next two years, if only to, say, 6.5 percent, through some combination of government interventions from the Obama administration and Federal Reserve along with something akin to a normal pattern of recovery. Within such a scenario, 4.8 million additional jobs through a spending shift that raises the labor intensity and domestic content of overall spending would drop the 6.5 unemployment rate to 3.4 percent. At this point, we would be at an unemployment rate where, in both the 1960s and 1990s, significantly in both periods when unemployment fell below 4 percent. In short, this kind of shift in investment priorities—toward clean energy and education and away from fossil fuels and the military—can be the foundation for building a sustainable full employment economy.

## **THE BATTLES BEFORE US**

The ascendancy of austerity economics, both in the U.S. and Europe, is the most harmful intellectual and political development of our time. First and foremost, the austerity hawks are alarmed over the sharp rise in fiscal deficits. But the deficits themselves obviously emerged to counteract the deflationary effects of the global financial crisis caused by Wall Street hyperspeculation. In fact, the financial crisis led to the global Great Recession. Yet yet the effects of the crisis would have been more severe still in the absence of the large fiscal deficits that supported countercyclical spending measures. Thus, while the crisis was clearly caused by Wall Street, and the fiscal deficits emerged to counteract the crisis, the austerity hawks have managed to turn the policy debate on its head, through their insistence that the overarching problem of our current period is actually the fiscal deficits themselves.

The austerity hawks have prevailed in advancing this position even though—focusing on the U.S case—the large-scale fiscal deficits from 2009 - 12 did not produce either dangerously high inflation or interest rates, as the hawks had repeatedly predicted. Of course, heavy borrowing by the federal government did produce rising government debt levels. But as we have seen, the U.S. has been able to service this debt with historically low levels of interest payments, precisely because the interest rates on U.S. Treasury bonds have themselves remained low since the onset of the crisis. As such, the U.S. is nowhere near experiencing a fiscal crisis in the commonsense definition of the term, which is to say, the government is facing difficulties in meeting its commitments to creditors. This is a simple fact which, to my knowledge, the austerity hawks have never recognized.

The recent experiences of state and local governments reviewed above show us clearly how the austerity agenda is attacking the foundations of what had already been a modest U.S. welfare state. But it is becoming increasingly clear that many, if not most, austerity hawks see

this development not as a problem, but rather as part of their agenda. That is, many austerity hawks in the U.S. view this historical moment as an opportunity to eviscerate the public sector, labor unions, social insurance and other basic social protections. To date, as we have seen, the austerity agenda has succeeded over the 2010-11 "recovery" years in delivering sharply rising incomes for the richest one percent of households while incomes for everyone else have stagnated or declined.

It is not difficult to develop viable alternatives to this austerity agenda. I have sketched some ideas capable of both moving the U.S. economy toward full employment in the short-term and sustaining full employment in the long term. Investing in the green economy and education, while allowing both the fossil fuel and military sectors to contract, are central to this long-term full employment agenda. The most difficult question with these and similar proposals is not whether they are analytically sound, which they are, most certainly in comparison with the unsupportable analytic claims of the austerity hawks. The real challenge with all such alternatives is whether progressives can develop the political strength to force these ideas onto the mainstream policy agenda, as effective tools for reversing the ongoing descent into austerity.

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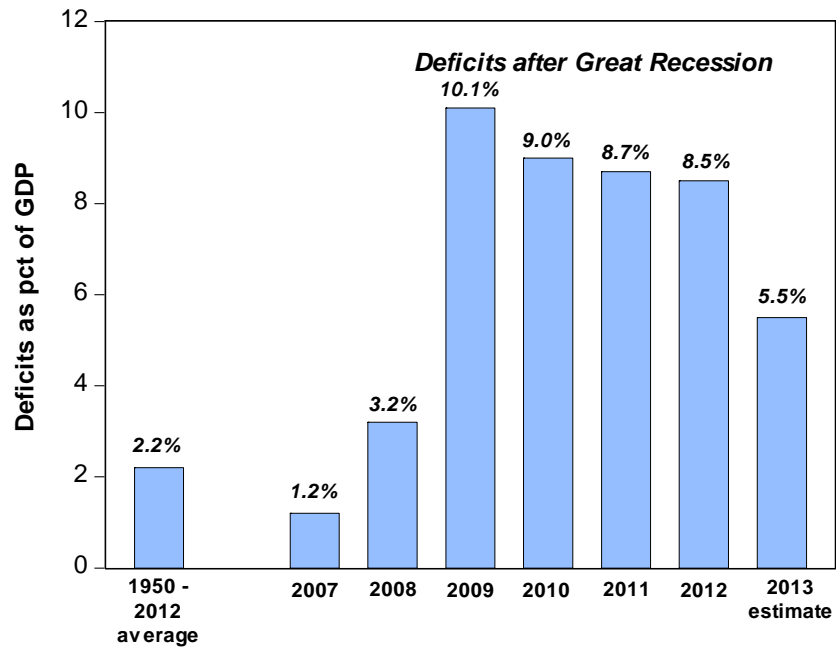
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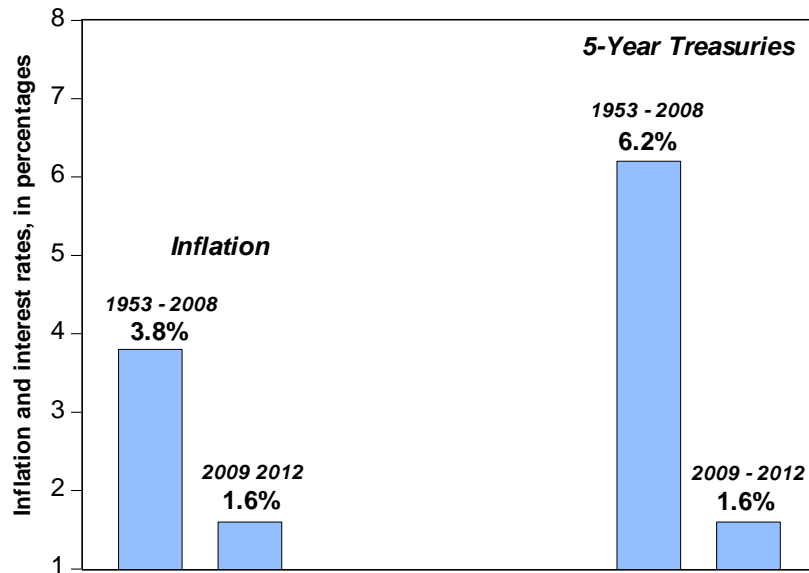
**Figure 1. U.S. Federal Deficits as Share of GDP**



Source: U.S. Office of Management and Budget

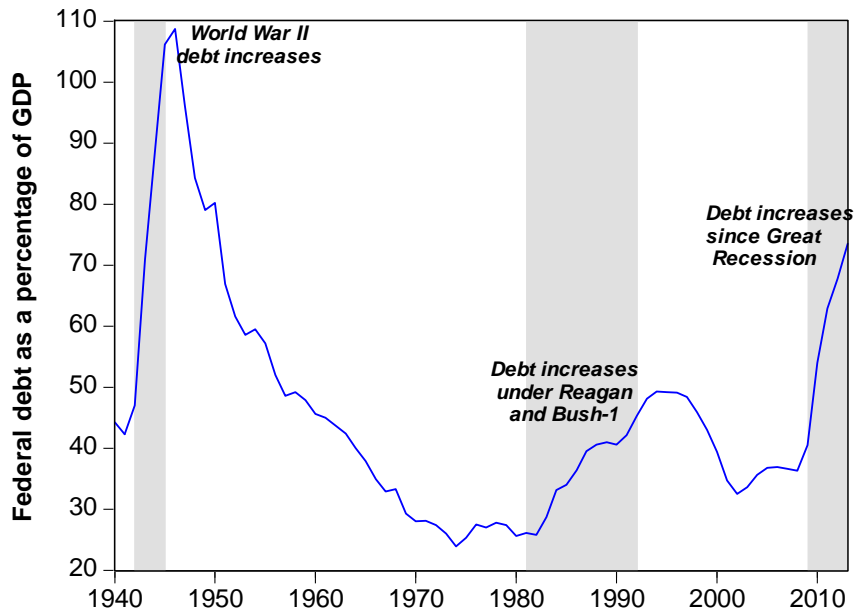


**Figure 2.**  
**U.S. Inflation and Government Bond Interest Rates:**  
*Long-term Patterns (1953 - 2008) and post-  
Great Recession Fiscal Deficit Spike (2009 - 2012)*



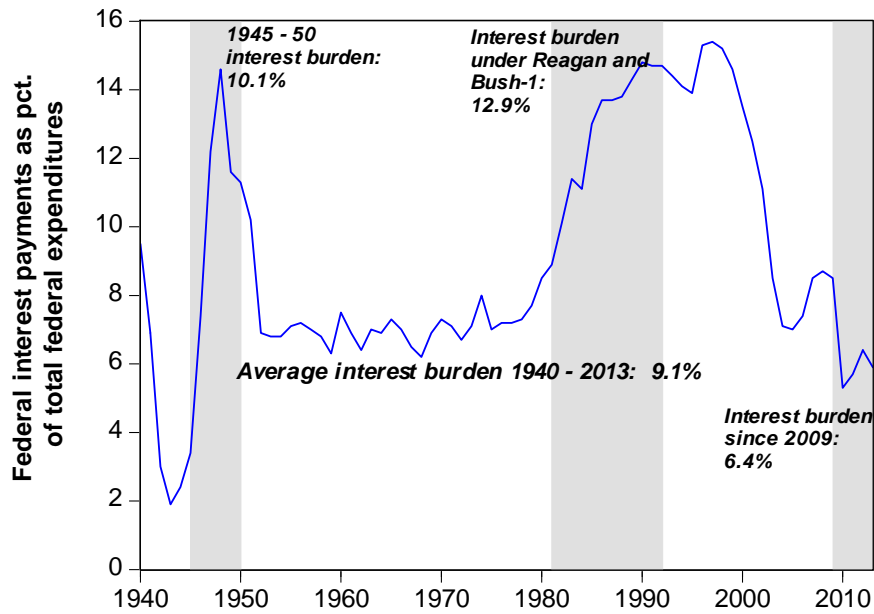
Source: Economagic

**Figure 3.**  
**U.S. Federal Government Debt Owed to the Public**  
**as a Share of U.S. GDP, 1940 - 2013**



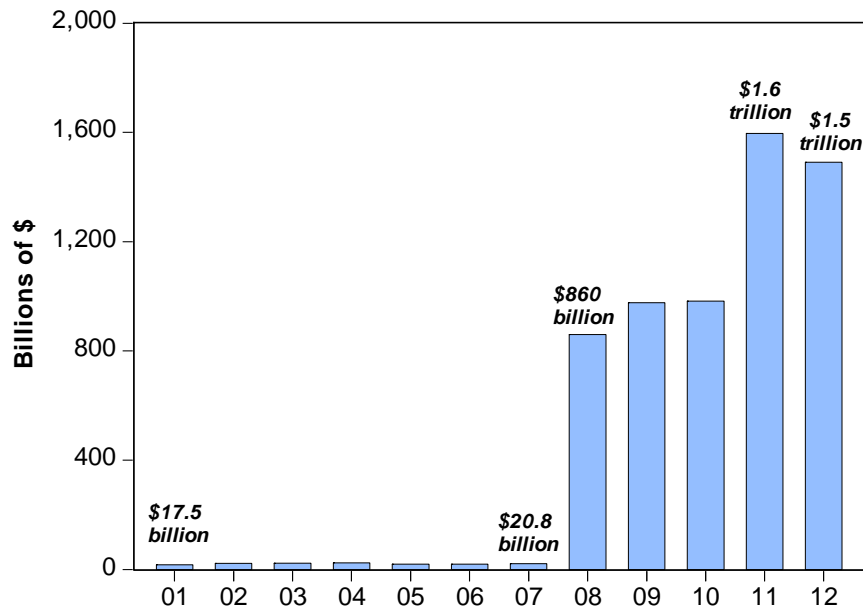
Source: Economic Report of the President 2013  
Note: 2012 and 2013 figures are estimates

**Figure 4.**  
**U.S. Federal Government Interest Payments as Share**  
**of Total Government Expenditures, 1940 - 2013**



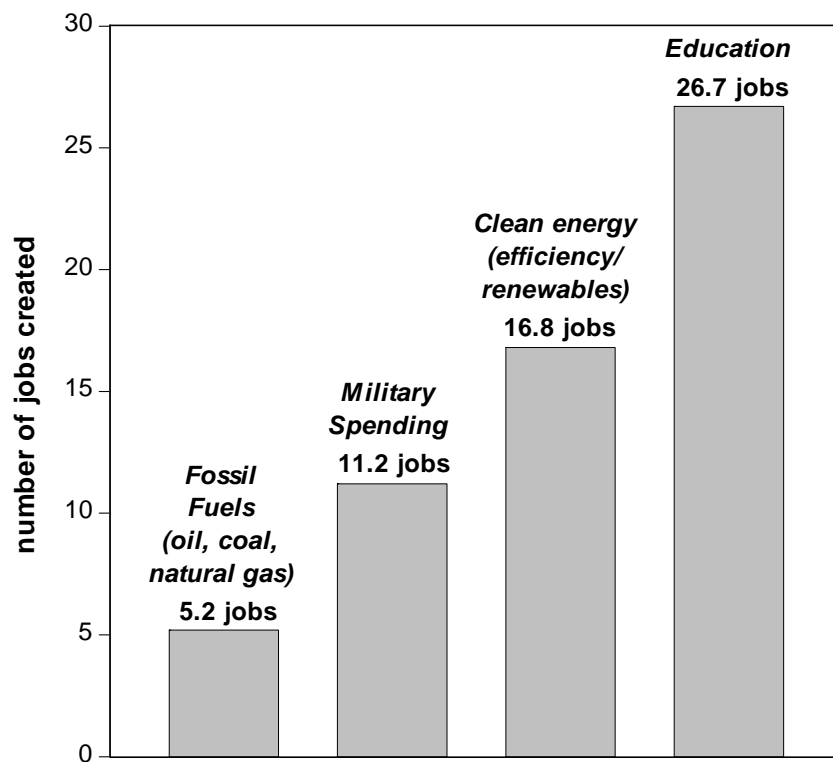
Source: U.S. Office of Management and Budget  
Note: 2012 and 2013 figures are estimates

**Figure 5.**  
**Cash Reserve Holdings by U.S. Commercial Banks, 2001 - 2012**



Source: Flow of Funds Accounts of U.S. Federal Reserve System

**Figure 6. Job Creation in the U.S. through  
\$1 Million in Spending**



Sources: Pollin, Heintz, and Garrett-Peltier (2009); Pollin and Garrett-Peltier (2011)

**TABLE 1.**  
**Decline in State Tax Revenues:**  
**From Pre- Great Recession Revenue Peak to 2011**

|                        |               |              |
|------------------------|---------------|--------------|
| <b>All U.S. States</b> | <b>-12.0%</b> | <b>-7.0%</b> |
| California             | -14.9%        | -4.8         |
| Illinois               | -18.7%        | -8.2%        |
| New Jersey             | -17.2%        | -15.0%       |
| New York               | -4.3%         | 0.2%         |
| Texas                  | -15.4%        | -9.2%        |
| Virginia               | -15.9%        | -12.6%       |

Source: State Budget Crisis Task Force (2012)

Note: Figures are adjusted for inflation, but not for legislative changes.

**TABLE 2.**  
**Employment Changes for State and Local Governments over the Great Recession:**  
**December 2007 to May 2012**

|            | Percentage Change in Employment |                      |
|------------|---------------------------------|----------------------|
|            | December 2007 –<br>June 2009    | June 2009 – May 2012 |
| All States | 0.7%                            | 2.9%                 |
| California | -0.4%                           | -5.6                 |
| Illinois   | 1.2%                            | -3.0%                |
| New Jersey | 0.8%                            | -3.6%                |
| New York   | 0.8%                            | -1.7%                |
| Texas      | 3.5%                            | -2.6%                |
| Virginia   | 1.6%                            | 2.4%                 |

Source: State Budget Crisis Task Force (2012)