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over the Debt Ceiling

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## Wrong Deficit Jobs, Deficits, and the Misguided Squabble over the Debt Ceiling

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These are obviously very grim economic times. One in six Americans who would like full-time work is unable to find a full-time job. Millions of Americans have lost their homes, and many millions more are “under water” – they owe more than their homes are worth. The pain has been felt by nearly every household in the US. Some have been hit harder than others. The unemployment rate for African Americans is double the rate for whites; since 2007, the median wealth of Black and Hispanic households has fallen by more than half.<sup>1</sup> The distributions of wealth and income in the US –the most unequal among industrialized countries before the crash of 2008 – have become more unequal.

In the midst of all of this suffering, US corporate profits are at an all-time high. In 1980, the richest 1% of income earners in the US claimed about 12% of all income; in 2008, they earned nearly one quarter of all income. The share of the top .1% has increased even faster.<sup>2</sup>

The US economy and the human beings it ought to serve are suffering, first and foremost, from a *jobs deficit*. Closing this gap – creating and facilitating the creation of good jobs -- should be the very top priority of Congress and the White House. At this point, it is not. Indeed, Republicans (enabled by President Obama) are currently doing what they can to make things worse.

The absurd squabble over the debt ceiling and the national debt is distracting, destructive, and almost entirely beside the point. The budget deficit is not the most pressing economic problem facing the US – not by a long stretch. Whatever comes of these negotiations, it will not address the jobs deficit, and it will not improve the lives of the overwhelming majority of US families. Indeed, it is likely to make things worse.

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<sup>1</sup> Sabrina Tavernise, “Recession Study Finds Hispanics are Hit the Hardest,” New York Times, 7/26/11.  
<http://www.nytimes.com/2011/07/26/us/26hispanics.html?ref=sabrinatavernise>

<sup>2</sup> See... Huffington Post, “Income Inequality is at an all-time high” (report on the work of UC-Berkeley Economist Emmanuel Saez). [http://www.huffingtonpost.com/2009/08/14/income-inequality-is-at-a\\_n\\_259516.html](http://www.huffingtonpost.com/2009/08/14/income-inequality-is-at-a_n_259516.html)  
Paul Krugman, “The Death of Horatio Alger,” *The Nation*, 1/5/04  
<http://www.thenation.com/article/death-horatio-alger>  
Joseph Stiglitz, “Of the 1%, by the 1%, for the 1%,” *Vanity Fair*, May, 2011  
<http://www.vanityfair.com/society/features/2011/05/top-one-percent-201105>  
Emmanuel Saez, “Striking it Richer: The Evolution of Top Incomes in the US,” 7/10/10  
<http://elsa.berkeley.edu/~saez/saez-UStopincomes-2008.pdf>

Let's be clear: the Republican approach to the economy and the budget is deeply misguided, wrong-headed, mean-spirited and irresponsible. Their approach is as familiar as it is appalling: more tax cuts for the rich; more tax cuts for corporations, and cuts in social programs, including Medicare and Social Security. This tack is unconscionable. It is also bad economic policy, that is, it will not promote growth and it will not create jobs. Nobel Prize winner Paul Krugman is exactly correct when he concludes that "the G.O.P... has gone off the deep end."

President Obama's approach is less troubling for sure, and clearly preferable to the appalling Republican strategy. But this is a very low bar. President Obama has, unfortunately, embraced the faulty premise that deficit reduction should be a top priority. As a result, the President is prepared to make substantial spending cuts at precisely the wrong moment – when the economy needs demand, and people need help. And, alas, Mr. Obama has demonstrated a disturbing willingness to pursue cuts in Medicare and Social Security.

An intelligent response to this crisis has to reflect an understanding of its causes. Cutting spending during a recession is like blood-letting an anemic patient, or invading Iraq in an attempt to disempower Osama Bin Laden.

### **Some good ideas and some bad ideas about the economic crisis, economic policy, and the federal budget**

1. *Cutting spending in the middle of a recession is a terrible idea.* It will destroy jobs, and undermine the economy's already feeble momentum. Intelligent spending -- extending unemployment benefits, block grants to states and municipalities, spending on green infrastructure, and keeping college affordable, for example -- will create jobs today, lighten the load of those who are in the most economic trouble, and facilitate growth and competitiveness in the long run. Serious, enforceable, well-funded efforts to liberate home owners from their enormous debt burden would help to re-ignite consumer spending and the housing market.

This is indeed the worst crisis since the Great Depression. *How did and why did the Great Depression finally come to an end?* After nearly a decade of mass unemployment (peaking at 25%), the US government increased its *debt financed spending* massively to pay for the War; that is, it ran enormous budget deficits. War spending put people to work; these newly employed workers spent their income, and this spending created jobs for others. In fact, during the war, the US economy suffered from *labor shortages*. The US government and corporations actively recruited women into professions and trades that had previously been off limits – women in large numbers “manned” the factories and shipyards.

An implication of this argument and this history is that *the primary problem facing the US economy is not the budget deficit.* Indeed, in the short run, *substantial budget deficits are likely to accelerate the recovery.*

The National Debt is often characterized as “a burden to future generations.” In fact, deficit spending – and the long run growth and opportunities that it can facilitate – can be *a gift to our children* and grandchildren. Debt financed investments today can leave them with a more prosperous, productive, sustainable economy, an economy that can provide them with educational, economic and personal opportunities that would not otherwise have been possible.

Notice, also, that, during a period of economic stagnation, budget deficits and government spending can be good for *business*. Rising demand means rising revenues, and this provides businesses with an incentive to hire workers. With adequate demand, it will be profitable for many businesses to increase hiring.

2. *The current debt ceiling “crisis” is utterly unnecessary; it is an irresponsible political maneuver by the Republicans.* Since 1962, the debt ceiling has been raised 74 times (including 18 times under President Reagan). With one exception – Newt Gingrich’s government shut down in 1995 – this has been trivial and routine. If Congress simply voted to raise the debt ceiling – allowing the Treasury to pay its bills, as it is mandated to do by the Constitution -- there would be no crisis. If the Republicans want to make changes in economic policy or shrink the federal government that is their prerogative. But this is not a reasonable or responsible way to make policy. It is especially irresponsible to make major decisions about the government’s long standing commitment to provide health coverage and minimal economic security to elderly Americans.
3. *The Republicans do not care about reducing the deficit.* Their objective is to cut taxes – especially for the rich – and dismantle what’s left of the New Deal. Indeed, they have a long history of enthusiastically supporting enormous budget deficits and squandering surpluses (see the presidencies of Reagan and George W. Bush). Representative Paul Ryan’s proposed ten year budget – which got *unanimous* support from House Republicans in April – proposes trillions in tax *cuts* (over ten years), cuts which will overwhelmingly benefit corporations and the rich. Note: tax cuts do not reduce deficits! Ryan’s plan also includes massive cuts to programs that benefit the poor and the middle class (most notably the gutting of Medicare and Medicaid). According to the non-partisan Congressional Budget Office (CBO), Ryan’s plan would reduce the deficit by \$155 billion over 10 years -- a meager \$15 billion per year. The Republican plan is rooted in politics, ideology, and mendacity. There is no evidence at all that it is rooted in a commitment to “fiscal responsibility.”
4. *Taxes in the US are extraordinarily low.* Taxes in the US are lower (as a share of GDP) than any other industrialized country. As a share of GDP, US corporate taxes are lower than every industrialized country but Iceland. Tax rates for corporations and the wealthy have fallen substantially over the past 30 years. In the three decades following World War II – when taxes on the wealthy and corporate profits were considerably higher -- the US economy performed better: higher average growth rates, lower average rates of unemployment, and a much more equal distribution of income. Tax cuts for the rich are unfair, and trickle-down economics – the notion

that giveaways to corporations and the rich will stimulate growth and employment – simply does not work.<sup>3</sup>

5. If political pressures compel us to focus on the deficit at this moment, *our first step should be to tax the rich more heavily*. Refusing to extend President Bush’s tax cuts (which will expire in 2013) for the top 5% income earners would raise government revenue by more than two trillion dollars over ten years. Spending cuts (if we must) should be back loaded – that is, they should occur disproportionately down the road, so that they do not undermine our efforts to get out of the current economic malaise.
6. *The US federal budget deficit (and the National Debt) is not analogous to overspending by a household*. The US government – despite a National Debt that is \$14 trillion and growing – will not go bankrupt. Budget deficits can be problematic for sure; but at this moment, the benefits of debt financed government investment overwhelm the costs. (More on this below.)
7. *Republicans have been working diligently to disempower the Government’s ability to regulate Wall Street’s excesses, and protect consumers*. Their current target is the brand new Consumer Financial Protection Bureau. If they are successful, another financial crisis is inevitable.
8. *This economic crisis is a devastating indictment of neoliberalism*, the free market ideology that has framed economic policy debates since Ronald Reagan. The financial meltdown of 2008 revealed (yet again!) that financial markets do not regulate themselves. The deep and ongoing recession that followed reflects the fact that depressed economies do not have a reliable mechanism for restoring full employment, prosperity and growth. The “Invisible Hand” cannot do it alone. In early 2009, many of us imagined that this ideology was on its last legs. Even Alan Greenspan – the once legendary Federal Reserve Chairman, the “Maestro” of monetary policy, and a devoted protégé of the libertarian icon Ayn Rand – acknowledged before Congress that the model on which his worldview and policy recommendations had been premised – the view that unfettered markets (including financial markets) are efficient and stable – had failed. Of course it had! How could anyone continue to argue that laissez faire works? How indeed! But bad ideas can be resilient – especially when they are promoted by well-funded think tanks.

## **The Logic of a Recession: What happened to all of the jobs?**

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<sup>3</sup> For wonderfully illustrative charts about this, see ...

Center for American Progress, “Ten Charts that Prove the US is a Low Tax Country,” 6/10/11  
[http://www.americanprogress.org/issues/2011/06/low\\_tax.html](http://www.americanprogress.org/issues/2011/06/low_tax.html).

Citizens for Tax Justice, “US is one of the least taxed countries,” 6/30/2011.

<http://www.scribd.com/doc/59076701/U-S-Is-One-of-the-Least-Taxed-Developed-Countries>

The catalyst to this current economic disaster was an unregulated financial system that ran amok – as unregulated financial systems inevitably do. Financial panics and crises are a chronic part of let-it-rip capitalism. If financial markets are not regulated adequately, this tendency will eventually manifest itself. The historical record is overwhelmingly clear about this.

The financial system crashed in October, 2008 – although the strains had been mounting for years. Major financial institutions failed; housing prices collapsed and foreclosures spiked; the Dow Jones Industrial Average fell by nearly half, and banks stopped lending money. Investors panicked – with good reason. Consumers, spooked by shrinking retirement accounts, plummeting home prices, layoffs, a pervasive sense of economic chaos and, of course, declining incomes, cut their spending. The US economy shed nearly two million jobs over the last third of 2008, and another four million in 2009.

The essential logic of a recession is not terribly complicated. When businesses experience declining demand, they shed workers (or decelerate hiring). These laid-off workers in turn cut their spending, because they must. In some cases, their increasingly nervous neighbors begin to reduce their spending also -- they put off buying a new car, taking a trip, or re-modeling the kitchen. This thus the process accelerates – car dealerships, airlines, hotels, and contractors (etc.) are forced to lay workers off. *These* newly unemployed workers spend less, and so on. Tax revenues fall, forcing state and local governments to fire teachers, cops, and to cut social spending when it was needed most. At some point, apparently healthy businesses begin to worry that their demand projections are overly optimistic; many decide to put off investment in plant and equipment. Because of this “multiplier” process, “shocks” to the economy have the potential to accelerate. According to a recent *Wall Street Journal* article:

The main reason U.S. companies are reluctant to step up hiring is scant demand, rather than uncertainty over government policies, according to a majority of economists in a new *Wall Street Journal* survey (Phil Izzo, “Dearth of Demand Seen Behind Weak Hiring,” *WSJ*, 7/18/11)

Insufficient demand explains the Jobs Deficit, not “high” corporate taxes, not regulation, not immigration, not “uncertainty” about taxation and regulation, not President Obama’s health care plan, nor his allegedly flawed leadership. Spending by the private sector – consumers and businesses – is not, at this moment, up to the job of ensuring full employment. So the government needs to provide demand.

The Federal Reserve can facilitate private spending (demand) by keeping interest rates low. The federal government can generate demand by (a) spending (including grants to strapped state and municipal governments); (b) working to reduce the debt overhang constraining homeowners, and/or (c) lowering taxes on the middle class and extending unemployment benefits (the middle class and the poor spend a greater share of their income, and so tax cuts for the middle class are more effective than tax cuts for the rich).

Again, the US economy emerged from the Great Depression because the Government spent like mad. “Future generations” (Baby Boomers, their kids, and their grandchildren)

benefited enormously from this debt financed spending, because they inherited a more prosperous, productive economy, an economy that provided them with educational, economic and personal opportunities that would not otherwise have been possible. Deficit spending – and the long run growth that it can facilitate – can be a *gift* to our children and grandchildren.

Let me be completely explicit: an intelligent response to this crisis will lead to *larger* budget deficits in the short term. Budget deficits and government debt are potentially problematic but, at this moment – as in 1939 -- the benefits of deficit spending overwhelmingly exceed the costs.

### **Burdening Our Grandchildren? Why a Smart Deficit is a Gift to Future Generations**

The commonplace assertion that budget deficits are a “burden to our grand-children” is both vague and deceptive, in large part because it fails to acknowledge that deficit spending today can – if done wisely – provide enormous benefits to us, our neighbors, our children and our grandchildren.

The US government finances its deficits (the difference between revenue and spending) by borrowing. Generally speaking, it borrows by selling bonds – which are essentially IOUs (with interest) from the US Treasury to bondholders (lenders). The Government borrows from many sources – individuals, pension funds, banks, foreign governments -- and it pays these lenders back with interest.

There is a tendency to think that borrowing is inherently problematic, that it implies that we are “living beyond our means.” But this is a dangerously narrow understanding of debt. Individuals borrow money all the time – to finance homes, cars, appliances, and college educations. Businesses borrow money to finance investment in equipment, technology, and research and development; many businesses have lines of credit with their suppliers, and this often works for both parties. Municipalities commonly undertake “bond issues” to finance school construction and other “capital” projects.

Sometimes, of course, borrowing is a bad idea. But borrowing can also allow a family, a business, or a government to make useful and/or productive purchases that otherwise would not be possible. Is borrowing a problem? *It depends on what the borrowing is for, and it depends on the capacity of the borrower to repay the debt.*

Government spending can improve the quality of our lives. Government spending pays for schools, environmental protection, parks and other public spaces, food and drug safety, public colleges and universities, fire and police protection, infrastructure, consumer protection, and health and income security in old age, to name just a few. Beyond the provision of these beneficial services, the government can create (and facilitate the creation of) jobs. When the economy is stagnant, an important benefit of borrowing is that it can lead to job creation.

So, we have a choice. We can limit the growth of the national debt by firing school teachers, cops, firefighters and mine inspectors; cutting health care coverage for the poor and

elderly; ignoring our long run energy issues, defunding our public schools, and forcing states to raise tuition at our public universities... *and* destroying millions of jobs. Or we can borrow money to support these services while, at the same time, preserving and creating jobs. The Republicans pretend that cutting the budget is a magic bullet – more jobs, and less debt. But this is utterly wrong.

In 1939, the US National Debt was about \$40 billion. By 1945, it had grown by a factor of *six* to \$259 billion dollars. The benefits of this borrowing were enormous. First, it allowed the Allies to defeat the Nazis (something that would have been more complicated if Congress were constrained by a Balanced Budget Amendment). Second, this debt financed increase in government spending facilitated economic growth and employment. The US economy was more productive by far in 1945 than it otherwise would have been. A rich country with a moderate debt burden is, by any reasonable measure, preferable to a moderately rich country with no debt. Deficit spending allowed the US to avoid six more years of massive waste – that is, unemployment. This was undoubtedly a very wise investment.

This does not imply that budget deficits are always wise. Again, it depends on what the government does with the money. For example, budget deficits soared under President George W. Bush. This stunning increase in debt was a terrible mistake, in my view, because the borrowing was used to finance massive tax cuts for the rich, and two expensive, ill-advised wars. (President Bush’s policies, by the way, have had a *much* larger effect on the deficit than President Obama’s time-limited fiscal stimulus.)<sup>4</sup> In contrast to Bush’s folly, borrowing for job creation and mortgage relief during an historic economic downturn is a good idea.

Government debt can be problematic, for sure, but it is *not* analogous to household debt. The US government will not go bankrupt – it has never missed a debt payment and, unless Congress impedes its ability to meet its obligations for political reasons, it never will. That is, the US government’s “capacity to repay” is enormous. No one who understands the basics of government finance believes that bankruptcy is an issue for the US government (although deficit hawks often *suggest* that it is, sometimes disingenuously, sometimes out of ignorance). The US government has run budget deficits in all but five years since 1961 (four of them under President Clinton). Sometimes it made sense, other times it did not.<sup>5</sup>

Why are budget deficits problematic? Deficits can cause inflation. They can also put upward pressure on interest rates, and these higher interest rates, by making borrowing more expensive, can restrict the accessibility of capital to businesses and households, which can be a drag on investment and growth. Over the long term, this sort of chronic under-investment can be substantial, as can its effects on our living standards down the road. (For the wonks and/or economics majors among you, economists refer to this as “crowding out,” as in government

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<sup>4</sup> For a breakdown of deficits under Bush and Obama, see... James Fallows, “The Chart that Should Accompany all Discussions of the Debt Ceiling,” *The Atlantic*, 7/25/11. <http://www.theatlantic.com/politics/archive/2011/07/the-chart-that-should-accompany-all-discussions-of-the-debt-ceiling/242484/>

<sup>5</sup>See also the short appendix to this essay, “The National Debt is not like your credit card debt”



borrowing may *crowd out* private borrowing and investment). It is worth worrying about, for sure.

The “good news” is that, in this depressed economy, interest rates are extraordinarily low. Inflation is also a minor concern; indeed “deflation” is arguably a greater threat.<sup>6</sup> At this moment in time, borrowing is especially easy and cheap because there are lots of potential investors sitting on big piles of cash and, further, in a depressed economy there are relatively few attractive alternatives – especially for risk averse investors.

All of this is to say that the potential benefits of deficit spending during a recession are great – it is by far the most effective way to address the jobs deficit; and borrowing can help us to deliver the goods and services on which many Americans depend, especially during a recession.<sup>7</sup> And at this moment in history, the “costs” of the deficit – its potential effects on inflation and interest rates are all but non-existent.

When the economy recovers sufficiently– when the Jobs Deficit has been resolved -- relatively large budget deficits will probably no longer make sense. But until then, cutting spending is a terrible idea. I repeat: cutting spending during a recession is like blood-letting an anemic patient. The Republican “jobs program” starts with massive dismissals of teachers and other public sector employees. That won’t work.

The content of this spending is important, of course. A detailed proposal is beyond the scope of this short paper. This said, it is clear that Congress should pass another economic stimulus package – several hundreds of billions of dollars at least. This package ought to include generous grants to state and municipal governments, investments in green infrastructure, urban jobs programs, extended unemployment benefits, and more generous financial aid for poor and middle class college students. Readers who are interested in what this might look like should look at Robert Pollin’s excellent “18 million Jobs by 2012.”<sup>8</sup>

The great John Maynard Keynes was (and is) right: unregulated, let-it-rip capitalism is prone to financial crises; capitalism has no reliable mechanism for resolving a jobs deficit, and the free market generates intolerable levels of inequality. In contrast, the Republican Party, the Neoliberals, the “Efficient Market” theorists and other fetishizers of “The Market” are wrong. Please spread the word!

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<sup>6</sup> For an excellent critical assessment of the “costs” of deficits, see...  
Robert Pollin, “Austerity is not a solution: why the deficit hawks are wrong,” *Challenge*, Nov/Dec, 2010.  
[http://www.peri.umass.edu/fileadmin/pdf/working\\_papers/working\\_papers\\_201-250/WP235.pdf](http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_201-250/WP235.pdf)

<sup>7</sup> Paul Krugman, “No, We Can’t? Or Won’t?,” *New York Times*, 7/11/11  
[http://www.nytimes.com/2011/07/11/opinion/11krugman.html?\\_r=1&ref=paulkrugman](http://www.nytimes.com/2011/07/11/opinion/11krugman.html?_r=1&ref=paulkrugman)

<sup>8</sup> Robert Pollin, “18 Million Jobs by 2012,” *The Nation*, 2/18/10, <http://www.thenation.com/print/article/18-million-jobs-2012>

## Appendix: The National Debt is not like your credit card debt

A government that issues bonds (i.e. borrows money) denominated in a currency that (a) it has the power to create and (b) is recognized as a reliable currency, does not need to worry about default (as a household or business does).

The US Treasury can borrow from a long line of willing lenders, who are happy to lend to the US government because there is so little risk. Indeed, raising the debt ceiling is important because it might undermine investors' confidence that US government bonds are essentially risk free. At this moment in time, borrowing is especially easy and cheap because (a) there are lots of potential investors sitting on big piles of cash and (b) in a depressed economy, there are relatively few attractive alternatives – especially for risk averse investors.

Unlike households and businesses, the US government has no problem finding lenders because (a) it has the authority to tax and (b) it has the authority to create money and thus (c) it has little trouble finding willing borrowers. When investors have lots of other alternatives, the Treasury will likely have to pay a higher interest rate on its debt. But, again, they can always find a borrower.

And further, about half of the US debt is owed to the Federal Reserve, which buys government bonds (i.e. lends to the government) with money that it *creates*. The Fed does not literally “print” money, but it does create it -- essentially out of thin air. If I had the authority to tax my neighbors and, in a pinch, to print dollars, my credit limit would be higher.

This story generally surprises and troubles my students, in part because they have a notion that “printing money” leads to “hyperinflation.” As noted above, deficits can indeed cause inflation, and overly exuberant money creation will surely make inflation more likely. Thankfully, the Board of Governors of the Fed understands this, and so the Fed uses its power to create money with caution; indeed, sometimes too much caution. The proof of the pudding is in the data: over the past 30 years – during which time large deficits been common, and the Fed has routinely used its power to “monetize” debt (by creating money) – inflation has been low and stable (in 2009 prices actually fell slightly; in 2010, the inflation rate was 1.6%).

I understand that this can be a little hard to accept – creating money to facilitate a government's borrowing *appears* to be irresponsible and unsustainable. But in the US case – and for most of the world's rich countries -- it has not been a problem.<sup>9</sup> In fact, it has played a key role in facilitating prosperity and growth over the post-World War II era.

I also understand that “money creation by the Fed” feeds into a theme in the Conservative narrative. Governments spending without limit! Creating money out of thin air! Imperiling future generations (and the value of the *dollar*)! I accept this intellectual discomfort – but this does not change the fact that these concerns are essentially unfounded and wrong. And this understandable misunderstanding should certainly not be the basis of economic policy – any

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<sup>9</sup> I do not mean to imply that Fed policy is beyond reproach – that is not the case at all. The Fed's errors in recent years have been abundant and often consequential. My point here is more limited: the creation of money by the Fed has not led to excessive inflation.

more than discomfort with Darwin should lead schools to teach our kids that the earth is six thousand years old. That is an essay for another day.

The US national debt is also different from the “foreign debts” that have regularly thrown many countries into financial and economy crisis (forcing many of them to run to the IMF because they are unable to pay their debts). These debts, generally, are denominated in dollars and other hard currencies. Banks (and the IMF) require repayment in hard currencies. A government in hock to Western banks cannot raise the money it needs by taxing its citizens; nor does it have the power to create dollars. And these “limitations” make it harder to attract private lending on reasonable terms. In cases like these, default is a very real and dangerous possibility.

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**A few excellent sources of information and commentary on the economy:**

Center for Economic and Policy Research: <http://www.cepr.net/>

Citizens for Tax Justice: <http://www.ctj.org/>

Economic Policy Institute: <http://www.epi.org/>

Political Economy Research Institute: <http://www.peri.umass.edu/>