The US Fiscal Dilemma: Stimulus is Needed, Austerity Means Doom
By Jeff Madrick

When the US financial crisis triggered the Great Recession that afflicted much of the world in 2008-2009, policy makers in the US and elsewhere clearly understood that their economies needed massive stimulus measures, and fast. But with US employment still weak and Europe mired in a debt crisis, why has the focus now shifted to deficits when further stimulus is what is required?
Jeff Madrick argues that the US risks ignoring the lessons of the Great Depression in the 1930s and making things worse, not better.

JOHN KENNETH GALBRAITH, rarely an optimist, believed that a Great Crash was likely to be repeated once those who lived through the 1929 collapse retired. But he did not believe another Great Depression would occur because of the Keynesian lessons learned from the experiences of the 1930s, World War II and economic growth in the post-war period. Today, however, almost every rich country has been doing exactly the opposite of what those lessons suggest. They are cutting government spending despite slow growth, high unemployment and likely recession. The policies are bound to make matters worse. The profound question is why the human race repeats colossal errors time and again.

In discussing the fiscal dilemma and potential tragedy of the United States, which has sadly adopted a version of austerity economics in the face of stagnation, it’s important to understand that American leaders believe they have been much wiser than their counterparts in Europe. In President Barack Obama’s administration, the 2008 Troubled Asset Relief Program (TARP), the massive easing by the Federal Reserve and the $800 billion stimulus sponsored by Obama, stand as the policies that turned the nation around. TARP plus Fed Chairman Ben Bernanke’s policies stopped the crisis from spiraling completely out of control. Treasury Secretary Timothy Geithner is right that the euro zone, as of this writing, has not been able to do that.

But the US administration seems to have abandoned the stimulus ship. There was another minor stimulus plan but little more. TARP may have saved Wall Street banks but it provided virtual-ly no relief to homeowners under water and has not re-started the US housing market. Business lending also remains weak. That TARP actually made the Treasury some money proved nothing. It should have made it much more—as great a return as, say, Warren Buffett earned by buying preferred shares of Goldman Sachs.

In fact, earlier in 2011, Geithner praised Prime Minister David Cameron’s budget stringency in Britain at around the same time that he was bragging about America’s 2008 stimulus measures. Now, like doctors of old, Cameron sees that his austerity plan is making the patient even sicker, so he is bleeding him even more. American GDP did perform better than Europe’s overall in 2009 and for much of 2010, but the unemployment rate in the United States soared much more rapidly and has recovered at a far slower rate than in the past. In a speech I heard Geithner give in high praise of TARP, he ignored the poor employment performance.

I bring up the last point because it goes to the heart of the matter about the failure of economic policy in the United States under Obama. As evidenced by its policies and public pronouncements, the administration did not seem to realize there was an employment crisis until this September, when Obama at last presented a serious jobs plan, if one over-weighted with tax cuts rather than new spending programs. There was and remains hope that the administration may get its “mojo” back. But it has consistently overestimated economic growth, based on the views of Obama’s original economics team. Geithner is the last of those still standing and, according to press accounts, Obama’s main go-to person on economic matters.

In fact, Obama has been excessively worried more about federal deficits than about jobs growth since the day he took office — and even a few days sooner. Before his inauguration, he announced that he intended to cut the deficit in half and said that he would hold a summit that February about how to do so. Keep in mind that this was the start of 2009, a time when the America economy had already collapsed. A year later, he organized a special commission to come up with a plan to balance the budget over 10 years. By then, the budget deficit had soared, not due to government spending other than defense, but because of what came to be called the Great Recession along with the Bush tax cuts, Obama’s own stimulus (the deficit effects of which have since petered out) and the cost of the wars in Iraq and Afghanistan. He placed a conservative Democrat, Erskine Bowles, and a very conservative Republican, Alan Simpson, in charge of his budget balancing commission.

Meanwhile, the Republicans remained remarkably united against any tax increase to close the budget gap. Like stubborn children, many signed a one-page pledge to Grover Norquist, the leader of a powerful anti-tax foundation, Americans for Tax Reform, never to raise taxes. They have paralyzed the government in the process. But the important point is that Obama rode the deficit-hawk train, with a brief exception in late 2010, from the start, consistently emphasizing cuts in government spending over job creation. He hardly defended his own stimulus plan in public. Thus, America has been deprived of a serious, bipartisan public discourse on economic policy for three years — at least until early fall when the president announced his jobs plan. The powerful mainstream media simply went along, refusing to think independently, as if the paltry public conversation under way encompassed all reasonable alternatives. The House of Representatives has even taken up a balanced budget amendment to the US Constitution that would require draconian, socially damaging cuts to the federal budget. It is being taken seriously.
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STIMULUS IS A DIRTY WORD

Obviously, taxes could be increased in other areas, or there could be modest cuts to some government programs, in order to arrive at the same result. But making this doubly tragic is the advent of austerity economics. The United States, like much of Europe, refuses to stimulate the economy in the midst of worldwide weakness.

Technically speaking, the American recession ended in the middle of 2009. But this is misleading. The employment situation is simply a mess. In the late fall of 2011, there were seven million fewer jobs, according to the Bureau of Labor Statistics, than there were in late 2007 before the Great Recession began. There are some 25 million people unemployed or unable to get full-time jobs.

In light of this, still more aggressive policies by the Federal Reserve and a major stimulus program are required. The Fed is hesitating. And Congress and the president are utterly paralyzed. The reason is that Republicans are united against any tax increase. Reversing all the Bush tax cuts? Forget about it. For the most part, they won’t even budge on taxes on the rich, who, the Congressional Budget Office recently reported, now earn about 20 percent of all personal income in America, up from 10 percent 30 years ago. The share of income for the remaining 80 percent has fallen significantly. Some Republicans may back off from their pledge to Norquist, but their constituencies seem to support this view. Norquist has basically threatened them with a highly financed campaign to unseat them in the next election if they drop the pledge.

But Obama has not offered an adequate counter-offensive. As noted, early in his administration he joined the anti-government spenders. Even his April budget deficit plan was more conservative than centrist plans. He would have arrived at a stable debt-to-GDP ratio by cutting two dollars of spending for every one in tax raises. A plan to bal-

BACK TO REALITY

Let’s return to the hard facts about America’s economy and its fiscal situation. The deficit today is not the main problem, restoring growth is. We can take the projections by the Congressional Budget Office (CBO) of US government debt as a general guideline. The CBO expects to see budget deficits in the range of 6 percent of GDP a year if the US economy recovers significantly. By 2021, the ratio of debt-to-GDP in America would reach 95 percent. But the alarmists usually cite projections farther out to frighten their audiences: by 2030, debt would rise to nearly 140 percent of GDP and then in the 2040s, it would really take off to 210 percent or so of GDP. The latter would be unmanageable, even to the most liberal commentators.

Let’s take these numbers apart. As noted, what drove the American deficit to 10 percent of GDP were the Bush tax cuts of the early 2000s, spending on the two wars, and the Great Recession itself, which cut tax revenues sharply. Spending on Bush’s drug plan for the elderly adds costs as well, but they taper off. The Obama stimulus also, as noted, tapers off, adding to the deficit only in the near term. Moreover, the stimulus undoubtedly kept the economy from sinking further, so its net addition to debt may be closer to zero.

At the risk of over-emphasizing the point, Social Security and Medicare do not drive the deficit over the next 10 years. The Bush tax cuts become a much higher proportion of the deficit as we continue out, as does interest on the debt. I am not sure the United States cannot handle a debt-to-GDP ratio of 90 percent. But there is general agreement that if debt is stabilized at around 70 percent, it can handle that. Such a goal by 2021 would require getting the deficit down to 3 percent of GDP and keeping it there. That would achieve “primary balance,” as it is called — budget balance before interest costs. Ironically, Obama’s budget proposal made in the winter of 2011 would basically get us to primary balance without cutting from Social Security. So would completely reversing the Bush tax cuts, with no cuts to entitlement programs.

The alarmists, meanwhile, cite the longer-term numbers. But these are almost entirely driven by higher Medicare and Medicaid costs due to expected rising healthcare costs more than by an aging population. Social Security is always lumped with Medicare, but shouldn’t be. Social Security payments, to be pushed up by the aging population plus slow wage growth among younger contributors (who therefore now pay in less), are expected to rise to 6 percent of GDP from slightly under 5 percent today. That can be handled with small cuts in benefits and modest increases in payroll tax rates. There need be no benefit cuts at all. It should be kept in mind that Social Security is hardly a generous retirement system. The average benefit is $14,000 a year, and the proportion of a beneficiary’s wage income to be replenished has been falling dramatically under changes enacted some time ago.

Medicare and Medicaid are another story. They will rise together from 5 percent of GDP to 9 percent by 2030 and to nearly 14 percent by 2040. Add interest to that and the deficits and total debt do become alarming. But we are talking about a healthcare problem of enormous proportions here, not simple Medicare reform. In fact, any significant cuts in Medicare to compensate for the rising costs would merely result in reduced coverage for seniors. If seniors went into the private system, these reforms would dramatically drive up total medical spending in America, placing the burden on the elderly, many of whom would simply go without coverage. This is triage.

LOOK AT THE BIGGER PICTURE

But alarmists are focused on the short-term deficit, and this myopia is pretty darned close to a tragedy. It will slow an already inadequate economic recovery and probably make producing a primary surplus harder. The first option among the alarmists is almost always Social Security cuts. Yet such cuts will add little to long-term stability. Always, alarmists avoid the elephant in the room — truly reforming America’s appallingly inefficient healthcare system. They would also make cuts to Medicare, ignoring the fact that Medicare costs per patient have risen significantly more slowly than costs per patient in the private system.

As noted, the deficit over the next 10 years could be stabilized at 3 percent of GDP, and total debt stabilized at roughly 70 percent of GDP, if the Bush tax cuts for all, not just those who earn over $250,000 a year, were reversed. In other words, if America went back to the rates under President Bill Clinton, we would have no problem over the next 10 to 15 years. Perhaps we could then focus on reforming healthcare, the much more urgent task.
The current level is 8.6 percent, but this may have been distorted by Christmas hiring and also a one-month drop in those looking for jobs. But he also may be able to scare voters into believing that any Republican president will tears to shreds their Medicare and Social Security. He would not necessarily be exaggerating.

The failure of the famed Congressional “super-committee” to come to an agreement to cut the budget by $1.5 trillion has also given him an opening. Having done nothing, he is now demanding the passage of the payroll tax cuts he proposed for his jobs plan, and Republicans are at last shying away from opposing every Obama program. The president is also insisting the cuts be financed by a tax on the wealthy. Many Republicans remain stubbornly opposed to this and say the payroll tax cuts must be financed by reductions in government spending. The Republican ranks are breaking down, however.

The rich nations stand on a precipice. People talk about facing a lost decade. It may well be a lost generation. Ironically, it is clear what to do. But human beings, ruled by emotion or some base instinct, do seem doomed to repeat the past. The best way to restore fiscal balance is to get the economy to grow. Nations with surpluses should stimulate sharply; nations with deficits should wait to consolidate their finances. But even a Democratic president in the United States does not fully embrace this position. How did we get here?