

A World Upside Down?

Deficit Fantasies in the Great Recession

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On the twelfth of June, 1812, the forces of Western Europe crossed the Russian frontier and war began, that is, an event took place opposed to human reason and to human nature.
Leo Tolstoy, War and Peace¹

Abstract

This paper analyzes the arguments and evidence in current debates about the government budget deficit. We critically examine claims put forward by Rinehart and Rogoff, the International Monetary Fund, and others about the dangers of rising debt to GDP ratios. We also scrutinize assertions by Alesina and Ardagno that cutting deficits is likely to be stimulatory. Our analysis of the U.S. budget outlook leads to surprising conclusions. We highlight the unheralded acknowledgement by the Congressional Budget Office in August, 2010, that financial assets held by the government should be netted out of U.S. debt calculations. This step takes the US further away from any hypothetical danger zone and should be a yellow flag to shrill warnings of danger from U.S. deficits. Our analysis of threats to the budget finds that not entitlement spending or Social Security, but the excessive costs of oligopoly in health care and defense spending play a large role in current concerns. So does the contingent liability of another financial crisis. In an era of unbridled money politics, concentrated interests in the military, financial, and medical industries pose much more significant dangers to U.S. public finances than concerns about overreach from broad based popular programs like Social Security, which is itself in good shape for as many years as one can make credible forecasts. The paper also examines two hypothetical scenarios: One involving a growth inducing public investment program and another, more pessimistic scenario in which underemployment equilibrium is allowed to persist for several years. From those scenarios we conclude that the risk to U.S. public finances, as measured by the debt/GDP ratio in 2020, is much greater on a trajectory of austerity than from any risk incurred by the very low public cost of borrowing to spur investment in infrastructure, education, and science that would generate large social and private gains in productivity.

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You don't need to be a great novelist or dispirited by the futility of war to start worrying when leaders in one country after another give every sign of losing their bearings in the face of looming catastrophe. Earlier this summer, in the midst of the greatest economic crisis since the Great Depression, economic policy turned upside down. Instead of promoting recovery and expanding employment, central banks and political elites suddenly focused on cutting budget deficits and raising interest rates.

Forget the famous "conservative counterrevolution" in policymaking since the late nineteen seventies - the break with past practice is real and dramatic. Save for a handful of exceptions, like Margaret Thatcher and, far more equivocally, Ronald Reagan, from the end of World War II until a few months ago, even conservative governments threw in the towel when they saw the Invisible Hand waving goodbye. At that point, instead of just cutting interest rates and waiting for Godot, policymakers would swallow hard and sigh. Following ritual dances of purity, they would directly expand aggregate demand by a mix of public spending, tax cuts, and subsidies to big business, while taking care that that premature monetary tightening did not choke off the upturn.²

These short lived triumphs of "Keynesian" realism over free market fundamentalism also compelled policymakers to call off long running crusades to whittle away unemployment benefits. In fact, governments were often forced to broaden jobless assistance, at least for a while. From the late seventies onward, countries embraced such emergency policies with more and more reluctance. But when the economy really tanked, they pursued them nonetheless - even in right thinking bastions of economic orthodoxy like Germany as late as 2009.³

The declaration that accompanied the 2009 G20 summit in Pittsburgh stood squarely in this tradition. The only surprise was that the summiteers dispensed with atonement rites and frankly admitted what they were doing - doubtless a reflection of how deeply the financial crisis had tarnished the prestige of conventional economics: "We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that when growth returns, jobs do too. We will avoid any premature withdrawal of stimulus."⁴

At the Toronto summit in early July 2010, though, all this suddenly became, in the legendary words of Richard Nixon's press secretary, "inoperative." The G20 radically changed course. Leaders decided to act as if prosperity were just around the corner. Endorsing calls for macroeconomic austerity promoted by Germany, the

European Central Bank and the International Monetary Fund, the group abandoned focusing on employment in favor of curbing deficits, raising interest rates, and reeling in special central bank programs for monetary ease.⁵

Backsliding is certain. We don't for a minute believe that many countries will meet the summit goal of cutting their deficits in half by 2013 - for reasons that Herbert Hoover and a succession of hapless German Chancellors in the 1930s all eventually came to appreciate: Trimming deficits in the face of feeble growth in incomes is a futile exercise in chasing a moving target, as tax collections fall off with declines in national income. Indeed, signs of revolt are cropping up around the globe: the U.S. central bank's recent switch to "quantitative easing" and talk of similar policies in the U.K. and Japan are plainly inspired by anxiety that the new austerity is already out of hand.

Still, the post-Toronto line is not just smoke and mirrors. The world appears to be on the cusp of a "Great Inversion" of almost Tolstoyan dimensions. The small, mortally-threatened countries stretching along Europe's new "crescent of crisis" from Ireland through Iberia to Greece are taking chainsaws to their budgets, and powerhouses like the UK, France, and Germany are doing the same. And while governments hack away at expenditures, the Governor of the European Central Bank, financial market spokespersons, and aspiring politicians take turns deriding each new round of cuts as insufficient.⁶

The oddity is that the U.S. has joined the parade. In the run up to Toronto, the Obama administration championed a globalized version of St. Augustine's famous appeal, "Lord, make me pure, but not yet": It sought economic expansion in the rest of the world to offset the contraction in the U.S. rate of economic growth. In its heart of hearts, the administration almost certainly still prefers this scenario. But in Toronto it signed on to austerity.⁷

With short term interest rates near zero and the Euro crisis sending the dollar higher and thus dashing hopes for an export revival, the White House quietly embraced a version of Toronto Lite. In the face of polls showing overwhelming public opposition, it is grimly plugging a special bipartisan National Commission on Fiscal Responsibility and Reform (hereafter: the "Deficit Commission") to consider cuts in Social Security and other programs. The commission itself is overweighted with deficit hawks and shadowed by some obvious conflicts of interest. Its staff is paid in part by private interests long associated with attacks on Social Security. Its report, carefully timed for a lame duck session of Congress, is due at the beginning of December, 2010. Thanks to an unheralded proviso inserted into legislation

by Democratic leaders, the U.S. House of Representative has committed itself to vote on the Commission's regulations if the Senate does like wise.⁸

Altogether less predictable and more striking has been the administration's approach to a series of budget issues. All through the spring and early summer, it tiptoed away from proposals to extend unemployment benefits and help states stave off mass layoffs of teachers, police, and social workers as their fiscal years turned over, which for most happened on July 1st.

Both notions represent core Democratic Party values and neither has any implication for long term deficits, because they represent one time emergency responses. But, stunningly, for many months, the White House and the Congress froze at any mention of the word "deficit." Democrats and Republicans took turns dragging their feet in the face of what even administration staffers conceded was a half-hearted presidential push.² As it became clear that the November elections were likely to become a Democratic counterpart to Napoleon's retreat from Moscow, the President finally jumped in - but only on behalf of extending unemployment benefits through the end of November, when the election would be safely over. In June, aid for the states, even for promised reimbursements of Medicare expenses, was allowed to die. Economists at Goldman Sachs estimated that the lost funds might subtract up to a three quarters of a percentage point from the growth rate through the rest of the year.¹⁰

Later, as bad economic news piled up and election polls became ever gloomier, the President and Congressional Democratic leaders relented. They mobilized and finally passed a bill providing for both the reimbursements and emergency aid to the states. The latter was quite modest - despite its passage analysts estimate that more than 360,000 workers will lose their jobs by the end of next summer.¹¹ And the legislation was supposed to be "deficit neutral," which it might actually be - much of the money came out of the food stamp program, now stretched by rising demands from homeless and out of work Americans.¹²

With interest rates virtually at zero, the ability of the Fed and other central banks to refloat the economy by further cuts in interest rates is limited, whatever hopes one entertains for "quantitative easing" in monetary policy. In this context, the White House decision to throw in with the rest of the G20 risks amounts to repeating the Roosevelt administration's historic mistake of cutting government spending after the 1936 election, this time on a world scale.¹³

Right now the global economy is adjusting to three big new shocks: the Euro crisis, a slowdown in China (which

pulls down economic growth in many other countries), and the ebbing of the administration's original, truncated stimulus. The three together probably add up to a bigger blow than the U.S. or the world economy can comfortably absorb right now. Banking systems in America and Europe are still choking from bad loans that indulgent banking regulators pretend not to see. Regulators continue allowing bankers to blow earnings on bonuses and lobbying against financial regulation, instead of writing off bad loans and shoring up bank capital. As a consequence, the developed world's financial system resembles Japan's in the nineties. It is destined to be "deleveraging" - that is, reducing total lending - for a long time and, in the U.S., at least, socking consumers with all manner of steep new fees.¹⁴

Nor is this all. The world financial meltdown triggered by the decision to let Lehman Brothers go bankrupt burned up the retirement savings of millions of people around the world, while decimating pension fund holdings. Markets for housing, which in the U.S. and some other countries represent a major form of savings by ordinary people, have almost dried up, supported only by inflows of money from governments and central banks. As evidence mounts that many mortgage lenders never bothered to fill out the paperwork on mortgages they sold, prices of U.S. houses seem likely to spiral down further, inflicting more punishment on both consumers and the banking system.

Here and elsewhere, high unemployment and contracting consumer credit guarantee that many consumers will not soon start spending again, either. As Richard Koo of Nomura Research Institute in Tokyo, an expert on Japan's "lost decade," has argued, many private businesses are likely to remain mired in a "balance sheet recession," preferring to use their positive cash flows and profits to continue paying down debts and shunning new investments. A recent attempt to quantify the amount of corporate "deleveraging" still facing American corporations is sobering: the study suggested it could be more than a decade before the process ceased for U.S. non-financial corporations.¹⁵

To the extent that the Euro crisis holds down the currency's value, a floor under incomes in that region should exist - or at least Germany's, as long as the financial system does not collapse or the Fed's quantitative easing policy succeeds in sending the Euro right back up. And exchange rates keyed to the dollar can safeguard export shares of many Asian countries. But both stratagems are literally "beggar thy neighbor" policies. They simply rob Peter to profit Paul and do nothing to expand total world demand. The world as a whole cannot devalue against itself and a sharp, sustained depreciation of the U.S. currency is likely to

depress the rest of a world, which still depends heavily on sales to American consumers.

The scale and duration of the human misery this quagmire implies is almost beyond reckoning. Almost 15 million people in the United States are unemployed right now. Millions more are either subemployed or have become so discouraged that they have dropped out of the labor force and thus are no longer counted as “unemployed.” A whole generation of young people is being reduced to begging for chances to work free in “internships” in hope of getting a foot inside doors that are otherwise slammed shut. Crusades to cut back Social Security threaten to remove a basic prop to the living standards of millions of people who first lost their savings in the financial crash and then paid with their taxes to bail out the financial system. And the Obama administration’s reluctance to extend aid to states means further deadly rounds of state cuts are inevitable. Just as in the Great Depression, these will neutralize federal efforts to stimulate the economy. They will also lay waste to enormous amounts of public capital built up over many years by the states, especially in their educational systems.

Why, then, have so many leaders in business and politics, even in the United States, suddenly become fixated on the new twin terrors of deficits and inflation?

Financial Deregulation and Keynesian Economic Policies

In some countries, local factors are plainly important. Given the gigantic sums spent on rescuing the U.K. financial sector, weaknesses in the British economic position, and the collapse of “New Labor,” anyone could predict that pressures to cut the budget would intensify there.

But in the U.K and most other countries, the fiscal and monetary about face is also rooted in broader changes in economic structure. One in particular is paramount: Over the last thirty years, in country after country, the very largest financial institutions grew to gigantic size. Their size and complexity made them literally too big to fail, as the decision by U.S. regulators let Lehman Brothers fail taught the whole world. But many of the giants also became too big to bail, in that rescues required plenary shares of national budgets and even, in some cases, national income.¹⁶

Only now are the implications of this towering fact coming to be appreciated outside of financial markets. But careful studies of bank stock prices show that markets grasped the key point much earlier: From the summer of 2007 forward, fears multiplied that one or more big banks might fail. Share values of the largest

banks fluctuated with perceptions that other emergency claims on national resources might empty national treasuries of the funds required to bail out the giants. That is, while financial bailouts (on favorable terms to the banks, which most were) had positive effects on bank stock prices, wider deficit spending packages drove big bank stocks down relative to the market as a whole.¹⁷ Here was a form of “crowding out” beyond the imaginations of both Keynesians and free market enthusiasts: the need to preserve financial resources for a contingent fund that would be available for further bailouts was killing the Keynesian revolution in economic policymaking.

Over the last thirty years, the biggest U.S. banks had swelled to enormous size. But so had the national economy. The Bush administration’s blank refusal to put forward any stimulus package and the small size of the Obama administration’s stimulus plan are consistent with such pressures, but the relevant research has not as yet been done. By contrast, the evidence for Europe and some other countries is quite strong: increases in government deficits pushed down bank stocks.¹⁸

In the early stages of the crisis, however, powerful political and economic counter pressures worked against immediate austerity. In an earlier paper we showed that higher average voting turnouts and the strength of socialist parties significantly influenced national policies toward bank bailouts.¹⁹ It was surely no accident that the British Labor government led the international campaign that embarrassed the Bush administration into convening the G20.²⁰ The surge of popular enthusiasm and hope that carried Obama into the White House further militated against immediate austerity, as did outrage over the rescue of the large banks and pressures from other parts of big business.

But once the combination of public money, loan guarantees, and regulatory forbearance stabilized financial sectors in the short run, the political balance quickly shifted. The brittle consensus in favor of demand expansion unraveled, in the face of a new wave of peripheral defaults threatening banks in the developed world. In late 2009, Dubai World, a state owned corporation, sought a moratorium from its creditors on interest payments. With markets reeling, neighboring Abu Dhabi stepped in and bankrolled a rescue. With financial markets on edge, anxiety about Greece triggered a broad sell off of the debt of other small countries in the Eurozone. The tardy, grudging responses of the European Union and the European Central Bank transformed a bad situation into a new crisis, heightening concerns about debt loads of both the private and public sectors.

But debt selling problems of the smaller European countries can account only in part for the wave of hysteria that is breaking over the U.S. or, for that matter, larger European countries. While the subject is too big for this paper, it seems plain that the European Central Bank and the Eurozone as a whole could resolve their crisis if the political will for enhanced integration existed. Despite the swelling size of European bailouts, there is little evidence that financial markets think that the crisis is likely to mortally threaten the solvency and credit ratings of most major European countries. Indeed, it is precisely the strong credit ratings of Germany and other major European countries on which rests the AAA rating of the new European Union bailout fund.²¹

When investors as a group fear default or inflation, interest rates rise. In particular, long term interest rates skyrocket. In the jargon of finance, the “yield curve” – the array of interest rates stretched out over time to maturity – steepens. If anxieties about inflation in the next couple of years are minimal, but markets are seized with fears for the more distant future, then rates rise at once on longer term bonds, making the yield curve very steep indeed.²²

But in the U.K., Europe’s other largest countries, and the U.S., yield curves are not steepening to any significant degree. On the contrary, despite some gyrations that are plainly traceable to fears about the U.S. Fed’s quantitative easing program and the Euro crisis, interest rates in most of these countries remain at or near historic lows. The Bank of England, for example, recently lowered short rates to the lowest level since 1694, while UK long term rates are nothing remarkable. Germany and France also have no trouble issuing longer term debt; indeed, German long term debt is selling at its lowest rates ever. The case of the United States is clearest of all: short rates are virtually at zero, while long rates have steadily fallen, to the obvious discomfiture of deficit doomsayers and inflation hawks. Corporations have rushed to issue new, long term debt, with a few corporations and countries even successfully issuing 100-year bonds.²³

Yet Alan Greenspan, European Central Bank governors, and many economists who kept claiming that bubbles in housing markets were impossible to perceive before 2008 and who still insist that policy is helpless against such developments now rue a bubble in government bond markets. Some also profess to foresee catastrophic inflation just ahead – never mind the blatant contradiction between what actual yield curves say about future rates of inflation and their faith that markets reflect available information. With the media hanging on these policymakers’ every word, as though it were still 2005, the result is a public discussion about

deficit reduction uncomfortably reminiscent of the propaganda campaign that prepared the way for the U.S. invasion of Iraq.²⁴

Conjectures, guesses, cherry-picked examples, and bold hypotheses are swirled together with striking, but perilously incomplete data, to produce potted narratives that are simple, powerful, and – at first sight – compelling, but which have not received nearly the critical scrutiny they should.

Consider, for example, what is perhaps the most widely touted claim of all – the assertion by economists Carmen Rinehart and Kenneth Rogoff that growth rates fall off in countries with levels of government debt to GDP above 90%.²⁵ Their claim derives much of its authority from the luster of their recently published historical survey of financial collapses. There is no question that this work is immensely valuable for the wealth of data it assembles. The authors’ many gifts as analysts are also plain. But while their book is a great achievement, it is a long way from being the definitive history of financial crises that some analysts declared it to be.²⁶

Its treatment of some major crises, including the German crisis of 1931, arguably the most fateful of all, for example, is cursory. And, as Rinehart and Rogoff themselves observe, many of their data series are incomplete or uneven, stitched together from what admirers like ourselves would hail as the pioneering extrapolations of other scholars. Nor does it help that while the book is out, the data are not, so that critical assessments are possible only if one is conversant with their data sources.²⁷

The data unevenness creates unique pitfalls in regard to the United States. Rinehart and Rogoff’s warnings about U.S. deficits lose a great deal of force when one realizes that for most countries they analyze, they rely on measures of debt held outside the government – “net debt” in economic jargon. For the U.S. and Canada, though, they use “gross debt,” which includes claims held by parts of the government on each other, such as the government bonds held within the Social Security system. That number towers much higher.²⁸ Using it makes little sense – if you want to understand a family’s financial position, you need to net out Mom and Dad’s loans to each other or the kids, not add them up with the outside debts.

The much touted 90% rule, though, is not in the book; it comes from subsequent articles.²⁹ And never mind confusions of gross with net debt, their case for the “rule” is completely unpersuasive. Part of the problem is that, like many other papers purporting to derive lessons relevant for U.S. deficit policy, they adopt an “Ellis Island” approach to statistical panel design. They jumble

big and small countries together, sometimes from different eras, into a single dataset.

This is exhilarating on first reading, but it is too broad a gauge to guide policy reliably. For the U.S., the number of really useful historical and comparative cases is much smaller, because of its unique situation in the world economy. Even in a globalized economy, for example, the U.S. economy stands out for its sheer size. Smaller economies, by contrast, frequently bob like corks on waves generated by their larger neighbors. Drawing policy lessons from samples replete with such cases is likely to be misleading. The true effects of the small fry's policy choices get lost in the backwash of policies adopted by their bigger neighbors.

Many deficit hawks, for example, rush to cite the apparently beneficial effects of fiscal consolidation in Canada in the 1990s. But the Canadian economy's outperformance in that period also reflected the tidal pull of the U.S. bubble economy. Raising taxes and cutting social spending in Canada was important for upper bracket taxpayers and the poor there, but the influence of the U.S. boom is obvious.³⁰

Political choices in smaller countries also frequently reflect external factors. Many things happen, not because anyone in the country wants them to, but because outside forces – foreign multinationals, larger neighbors, eccentric billionaires, kleptomaniac rulers, or even hierarchal structures in the international system – e.g., military alliances leading to wars, etc. – compel them. When economic policies reflect such forces, spurious causal inferences readily follow. Some U.S.-supported Latin American dictatorships, for example, surely protected the position of economic elites in those countries at the expense of economic growth that would have benefited the whole population. To help keep social peace, or simply please insistent militaries, some of these countries piled up debts. The true lesson of such cases is nothing so simple as high debt to GDP ratios hold back growth rates.

This problem is first cousin to the broader problem of “reverse causality” highlighted by Paul Krugman. He observes that the causal relationship might well run “largely” from “growth to debt rather than the other way round.” Krugman explains that “That is, it's not so much that bad things happen to growth when debt is high, it's that bad things happen to debt when growth is low.” He cites the U.S. as an obvious example of this pattern:

This is definitely the case for the United States: the only period when debt was over 90 percent of GDP was in the early postwar years, when real GDP was falling, not because of debt problems, but because wartime

mobilization was winding down and Rosie the Riveter was becoming a suburban housewife. It's also clearly true for Japan, where debt rose after growth slowed sharply in the 1990s. And European debt levels didn't get high until after Eurosclerosis set in.³¹

Issues about the direction of causality, however, are not the only, or even perhaps the major, challenge to Reinhart and Rogoff's 90% rule. The obvious, outstanding fact about the U.S. today is that it is not only a big country but a global financial center. And the plain fact is that financial centers, whose currency is widely desired outside the country, occupy an entirely different space from everyone else when it comes to handling deficits.

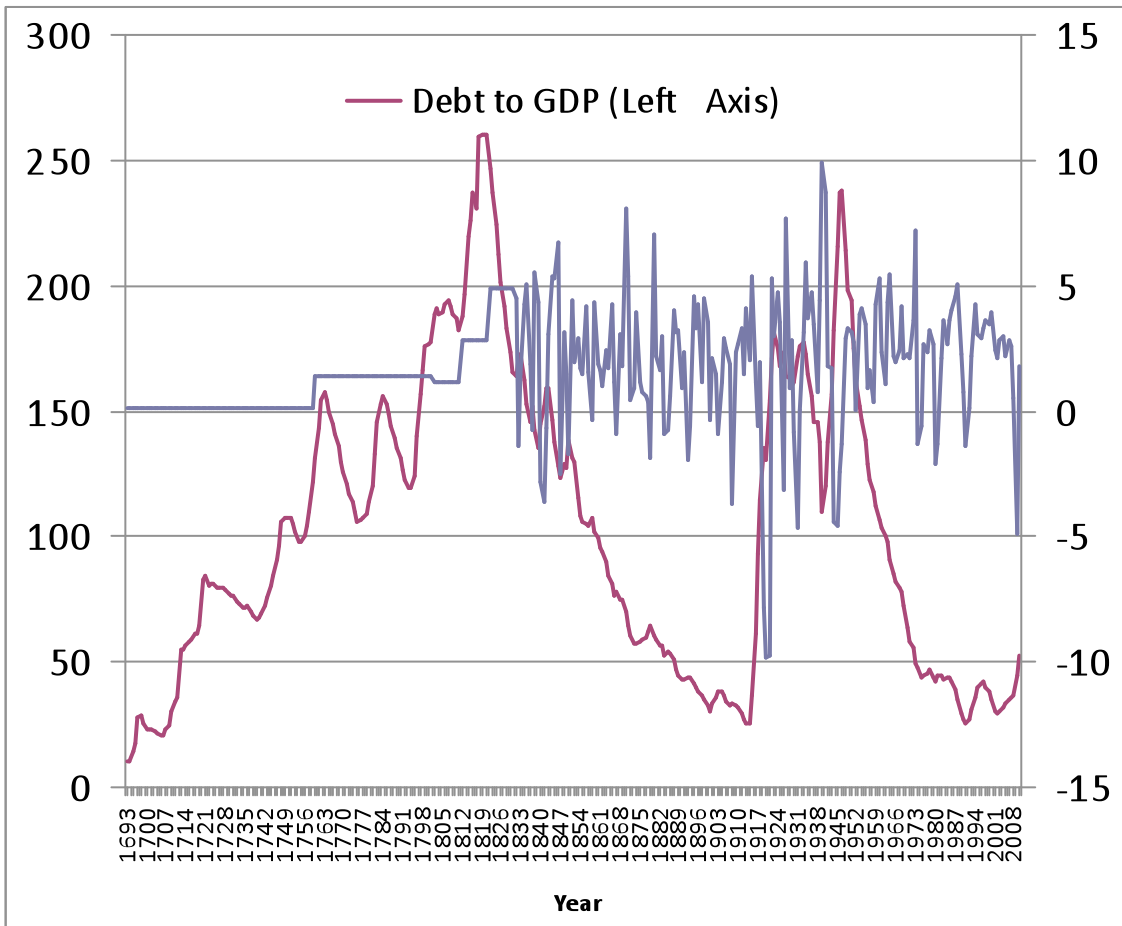
The U.S. issues debt in its own currency. Its situation thus differs sharply from, say, Greece, which cannot issue Euros to pay its debts or from small countries which typically borrow in dollars, not their own currencies. For a country in the situation of the U.S., default in a strict sense simply cannot happen. No matter what the Chinese or anyone else does with their dollars, the U.S. cannot run out of them. As we will see below, this does not mean that the U.S. can limitlessly issue debt without eventually suffering adverse consequences, but it does mean that the usual Halloween scenarios are fairy tales.

For now, however, the key point is that in assessing the 90% rule, historical cases involving financial centers merit especially careful review. Besides the U.S., there has really been only one other in the last three hundred years: Great Britain.

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The British record is disastrous for Reinhart and Rogoff's claim. Figure 1 plots the UK debt to GDP ratio since 1694, along with rates of economic growth.³² Regardless of where you stand on the endless arguments about exactly when the Industrial Revolution began (or even whether there was one), or whether war time demands for finance possibly crowded out some private investment from time to time, the facts are clear: The British economy forged ahead decade after decade while carrying far higher ratios of debt to GDP than Reinhart and Rogoff's magic number.³³

Figure 1
 Britain Industrialized With Rates of Debt to GDP Far Higher Than 90%



Rate of Growth (Right Axis)

Source: Christopher Chantrill, http://www.ukpublicspending.co.uk/downloadmult_ukgs.php?year=1692_2015&state=UK&view=1&expand=&units=p&fy=2010&chart=FO-total&bar=1&stack=1&size=m&color=c&title=

The point can be put even more forcefully: the UK made its epochal breakthrough to industrialization - leaving the rest of the world far behind - while carrying a debt load that should have crushed it, not only in the eighteenth century, but many decades into the nineteenth. And it was precisely as the debt to GDP ratio soared that the rate of growth finally picked up.³⁴ Of course, British debt levels through most of the twentieth century remained almost as high because of expenditures run up for World Wars I and II.

Why does this pattern go unremarked by Rinehart and Rogoff? Part of the answer is simple: In their paper announcing the 90% rule, they start their UK data series with 1830. It is true that British GDP data for the period before then are surely less reliable, but they are certainly no worse than the data for many other countries in the paper. The pre-1830 data were also good enough for the book, which did reference them.³⁵

One might respond, as many deficit hawks do when talk turns to the glorious postwar booms in both the U.S. and the UK, that those mountainous deficits were incurred during wars. So they were. But so what? The excuse that growth in the face of debts run up in wartime somehow shouldn't count against the 90% rule makes little sense.

Suggestions that wartime debts did not hobble the economy because they were broadly accepted across all levels of society rest on misconceptions. It is perhaps true that in the wake of a "national-patriotic" struggle for survival, which is how most Brits and Americans experienced World War II, citizens might be less likely to succumb to temptations to default or inflate the debt away, though weighty historical counterexamples exist. But few, if any, earlier British wars resembled World War II in that respect. We doubt that even World War I did by its close, which is presumably decisive for debt policy. Eighteenth century wars, with their impressment gangs,

taxes and other discomforts for average citizens, were widely detested among both the middle and lower classes. While some episodes in the Napoleonic wars might qualify, whatever “national feelings” those struggles generated almost certainly did not survive the Peterloo Massacre and other repressive measures enforced by a succession of British governments that eventually drew scorn from even literary types fashionable in high society, such as Shelley and Lord Byron.³⁶

One might respond that once the war was over, budgetary baselines and trends no longer embed projections of continuing war, so debts can be consolidated at lower cost. But this is hardly persuasive. Firstly, many treaties of peace in world history have simply punctuated a whole series of wars and both bankers and strategists recognized it. Certainly that was the case in the 18th century and, indeed, the Napoleonic period, with, for example, the ill-fated Treaty of Amiens displaying a half-life approaching that of an atomic particle. Indeed, even World War II represents such a case, since the war’s end was followed almost immediately by the onset of the Cold War, with vast new demands for military spending. In the end, our view is that either there is an empirical claim about debt to GDP ratios or there isn’t. If a debt consolidation can whisk away the effects of, say, a debt to GDP ratio of 225%, there is something wrong with the whole approach.

A simple question of Krugman’s should finish off any notion that war or peace are critical factors in debts’ effects: In wartime, much of the money goes to pay for junk that will ultimately be left rusting on some battlefield. Why is that supposed to be so much better for the economy than producing useful things via deficit spending?³⁷ That Britain flourished for decades with debt to GDP ratios of over 200% is therefore devastating to Rinehart and Rogoff’s claims.³⁸

The British case, however, raises other pointed questions for deficit hawks today. The most common case against government deficits rests on their alleged effects on interest rates.³⁹ Deficits are supposed to push interest rates higher, because the government competes with private business for scarce capital. Higher interest rates mean less investment, and thus lower rates of growth. The implication for rising debt to GDP ratios is straightforward and we have seen it defended by at least one Nobel Prize winning economist: They are supposed to drive up rates in the long run, as investors demand higher returns as prospects for repayment darken, either because growth slows or public sentiments for default intensify.

The British experience, though, suggests that fears about interest rates are overblown, at least when a country is the financial center of the world. Eighteenth century usury laws may have led to credit rationing instead of surges in interest rates, so studies that focus on the level of rates may miss evidence of credit stringency.⁴⁰ As Figure 1 indicated, British debt to GDP ratios towered far above 90% for decades in the eighteenth century, reaching stratospheric levels during the Napoleonic Wars. They remained far above 90% for decades after 1815, when even staunch defenders of wartime crowding out do not suggest that high interest rates chronically hampered economic growth. Yet Bank Rate, the Bank of England’s basic interest rate, stood at 4% in 1716. In 1719, it rose to 5%. It remained there until 1822, when it was lowered to 4%. Throughout the rest of the century, the Bank of England allowed the rate to fluctuate. But rates remained generally very low, rising sharply only during periods of extreme crises – and never for long. After 1815, Bank Rate touched 10% for one month during the Crisis of 1857, before falling back to 3% only three months later. To be sure, comparisons between the US now and the UK then are necessarily precarious, but the conclusion has to be that British interest rates simply did not behave like many deficit hawks believe they should have. Rates stayed close to earth in the face of levels of debt to GDP several times larger than in most advanced economies today.⁴¹

Not to be deterred, the indefatigable International Monetary Fund has produced several studies of its own claiming to show that high GDP ratios clip growth rates. They have the merit of making serious stabs at sorting out the direction of causality and influences from unobserved variables. But they also have a fatal flaw. Their guiding idea is to trace how increases in debt to GDP ratios affect growth through time. But all their samples begin in 1970 and run forward to the recent past. They thus coincide almost perfectly with the rise of free market fundamentalism in the West.⁴²

This was precisely the period in which central banks either threatened or actually did raise interest rates (or refused to lower them) when parliaments declined to chop budgets as business leaders and central bankers thought they should or, especially in Europe, when trade unions refused to agree to wage cuts.⁴³ (American readers may recall the media frenzy over whether the incoming Clinton administration’s proposed budget cuts would be enough to satisfy Federal Reserve Chair Alan Greenspan and induce the Fed to cut interest rates.⁴⁴) These IMF works simply ignore the large literature that relates slow growth to high interest rates in advanced countries. They fail to consider how a pattern of such threats, even if not invariably carried out, might paralyze investment. For sure, the stop/go pattern the IMF studies find are exactly what one would expect given

what is known about central banks' preferences for budget cuts, but this testifies more to the role ideology and politics play in central bank behavior than any effect of rising deficits on growth.⁴⁵

Taking Away the Cake and Eating It Too

Republican Senator Arthur Vandenberg famously advised President Harry Truman that if he wanted to generate public support for a vast new program of aid for Greece and Turkey he would have to "scare hell out of the American people."⁴⁶ Alarms about deficits killing growth suggest that policymakers in the U.S. and elsewhere still borrow from Truman's playbook. But in an age which celebrates extravagant self-indulgence in its movies, news, and ads, some economists have begun to promote a different line: That angst about the political and economic costs of budget cuts and tax rises – fiscal "consolidation" or "adjustment" – is way overblown.

In a series of papers, Alberto Alesina and colleagues have argued that countries can have their cake and eat it, too, because cutting deficits does not necessarily cause aggregate demand to fall. Instead, they assert, by some kind of black magic whose nature is simply hypothesized, rather than clarified, "large" and "decisive" cuts in public spending fire up the energies of the private sector, leading to an economic expansion. For this reason, they also argue, sponsoring such policies is not even that risky for politicians' reelection chances.⁴⁷

Not surprisingly, these "something for nothing" claims have thrilled New York Times columnist David Brooks and other commentators.⁴⁸ But their enthusiasm is valuable mainly for pointing up how a conservative media establishment exploits serious and original, but still speculative, academic work to manufacture worthless political arguments by ignoring fine print.

The basic idea behind Alesina's most recent major study, with Silvia Ardagna, is surely a good one: To survey what actually happened in many countries over a generation when governments actually cut budgets or raised taxes in "major" ways. The pitfalls in such efforts are well known; they arise from the need to translate into statistical terms outcomes and processes that are fundamentally institutionally specific. Politics and economics intertwine in strange ways and sometimes with lags. Often something goes pop because of a dramatic shift in the midst of deep crises, but on other occasions it does not – changes instead reflect the cumulative impact of seemingly tiny events or shifts in political coalitions that occurred several years before. Margaret Thatcher's victory in 1979, for example, was a pivotal moment in UK policies toward deficits, regardless of what size of budgetary tightening followed immediately. Roughly the same appears to be true of the

year 1982 in Dutch politics, though that switchover involved far less acrimony and drama and differed importantly in its distributional consequences.

It thus bothers us, as it bothered Paul Krugman, that some famous examples of fiscal adjustments in Japan, the UK, and other countries do not make Alesina and Ardagna's list.⁴⁹ It is also worrisome that perhaps the most successful fiscal consolidation of recent history – the literal erasure of the U.S. deficit during the Clinton years – did not qualify for their roster of successes.⁵⁰ But these are just reservations, albeit ones that Brooks and other enthusiasts should have noted. Alesina and Ardagna's decision to pick a swing of 1.5% of GDP as the threshold for a "large" change in fiscal policy is surely reasonable, as is their idea of seeing what happens over a maximum of four years later and benchmarking policy successes by whether they pushed down debt to GDP ratios by at least 4.5%.

Real jokers start cropping up, however, when one takes a close look at what they count as successful examples of "growth" in the wake of the big budget cuts. They eschew the obvious, commonsensical standard: Did the country's own growth rate slow down or accelerate after it downsized its deficit? Instead, Alesina and Ardagna take refuge in a definition that is highly technical and very curious. It gives a good part of the game away: Basically, it turns on how the country fares relative to the rest of the OECD, not on the change in its own growth trajectory. If a country cuts its budget and growth falls sharply, but it still succeeds in growing faster than three quarters of the rest of the OECD, they hail the country for producing growth via budget cuts!

This is Alice in Wonderland math. It provides no real support for magical effects on growth from budget cuts. Standard postwar "Keynesian" doctrine recommended that economies that appeared to be growing at an "unsustainable" pace – one that was likely to produce bottlenecks, shortages, or, perhaps, inflation – should be cooled down by throttling back government spending if raising interest rates was awkward or impossible. No one ever suggested that such cases infringed any tenet of Keynes' about the key role of aggregate demand. And shrinking debt to GDP ratios when growth is simply slowing down from unsustainable levels is radically different from making further cuts in aggregate demand at the bottom of a recession – the difference for public life is night and day.⁵¹

Such cases comprise at least three of the nine cases between 1970 and 2007 which Alesina and Ardagna instance as those in which policymakers squared the circle and not only engineered fiscal contraction with growth, but also succeeded in reducing debt to GDP ratios by 4.5% of GDP in the longer run. But the budget

cuts did not produce the growth - it was already in train - and they were not what made cutting the deficit so easy. That was accomplished the old fashioned way, by paying down deficits out of revenues from growth, just like the U.S. and Britain did after World War II.⁵² In the other six cases on their list, a recent paper by Jayadev and Konczal shows that every one posted positive rates of growth in the year preceding the budgetary consolidation, so that while these others may not have been booming, they were far from comparable to the U.S. now, which is in deep recession.⁵³

Their tortured definition of “growth” is not the only problem with Alesina and Ardagna’s list of winners. Every country on it is a small, open economy, where performance, as we have seen, is hugely affected by external forces. Such economies, in particular, can often compensate for fiscal contractions by currency devaluation, or simply let strength in the world economy elsewhere offset falls in domestic demand by increasing exports.

After 1970, alas, bungled efforts at financial deregulation put all too many countries into situations where falling exchange rates stimulated exports for a while. The basic plot is drearily familiar: First, governments gave in to pressures from financial and business opinion and threw open financial markets. Deregulation attracted huge inflows of hot money. This drove up the exchange rate and killed exports, while fueling a financial bubble. Eventually the bubble burst, leading to tumescent increases in debt to GDP ratios as states were forced to bail out their banks. As exchange rates fell back to more normal levels, exports surged while the country struggled to get its finances under control. Exchange rate depreciation played roles in the success of at least two countries on their list, Finland in 1998 and Sweden in 2004, while strong world demand for exports also benefitted the Netherlands as its growth rate came down from high levels in the manner described earlier.⁵⁴

Performance of small economies frequently hinges on the fates of a handful of large firms or dominant sectors that are anything but representative of other economies. Both budgets and economic growth in Norway, for example, are strongly affected by the heavy weight the petroleum industry pulls there. When oil prices or production are up, as they were in 1979, 1980, and (locally) in 1996, Norway’s public finances can hardly help improving. But the three cases Norway supplies to Alesina and Ardagna’s list (one of which also qualifies as a clear case of growth deceleration as described above, since 1996 was, as Statistics Norway commented, a “golden” year in the Land of the Midnight Sun) shed little light on how to shrink deficits in less fortuitously circumstanced economies.⁵⁵

That leaves only the two New Zealand cases of 1993 and 1994 left from Alesina and Ardagna’s list. Though New Zealand is plainly a small, open economy, it does not appear to have benefitted materially from prior devaluations or oil price windfalls or even world demand for exports. In neither year, however, was it in recession, as mentioned above. But its value as a successful case of “something for nothing” is even more limited: Comparative studies suggest that New Zealand’s big drop in its debt to GDP ratio coincides with a sharp decline in its relative economic performance vis-à-vis nearby Australia, which, until 1993-94, it closely tracked.⁵⁶

If one steps back and surveys Alesina and Ardagna’s data as a whole, the weakness of their case stand out in bold relief. Set aside all questions about New Zealand, and the other seven cases they reckon as successes. Now just ask the obvious question that a citizen or politician who had any choice would before embarking on the austerity route to budgetary consolidation: What are the chances that the policy will work? That is, actually reduce the deficit while also stimulating growth?

The striking fact that emerges from their tables is the meager number of successes. They indentify 107 separate cases of major fiscal contraction in the OECD between 1970 and 2007. Only 26 of these 107 qualify by even their Rube Goldberg definition as leading to “growth.” Now also set aside all qualms about definitions and whether countries were booming or in recession when they started cutting the budget. Just focus on the overarching pattern: Only nine of those “growth” cases actually achieved major reductions in debt to GDP ratios. That shouts out a demoralizing result: that 92% of the time countries tried fiscal contraction, it did not lead to growth with big reductions in debt to GDP ratios. We are not surprised that even a recent IMF study has now repudiated Alesina and Ardagna’s core argument.⁵⁷ As Ireland is now discovering, the royal road to reducing debt to GDP ratios runs elsewhere. Arguments that current levels of debt to GDP profoundly threaten future U.S. economic growth are mere assertions crying out for empirical evidence. They should carry no weight in national policy debates.

The Deficit “Problem”

If no magic number yokes together debt to GDP ratios and growth rates, at least in large, developed economies, and claims that budget cuts stimulate aggregate demand are the twenty-first century’s equivalent of the Laffer Curve, then how should one think about deficits and, more broadly, the Toronto Consensus?

Our discussion begins with some cautionary notes. Firstly, the absence of a magic number has a paradoxical implication for debates about fiscal sustainability. If high debt to GDP ratios are not necessarily toxic, then it also follows that lower levels will not offer guaranteed protection. In theory, at least, a country could get into trouble at almost any level of debt to GDP. Waiving cases where the level of debt is insignificant, that is the conclusion we squeeze out of the variegated histories of debt and crises produced by Rinehart and Rogoff, Marc Flandreau, Charles Kindleberger, and other economic historians.⁵⁸

The reason is straightforward, though economic historians customarily hurry past the evidence: Debt crises are not purely economic events. Virtually all crucially involve political factors.⁵⁹ The relation between the politics and the economics is typically complex. The political party considerations and factional rivalries that entrance most historians are invariably linked with dense networks of investor, firm, and sectoral interest groups. The parties and these investor blocs normally interact with broader, mass-based interest groups, in contexts suffused with ideologies of varying ages and tendencies. If the state structure is also complex (e.g., federal rather than centralized, parliamentary rather than presidential, etc.) then the variations can become Byzantine. But our guess is that if a valid 90% rule is ever discovered to hold for debt crises, it will refer to the way short run political and economic factors combine to trump long run economic considerations: When none dare call it reason and political stalemate develops, then rising debts or slow growth can trigger crises at even comparatively low levels of debt to GDP, as Spain is just now discovering. Conversely, as long as the political system continues grinding away – either because, like Great Britain for most of its history, it is dominated by financial interests in coalition with other business groups or because it balances social groups successfully through institutionalized compromises – then even very high rates of debt to GDP will be shrugged off, as long as grandiose policy failures (such as losing wars) do not discredit the regime.

This “unsafe at any speed” quality to debt build up makes it important to underline just how disastrously off course debt crises can propel countries when they do occur. We are mightily impressed by the devastation that ensues when governments cannot roll over their debts. Especially when real depreciations of the currency are involved, such disasters typically have far reaching political consequences, almost invariably involving huge shifts to the political right. In more than a few instances, they have shattering consequences for society as a whole.

Some analysts have recently questioned whether a country the size of the United States could actually confront such an event. They argue that banks have no alternative to buying the debt of the government if cash is legal tender and they want a return on their reserves. Some versions of the argument add cheerfully that the U.S. currency’s continuing predominance in the world economy precludes damaging runs out of the dollar, allegedly for lack of better alternatives. We do not share this confidence. This experiment has been run. Its results were discouraging. In 1978-79, long before the Euro and at a time when the Yen was heavily regulated – in other words, under conditions probably far more favorable for the dollar than today – the U.S. endured a genuine dollar crisis. The sharp rise in interest rates this precipitated sent shockwaves around the world. Life for most Americans and citizens of many other countries immediately became markedly worse. For many, especially in the Third World, it became almost unendurable for years.⁶⁰ We do not doubt that such crises are possible or that taking reasonable precautions against them is the height of wisdom.

But the shrill claims of looming disaster advanced by proponents of the Toronto Consensus are pathetically overblown. For centuries, the consensual herald of impending disaster was the appearance of a truly spectacular comet. Listening to deficit hawks, one would think that the giant recent upward lurch in U.S. deficits and debt to GDP ratios – most of which reflects the impact of the financial crisis and not “exploding entitlements” – amounts to the Great Comet of 2010, portending all kinds of woes.

This is silly. We have already observed that evidence from financial markets, notably the yield curve for U.S. government debt, points strongly in the other direction. But given the clamor about an impending financial Armageddon, it is worth tracing the case in more detail. Most discussions of U.S. debt take the Congressional Budget Office’s studies as their point of departure. For reasons explained below, we are skeptical of parts of the CBO’s analysis. It is not obvious why the agency’s figures are to be preferred to, for example, the Office of Management and Budgets, at least when the latter reports to presidents who are, in the famous words of a Bush administration spokesperson, fundamentally “reality based.” But the CBO is formally non-partisan and its studies, in sharp contrast to some IMF presentations, almost invariably report “government debt held by the public.” This statistic consolidates the holdings of the Social Security Trust into one figure along with the rest of the government’s own debt. If one then subtracts financial assets the government holds from its financial liabilities, the result is “debt held by the public net of financial assets,” which is the economically appropriate figure to worry about.⁶¹

Deficit superhawks often get carried away. They throw around many other numbers with blind abandon. Popular websites and, on occasion, some official sites, including the IMF, occasionally post “Gross Debt.” This double counts U.S. government bonds held by the U.S. government in the Social Security Trust. As observed previously, the practice is roughly like failing to net out loans parents make to each other or their children in calculating the family’s external debt position. Some bank analysts argue for including all the debts of Freddie Mac and Fannie Mae. We are more sympathetic to this, but doing it right would not take the critics very far down the road they want to go: The two giant Government Sponsored Enterprises (GSEs) certainly hold many mortgages that are underwater and destined to fail. But they also hold an enormous number of mortgages that will eventually pay off in full or in significant part. Rolling their gross debts into the usual government net debt figures thus ridiculously exaggerates the dimensions of the problem.⁶²

We think the same is true of proposals to treat all state and municipal debts as future liabilities of the federal government. There is no question that some states and cities face acute funding problems, though many of the most celebrated cases owe as much to the economy’s disastrous cyclical condition as to mismanagement. And if the government does nothing to stimulate the economy, many more will face problems in the future. But plenty of remedies exist for these problems short of federal government assumption of their debts. The recent demand by the Securities and Exchange Commission for adequate disclosure by the New Jersey state pension fund, for example, will go far to fixing the problem if the SEC does not back off.⁶³ And there is time, because the looming issue is commonly pensions.

We are equally skeptical that it makes sense to roll other vast “contingent liabilities” into published federal government deficit totals. Contingent liabilities are financial claims that the federal government has agreed to guarantee, so pleas that they should be included appear on the surface to make sense. But contingent liabilities are mostly quite different animals from the entries in regular governmental debt accounts. Analysts classically distinguish guarantees of liquidity from those involving basic solvency; the suggestion is customarily that the former are fairly safe, but the latter are risky. But this distinction mostly slides past the realities of modern national income theory. As the discussion below will show, the state of aggregate demand and the growth rate of the economy over time fundamentally determine how many and what kinds of contingent liabilities the government is forced to take on. Depending on what you assume about these drivers, realized contingent liabilities – the total that will have to be made good – will vary wildly. Swelling deficit estimates by piling on worst

case scenarios are more rhetorical steps in some political argument than exercises in economic analysis. We are struck, for example, that deficit hawks who exuberantly pile on hypothetical liabilities from state pension funds and such typically pass over any mention that the biggest unfunded liability the federal government is likely to face sometime in the future is probably the bill for yet another banking crisis, given the inadequacies of recently enacted financial reforms.

The Congressional Budget Office is right to concentrate on basic budgetary numbers and forego chasing wild hares. We, accordingly, take their work as our point of departure. As mentioned previously, however, we do this with some qualms. Of late the CBO has been almost insouciant about its calculations of federal government “net debt.” The agency routinely issues its own estimates of federal government finances. It also frequently analyzes White House proposals. But for all its vaunted independence and non-partisan character, in recent years it has taken to subtly promoting alarmist accounts. It has puffed both Rinehart and Rogoff’s 90% rule and Alesina and Ardagna’s “something for nothing” approach.⁶⁴ Since it, like other federal agencies, is ultimately financed by taxpayers, we have the rather odd circumstance that the people’s funds are being used to propagandize the press and the people.

The propaganda and the projections recently combined to manufacture an intimation of impending U.S. financial mortality out of whole cloth. The CBO’s March analysis of the Obama administration’s proposed budget for 2010 (including its proposals to sunset the Bush tax cuts for the top 2% of high income Americans) turned heads by publishing deficit projections that had the U.S. reaching the magic 90% level of debt to GDP by 2020 in the event the President’s proposals were enacted. The announcement had a predictable effect: a rolling wave of handwringing and cries of impending doom that also pumped up the 90% threshold.⁶⁵

In mid-August, 2010, however, when official Washington sinks into a seasonal Bermuda Triangle where news announcements vanish without trace, the CBO issued a reanalysis of its “baseline” budget projections from now until 2020. Buried without notice in one table is an entirely new row of figures that subtracts out from the CBO’s earlier published figures for net debt, as should have been done all along, many financial assets owned by the federal government that are not held by the Social Security Trust. The correction is huge, amounting to a drop in the projected debt to GDP ratios of about 8% of GDP!⁶⁶ The CBO has yet to revise its estimates of the impact of the President’s program. But the size of the adjustment that it now needs to make is obvious from the new baseline forecast.⁶⁷

The ubiquitous 90% figure has since reappeared in a New York Times editorial, but the frisson over an imminent slide of the U.S. economy into a Night of the Living Dead is entirely chimerical.⁶⁸ A faulty estimate of net government debt became a story because a bad economic theory that the CBO was promoting (along with the IMF) made a non-fact suddenly look significant.

Our Table 1 displays the magnitude of the difference. The first two columns compare the CBO baseline budget projection, as slightly revised in August 2010, with the revised figures taking account of the U.S. government's financial assets.⁶⁹ The third column

displays the differences between the first two, which are substantial. The fourth column shows the CBO's March estimates of the impact of the President's program; these figures also should be adjusted by the amount of the government's financial assets that the CBO at last recognizes. This can be approximated by simply marking down each entry in the estimates of the President's budget by the corresponding figure in column 3. Enacting the President's fiscal program would not in fact push the US across the mythical 90% threshold. In 2020 the U.S. would be operating within the range of debt ratios at which other large countries function successfully right now.

Table 1
Projections of CBO Debt to GDP Ratios Compared

Year	Base Aug	Net of Fin Assets	Diff Base and Net	CBO Pres Bud March	High Growth	Low Growth
2009	53.02%	45.90%	-7.10	53.00%	53.02%	53.02%
2010	61.58%	54.10%	-7.50	63.20%	60.41%	61.58%
2011	66.06%	59.40%	-6.70	70.10%	63.63%	66.06%
2012	68.45%	61.40%	-7.10	73.60%	65.11%	68.45%
2013	68.37%	61.10%	-7.30	74.80%	65.31%	69.84%
2014	67.29%	60.00%	-7.30	75.70%	64.64%	71.47%
2015	67.33%	60.00%	-7.30	77.40%	64.08%	73.25%
2016	67.74%	60.40%	-7.30	79.60%	63.65%	75.00%
2017	68.07%	60.70%	-7.40	81.80%	62.95%	76.62%
2018	68.31%	60.80%	-7.50	84.30%	61.95%	78.10%
2019	68.82%	61.10%	-7.70	87.10%	61.03%	79.80%
2020	69.42%	61.50%	-7.90	90.00%	60.10%	81.56%

The conclusion has to be that if nothing else changed and the Bush tax cuts were extended for everyone except the Superrich (i.e., the top 2% of American income earners) as the President proposes, the skies are unlikely to fall. Quite possibly nothing would happen in markets for U.S. debt - a conclusion these markets appear also to have reached, as previously observed. The endlessly repeated claim by deficit hawks and the media that not just the rich, but all Americans need to pay much higher taxes to make a real dent in a debt that has mounted to dangerous proportions is a gross exaggeration.

But there is more to be said. First of all, there are some grounds for suspecting that the situation is even more favorable than the revised CBO estimates suggest. When one looks beneath the hood of its January projections, several assumptions it makes look problematic. The rates of productivity growth the CBO assumes is perhaps a bit low by recent historical standards. This is of real importance. If you raised

productivity or made other adjustments to increase the economy's rate of growth by one-half of one percent above what the CBO assumes, the cumulative effects over 10 years are substantial. Already relatively benign debt to GDP ratios turn even more auspicious, as the "High Growth" column indicates.⁷⁰ (This column, too, should properly be adjusted by subtracting the financial assets, just like the CBO's estimate of the President's budget, so the actual debt to GDP figures would all drop further.⁷¹) For comparison, we include a final column that estimates the effect of lower growth rate, of which more later in the paper.⁷²

By contrast, the CBO's treatment of unemployment rates raises more complex questions, with implications that cut both ways. The CBO forecast has unemployment sitting on a plateau at very high levels until 2013, whereupon it drops steeply, arriving at 5% by 2015. The agency takes the latter figure to represent full employment, which it then projects to remain unchanged all the way to 2020.

We have deep misgivings that the 5% figure represents anything more than a convention with regard to the true rate of “full” employment in the U.S. economy. But that is for later; right now, the important question is whether the 5% figure can possibly be consistent with the rest of the CBO’s projections. The assumption of a relatively swift return to full employment reduces deficit estimates in later years, since tax revenues swell mightily with rising employment levels. But the CBO assumes inflation rates of 2% in those years of “full employment,” along with short term interest rates of 5%. As several analysts have noted, the combination is hard to justify.⁷³ Nobody doubts that the Federal Reserve controls short term interest rates – quibbles about what happens when it pays interest on bank deposits as it does now can be set aside. But short rates that high can arise only from the Fed’s concern about inflation – which the 2% assumption rules out. Higher rates run up interest costs on the debt, which inflates deficit projections.

Raising the question about unemployment, however, brings up a more ominous possibility. The recent sunburst of publicity about the “new normal” may in part represent a public relations campaign designed to lower popular expectations, but it points to something real. We are persuaded by research indicating that recoveries from financial crises take far longer than the average cyclical upswing; and we are convinced that the U.S. economy is undergoing structural shifts.⁷⁴ Our best guess, accordingly, is that U.S. unemployment rates are destined to remain very high for a long time. If not brought down by vigorous government action, higher rates of unemployment will increase outlays for unemployment and social welfare, while squeezing state finances still more. The deficit will thus swell beyond projections.

Conservative economists and business analysts are also waging a campaign to convince the Federal Reserve that “full employment” should be redefined upward to perhaps 7 to 7.5 percent.⁷⁵ If that campaign succeeds, big trouble is inevitable. Accepting 7.5% unemployment as “full employment,” for example, would have ruinous effects on the deficit, because tax revenues would run far lower year after year. The last column of Table 1 can be used to glean a rough estimate of how higher unemployment could affect the deficit. It is for a “low growth” economy in which unemployment remains at 7.5% instead of sinking back to the 5% the CBO assumes in its projections. The impact on deficits is substantial and we will return to this point at the conclusion of the paper.⁷⁶

Prolonged unemployment would also generate other pressures that would cloud the deficit picture. American corporations are laying off massive numbers of older

workers, whose retirements, thanks to the financial meltdown and changing pension practices (i.e., simply paying none or using them to prop up company stock values), are precarious in the extreme. Though free market fundamentalists will continue denying the obvious, many out-of-work Americans are unlikely to find work ever again – and not because they mysteriously lost job skills that kept them steadily employed prior to the financial crisis.⁷⁷

Other minor threats to the budget might arise from efforts to fix shortcomings in various federal programs. Social Security, for example, was designed for a different world than the one we live in. As Bing Chen has lucidly emphasized, the program’s failure to adjust historic benefit practices to contemporary demographic realities imposes hardships on some groups of beneficiaries, notably widowed spouses, mostly women.⁷⁸ These problems have relatively simple fixes which do not threaten either the program’s solvency or U.S. finances, but remedying them might add marginally to deficits.

Through the Looking Glass: The Far Future

Mention of Social Security transports us to the heart of current debates about the deficit. Most readers of this paper will have seen newspaper or web reproductions of charts from studies – many financed directly or indirectly by the Peterson Foundation – tracing out scary arabesques of the time path of U.S. debt to GDP ratios. These typically ascend gradually to about 2020, when the usual CBO projections stop, then start rising explosively. The precise date of Apocalypse varies. A recent study by Pew, which works closely with the Peterson Foundation, suggested 2035 or thereabouts – but the impression is always of a system spiraling out of control and lurching to the brink of collapse.⁷⁹

What should one think of these doomsday scenarios?

The answer, alas, is not edifying. We think that all discussions of the budget should begin by taking to heart how easily even very gifted people can lose all sense of discrimination when they start to reflect on things in the very long run.

The problem is not simply that many reach their scary conclusions by adding apples to oranges, as discussed earlier. Or that they draw freehand from economic history and experience. It is that in laying out detailed projections of budgets and the economy in the far future, they affect to speak authoritatively about things that cannot possibly be forecast with precision. And on the basis of these airy projections, they promote

sweeping recommendations that would drastically impact the livelihoods of millions.

If the shattering events of 2008 have taught us anything, it is the fragility of economic forecasts that simply spin trends remorselessly out into an indefinite future. Most central bankers, economists, and business leaders failed not only to foresee, but even to imagine, the colossal dimensions of the 2008 catastrophe. Why should anyone repose much faith in their clairvoyance? Particularly when they continue to rely on notions like “rational expectations” or dynamic, stochastic general equilibrium models that ignore feedbacks from the political system and society?

Current discussions of Social Security point up the dangers of proceeding in this manner. These sort mostly into two groups: One rails on about how “runaway entitlements” are leading to a deficit explosion; while the other advises patronizingly that Social Security can be saved in the long run by timely changes, typically involving a mix of taxes and benefit cuts, including, notably, yet another rise in the age of eligibility for the program.

Neither point of view is persuasive. The “explosion” story can be immediately dismissed. The simple fact is that the deficit did not swell tidally until the financial crisis hit. While George W. Bush’s tax cuts destroyed the Clinton budget surpluses, tax revenues poked along at a rate that kept the deficit from blowing out until the economic equivalent of Hurricane Katrina hit. It was the one-two punch of the bank bailouts and the Great Recession that led to today’s giant gap between general revenues and expenditures.⁸⁰ But even with this there is no near term threat to Social Security’s solvency: Our earlier point about the undramatic implications of the CBO’s deficit projections through 2020 holds for Social Security, too, because those estimates include the program.

It is true that Social Security tax receipts declined during the Great Recession, so that for the first time since 1983, the program’s outlays exceeded revenues by a small amount. But this in no way threatens the program’s basic solvency. In 1983, Congress enacted into law recommendations of the Greenspan Commission to raise Social Security taxes to cover the retirement bulge coming from baby boomers. Since then, the program has piled up enormous surpluses. These have been invested in government bonds, thus helping to finance the rest of the government. As the baby boomers mature, the surplus funds will be drawn down. The 2010 Report of the Trustees of the Social Security Trust Fund projects that the Trust Fund and interest earnings from it will suffice to cover all benefit payments until 2037. Even then, the Fund will not be empty – the Trustees Report

projects that the Trust Fund would still cover 75% of all benefits due.⁸¹

2037 is a long way away. The argument in 2010 is about whether there is any reason to do anything at all right now. The case pressed by self-proclaimed rescuers of Social Security such as Peter Orzag, who just resigned as the head of the Obama administrations’ Office of Management and Budget, is unpersuasive.⁸² The first yellow flag is Orzag’s frank acknowledgement that Social Security features barely at all in any putative budget short fall. “Social Security is not the key fiscal problem facing the nation. Payments to its beneficiaries amount to 5 percent of the economy now; by 2050, they’re projected to rise to about 6 percent.”⁸³ A rise of 1%! Even from the perspective of Rinehart and Rogoff’s 90% threshold, this is a drop in the bucket. Former Senator Alan K. Simpson, co-chair of the President’s deficit commission, claims that his group’s upcoming deficit report “harpooned all the whales in the ocean, and some of the minnows.”⁸⁴ Lost in the blaze of publicity about the Commission is the crucial fact that Social Security is plainly one of the minnows.

The whole discussion, in fact, strikes us as even fishier. In the event any shortfall does materialize, it could easily be made up by transfers from general tax revenues, though that would breach the long maintained fiction that Social Security is a contributory system on the model of most private insurance. (It is actually a pay as you go system, where current taxes pay benefits to current beneficiaries, with the final guarantee of the whole system’s soundness being, in the last analysis, the success of the economy as a whole.) But if fears about 2037 are unbearable, plenty of ways exist that would fix the program without threatening anyone’s life support system.

Between 2002 and 2007, for example, the richest 1% of Americans garnered 62% of all income gains, while the bottom 90% of the population saw their incomes grow by 4%.⁸⁵ At the same time, thanks to the Bush tax cuts, most affluent Americans were also paying proportionately fewer taxes. Considering that ordinary Americans fronted most of the money for the bank bailouts and have endured most of the recession’s “collateral damage,” it seems only simple justice that if the program needs fixing, the best way to do it would be to raise the ceilings on earnings subject to the Social Security tax, which is currently only \$106,800.⁸⁶ That would put the burden on people who cannot plausibly claim to be suffering.

Even here, though, our skepticism gives us pause. Some caution is in order before everyone swallows any more recommendations from analysts who often spent the last decade insisting that they could not recognize a stock

market bubble even when price earnings ratios soared past 100 to 1. If, for example, productivity runs even slightly higher than in the forecasts, then there may be no shortfall of any kind. Considering that the projected shortfall is still 27 years away, it strikes us as more prudent not to rush to tinker with the program that is the sole source of income for so many Americans.

Orzag and others, however, who agree that the program makes at most a minor dent in the budget, nevertheless argue for “fixing” it now. Their reason is remarkable: “even though Social Security is not a major contributor to our long-term deficits, reforming it could help the federal government establish much-needed credibility on solving out-year fiscal problems.”⁸⁷ Cut benefits, in other words, simply to prove to financial markets that the government can do it. As Krugman observes, this position is tantamount to claiming that we should cut Social Security now, because we might have to do it in the future.⁸⁸ In light of the financial crisis’ disastrous impact on home values and pensions of ordinary Americans, it takes a certain amount of nerve to put forward such views, even given the one-sided incentives that America’s plutocracy provides to “experts.”

The Far Future: Whale Watch - Health Care

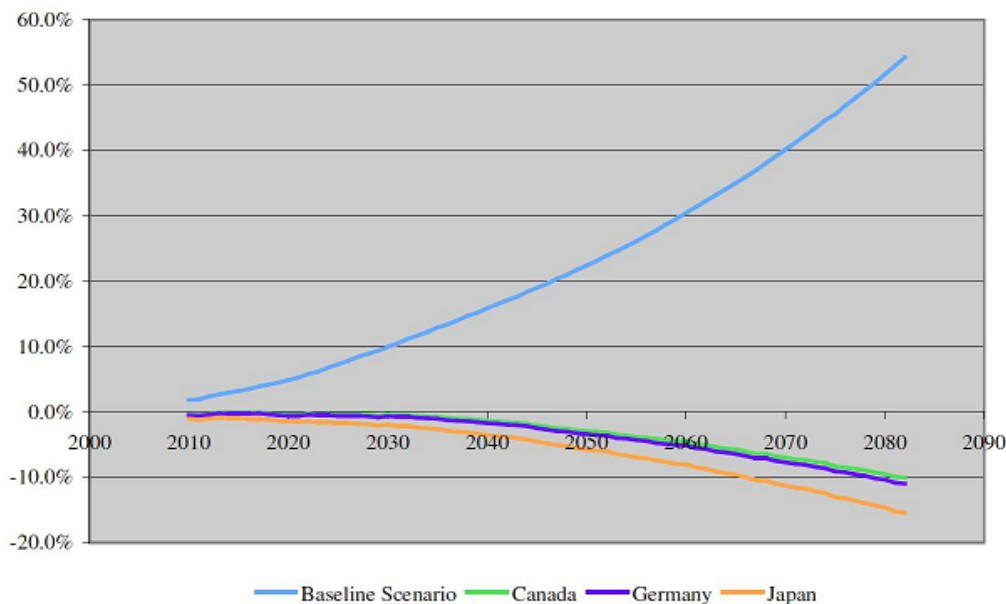
Social Security is not, of course, the only program usually singled out as a budgetary “whale.” Other programs exist, including some with better claim to that

title. But once again, caution is in order. The real nature of the problems is almost entirely lost amid all the handwringing in the academy and the media: In the money-dominated U.S. political system, problems of out of control expenditures rarely arise from programs that confer benefits on large numbers of ordinary Americans. Political leaders responsive to major investors normally take extreme care to design such programs so that the burden of financing them falls heavily on precisely the people who receive the benefits. The famously regressive Social Security taxes, with their caps on incomes subject to any tax at all are a case in point.

The nature of what we take to be the real threats to deficits - the budgetary “whales, as former Senator Simpson calls them - is quite different. It is that powerful blocs of corporations and investors have extensively captured the process of making public policy in key areas and used policy to reinforce oligopoly or even monopoly, while promoting demands for service that defy rational assessments. Such areas require wholesale regulatory reform, serious anti-trust restrictions, and cost-benefit systems that are not shaped by big money; controlling them by simply cutting expenditures, as deficit hawks usually propose, is like shooting at pigeons with a blunderbuss.

By far the most important such area is health care. When one examines the rocket-like trajectories of future budget deficits in alarmist studies of deficits, the hair-raising conclusions derive almost entirely from simple extrapolations of one driver: health care costs.

Figure 2
What If US Health Costs Grew Like Other High Income Countries?
How That Would Affect The Deficit As A Percent of GDP



Baseline Scenario (Blue) - CBO Estimates of US Cost Explosion

Here, one picture is worth a thousand words. We, accordingly, borrow from Dean Baker's admirable discussion of some months ago (Figure 2). The U.S. spends a far higher percentage of its GDP on health care than any other country. It also gets less health for it than any other major country, in the sense other countries do just as well or better on most health indicators, though they spend much less.

Why is no mystery, despite all the sound and fury of the health care "debate." The U.S. health care system is in no sense a competitive marketplace. Instead, it is chain of private oligopolies connected to each other by streams of payments administered by a vast, non-competitive private insurance network and the federal government. Producers and insurers together dominate government policymaking, at both federal and most state levels. Basically, health care regulation is like banking regulation: It is subject to the deadly syndromes we identified in an earlier paper on the financial crisis. Besides the tidal wave of direct and indirect political contributions, think tanks working in the area are virtually all dominated by producers. Perhaps even more devastating, a gap the size of the Grand Canyon yawns between compensation of regulators and the regulated, creating a pronounced tendency for regulatory agencies to function mostly as employment agencies for the regulated firms.⁸⁹

The new health care reform law vastly extended coverage, but did little to control the oligopolies, not least because the administration relied on key parts of precisely that network to supply the political muscle to put over its program. The danger this creates for the future is obvious: some way has to be found to control the oligopolies just entrenched. Arguments about how health care affects the deficit are really bets on this and nothing else.

In the debate over the deficit, health care now functions rather like weapons of mass destruction in the run up to the invasion of Iraq. It is the device of choice to terrify the public. Current long term deficit projections, including the CBO's, are just guesses. Those for the long term make little sense and have been powerful instruments for sowing fear among the public. They project past rates of the growth of costs out year after year. Not surprisingly, over a generation, health care looks like Pac Man, eating up much of the economy. That appetites on this scale are certain to bring forth powerful opposition does not cross the official mind.

Figure 2, which is taken from a study by Dean Baker and Peter Rosnick, shows how simply limiting health care costs to the same percentage of GDP in several countries that enjoy better health care than the US would hold down deficits. Plainly, with health care there

is no "deficit problem" per se; there is an imperative for effective regulation and anti-trust. There are at least two quick fixes which would represent giant steps toward reducing deficits, but we are prepared to bet neither will not feature prominently on the menu that the President's Deficit Commission hands the public. The first is to just adopt Canadian style health care and get rid of the insurers. Or, if that sounds too harsh and "socialistic," re-label it as generalizing Medicare to the whole population. Whatever one calls it, getting rid of the enormously wasteful and duplicative private insurers would shrink health care expenses spectacularly - by at least 20 to 25% without detracting from anyone's care. As a fallback, even putting in the celebrated "public option" would mark a giant step forward. The other measure is to let the federal government bargain with pharmaceutical concerns over health care costs. As our colleague Joseph Stiglitz suggests in his paper assessing various proposals for cutting the deficit, savings from this measure would likely mount into the trillions of dollars - which is why the new health care law mostly blocks this.⁹⁰

Whale Watch: Defense

A certain irony surrounds the second whale in budget debate, defense spending. Once upon a time, the proposition that nothing could be more dangerous to a country's finances than war was a shibboleth of conservative business opinion. In the interwar period, indeed, pressure from financial circles for arms limitation was intense and at times, decisive.⁹¹ In America, if not Europe, however, this has gone by the boards. Remarkably few deficit discussions direct much attention to military spending, though, to its credit, the Deficit Commission is discussing the issue.

But it is disconcerting that neither the commission nor most other analysts appear to recognize the dimensions of the problem. Most summaries of total U.S. spending on defense and the military seriously undercount. The CBO, most think tanks, and major media routinely use figures suggesting that military spending makes up perhaps 20% of the budget.⁹² But as Chalmers Johnson and Robert Higgs each noted some years ago, spending in this area is scattered across a maze of agencies.⁹³ Spending on Homeland Security, which has clearly grown without much rational direction, for example, should be counted, along with parts of the budget for the Department of State, Energy, and even Transportation, along, obviously, with all spending by Defense and the intelligence agencies. Less obviously, interest on the debt for this part of the budget properly belongs in the totals. One careful effort at a more comprehensive reckoning suggests that perhaps 39% of the proposed Fiscal Year 2011 budget goes toward defense.⁹⁴

But the astronomical totals obscure the central problem for the future, which is the question of national strategy. We suspect that future historians will regard September 15, 2008, the date U.S. authorities allowed Lehman Brothers to slide into bankruptcy, as one of the great turning points in the history of international relations, as well as finance. The subject, though, is too big for this paper. But the implications for future deficits can be dealt with summarily. For a year or so after the financial collapse, most U.S. policymakers lowered their profiles and talked up a more cooperative, internationalist line. Now, however, they increasingly acknowledge their aim of restoring the status quo ante. They are matching their words with deeds, notably in the western Pacific, where civilian leaders seem disinclined to acknowledge how shore to ship missiles are destined to reshape U.S. naval deployment patterns.

We think this posture is delusory and that imperial overstretch once again looms as a real temptation for the U.S. But that would require a separate paper. For now, it will have to suffice to draw attention to the obvious: Both Afghanistan and Iraq, even in the drawn down forms projected, which we are dubious will hold, are sure to consume enormous resources. So will the U.S. build up in the Indian Ocean basin, even if, as recently proposed, the Afghan commitment were to be cut back to the northern, non-Pashtun areas. As the last minute hold up of the nuclear arms treaty with Russia by Senator Kyl and other Republicans vividly illustrates, pressures for more defense spending, including immensely costly programs of nuclear weapons modernization, are likely to threaten CBO's estimates. And any new wars, such as an attack on Iran, assuredly would bust the budget unless financed by new taxes - precisely what the biggest Senate champions of an attack on Iran most stridently oppose.

Whale Watch: The White Whale - Another Financial Crisis

Last, but hardly least, among the whales that threaten U.S. budget estimates is another financial crisis. Despite the trumpets and flourishes that accompanied passage of the Dodd-Frank financial reform bill in the United States and the brave talk that surrounds the preparation of a "Basel III" revision of international banking guidelines, the plain fact is that the "too big to fail" problem has not been resolved either in the U.S. or the rest of the world. We could develop this theme in any degree of detail; here, we simply observe that neither off balance sheet practices, nor derivatives, nor bank compensation practices, nor cross-border resolution practices for failed institutions, nor most of the other key factors in the last disaster have changed all that much. Dodd-Frank was watered down to a point that would be comic if the issues were less serious, while the

Basel guidelines are plainly being adulterated by concentrated bank lobbying.⁹⁵ With short term interest rates near zero in the U.S. and other developed countries, speculative excesses, high bank bonuses, and other touchstones of an out of control system are recurring. And, like many other observers, we are hardly persuaded by brave-sounding official declarations that the financial sector is at all likely to be left to its own devices when the next Lehman strikes. To anyone with the eyes to see, the course of the Euro crisis is once again underlining the critical role state guarantees and public subsidies play in bank stock prices.

The unpleasant truth is that institutions the size of Bank of America, Citigroup, or, a fortiori, Goldman Sachs, simply cannot be allowed to fail. If they are permitted to exist at all, the only policy question is whether, as happened last time, not only the banks, but the bankers, will be rescued at public expense. That prospect, however, ranks right up with another major war as a mega-threat to the budget, because of the gigantic collateral damage that financial crises wreak. These costs go way beyond the direct outlays for TARP, "ring fences," public-private partnerships, and guarantees that were pivotal in the recent crisis. The now notorious costs of bailing out Freddie Mac and Fannie Mae, for example, are actually disguised subsidies to the financial sector, though public debates create the impression that some unique "government" failure is at issue. The losses that the Treasury will allow the Federal Reserve to recoup by debiting its normal payments to the U.S. government will also be very large.

Most of the increase in the federal deficit, however, stems from the conjunction of falling tax revenues, bank bailouts, and countercyclical spending mounted to head off the downward economic spiral that financial collapses customarily trigger. The increases in the deficit that result are gigantic: In 2007, the U.S. deficit amounted to just over 1% of GDP. After the financial crisis, it ballooned - in both 2009 and 2010 to approximately 10% of GDP.⁹⁶

It is clear that the Euro crisis is moving into a new stage, in which risks to countries from potential bailout costs are rising to the point where some sovereign credit ratings are coming under pressure. In turn, this is squeezing some countries, notably Germany, to throw back risk on the private sector, thus heightening chances that private banks will eventually fail. If sovereign defaults in peripheral Europe eventually trigger a banking crisis in the Euro area, as is quite possible, the risks of international contagion are serious. Such a "Lehman in reverse" is likely to have roughly the same impact on some major U.S. banks that Lehman had on financial institutions in Europe. Should the worst occur, the U.S. government will again intervene to save them.

The only open question is whether major parts of the bailout will once again be disguised as bailouts for some particular financial institutions like AIG or next time a derivatives clearinghouse, or paid out directly, as with TARP, the Citigroup and Bank of America “ring fences,” public-private partnerships, or the FDIC payouts and guarantees. Whatever the form they take, they will wreck havoc with the CBO’s deficit estimates.

Conclusion: The World Right Side Up

There is a sense in which all this might add up to a cautiously optimistic assessment. If the sky is not falling – that is, the United States is not about to bump into some magic limit on its rate of growth and enactment in full of the President’s budget proposals is unlikely to stir up financial markets, then most of the hue and cry about deficits is beside the point. Existing “entitlements” do not threaten national insolvency, nor is there any real threat to Social Security (whose effects are fully subsumed in the budget projections just discussed, despite all the propaganda about how the system is “going broke”). By enacting something like the tax program proposed by the President, the U.S. debt to GDP could stabilize at a somewhat higher, but non-threatening level.

But, as a medieval adage reminds us all, if wishes were horses, paupers would ride. Our analysis suggests several ways this calculation could easily go astray. Their peculiarity is a common denominator strangely absent from public debate in the mass media: Not insatiable public demands, but the ability of private oligopolies to dominate state policymaking against the interests of the vast majority of the population.

Or in other words, the way the dysfunctional, money-driven character of the American political system (where this is taken in a properly extended sense that includes the role major investor blocs play in subsidizing policy ideas and economic inequality’s debilitating effects on citizen political action) ties the U.S. political system up in knots.

From this standpoint, the outlook does not look so benign. On the expenditure side, not one, but three powerful sets of interest groups – finance, the defense establishment, and the “medical-industrial” complex – all have to be controlled for things to work out well. Obviously, one can hope, but the prospect of a successful triple play looks doubtful at best. We are exceedingly wary of simply setting expenditure limits on health care, for example. That is likely only to lead to quantity rationing by the oligopolies to the detriment of the public’s health. In this area, the main public policy problems are analogous to those in finance: Make markets be markets: break up oligopolies or, where

competition is unlikely to be feasible (which is to say, many parts of the “market”), regulate them intelligently. As noted previously, in finance it is clear that the American government has already dropped the ball, for familiar reasons of money politics. Neither are we holding our breath on defense policy, where the commitment to two ongoing wars and a steady drumbeat by various interested parties for one or two more cast a long shadow over all discussions of budget reduction.

Prospects are probably even bleaker on the tax side. The Republican Party is plainly determined to retain the entirety of the Bush tax cuts; many Democrats share their conviction. Washington’s focus on extending the tax cuts is vivid proof that talk about deficit reduction is simply cant, save for programs that target ordinary Americans and the poor, like Social Security. Any cuts in Social Security will simply be swallowed either by tax cuts for the rich or additional expenditures by finance, the defense establishment, or the medical-industrial complex. We see no point in playing that game.

So is there nothing to be done?

Not quite, actually. Especially given the likelihood of another banking crisis, we agree it would be desirable to take out a bit of insurance by trying to stabilize the debt as a percentage of GDP, so that when shocks hit, they can be contained.

Happily, this is not as difficult as it sounds. Most current analyses of the U.S. deficit badly misdirect by considering only the liability side of the government’s balance sheet. That is, they are interested only in what the government owes. But governments not only run up debts, they also build up or acquire assets – assets that are in many cases vital to the functioning of the national economy and greatly raise productivity.

Any serious analysis of the modern pharmaceutical industry, for example, will show that federally supported research, particularly the National Institute of Health, drives that industry’s development. “Competition” in that sector extensively takes the form of finding ways to get close to government supported researchers and inveigling them or their students to pursue later stages of their research within particular firms. This pattern is fabulously profitable for the companies. It also has major benefits for the economy as a whole.⁹⁷ Similar phenomena mark parts of the defense industry, as well as telecommunications and many other sectors. Many Republican analysts were happy to remind everyone that Al Gore did not invent the Internet; they are less vocal about the fact that free enterprise did not, either.

Yet most discussions of deficits, including those of the IMF, pay almost no attention to the productivity of government assets and the difference between social and private rates of return on investment. Disregarding quantitative historical studies that show economies with low rates of public investment grow slower than economies with higher rates, they keep making silly “crowding out” arguments that imply that a dollar of private investment has roughly the same social rate of return as a dollar of public investment.⁹⁸ Current national income accounting facilitates this nonsense by neglecting all calculations of return on investment and treating profits in pharmaceuticals and other industries as though they originate there. So does the common econometric practice of testing for crowding out by relying on short run models that have virtually no hope of picking up cumulative effects of government investment.

Several economists and financiers have argued in favor of longer term investment programs designed to raise rates of growth and productivity while also promoting full internalization of energy (“carbon”) costs. The usual suggestions include policies designed to further “green” energy and industry, along with major investments in education and infrastructure. That some claim, incoherently, that such programs are alternatives, rather than complements to traditional Keynesian demand stimulus policies in periods of high unemployment does not make them bad ideas. Our Table 2 earlier showed how simply substituting a slightly higher rate of growth for the CBO’s lower rates vastly improves the U.S. deficit outlook.

In the nineteen nineties, the Clinton administration demonstrated once again how approaches to full employment shrink budget deficits by swelling tax revenues and reducing cyclical outlays of such “built in stabilizers” as remain from the halcyon days of the New Deal. The Obama administration’s failure to mount a stimulus program that was big enough to drive down unemployment has discredited the whole approach politically.

But in fact our earlier simulations of how “high” and “low” growth scenarios affect the CBO’s deficit projections show that the notion remains compelling. Under the high growth scenario, the debt to GDP ratio in 2020 drops by 10% from what it would be under the CBO’s baseline projection – from 69% to 60% of GDP (or approximately 61% to 52%, when financial assets are taken into account). This would bring the ratio right back to where it is now! Under the low growth scenario, the ratio rises from 69% to 82% (or from 61% to 73% when financial assets are recognized). The latter, dismal projection can be taken as a measure of the downside risk if nothing is done, while the former benchmarks

what might be achieved with effective government action.

Both potential gains and losses are gigantic, amounting to trillions of dollars. In the slow growth case, the implication is that one could invest roughly \$2 trillion dollars in a program of public investment. If the program raised growth by a half of one percent a year over the next ten years, then one would have no worse a debt to GDP ratio than the baseline, but many more people would be employed and GDP would be far higher. It hardly requires John Maynard Keynes to see the obvious implication for government action. Especially when the government can borrow at almost zero rates of interest, it is fairly easy to have one’s deficit cake and eat it, too. The upside down world of the Great Recession needs to be put right side up. There is no excuse for failing to move vigorously to put America back to work, in the long run lowering the deficit.

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Notes

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more than normally, it is necessary to observe that none of them necessarily agrees with us.

Footnotes

1. The quotation from War and Peace comes from the Maudes' translation, on line at http://www.online-literature.com/tolstoy/war_and_peace/. Unless otherwise indicated, references to newspapers and magazines are cited according to the dates specified in the electronic versions of their text on their websites; note that those are often published there in the evening before the hard copy comes out.
2. A standard source on the earlier phases of the Keynesian Revolution is Robert Collins, *Business Response to Keynes* (New York: Columbia University Press, 1981).
3. For policy after the seventies, see Andrew Glyn, *Capitalism Unleashed* (New York: Oxford University Press, 2007); for the statistics on "real government consumption" in Germany see Paul Krugman, "The Strange Death of Fiscal Policy," *The Conscience of A Liberal* (2010), <http://krugman.blogs.nytimes.com/2010/11/03/the-strange-death-of-fiscal-policy/>. Joseph Halevi has drawn attention to the gap between the popular perceptions and the reality of German economic policy, in Joseph Halevi, "Germany: The Shadows of Recovery," *Monthly Review* *mrzine* (2010), September 14.
4. G20, "Leaders' Statement, the Pittsburgh Summit," (Pittsburgh: G20 Media Center, 2009).
5. For Nixon's press secretary, see "The Nation: It's Inoperative: They Misspoke Themselves," *Time*, April 30 1973; Chris Giles, "Strategy: Focus Switches from Exit to Growth," *Financial Times*, June 25, 2010. The changed stance of the IMF stance is detailed there. For Germany and the European Central Bank, cf. Joerg Bibow, "It Is Worrying That the German View of Austerity Is Now Europe's," *Financial Times*, June 28, 2010.
6. See, e.g., Martin Wolf, "Why the Battle Is Joined over Tightening," *Financial Times*, July 18, 2010. A striking example of demands for more cuts is Simon Kennedy, "Trichet Says Failure to Cut Government Debt Risks 'Lost Decade'," *Bloomberg.com*, August 27 2010.
7. As the summit approached, the discord between the U.S. and others was obvious; see, e.g., Charles Wallace, "U.S.-European Discord Could Hamper

G20 Financial Reforms," *Daily Finance: An AOL Money and Finance Site*, June 25, 2010.

8. The Peterson Foundation made yeoman efforts in the summer of 2010 to create the impression that public opinion favored cuts in Social Security and other programs. The claims were nonsense. See Benjamin Page and Lawrence Jacobs, "Understanding Public Opinion on Deficits and Social Security," in *Roosevelt Institute Working Paper* (New York: Roosevelt Institute, 2010). Working Paper No. 2. More broadly on the Peterson Foundation and the Deficit Commission, see Marshall Auerback, "Which Party Poses the Real Risk to Social Security's Future?," *New Deal 2.0*, August 16, 2010; James K. Galbraith, "Statement to the Commission on Deficit Reduction," *New Deal 2.0*, June 30, 2010; Bryce Covert, "Peterson Is to the Dangers of Deficit Spending as Hugh Hefner Is to Sex?," *New Deal 2.0*, May 1, 2010; David Dayan, "Pete Peterson's Purchase of Cat Food Commission, Media Pays Off," *FiredogLake*, November 11, 2010. The House resolution was formally non-binding; cf. Dayan, "The War Supplemental: A Rundown," *FiredogLake.com*, July 2, 2010.
9. See the plainly stated acknowledgements in David Leonhardt, "A Few Steps Short on Jobs," *New York Times*, June 8, 2010.
10. Cf. William Selway, "Most U.S. States Cut Jobs as Tax Collections Erode, Study Says," *Bloomberg.com*, July 23 2010; and the discussion in Money News.com, "Broke U.S. State Pose Growing Threat to Recover," *MoneyNews.com*, August 8, 2010.
11. Jeannine Aversa, "More Layoffs Expected at State and Local Levels -- Federal Aid Won't Stanch Job Losses," *Boston Globe*, August 9, 2010.
12. Joshua Green, "The Raid on Food Stamps," *Boston Globe*, August 12, 2010.
13. The Roosevelt administration also raised interest rates, as part of a deal with leaders of the banking community struck during the 1936 election. See the discussion in Thomas Ferguson, "From 'Normalcy' to New Deal: Industrial Structure, Party Competition and American Public Policy in the Great Depression," in *Golden Rule: The Investment Theory of Party Competition and the Logic of Money-Driven Political Systems*, ed. Thomas Ferguson (Chicago: University of Chicago Press, 1995). The Fed is unlikely to repeat this error, but it has resisted pressures to do more to combat unemployment and in any case, the chorus of opposition from the right is clearly going to crimp the program.
14. We lack the space for a detailed review of the administration's record on financial legislation. But see our earlier two part study Thomas Ferguson and Robert Johnson, "Too Big to Bail: The 'Paulson Put,' Presidential Politics, and the Global Financial Meltdown, Part I: From Shadow Banking System to Shadow Bailout," *International Journal of Political Economy* 38, no. 1 (2009); "Too Big to Bail: The 'Paulson Put,' Presidential Politics, and the Global Financial Meltdown Part II: Fatal Reversal- Single Payer and Back," *International Journal of Political Economy* 38, no. 2 (2009). Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Pantheon, 2010). On credit and debit card fees, see especially Jessica Silver-Greenberg, "The New Credit Card Tricks," *Wall Street Journal*, July 31, 2010.
15. Richard Koo, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, Revised ed. (Singapore: Wiley 2009); for the study, which was not based directly on Koo's analysis, see Rebacca Wilder, "Evaluating the 'Excess' in the U.S. Corporate Financial Balance," *Roubini Global Economics Economonitor*, September 20, 2010, which is a discussion of Yves Smith and Rob Parenteau, "Are Profits Hurting Capitalism?," *New York Times*, July 5, 2010.
16. Johnson and Kwak, *13 Bankers*. Ferguson and Johnson, "'Paulson Put' Part I."
17. Asli Demirguc-Kunt and Harry Huizinga, "Are Banks too Big to Fail or Too Big to Save? International Evidence from Equity Prices and Cds Spreads," (Washington, D.C.: World Bank, 2010).
18. Ibid.
19. Thomas Ferguson and Robert Johnson, "When Wolves Cry 'Wolf': Systemic Financial Crisis and the Myth of the Danaid Jar," in *Institute for New Economic Thinking Inaugural Conference* (King's College Cambridge: 2010), <http://ineteconomics.org/sites/inet.civactions.net/files/INET%20C%40K%20Paper%20Session%208%20-%20Ferguson%20%28Rob%20Johnson%29.pdf>
20. Ferguson and Johnson, "'Paulson Put' Part I."
21. As this essay nears completion, anxiety over the EU's handling of bailouts is rising. We share the view that this has been maladroitness, but the text's

- statement remains true. On the other hand, there may be a limit to how foolish policymakers can be in prolonging debates about bank bailouts and indulging bank excesses. See our earlier discussion in "When Wolves Cry 'Wolf': Systemic Financial Crisis and the Myth of the Danaid Jar."
22. Markets for credit default swaps on sovereign bonds also exist and should also reflect such pressures. But the CDS market in such debt is thin and subject to possible manipulation, making its evidence rather more ambiguous.
 23. Nicole Bullock, "Norfolk-Southern in 100-Year Issue," *Financial Times*, August 24, 2010. Credit Markets, "Bankers Pitch 100 Year Bonds," *Wall Street Journal*, August, 24, 2010.
 24. See, e.g., Reuters, "Greenspan: High Deficits Could Spark Bond Crisis," *Yahoo News*, November 14, 2010. For the earlier lack of warnings, see, inter multa alia, Ferguson and Johnson, "'Paulson Put' Part I."
 25. Carmen M Rinehart and Kenneth Rogoff, "Growth in a Time of Debt," (Cambridge: National Bureau of Economic Research, 2010).
 26. Rinehart and Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009).
 27. On the problems with the data, see, e.g., Yeva Nersisyan and Randall Wray, "Does Excessive Sovereign Debt Really Hurt Growth? A Critique of *This Time Is Different* by Reinhart and Rogoff," (Levy Economics Institute of Bard College, 2010). On the German crisis, see Thomas Ferguson and Peter Temin, "Made in Germany: The Germany Currency Crisis of July 1931," in *Research in Economic History* 21, ed. Alexander J. Field (Oxford: Elsevier Science, 2003); Ferguson and Temin, "Comment on 'the German Twin Crises of 1931,'" *Journal of Economic History* 64, no. 3 (2004).
 28. James R. Horney, Kathy A. Ruffing, and Paul N. Van de Water, "Fiscal Commission Should Not Focus on Gross Debt," (Washington, D.C.: Center for Budget and Policy Priorities, 2010). See also John Irons and Josh Bivens, "Government Debt and Economic Growth," (Washington, D.C.: Economic Policy Institute, 2010).
 29. Carmen Reinhart and Kenneth Rogoff, "Growth in a Time of Debt," (Cambridge: National Bureau of Economic Research, 2010), Working Paper 15639.
 30. Cf. William J. Baumol et al., *Macroeconomics: First Canadian Edition* (Toronto: Nelson, 2010), p.107. Changes in terms of trade may also have exerted some influence.
 31. Paul Krugman, "Debt and Transfiguration," *New York Times Blog*, March 12, 2010.
 32. Our graph depicts both figures in the same year; depending on one's economic theory, it might be reasonable to prefer a figure that lagged one of the series by a year. Nothing in our argument will change with such a device.
 33. The literature is enormous; all short statements about the Industrial Revolution require extreme care. A convenient, well written recent discussion of many of the classic debates is Joel Mokyr, ed., *The British Industrial Revolution: An Economic Perspective*, 2nd ed. (Boulder: Westview, 1998). Whether crowding out actually happened has been intensely debated. A recent discussion, with much new evidence, arguing that it did, is Peter Temin and Hans-Joachim Voth, "Credit Rationing and Crowding out During the Industrial Revolution: Evidence from Hoare's Bank, 1702-1862," *Explorations in Economic History* 42 (2005).
 34. This is not to say it "took off," which has been a long, bitter discussion. Or that correlation is necessarily causation. But the result flies in the face of 90% warnings.
 35. Compare the discussions of data in the two works.
 36. Both Shelley and Byron wrote bitterly about Castlereagh. The former's lines after Peterloo remain famous:
I met Murder on the way -
He had a face like Castlereagh -
Very smooth he looked, yet grim;
Seven bloodhounds followed him.
 37. Paul Krugman, "A Far Away Country of Which We Know Nothing," *New York Times Blog*, October 25, 2010.
 38. Note that Temin and Voth, "Credit," limit their claims about crowding out to war time; they believe British growth was relatively robust after 1815 and use that fact to try to square several circles about growth in the Industrial Revolution. See p. 346. We wonder if their proposals are compatible with Temin's earlier findings about technological change that they discuss, but that is another paper.

39. Proponents of “Ricardian Equivalence,” of course, claim people lower their spending to save for future taxes they supposedly know are coming. Anyone familiar with patterns of U.S. political finance will entertain a radically different idea of what affluent people do with part of their income if they suspect taxes might be raised on them.
40. Temin and Voth, “Credit.” Note that they doubt that movements of funds from abroad relieved the congestion they argue characterized the money markets during wartime.
41. See the Bank of England’s Excel file of Bank Rate changes, available at <http://www.bankofengland.co.uk/mfsd/iadb/Index.asp?first=yes&SectionRequired=1&HideNums=-1&ExtraInfo=true&Travel=Nlx>
42. Manmohan Kumar and Jaejoon Woo, “Public Debt and Growth,” (Washington, D.C.: International Monetary Fund, 2010). Jonathan Ostry et al., “Fiscal Space,” (Washington, D.C.: International Monetary Fund, 2010).
43. Glyn, *Capitalism*. Joseph Halevi and Peter Kriesler, “Stagnation and Economic Conflict in Europe,” *International Journal of Political Economy* 32, no. 2 (2005).
44. Joseph Stiglitz, *The Roaring Nineties* (New York: W.W. Norton, 2004); Thomas Ferguson, “Blowing Smoke: Impeachment, the Clinton Presidency, and the Political Economy,” in *The State of Democracy in America*, ed. William Crotty (Washington, D.C.: Georgetown University Press, 2001).
45. See, e.g., Engelbert Stockhammer, *The Rise of Unemployment in Europe: A Keynesian Approach* (Cambridge: Edward Elgar, 2004); and Constantine Alexiou, “Crafting a Post-Keynesian Macroeconomic Framework to Explain European Unemployment: Econometric Evidence from the European Countries,” *Journal of Post-Keynesian Economics* 24, no. 1 (2001).
46. Robert Pastor, *Congress and the Politics of U.S. Foreign Economic Policy, 1929-1976* (Berkeley: University of California Press, 1980), p. 259.
47. Alberto Alesina and Silvia Ardagna, “Large Changes in Fiscal Policy: Taxes Vs. Spending,” (Cambridge: National Bureau of Economic Research, 2009), Working Paper 15438; Alberto Alesina, “Fiscal Adjustments: Lessons from Recent History,” Paper Prepared for *Econfin Meeting* (Madrid: 2010).
48. David Brooks, “Prune and Grow,” *New York Times*, June 10, 2010.
49. Paul Krugman, “Alesina on Stimulus,” *New York Times Blog*, February 6, 2010.
50. Probably because it was so drawn out.
51. See the discussion and tables in Alesina and Ardagna, “Large.”
52. Ireland in 2000, Netherlands in 1996, Norway in 1996.
53. Arjun Jaydev and Mike Konczal, “The Boom Not the Slump: The Right Time for Austerity,” (New York: Roosevelt Institute, 2010), Working Paper No. 3.
54. Sometimes the fall in the exchange rate represents simply a recovery to more normal levels following disastrous capital inflows as a result of foolish financial deregulation.
55. For the “golden year”, cf. Statistics Norway, “Economic Survey 1/97,” (Oslo: Statistics Norway, 1997).
56. Paul Dalziel, “New Zealand’s Economic Reforms: An Assessment,” *Review of Political Economy* 14, no. 1 (2002).
57. International Monetary Fund, “World Economic Outlook,” (Washington, D.C.: 2010), Chapter 3.
58. See, inter alia, Charles Kindleberger, *A Financial History of Western Europe* (Boston: Allen & Unwin, 1984). Marc Flandreau and Frederic Zumer, *The Making of Global Finance 1880-1913* (Paris: OECD, 2004).
59. Compare Ferguson and Temin, “Made” and “Comment” with previous discussions of what is still perhaps the most fateful of all financial crises, the 1931 German .
60. James K. Galbraith, “A Perfect Crime: Inequality in an Age of Globalization,” *Daedalus* 131, no. 1 (2002); Thomas Ferguson and Joel Rogers, *Right Turn: The Decline of the Democrats and the Future of American Politics* (New York: Hill & Wang, 1986).
61. See e.g., Congressional Budget Office, “The Budget and Economic Outlook: An Update,” (Washington, D.C.: Congressional Budget Office, 2010) and the discussion below.

62. Willem Buiter, "Citi Global Economics View: Sovereign Debt Problems in Advanced Industrial Countries," (New York: Citigroup, 2010).
63. Mary Williams Walsh, "Pension Fraud by New Jersey Is Cited by S.E.C.," *New York Times*, August 18, 2010.
64. For Alesina and Ardagna, see, e.g., p. 8, Note 20 of Congressional Budget Office, "Federal Debt and the Risk of a Fiscal Crisis," (Washington, D.C.: Congressional Budget Office, 2010). The same report invokes the debt to GDP ratio of 90%. For Reinhart and Rogoff, see below, where the issue is the publication of an estimate of the President's budget that just happens to hit 90% exactly.
65. CBO, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2011," (Washington, D.C.: Congressional Budget Office, 2010), March. For the explicit linkage with Reinhart and Rogoff, see, e.g., Committee for A Responsible Federal Budget, "The 90% Debt-to-Gdp Thresold and the CBO's New Debt Estimates," (Washington, D.C.: Committee for a Responsible Federal Budget, 2010), March 9, 2010.
66. Office, "The Budget An Update". p. 23
67. So are the adjustments required in the torrent of alarmist papers now rolling out of Washington think tanks, which virtually all ignore this unheralded correction.
68. Editorial, "A Real Debate on Taxes," *New York Times*, August 23, 2010.
69. The original budget projection came out in January, 2010. Cf. Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," (Washington, D.C.: Congressional Budget Office, 2010). The August revision is presented in CBO, "The Budget An Update".
70. The higher growth scenario uses the CBO rule of thumb from Appendix C in the CBO January budget outlook (not revised in August) which shows what happens to the deficit for a .1 percent change in the growth rate of GDP. GDP is assumed to rise by .5 percent and then its impact is traced out over the years on GDP (higher) and deficits (lower) using the Appendix C schedule for 2010 to 2020 multiplied by 5. The cumulative reduction in deficits leads to a lower debt in 2020 to accompany the higher GDP level.
71. Higher or lower growth would doubtless affect the assets values in practice.
72. The column, too, should be adjusted for the financial assets.
73. E.g., Galbraith, "Statement."
74. Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009).
75. Renee Courtois, "The 'New Normal': Economists Ponder Whether the 'Natural' Rate of Unemployment Has Risen," *Federal Reserve Bank of Richmond: Region Focus* 14, no. 1 (2010).
76. The lower levels of economic activity and higher deficits lead to cumulative debt. The exercise relies on several rules of thumb based on regressions by Josh Bivens at the Economic Policy Institute. A 2.5 percent unemployment gap that persists appears to correlate with about a 4 percent output gap relative to potential GDP. So baseline GDP is reduced in each year by the difference between the unemployment rate and the CBO's 5% rate. The exercise is not directly saying that any "natural rate" has shifted, but that an output gap persists. A second rule of thumb is that a 1 percent GDP output gap leads to a .375% GDP rise in the budget deficit due to cyclical adjustment. So a 4 percent decline in GDP relative to potential leads to a 1.4 percent of GDP increase in the deficit. The cumulative deficits are then used to change the numerator in the Debt/GDP ratio and the denominator is also lower by the persistent output gap.
77. The reference is to debates about "structural" unemployment and higher natural rates of unemployment. Cf., *inter alia*, Arjun Jaydev and Mike Konczal, "The Stagnating Labor Market," (New York: Roosevelt Institute, 2010), Working Paper No. 4.
78. Bing Chen, "Social Security's Family Benefits and the Fiscal Commission," *New Deal* 2.0, June 24, 2010.
79. Pew Economic Policy Group, "No Silver Bullet," (Washington, D.C.: Pew Economic Policy Group, 2010). Pew and Peterson have cosponsored several initiatives in this area.
80. Dean Baker, "The Budget Deficit Scare Story and the Great Recession," (Washington, D.C.: Economic Policy Institute, 2010). Cf. also the discussion of the Bush administration in Martin Feldstein, "Preventing a National Debt Explosion," (Cambridge: National Bureau of Economic Research, 2010), Working Paper 16451.

81. Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, "The 2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," (Washington, D.C.: U.S. Government Printing Office, 2010).
82. Peter Orzag, "Safer Social Security," *New York Times*, November 14, 2010.
83. Ibid.
84. Richard Wolf, "Task Force Faces an Uphill Battle on Plan to Cut 3.8t," *USA Today*, November 11, 2010.
85. Avi Feller and Chad Stone, "Top 1% of Americans Reaped Two-Thirds of Income Gains in Last Expansion," (Washington, D.C.: Center for Budget and Policy Priorities, 2009).
86. Indeed, the ceiling could be raised substantially and the rate cut for everyone; on equity grounds, this is very attractive.
87. Orzag, "Safer." This view is widely shared within the financial community. Cf. the quotation from Paul Volcker in William Greider, "Whacking the Old Folks," *The Nation*, June 7, 2010. This fine article also cites John Podesta of the Center for American Progress making the same point.
88. Paul Krugman, "Attacking Social Security," *New York Times*, August 15, 2010.
89. For think tanks and regulatory agencies as employment agencies for the industry, see Ferguson and Johnson, "When Wolves Cry 'Wolf': Systemic Financial Crisis and the Myth of the Danaid Jar." The example there is finance, but the situation in health is similar. See also Thomas Ferguson, *Golden Rule: The Investment Theory of Party Competition and the Logic of Money-Driven Political Systems* (Chicago: University of Chicago Press, 1995).
90. Joseph Stiglitz, "Principles and Guidelines for Deficit Reduction," (New York: Roosevelt Institute, 2010). Working Paper 6, in press.
91. See, e.g., Ferguson, "Normalcy."
92. Anthony Cordesman, Robert Hammond, and Jordan D'Amato, "The Macroeconomics of U.S. Defense Spending," (Washington, D.C.: Center for Strategic and International Studies, 2010). Note that this study prefers to report U.S. defense spending as a percent of GDP, which looks much smaller. Its charts also exclude Veterans, Space and some other spending from Defense, which is precisely our point here.
93. Chalmers Johnson, *Nemesis* (New York: Henry Hold, 2006); Robert Higgs, "The Trillion Dollar Defense Budget Is Already Here," *The Independent Institute Website*, March 15, 2007, <http://www.independent.org/newsroom/article.asp?id=1941>
94. See the website of the Friends Committee on National Legislation, especially the pie chart at <http://www.fcnl.org/pdfs/budget/FY2011PieChart.pdf>
95. Eric Dash and Nelson Schwartz, "As Reform Takes Shape, Some Relief on Wall Street," *New York Times*, May 23, 2010 and the contributions to Simon Johnson and James Kwak's website, *The Baseline Scenario*.
96. The figures come from the corresponding tables at the website of the Office of Management and Budget: <http://www.whitehouse.gov/omb/budget/Historicals/> One point of our paper, of course, is that the deficit would have been less if the Obama administration's stimulus policy had been more aggressive.
97. William Lazonick, *Sustainable Prosperity in the New Economy: Business Organization and High Tech Employment in the United States* (Kalamazoo: Upjohn Institute, 2009).
98. Peter Lindert, *Growing Public: Social Spending and Economic Growth since the Eighteenth Century* (Cambridge: Cambridge University Press, 2004). We lack the space for a discussion of the controversy over multipliers; we agree with our colleague Joseph Stiglitz and others that the multiplier for the US right now is reasonably high and positive.