

**Comments by Dean Baker,
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I am about to make comments that will likely place me seriously at odds with the other members of this panel and most likely with the sponsors of the session as well. Those who are outside of the consensus in Washington can usually expect to have their views disregarded at events like this. However, I would point out that if I had been on a comparable panel three years ago I would have been yelling about the dangers to the economy from the collapse of the housing bubble and how it was likely to lead to a severe recession. That would have also placed me outside of the Washington consensus.

I want to say first and foremost there is no real deficit problem and therefore there is no reason to talk about taking an ax to the country’s already weak safety net for the poor. The short-term story is one where a large government deficit is creating demand and sustaining employment due to a collapse of private sector spending. In the mid-term, we can point to deficits that are somewhat higher than desired, however this is largely a story of debt needlessly creating an interest burden for the country.

In the long-term the country is projected to face a severe problem of exploding private sector health care costs. If this projection proves accurate then health care costs will impose an enormous burden on the economy. Since more than half of our health care is paid for through public sector programs like Medicare and Medicaid, this explosion in health care costs will also create a budget problem, however it is highly misleading to refer to this as a deficit problem.

This argument is 180 degrees at odds with the conventional view in Washington, which is that the bond market vigilantes will make it impossible to borrow if we don’t follow their advice on deficit reduction. The reality is that the markets stubbornly refuse to cooperate with the deficit hawks, continuing to lend money to the U.S. government at historically low rates.

We are also told that the bond rating agencies may downgrade U.S. debt. It isn’t clear why we should be concerned that rating agencies (that thought mortgage-backed securities, filled with subprime mortgages issued at the peak of a housing bubble, were the highest quality debt) have lowered their assessment of government debt. They made a similar assessment of Japanese government debt in the late 90s, yet Japan’s government has continued to borrow huge amounts from financial markets at rock bottom interest rates.

It is not hard for any of us to come up with scary stories about what could happen in the future. However, for policy discussions we are better off sticking with reality.

Starting with the short-term situation, the large deficits of the last three years are explained almost entirely by the severity of the downturn. The deficit in fiscal 2007 was 1.2 percent of GDP. It was projected to be just 1.5 percent of GDP in 2008 before the economic and financial collapse sent the deficit soaring. Arguably these pre-crash deficits were larger than desired, but no serious person can claim that they posed a grave risk to the economy.

The bloated deficits of 2009-2011 are due to the fact that public sector spending is needed to make up for the enormous shortfall in private sector demand resulting from the collapse of the bubbles in residential and non-residential real estate. The falloffs in residential and non-residential construction that were a direct result of the collapse, coupled with the lost consumption due to the housing wealth effect, cost the economy at least \$1.2 trillion in annual demand. In addition, contractions by state and local governments would have reduced demand by an additional 1.0 percent of GDP in the absence of offsetting aid from the federal government.

With both short and long-term interest rates at their lowest levels since the Great Depression, there is no plausible mechanism through which lower government deficits would lead to increased private sector spending. Those who advocate smaller deficits in the current context are arguing for less demand and higher unemployment. It is that simple. The economy is like a plane in which one engine has gone out. Those who want to stop the remaining engine of growth in the public sector are asking for the plane to crash.

Getting out to the post-recovery period, for example 2020, the projections do show deficits that are somewhat problematic, but the issue is overwhelmingly one of an excessive interest burden due to the debt built up during the downturn. The Congressional Budget Office (CBO) projects the deficit, based on the President's budget, to be 5.6 percent of GDP. However, this figure includes a projected net interest burden of 4.1 percent of GDP. If the interest burden were the same as in 2008, or 1.8 percent of GDP, then we would be looking at a projected deficit of 3.3 percent of GDP. A deficit of 3.3 percent of GDP is arguably larger than desired, but hardly the sort of cataclysm that requires action ten years ahead of time.

It is also important to note that allowing the debt built up during the downturn to become a burden to taxpayers is a policy decision, not an economic fact. The Fed could buy and hold the debt incurred as a result of the need to boost the economy out of the downturn. To some extent it is following this path at present. As a result, in fiscal year 2010 CBO projected that the Fed would refund \$77 billion to the Fed, nearly 40 percent of the Federal government's net interest burden for the year.¹

However, CBO projects that the Fed will resell much of this debt back to the public in coming years, rather than acquiring new debt. The Fed does not have to follow this

course. It could continue to buy and hold debt with the intention of preventing the debt incurred due to the downturn from creating an interest burden for taxpayers. In normal times this could create a problem of inflation, however inflation is clearly not a concern in the current economic situation, with the rate of inflation dropping towards zero. In fact, a somewhat higher rate of inflation would provide a boost to economic growth as Federal Reserve Board Chairman Ben Bernanke himself argued with reference to Japan in the 1990s.²

When the economy recovers, the reserves created by buying debt could lead to inflation, but this problem can be prevented if the Fed were to increase reserve requirements as part of the process of raising interest rates to restrain demand. Since this could require a substantial rise in reserve requirements, the Fed could schedule the increases in advance in order to minimize uncertainty for the banking system.

There are issues created by this process of raising reserve requirements, but it is important to recognize that not going the route of increased Fed holding of debt involves a policy decision to impose a substantial debt burden on taxpayers. This does not have to happen. Certainly before we consider cuts to important safety net programs, it is reasonable to ask about alternative Fed policies than what CBO has assumed in its projections.

Over the longer term deficits are projected to reach explosive levels, but this is due entirely to the projected explosion in health care costs. Currently the United States pays more than twice as much per person for health care as the average for other wealthy countries. The projections showing explosive deficits assume that the ratio of per person health care costs in the United States to costs in other wealthy countries rises to 3 or 4 in the decades ahead. If the United States really will pay 3 or 4 times as much per person for its health care as will people in Germany and Canada then health care costs will impose an enormous burden on the economy.

Since we pay for more than half of our health care through the public sector, these projections imply enormous deficits for the federal government. However, it is misleading and perverse to treat this projected explosion in health care costs as a budget problem. If we projected a nuclear war in 2029 then our budget projections for the decade of the 30s would show enormous deficits. The death and destruction from the war would lead to an enormous decline in tax revenues. At the same time the injuries and sickness caused by the war would be placing an enormous strain on our public health system.

In this context, no serious person would be suggesting austerity to address the projected strain on the budget. The obvious focus for policy would be to prevent nuclear war.

In the same vein, those concerned about the projected explosion of the deficit in the decades ahead should be focused on health care costs. This doesn't mean finding ways to shift the burden of costs from the government to individuals, it means fixing the private U.S. health care system so that our costs are not so out of line with costs in other countries. People in the United States don't pay twice as much for cars and computers as

people in Germany, Canada and elsewhere; there is no reason that we should be spending twice as much for health care.

It is of course difficult to control health care costs, as those involved in the reform debate over the last two years will readily attest. Cost savings mean a reduction in income for powerful interest groups: doctors, the pharmaceutical industry, the insurance industry, the medical supply industry among others. All of these groups have powerful lobbies who will do everything they can to prevent cost containment measures that comes at their expense.

However there is no alternative to confronting these interest groups. It is the height of irresponsibility for deficit hawks to suggest budget cuts that would hurt vulnerable populations because they lack the courage to confront the interest groups who are making health care in the United States unaffordable. If the deficit hawks really had the courage they like to ascribe to themselves they would be attacking the rich and powerful, not the poor and the elderly.

1 Congressional Budget Office, 2010. *Budget and Economic Outlook, 2011-2020*, Washington, DC: Congressional Budget Office, Table 4-1 available at <http://www.cbo.gov/ftpdocs/108xx/doc10871/Chapter4.shtml#1098031>.

2 Bernanke, B., 1999. "Japanese Monetary Policy: A Case of Self-Induced Paralysis," Presentation given at the ASSA Meeting, Boston, MA, January 9, 2000.