Statement to the Commission on Deficit Reduction

by James K. Galbraith, Lloyd M. Bentsen, jr. Chair in Governnment/Business Relations, Lyndon B. Johnson School of Public Affairs, The University of Texas at Austin, and Vice President, Americans for Democratic Action. June 30, 2010.

Mr. Chairmen, members of the commission, thank you for inviting this statement.

I am a professional economist, but I have served in a political role, as Executive Director of the Joint Economic Committee of the United States Congress. I am offering this statement on behalf of Americans for Democratic Action, an organization co-founded in 1949 by (among others) Eleanor Roosevelt, John Kenneth Galbraith, Arthur M. Schlesinger, jr., and Ronald Reagan. Accordingly I would like to begin with a political comment.

1. **Clouds Over the Work of the Commission**.

Your proceedings are clouded by illegitimacy. In this respect, there are four major issues.

First, most of your meetings are secret, apart from two open sessions before this one, which were plainly for show. There is no justification for secret meetings on deficit reduction. No secrets of any kind are involved. Nothing you say will affect financial markets. Congress long ago – in 1975 – reformed its procedures to hold far more sensitive and complicated meetings, notably legislative markups, in the broad light of day.

Secrecy breeds suspicion: first, that your discussions are at a level of discourse so low that you feel it would be embarrassing to disclose them. Second, that some members of the commission are proceeding from fixed, predetermined agendas. Third, that the purpose of the secrecy is to defer public discussion of cuts in Social Security and Medicare until after the 2010 elections. You could easily dispel these suspicions by publishing video transcripts of all of your meetings on the Internet, and by holding all future meetings in public. Please do so.

Second, there is a question of leadership. A bipartisan commission should approach its task in a judicious, open-minded and dispassionate way. For this, the attitude and temperament of the leadership are critical.

I first met Senator Simpson when we were both on Capitol Hill; at Harvard he became friends with my late parents. He is admirably frank in his views. But Senator Simpson has plainly shown that he lacks the temperament to do a fair and impartial job on this commission. This is very clear from the abusive response he made recently to Alex Lawson of Social Security Works, who was asking important questions about the substance of the commission's work, as well as calling attention to the illegitimate secrecy under which you are operating.

A general cannot speak of the President with contempt. Likewise the leader of a commission intended to sway the public cannot display contempt for the public. With due respect, Senator Simpson's conduct fails that test.

Third, most members of the Commission are political leaders, not economists. With all respect for Alice Rivlin, with just one economist on board you are denied access to the professional arguments surrounding this highly controversial issue. In general, it is impossible to have a fair discussion of any important question when the professional participants in that discussion have been picked, in advance, to represent a single point of view.

Conflicts of interest constitute the fourth major problem. The fact that the Commission has accepted support from Peter G. Peterson, a man who has for decades conducted a relentless campaign to cut Social Security and Medicare, raises the most serious questions. Quite apart from the merits of Mr. Peterson's arguments, this act must be condemned. A Commission serving public purpose cannot accept funds or other help from a private party with a strong interest in the outcome of that Commission's work Your having done so is a disgrace.

In my view you also should not have accepted help from the Economic Policy Institute, even though EPI's positions on the merits are substantially closer to mine.

Let me now turn to the economic questions. A first economic question is, *what caused the deficits and rising public debt*? The answer comes in two parts: present deficits and projected future deficits.

2. **Current Deficits and Rising Debt were Caused by the Financial Crisis.**.

Overwhelmingly, *the present deficits are caused by the financial crisis*. The financial crisis, the fall in asset (especially housing) values, and withdrawal of bank lending to business and households has meant a sharp decline in economic activity, and therefore a sharp decrease in tax revenues and an increase in automatic payments for unemployment insurance and the like. According to a new IMF staff analysis, fully half of the large increase in budget deficits in major economies around the world is due to collapsing tax revenues, and a further large share to low (often negative) growth in relation to interest payments on existing debt. *Less than ten percent* is due to increased discretionary public expenditure, as in stimulus packages.

This point is important because it shows that the claim that deficits have resulted from "overspending" is false, both in the United States and abroad.

3. **Future Deficit Projections are Generally Based on Forecasts which Begin by Assuming Full Recovery, but this Assumption is Highly Unrealistic**.

Unlike the present deficits, expected future deficits are *not* usually considered to be due to continued recession and high unemployment. To understand how the discussion of future deficits is being framed, it is necessary to grasp the work of the principal forecasting authority, the Congressional Budget Office. CBO's projections proceed in two steps. First, they wipe out the current deficits, over a very short time horizon, by *assuming* a full economic recovery. Second, they create *an entirely new source of future deficits, essentially out of whole cloth.*

The critical near-term assumption in the CBO baseline concerns employment. CBO claims to expect a relatively rapid return, over five years, to high levels of employment, and the baseline incorporates a correspondingly high rate of real growth in the early recovery from the great crisis. If this were to happen, then tax revenues would recover, and ordinarily the projected deficits would disappear. This is what did happen under full employment in the late 1990s.

But under present financial conditions this scenario of a rapid return to high employment is highly unrealistic. It can only happen if the credit system finances economic growth, which implies a rising level of *private* (household and company) debt relative to GDP. And that clearly is not going to happen. On the contrary, de-leveraging in the private sector is sure to remain the rule for a long time, as mortgages and other debts default or are paid down, and as many households remain effectively insolvent due to their mortgage debt.

With high unemployment, high public deficits are inevitable. The only choice is between *an active deficit*, incurred by putting people to work or otherwise serving national needs – such as providing a decent retirement and health care to the aged – and a *passive deficit*, incurred because at high unemployment tax revenues necessarily fail to cover public spending. *Cutting public spending or raising taxes, now or in the future, by any amount, cannot reduce a deficit due to high unemployment.* The *only* fiscal effect is to convert an active deficit into a passive one – with disastrous economic and social effects.

4. **Having Cured the Deficits with an Unrealistic Forecast, CBO Recreates them with Another, Very Different, but Equally Unrealistic Forecast.**

In the CBO models, high future deficits and rising debt relative to GDP are expected. But the source is not a weak economy. It is a set of assumptions describing an economy after full recovery from the present crisis. In the CBO forecasts, big future deficits arise from a combination of (a) rapidly rising health care costs and (b) rising short-term interest rates, in the context of (c) a rapid return to high employment and (d) continued low overall inflation. This combination produces, mechanically, a very large net interest payout and a rapidly rising public debt in relation to a slowly rising nominal GDP.

Even if CBO were right about recovery, which it is not, this projection is *internally inconsistent* and *wholly implausible*. It isn't going to happen. Low overall inflation (at two percent) is inconsistent with the projected rise of short-term interest rates to nearly five percent. Why would the central bank carry out such a policy when no threat of inflation justifies it? But the assumed rise in interest rates drives the projected debt-to-GDP dynamic.

Similarly, the rise in projected interest payments is inconsistent with low nominal inflation. Interest payments rising to over 20 percent of GDP by mid-century would constitute new federal spending similar in scale to the mobilization for World War II. Obviously this cannot happen with two percent inflation. And although a higher inflation rate is undesirable, arithmetically it means a lower debt-to-GDP ratio.

Finally, rapidly rising health care costs and low overall inflation are mutually consistent only if all prices except health care are rising at less than that low overall inflation rate – including energy and food prices in a time of increasing scarcity. This too is extremely unlikely. Either overall health care costs will decelerate (relieving the so-called Medicare funding problem) or the overall inflation rate will accelerate – reducing the debt-to-GDP ratio.

In sum: the economic forecasts on which you are being asked to develop a credible plan for reducing deficits over the medium term are a mess. The unemployment and growth forecasts are implausibly optimistic, while the inflation and interest rates projections are implausibly pessimistic and mutually inconsistent.

Good policy cannot be based on bad forecasts. As a first step in your work -- long overdue -- the Commission should require the development of internally consistent, and factually plausible, economic forecasts on which to base future deficit and debt projections.

5. **The Only Way to Reduce *Public* Deficits is to Restore *Private* Credit.**

The conclusion to draw from the above argument is that large deficits going forward are likely to have the same source as they do right now: stubbornly high unemployment.

The only way to reduce a deficit caused by unemployment is to reduce unemployment. And this must be done with a substantial component of *private* financing, which is to say by bank credit, if the *public* deficit is going to be reduced. This is a fact of accounting. It is not a matter of theory or ideology; it is merely a fact. *The only way to grow out of our deficit is to cure the financial crisis.*

To cure the financial crisis would require *two* comprehensive measures. The first is debt restructuring for the entire household sector, to restore private borrowing power. The second is a reconstruction of the banking system, effectively purging the toxic assets from bank balance sheets and also reforming the bank personnel and compensation and other practices that produced the financial crisis in the first place. To repeat: *this is the only way to generate deficit-reducing, privately-funded growth and employment.*

As a former top adviser in the Clinton White House, co-chairman Bowles no doubt knows that privately-funded economic growth produced the boom years of the late 1990s and the associated surplus in the federal budget. He must also know that the practices of banks and investment banks with which they were closely associated worked to destroy the financial system a decade later. But I would wager that the Commission has spent no time, so far, on a discussion of the relationship between deficit reduction and financial reform.

To be clear: unemployment can be cured *without* private-sector financing, if public deficits are large enough – as was done during World War II. But if the objective is to reduce public deficits, for whatever reason, then a large contribution from private credit is essential.

One more time: without private credit, deficit reduction plans through fiscal austerity, now or in the future, will fail. They cannot succeed. If at the time the cuts take effect the economy is still relying on public expenditure to fund economic activity, then reducing expenditure (or increasing taxes) will simply reduce GDP and the deficits will not go away.

Further, if the finances of the private sector could be fixed, then an austerity program would be entirely unnecessary to reduce public debt. The entire national experience from 1946 to 1980, when public debt fell from 121 to about 33 percent of GDP and again from 1994 to 2000, proves this. In those years the debt-to-GDP ratio fell mainly because of credit-driven economic growth -- certainly not because of public-sector austerity programs. And this is why the deficits returned, in 1980-2 and in 2000, once the credit markets froze up and the private economy entered recession.

Thus until the private financial sector is fully reformed -- or supplemented by parallel financing institutions as was done in the New Deal – high deficits and a high public-debt-to-GDP ratio are inevitable. In the limit, if there is no private financial recovery, debt-to-GDP will converge to some steady-state value, probably near 100 percent - a normal number in some countries - and at that point the public deficit will be the sole engine of new economic growth going forward. Only when the private sector steps up, will the debt-to-GDP ratio begin to decline.

For this reason, a Commission report focused on "entitlement reform" rather than "financial reform" would be entirely beside the point. *Entitlement cuts, no matter how severe, cannot and will not achieve deficit reduction.* They cannot "meaningfully improve the long-term fiscal outlook," as required by your charter. All they will accomplish is to impoverish vulnerable Americans, impairing the functioning of the private economy and the taxing capacity of the government.

6. **Social Security and Medicare "Solvency" is not part of the Commission's Mandate.**

I note from Chairman Simpson's conversation with Alex Lawson that the Commission has taken up the questions of the alleged "insolvency" of the Social Security system and of Medicare. If true, this is far outside any mandate of the Commission. Your mandate is strictly limited to matters relating to the deficit, debt-to-GDP ratio and fiscal stability *of the U.S. Government as a whole*. Social Security and Medicare are part of the government as a whole, so it is within your mandate to discuss those programs – but only *in that context*.

To make recommendations about the matching of benefits to payroll taxes – now or in the future – would be totally inappropriate. Within your mandate, the levels of payroll taxes and of Social Security benefits are relevant only insofar as they influence the current and future fiscal position of the government as a whole. Their relationship to each other is not relevant. You are not a "Social Security Commission" and there is no provision in your Charter for a separate discussion of the alleged financial condition of either program taken on its own. Such discussions, if they are occurring, should be subjected to a point of order.

The usual "solvency" arguments directed at the Social Security system and at Medicare as separate entities are in any event complete nonsense. These programs are just programs, like any others, in the Federal Budget, and the Social Security and Medicare "systems" are thus fully solvent so long as the Federal Government is. Further, as explained below, under our monetary arrangements there is no "solvency" issue for the federal government as a whole. The federal government is "solvent" so long as U.S. banks are required to accept US. Government checks – which is to say so long as there is a Federal authority in the Republic. This point has been demonstrated repeatedly in times of stress, notably during the Civil War and World War II.

7. **As a Transfer Program, Social Security is Also Irrelevant to Deficit Economics.**

Political discussions of "long-term fiscal sustainability" – including in the Charter for this Commission – make an economic error when they loosely use the word "entitlements" and suggest that supposed economic dangers of federal deficits (for instance, rising real interest rates) can be reduced by "entitlement reform." As a matter of economics, this is not true.

"Government Spending" – as any textbook will verify – is a component of GDP only insofar as the spending is directly on purchases of goods and services. That alone is what economists mean by the phrase "government spending." GDP is the final consumption of produced goods and services, and government is one of the major consuming sectors; the others being private business (investment) and households (consumption).

Social Security is a transfer program. It is not a spending program. A dollar "spent" on Social Security does not directly increase GDP. It merely reallocates a dollar from one potential final consumer (a taxpayer) to another (a retiree, a disabled person or a survivor). It also reallocates resources within both communities (taxpayers and beneficiaries). Specifically, benefits flow to the elderly and to survivors who do not have families that might otherwise support them, and costs are imposed on working people and other taxpayers who do not have dependents in their own families. Both types of transfer are fair and effective, greatly increasing security and reducing poverty – which is why Social Security and Medicare are such successful programs.

Transfers of this kind are also indefinitely sustainable – in fact there can intrinsically be no problem of sustainability with transfer programs. Apart from their effect on individual security, a true transfer program uses (by definition) no *net* economic resources. The only potential macroeconomic danger from "excessive" transfers is that the transfer function may be badly managed, leading to excessive *total demand* and to inflation. But there is no risk of this so long as the financial crisis remains uncured. Under present conditions Social Security and Medicare are bulwarks for stabilizing a total demand that would otherwise be highly deficient.

Similarly, cutting Social Security benefits, in particular, merely transfers real resources away from the elderly and toward taxpayers, and away from the poor toward those less poor. One can favor or oppose such a move on its own merits as social policy – but one cannot argue that it would save real resources that are otherwise being "consumed" by the government sector.

The conclusion to be drawn is that Social Security should in any event be off the agenda of your Commission, as it is a transfer program and not a program of public spending in the economic sense. In particular it does not use capital resources and will not drive up interest rates. This is true whether the "Social Security System" is in internal balance or not.

8. **Markets are *not* calling for Deficit Reduction*; now or later*.**

Let me turn next to a larger economic question. Do deficit projections matter? Are they important? Was the President well-advised to frame the mandate of the Commission as he did?

What, in short, are the economic consequences of a high public deficit and a rising debt-to-GDP ratio, and what (if any) benefits are to be expected from creating an expectation that deficits will come down and that the debt-to-GDP ratio will fall?

The idea that US economic policy should aim for a path of reduced deficits in the future, is shared by liberals and conservatives, and it is, from a political standpoint, a very powerful idea. The Commission's charter takes for granted that this goal is desirable. It specifies that your objective is to achieve a balanced "primary budget" – net of interest payments, by 2015.

Yet your charter does say *why* this is an appropriate goal. It cites no study to which one might refer. It does not explain why 2015 is the right target date, as opposed to (say) 2025 or even 2050. It does not spell out the economic consequences – if any – of failing to meet the stated objective.

Does the requirement make economic sense? I shall tackle that question in two parts. The first accepts the view most people hold of the fiscal and financial world. The second reflects, from an operational standpoint, how that world actually works in practice.

Most informed laymen believe that the Federal government must borrow in order to spend. They believe that the interest rate on Treasury securities is set in a market for government bonds. The markets impose discipline on the government. Thus their idea is that "fiscal responsibility" will produce low long-term interest rates and tolerable borrowing conditions for the federal government, while "irresponsibility" will be punished by higher, and eventually intolerable, debt service costs.

Accepting this view for the moment, what does the present level of long-term interest rates tell us? As I write, thirty year Treasury bonds are yielding just over four percent – or just a little more than half their yield a decade back. On the argument just given, *this must be an extraordinary success of virtuous policy*. It seems that Wall Street has made a strong vote of confidence in the fiscal probity of our current policies. This vote is unqualified, backed by money, contingent on nothing. It therefore represents a categorical rejection, by Wall Street itself, of the CBO's doomsday scenarios and all other deficit-scare stories.

On this theory, it follows that the mandate to reduce the primary deficit to zero by 2015 is unnecessary. Such an action can hardly reduce interest rates – neither short nor long-term – which are already historically low.

But wait a minute, some may say. Yes interest rates are low at the moment. But bond markets are fickle, they can turn on a dime. And what then?

Yes, it is possible that interest rates could rise. But the problem with this argument is that it takes us away from the premise of rationality. If bond markets are fickle and arbitrary, who is to say what they will do in response to any particular policy? In the face of irrational markets, the sensible policy is to borrow heavily for so long as they are offering a good deal. One may say that all good things end, and perhaps they will. But if markets are irrational, then by construction you cannot prevent this by "good behavior."

The conclusion from this section is that one cannot logically argue that markets insist on deficit reduction. Either the markets are rationally unworried about deficits, or they are acting irrationally right now, in which case they can hardly "insist" on anything.

9. **In Reality, the US Government Spends First & Borrows Later; Public Spending Creates a Demand for Treasuries in the Private Sector.**

As noted, the above argument is based on the common belief that the government must borrow in order to spend, and thus that the government faces "funding risks" in private markets. Such risks exist, of course, for private individuals, for companies, for state and local governments, and for national governments such as Greece that have ceded monetary sovereignty to a central bank. But the situation of the United States government is quite different.

The U.S. government spends (and the Federal Reserve lends) in a very simple way. It does so by writing checks -- in fact simply by marking up numbers in a computer. Those numbers then appear in the bank accounts of the payees, who may be government employees, private contractors, or the recipients of federal transfer programs.

The effect of government check-writing is to create a deposit in the banking system. This is a "free reserve." Banks of course prefer to earn interest on their reserves. Thus they demand a US Treasury bond, which pays more interest without incurring any form of credit or default risk. (This is like moving a deposit from a checking to a savings account.) The Treasury can meet that demand, or not, at its option – it can permit, or not permit, the stock of US Treasury bonds in circulation to increase.

So long as U.S. banks are required to accept U.S. government checks – which is to say so long as the Republic exists – then the government can *and does* spend *without* borrowing, if it chooses to do so. And if it chooses to issue Treasuries to meet the demand, it can do that as well. There is *never* a shortfall of demand for Treasury bonds; Treasury auctions do not fail.

In the real world, the government creates demand for bonds by spending above the level drained by taxation from the system. The extent to which those bonds are held locally, or abroad (another common source of worry) depends on the US current account deficit. This also has nothing to do with approval or disapproval by foreign bankers, central bankers, or their governments of American deficit policy. A foreign country cannot acquire a US Treasury bond unless someone outside the United States has acquired dollars to pay for them, which is generally done by running a trade surplus with the United States. And when foreigners do acquire those dollars, then like domestic banks they prefer to earn interest, which is why they buy Treasury bonds.

Insolvency, bankruptcy, or even higher real interest rates are not among the actual risks to this system. The actual risks in this system are (to a minor degree) inflation, and to a larger degree, depreciation of the dollar. However at the moment there is wide agreement that a lower dollar would be a good thing – against the Chinese RMB and now also the euro. So it is difficult to believe that the goal of deficit reduction *per se* serves any coherent, or presently desirable, economic objective.

We can conclude that there is actually no economic justification for the target of reducing the primary deficit to zero by 2015 or any other date. The right economic objectives are to meet real problems, not those conjured from thin air by economists. Bringing about a rapid end to unemployment, caring properly for an aging population, cleaning up the Gulf of Mexico, coping with our energy insecurity and with climate change are all far more important objectives than reducing a projection of future budget deficits.

10. The Best Place in History (for this Commission) Would be No Place At All.

Most people assume that "bipartisan commissions" are designed to fail: they are given thorny (or even impossible) issues and told to make recommendations which Congress is free to ignore or reject. In many cases – yours is no exception – the goal is to defer recognition of the difficulties for as long as possible.

You are plainly not equipped by disposition or resources to take on the true cause of deficits now and in the future: the financial crisis. Recommendations based on CBO's unrealistic budget and economic outlooks are destined to collapse in failure. Specifically, if cuts are proposed and enacted in Social Security and Medicare, they will hurt millions, weaken the economy, and the deficits will not decline. It's a lose-lose proposition, with no gainers except a few predatory funds, insurance companies and such who would profit, for some time, from a chaotic private marketplace.

Thus the interesting twist in your situation is that the Republic would be better served by advancing no proposals at all.

Thank you again for the opportunity to present this statement.