Session 4
The Economic Crisis

30 July 2010

I have included the economic crisis as the second main threat to our national security (along with the threat of terrorist attacks). In many ways, I consider it to be a much greater threat than terrorism. The economic threat is much harder to grasp for most people and it is largely an internal matter. This should not be interpreted to mean that we are isolated from the global economic system; nothing that follows should imply that. The global economic system is so integrated that what happens in one part of the system impacts on the rest of the system. This fact alone dictates that there is international cooperation in solving the problem. Unless one accepts this reality, and the necessity of yielding some national sovereignty to international organizations such as the United Nations and the G-20 group, the system will collapse with catastrophic consequences. Nonetheless, people see it as an internal problem that can be blamed on our government and the threat is hard to understand. This makes it difficult to rally national will.

Time limitations preclude any in-depth treatment of this subject, particularly the international aspect of the problem. So we will focus on the main points of contention that threaten a rational approach to the threat we face. Much of the heated debate that divides the people revolves around the growing national debt and the yearly deficit that is adding to that debt. It is a complex issue and understandably most people are confused about the correct policy. Consequently, people look to some authoritative source to explain the issue in simplistic terms. Unfortunately, many of these explanations are framed for their ideological and political impact. I will do my best to summarize the facts as best as I can in a non-partisan way, but we will have the full spectrum of ideological and political views represented in the classroom. Hopefully, we can agree on some empirical data and discuss our ideological differences in a dispassionate manner. I will begin with some basic concepts that need to be understood.

<u>The Deficit</u>. The gap between revenues and spending for a given Fiscal Year (1 October-30 September) represents the annual deficit. According to the Congressional Budget Office (CBO), the current deficit is running about $1.3T. One might get confused over the conflicting figures describing deficits, because different figures are used for different purposes—sometimes to mislead the reader. For many years Social Security revenues from payroll deductions ran a surplus. Since these go into the general revenue pot (LBJ engineered this in the 1960s to make it appear that we could afford “guns and butter”), the reported deficits have been understated. This hides the fact that the government has been borrowing much more than indicated by the announced deficit. Now that the revenues from payroll deductions are not enough to cover the expenditures for Social Security benefits, the government must start drawing from the Trust Fund to make up the shortage. Because of the recession and loss of revenues, for 2010, this amounts to $46B. In essence, for many years we were mortgaging the future and covering it up, but we can no longer do that.

<u>The National Debt</u>. The accumulation of annual deficits over the years is the total national debt. We are faced with a national debt of about $14T and are running annual deficits of about $1.3 T. The debt is projected to reach $16T-$18T by 2014, smack in the middle of the next administration. Approximately 55% of this debt is held by the public; the rest is debt owed to trust funds, such as the Social security Trust Fund ($2.5T). Of the portion held by the public, about $3.4T is held by foreign countries (China, almost $1T). The public held debt must be

serviced as securities expire; the trust funds don't have to compete. In this regard, the public portion is more critical than the trust funds; but don't be deceived, both are obligations. The public portion must compete in the open market when new borrowing is required. The projected U.S. deficit financing needs are: 2011-$2.4T; 2012-$2.1T; 2013-$1.4T. Nations around the world will be doing the same and the private sector will be borrowing also. All will be competing and interest rates will likely rise. The portion of our spending to service the debt will grow accordingly

Servicing the national debt is somewhat analogous to a private family debt. If you have a variable-rate mortgage, you must pay, and at critical times, your interest rate goes up. If at the same time, you borrowed some money from your spouse, you may not be in a bind when rates increase. In the case of the national debt obligations, the government must draw form the Social Security Fund to pay entitlements. Since there are no greenbacks there, it must go to the public auction to issue new security notes. These trust funds represent obligations in the form of government securities. They are just as much part of the debt as are the securities held by the public. When you hear that these trust funds are nothing more than "paper", remember that all obligations are "paper" or, more often than not, electronic. If you have a bank account, the bank doesn't have a wad of greenbacks stored in a vault with your name on it; it has an electronic entry obligating the amount owed. If you own government securities, they are mere electronic entries.

How did we get to this point and why are we screaming about the deficits and debt? When Carter left office in 1981, our total debt was less than $1T. When Reagan left office, it was approximately $3T; when GHW Bush left office, it was $4.2T; when Clinton left office, it was $5.7T; when GW Bush left office, it was $11.2T. This was the result of deficit financing; there was a gap between revenues and expenditures. Most of this was produced by tax cuts without spending cuts. Because Social Security revenue was running a surplus, the actual deficit was hidden from published figures. To cover the real debt, officials would only cite the "public" debt, which hid the debt to the trust funds. We did not hear much about the deficits that led to this massive accumulation of debt; the public seemed to be unconcerned. The only administration to balance the budget was Clinton's, which had a surplus by the end of the second term. He raised taxes and cut some spending.

In the most basic terms, deficits occur when revenues do not cover spending. That means that the government is spending more than it is taking in. If we don't want to cut spending, we have a choice: "tax and spend," or "borrow and spend." The American voters do not like cuts in spending, except when it does not "gore their ox." Neither do they like to pay taxes. The popular thing to do politically is to borrow and spend. That is the policy adopted by Reagan. The marginal rate of income taxes (the rate that kicks in at a certain income level). Since the income tax was adopted after the 16th amendment in 1913, the top rate was never (except in the 20s) under 39.6% until Reagan cut it to 28% in two steps. During the period from WWII to the Kennedy administration, it was 91%. This high rate contributed to our reduction of the debt accumulated in WWII. Kennedy lowered it to 70% and we continued to reduce the debt. It remained there until Reagan lowered it to 50% and later to 28%.

In essence, Reagan adopted the policy of borrow and spend. He argued that the cuts would pay for themselves. That economic theory is still the favored theory of the current Republican leadership. In addition to the rates, Reagan adopted the "supply-side" theory of tax cuts. If the wealthy keep their money, they will create jobs and all boats will rise. Empirical data do not appear to support those assumptions. When GHW Bush ran against Reagan in 1980, he called these theories “Voodoo economics.” In spite of that view, during the 1988 election campaign GHW Bush declared, “read my lips, no new taxes.” After assuming office, Bush acknowledged his error and raised the marginal rate to 31%. This helped to narrow the deficit, but it may have cost him a second term.

In his first budget, Clinton raised the marginal rate to 39.6%. (Not one Republican in either the Senate or House voted for these increases). In the next election, the Democrats lost both houses of Congress. Raising taxes, even if it is on the wealthy and reduces deficits, is the third rail of politics. Clinton also cut spending, announcing that “we would end welfare as we know it.” (That included throwing 6 million into poverty). By the end of Clinton’s administration, we were running large surpluses, which Clinton pledged would be used to reduce the debt.

When GW Bush took office, he returned to “Reagonomics.” He reduced the marginal rate to 35% (of five tax brackets, the lowest rate is 10% and the intermediate is 28%). In congressional testimony, Alan Greenspan argued that if we reduced the debt too fast, we would invite more government spending; he supported the tax cuts. Bush wanted the cuts to be permanent, but Congress would only make them temporary. (They expire this year unless they are renewed). Congress passed the cuts by a large margin; it was politically risky to vote against tax cuts, even though the benefits were mostly for the higher income earners. (In 1980, the top 1% of earners took home 10% of income; in 2008 the top 1% took home 23%). The Bush years steadily increased deficits and at the end of his second term there were huge deficits

The recession that started in late 2007 gained speed as the financial industry started to collapse. After the refusal of the Bush administration to bail out one large firm, there was panic throughout the international financial industry. In pushing for the Troubled Asset Relief Program (TARP), Bush said that all his advisors told him that if he did not do it, we would likely have a depression greater than the 1930s. Some who voted for it, Republicans and Democrats, have paid the price even thought the government has already recouped its money, with interest. The negative View of TARP by the public hurts Obama even though he had nothing to do with it, other than voting for it as a senator. Only 34% attribute it to Bush; 47% “blame” Obama.

Obama came to office in the midst of a recession that threatened to turn into a worldwide depression. Virtually all economists believed that something had to be done. The G-20 group agreed that all countries would initiate a stimulus program to make up for the lack of private-sector stimulus. In short, this was a decision to employ Keynesian economics instead of letting the market work itself out of the recession. In essence, Reagan and Bush followed it to some extent. Keynes, however, argued that government stimulus was to be used in emergencies and as soon as the emergency, e.g. WWII, was over, the debt should be paid.

Obama asked for a stimulus package; congress; Congress approved $787B. The package was a compromise between the Republican preference for large tax cuts and the Democratic preference for government spending programs. About 1/3 went to taxes, about 1/3 to repair infrastructure, and the remainder to retain workers in the service sector, to include teachers, health workers, etc. Much of the latter funds went to the States. The program will end in 2010. Depending on whom you ask, this program was either a failure or a success. The following is an article that summarized various sources:

> According to private forecasters -- we're not talking Obama administration folks, but private firms that are paid by other private companies to accurately analyze the market -- the stimulus worked. "Perhaps the best-known economic research

firms are IHS Global Insight, Macroeconomic Advisers and Moody's Economy.com," reports David Leonhardt. "They all estimate that the bill has added 1.6 million to 1.8 million jobs so far and that its ultimate impact will be roughly 2.5 million jobs. **The Congressional Budget Office, a non-partisan organization, considers these estimates to be conservative."**

A recent survey indicated that only 6% of the public believes the stimulus created jobs! In terms of national will, perception is reality.

The current unemployment rate is 9.5%. What would it have been if there had been no stimulus plan? We will never know, because one can never prove the negative. Should it have been bigger? Some economist argued for a $1.5T package and some are arguing for an additional program for this coming year. As a percentage of GDP, China's stimulus was three times that of the U.S. There is a political clamor to reduce the "runaway spending," the deficit, and the debt. How do we balance the need for stimulating the economy while reducing the deficit? Reduced government spending and/or tax increases may nip the recovery in the bud and send the economy on another path downward.

The answer seems to be that there is a short-term problem and a long-term problem. In the short term we must ensure that we maintain the recovery path. In the long term, we must have an economic strategy that puts our fiscal house in order. Since Congress has shown no willingness to come to grips with the problem, what is the solution? Obama asked Congress to pass legislation to form a bi-partisan committee that would develop a strategy that would be presented to Congress for an up-or-down vote, similar to the Base Realignment and Closing program (BRAC). Congress refused, and Obama appointed the National Commission on Fiscal Responsibility and Reform (NCFRR) by a directive. That will not have the clout of a congressional-mandated group, but we will see if it works. That group will report out in December 2010.

So where are we, and is it a problem? For reasons beyond the scope of this paper, we have been able to service our debt fairly cheaply. Interest rates are low and we have had no trouble replacing the securities when they come due. But this has depended on our "credit rating," that is, do people who loan us the money have confidence that we will honor our obligations? And as we know, those who finance us will demand higher returns as the risk increases. Already, the questions are arising concerning our fiscal stability. Will we run up a debt so large that we cannot meet our obligations?

Here are a few comments describing the problem:

OMB Director Peter Orszag stated in a November 2009 interview: "It's very popular to complain about the deficit, but then many of the specific steps that you could take to address it are unpopular. And that is the fundamental challenge that we are facing, and that we need help both from the American public and Congress in addressing." He characterized the budget problem in two parts: a short- to medium-term problem related to the financial crisis of 2007–2010, which has reduced tax revenues significantly and involved large stimulus spending; and a long-term problem primarily driven by increasing healthcare costs per person. He argued that the U.S. cannot return to a sustainable long-term fiscal path by either tax increases or cuts to non-healthcare cost categories alone; the U.S. must confront the rising healthcare costs driving expenditures in the Medicare and Medicaid programs.

Fareed Zakaria said in February 2010: "But, in one sense, Washington is delivering to the American people exactly what they seem to want. In poll after poll, we find that the public is generally opposed to any new taxes, but we also discover that the public will immediately punish anyone who proposes spending cuts in any middle class program which are the ones where the money is in the federal budget. Now, there is only one way to square this circle short of magic, and that is to borrow money, and that is what we have done for decades now at the local, state and federal level...So, the next time you accuse Washington of being irresponsible, save some of that blame for yourself and your friends."

Andrew Sullivan said in March 2010: "...the biggest problem in this country is...they're big babies. I mean, people keep saying they don't want any tax increases, but they don't want to have their Medicare cut, they don't want to have their Medicaid [cut] or they don't want to have their Social Security touched an inch. Well, it's about time someone tells them, you can't have it, baby...You have to make a choice. And I fear that -- and I always thought, you see, that that was the Conservative position. The Conservative is the Grinch who says no. And, in some ways, I think this in the long run, looking back in history, was Reagan's greatest bad legacy, which is he tried to tell people you can have it all. We can't have it all."

Harvard historian Niall Ferguson stated in a November 2009 interview: "The United States is on an unsustainable fiscal path. And we know that path ends in one of two ways; you either default on that debt, or you depreciate it away. You inflate it away with your currency effectively." He said the most likely case is that the U.S. would default on its entitlement obligations for Social Security and Medicare first, by reducing the obligations through entitlement reform. He also warned about the risk that foreign investors would demand a higher interest rate to purchase U.S. debt, damaging U.S. growth prospects.

According to a CBS News/New York Times poll in July 2009, 56% of people were opposed to paying more taxes to reduce the deficit and 53% were also opposed to cutting spending. According to a Pew Research poll in June 2009, there was no single category of spending that a majority of Americans favored cutting. Only cuts in foreign aid (less than 1% of the budget), polled higher than 33%. Economist Bruce Bartlett wrote in December 2009: "Nevertheless, I can't really blame members of Congress for lacking the courage or responsibility to get the budget under some semblance of control. All the evidence suggests that they are just doing what voters want them to do, which is nothing."

A Bloomberg/Selzer national poll conducted in December 2009 indicated that more than two-thirds of Americans favored tax increases on the rich (individuals making over $500,000) to help solve the deficit problem. Further, an across-the-board 5% cut in all federal discretionary spending would be supported by 57%; this category is about 30% of federal spending. Only 26% favored tax increases on the middle class and only 23% favored reducing the growth rate in entitlements, such as Social Security.

A Rasmussen Reports survey in February 2010 showed that only 35% of voters correctly believe that the majority of federal spending goes to just defense, Social Security and Medicare. Forty-four percent (44%) say it's not true, and 20% are not sure. A January 2010 Rasmussen report showed that overall, 57% would like to see a cut in government spending, 23% favor a freeze, and 12% say the government should increase spending. Republicans and unaffiliated voters overwhelmingly favor spending cuts. Democrats are evenly divided between spending cuts and a spending freeze.

According to a Pew Research poll in March 2010, 31% of Republicans would be willing to decrease military spending to bring down the deficit. A majority of Democrats (55%) and 46% of Independents say they would accept cuts in military spending to reduce the deficit.

In the January edition of Atlantic Monthly, James Fallows declared that the U.S. political system is dysfunctional. Unless we fix it, he said, we will either have a new Constitution, or a coup. He rules out both as unthinkable, and argues that we will fix it. His 26-page essay did not convince me. The coming election promises to be one that will bring new members to Congress who are dedicated to "controlling spending." Few, if any, have provided specifics on how they intend to do this. Most, especially those with the support of the "Tea Party," pledge to not raise taxes.

Reducing our debt to a manageable amount will take a mixture of increased taxes and reduced benefits. Both bitter pills will need to wait until the recovery is well underway; taking the medicine too soon could nip the recovery in the bud. Delaying will accumulate more debt and run the risk of hyper-inflation. It will take a careful balancing act. Whether enough politicians of either party will have the moral courage to bite the bullet is open to question. The fate of our nation rests on the outcome. On the other hand, if we slide into a deep depression because we do not take aggressive action to prevent it, we will end up on the same list. If we continue down the path of the past 30 years, we may end up on the list of countries in Paul Kennedy's book, The Rise and Fall of the Great Powers. His central thesis is that all the great powers have bankrupt themselves by trying to extend their control through the use of military power.

Competing Political Philosophies.

The most fundamental problem facing the American people, it seems to me, is what role they want the federal Government to play in their economic lives, especially in the budget. At the heart of the issue is what percentage of the GDP do we want to allocate to the government. For the last few decades, it has amounted to slightly over 20.5% for the national government. State and local governments get another 15-18% (This varies of course) for a total of 35-38%. In comparison, most European countries average about 50% total. Benefits in those countries, of course, are much greater. All provide universal health care, free education at higher levels, etc. the U.S. has focused more on “small government” and lower taxes. This philosophy is deeply ingrained in our body politic and provides bumper-sticker political slogans.

What should share of our GDP should go to the Federal Government? Some in the Republican leadership has given the figure of 18% as a cap. That would result in drastic, even draconian cuts to major programs, especially since they have fenced off defense. Some on the other end of the spectrum argue that the figure should be 22%, still far below that of European countries. That is an annual gap of $600B. Interestingly, Senator Simpson, a Republican member appointed by Obama, said the NCFRR is considering 21%. The Obama agenda would put us at the upper range.

Obama’s economic agenda is at the heart of the bitter partisan divide over his domestic policies. The Obama economic agenda is very ambitious and if implemented, has far-reaching consequences regarding government involvement in economic affairs. Projections show a significant increase in an-already massive national debt. The two political parties have sharply different economic philosophies that underlie the bitter debate. The specter of “socialism” is constantly raised. “Communism” is often used interchangeably with “socialism” to describe his agenda.

The debate over government intervention in economic affairs is in reality a subset of a broader debate about the role of government involvement in people’s lives. This goes back to the founding of the Republic and the crafting of the Constitution. There was a general consensus by the Founding Fathers that the “least government is the best government.” That philosophy is deeply imbedded in the American psyche and has a powerful political appeal. In essence, the Constitution stresses that philosophy. As interpreted by the Supreme Court, government, at any level, can restrict privacy and individual freedom only when it (government) can show a compelling interest of society to do so. This would seem to side with the Republican philosophy regarding economic freedom; thus, “free enterprise” should be protected. The devil is in the details; what constitutes a “compelling societal interest” is open to a wide range of interpretations.

Throughout the history of the nation, competing philosophies about the role of government in economic affairs have competed in the political arena. The competing philosophies play out in elections and the legislative process and ultimately reflect the will of the people. Since the beginning, the trend has steadily moved toward more government involvement in economic affairs. The final arbiter on how far this can go within the bounds of the Constitution is, of course, the Supreme Court. That body decides how far the “will of the people” can go. One should read the history of Supreme Court decisions to see the logic, or illogic, of this trend (see my summary in the essay, regulation of economic activities in session two).

The current struggle between the Republicans and Democrats over the role of government in economic activities goes back to the birth of our republic, when Hamilton and Jefferson squared off in a battle to define the role of the federal government in, among other issues, economic affairs. The conflict was a broader debate over whether we would have a strong or weak central government. While these two were the most visible antagonists, their philosophy is best contained in two documents: The Federalist Papers and the Federalist Farmer. The authors of the former document (Federalists) advocated a strong role for the national government and the authors of the latter (Anti-Federalists) favored a weak national government with more power residing in the States. The Republicans are the Anti-Federalists today.

From what I can glean from recent voter behavior, this is the prevailing view: "Don't tax me, tax the person behind the tree; don't cut my benefits, cut those of the person behind the tree." Specifying tax increases or cuts in spending are recipes for failure in a political campaign.