The Budget Deficit Scare Story
and the Great Recession

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Executive Summary

The country is suffering through the worst economic downturn since the Great Depression. Tens of millions of people face unemployment, underemployment and/or the loss of their homes. The enormous suffering created by this crisis should be the main focus of economic policy. However, a well-funded public relations campaign has managed to largely push the economic crisis to the back burner and instead focus on the federal budget deficit. This anti-deficit campaign has helped to derail efforts to address the downturn, leading to an enormous amount of unnecessary suffering.

This paper corrects some of the misperceptions being fostered by the anti-deficit campaign. It points out that:

1) The extraordinary level of current deficits is overwhelmingly the result of the economic crisis. There is little reality to the claim that Congress is out of control in its tax and spending policies.

2) The budget deficit does not pose an economic problem at present. If the budget deficit were smaller, we would simply be seeing higher unemployment. There would be no short-term or long-term benefit from reducing the current deficit.

3) The size of the longer-term deficit problem has been both exaggerated and misrepresented. Projections show that debt-to-GDP ratios will be well within manageable levels at least a decade into the future, even if there are no major changes from baseline scenarios. As a long-term issue, the United States must fix its broken health care system.

4) The wealth of near-retirees has been devastated by the collapse of the housing bubble and the plunge in the stock market. Any substantial reduction in Social Security or Medicare benefits will likely leave large segments of middle-income workers with near-poverty level incomes in retirement.

5) Concerns about foreign ownership of the government debt are offensive jingoism. There is an issue about foreign indebtedness because this implies that an increased portion of future output will be paid out as interest and/or dividends to foreigners rather than being available for domestic consumption. However, this is driven by the trade deficit, not the budget deficit. The trade deficit, in turn, is attributable to the over-valuation of the dollar.
Introduction

The country is suffering through the worst economic downturn since the Great Depression. Tens of millions of people face unemployment, underemployment and/or the loss of their homes. By any objective standard, the enormous suffering created by this crisis should be the main focus of economic policy. However, a well-funded public relations campaign has managed to largely push the economic crisis to the back burner. Instead, news reports and political debates are filled with discussions of the federal budget deficit. This anti-deficit campaign has helped to derail efforts to address the downturn, leading to an enormous amount of unnecessary suffering.

This paper corrects some of the misperceptions being fostered by the anti-deficit campaign. It points out that:

1) The extraordinary level of current deficits is overwhelmingly the result of the economic crisis. If any part of the system is “broken,” as claimed by some deficit hawks, it is the structure of economic policymaking that allowed for an $8 trillion housing bubble to grow unchecked. It was inevitable that this bubble would eventually burst, leading to the sort of economic crisis that the country is now experiencing. This crisis was both foreseeable and preventable. There is little reality to the claim that Congress is out of control in its tax and spending policies.

2) The budget deficit does not pose an economic problem at present. If the budget deficit were smaller, we would simply be seeing higher unemployment. There would be no short-term or long-term benefit from reducing the current deficit.

3) The size of the longer-term deficit problem has been both exaggerated and misrepresented. Projections show that debt-to-GDP ratios will be well within manageable levels at least a decade into the future, even if there are no major changes from baseline scenarios. As a long-term issue, the United States must fix its health care system. This, not demographics, is the real long-term deficit problem, as can be easily shown.

4) The wealth of near-retirees has been devastated by the collapse of the housing bubble and the plunge in the stock market. The economic prospects for these age cohorts look bleak even assuming currently scheduled benefits from Social Security and Medicare. Any substantial reduction in these benefits will likely leave large segments of middle-income workers with near-poverty level incomes in retirement.

5) Concerns about foreign ownership of the government debt are offensive jingoism. There is an issue about foreign indebtedness because this implies that an increased portion of future output will be paid out as interest and/or dividends to foreigners rather than being available for domestic consumption. However, this is driven by the trade deficit, not the budget deficit. The trade deficit, in turn, is attributable to the over-valuation of the dollar. The deficit hawks have rarely focused on the value of the dollar, preferring instead to hype misleading concerns about foreign (especially Chinese) ownership of government debt.

There are real issues with the budget that the country will have to address, however virtually all of the current discussion of the deficit has been misleading and has obstructed the effort to address the
worst downturn since the Great Depression. Remarkably, the country is allowing many of the same policy experts whose incompetence led us into this crisis to continue to guide economic policy as we try to cope with the crisis.

The Surging Deficit: Where Did It Come From?

In fiscal year 2007, the country had a unified budget deficit of $162.8 billion, or 1.2 percent of GDP. Since this was at a business cycle peak, the deficit was arguably higher than would have been desirable, but no one would have claimed a deficit of this magnitude posed any major threat to the economy. Moreover, there was little need for any major concerns about the size of the deficit for the near-term future. The Congressional Budget Office (CBO) projected the deficits to remain low through 2011 and then turn to a small surplus in 2012. The budget was projected to remain in surplus through the rest of the decade, as shown in Figure 1.

Arguably, this baseline picture is overly optimistic about the deficit since it assumes that President Bush's tax cuts would be allowed to expire at the end of 2010. It also assumes that a number of tax cuts that are regularly extended, most importantly the inflation adjustment for the alternative minimum tax, will instead be allowed to expire. Adjusting for these issues makes the budget situation look somewhat worse, but hardly out of control.

The deficit in this adjusted set of projections (also shown in Figure 1) averages less than 2.5 percent of GDP in the decade from 2009 to 2018. This is probably somewhat higher than would be
desirable, but it is still consistent with a stable debt-to-GDP ratio. Also, it is worth noting that the tax cut assumptions in this scenario are somewhat extreme in that they assume that none of the tax breaks for even the wealthiest families are allowed to expire and the estate tax is eliminated completely.

Of course the budget situation has turned out much worse than was projected at the beginning of 2008, even under the assumption that the Bush tax cuts and other tax provisions would not be allowed to expire. The deficit jumped to 9.9 percent of GDP in 2009 and is projected to be 9.2 percent of GDP in 2010, as shown in Figure 1. It is not projected to fall back to more normal levels until 2014, when it is projected to be 2.7 percent of GDP.

In 2018, the last year of overlap between the two sets of projections, the 2010 CBO baseline shows a deficit of 2.6 percent of GDP compared to a surplus of 1.0 percent of GDP in the 2008 baseline. While this is a marked deterioration in the budget picture, the overwhelming majority of this change is attributable to the worsening of the economic situation rather than legislated changes in taxes or spending. Higher interest payments alone, due to the large budget deficits directly caused by the recession, account for almost half of the increase in the deficit projections over this period.

The contribution of legislated changes in spending and taxes to the larger deficit is relatively small. Only 21.8 percent of the increase in the projected deficit for 2018 over this period was attributable to legislated changes in spending. And almost 60 percent of this increase was in defense-related spending, as shown in Figure 2. Legislated changes in non-defense spending increased the deficit projected for 2018 by less than 0.3 percent of GDP. Legislated changes in revenue actually went the other way, reducing the deficit projected for 2018 by $20 billion, or 0.1 percent of GDP, between 2008 and 2010.¹

¹ These calculations were obtained from summing the Congressional Budget Office’s calculations of the changes in its budget projections due to legislation, from CBO 2008(b) (Table A2), CBO 2008(c) (Table A-1), CBO 2009(a) (Table 8), CBO 2009(b) (Table 1-3), CBO 2009(c) (Table A1), and CBO 2010 (Table 1-3).
In short, the longer-term budget picture did not deteriorate primarily due to a spending splurge or a spree of tax cutting, but rather due to a much higher projected interest burden and a weaker economy. This higher interest burden is in turn a direct result of the high deficits incurred during the downturn, which have substantially increased the national debt.

The jump in the deficit in 2009 and 2010 is also not a result of wasteful spending or reckless tax cuts. There were three factors that led to the extraordinary increase in the deficits in these years. First and most importantly, the deficits rose for normal cyclical reasons. The budget deficit always increases when the economy weakens. Tax collections fall when income falls. Similarly, benefit payments for programs like unemployment insurance and food stamps rise when more workers lose their jobs. The second reason that the deficits rose was due to the bailouts of Fannie Mae, Freddie Mac, AIG, and other bankrupt companies. CBO calculated that these bailouts added $243 billion (1.6 percent of GDP) to the deficit in 2009. Finally, the stimulus package approved by Congress last February added $200 billion to the deficit in fiscal year 2009 and is projected to add $404 billion in 2010.²

While the trillion-dollar-plus deficits for 2009 and 2010 have often been held up as examples of out of control government spending, the main result of a smaller deficit in these years would simply be weaker growth and higher unemployment. The reason for the downturn is the plunge in private sector spending associated with the collapse of the bubbles in residential and non-residential construction. This fall in spending has left the economy far below full employment levels of output.

The conventional argument against budget deficits is that they pull resources away from the private sector. The government’s borrowing raises interest rates, thereby reducing private sector investment and consumption. However, there is currently no basis for concern about the government pulling away resources from the private sector since there is an enormous amount of unemployed labor and capital. In addition, interest rates are presently at historically low levels, being kept there by Fed

² CBO (2010), Table A-1.
policy. This means there is no remotely plausible case that government deficits are crowding out private investment.

Rather, the stimulus provided by government spending has boosted the economy. CBO projected that in 2009 the stimulus added between 1.4 percent and 3.8 percent to GDP and in 2010 that it will add between 1.1 percent and 3.4 percent to GDP. CBO also projected that the stimulus would lower the unemployment rate in 2009 by between 0.5 percentage points and 1.2 percentage points, as shown in Figure 3. It projected that it would lower the unemployment rate in 2010 by between 0.6 percentage points and 1.9 percentage points.

FIGURE 3
Impact of the Stimulus Package on the Economy

Source: Averages of ranges in CBO (2009d), Table 3.

Given the boost to the economy and employment from the deficits, it would be irresponsible not to run large deficits in the current economic environment. In fact, given the extent of the suffering associated with levels of unemployment that are now projected to remain well above normal levels until 2015, it is arguably irresponsible not to run larger current deficits. The main reason that people cannot find work at present is not that they lack the necessary skills or are unwilling to work, but rather that economic mismanagement has led to a situation in which the economy is operating well below full employment levels of output.

By not providing sufficient economic stimulus to bring the economy more quickly back to full employment, policymakers are making a decision to perpetuate this suffering. Inadequate stimulus will leave willing workers unable to find jobs and to properly support their children. This is a high
price to impose on ordinary workers simply because the economy was poorly managed by people in
positions of responsibility over the prior decade.

The Longer-Term Deficit Picture

The main argument made against additional stimulus at this point is that it would jeopardize the
standing of the U.S. government in financial markets. This assertion seems to contradict the current
behavior of financial markets, where long-term Treasury debt continues to be held at very low yields.
If financial markets questioned the ability of the U.S. government to honor its debt, they should
already be demanding a premium on longer-term issues, like 10-year or 30-year Treasury bonds. As
it stands, these bonds continue to trade at interest rates that are near post-World War II lows. In
other words, the investors who are actually betting on the financial health of the U.S. government
don’t seem to share the fears of the policy analysts and economists complaining about the deficit.

It is also worth noting that neither the current debt-to-GDP ratio or the ratio projected for 2020
stand out for being especially high compared to either past U.S. levels or the levels of other
advanced countries at present. CBO projects that the year-end debt-to-GDP ratio for 2010 will be
60.3 percent. It projects that this ratio will rise to 66.7 percent by the end of 2020. Even assuming
that normal adjustments are made to the baseline for the extension of expiring tax provisions and
other predictable additions to the deficit, the debt-to-GDP ratio is still likely to be under 90 percent
by the end of the decade.

By comparison, the debt-to-GDP ratio at the end of 1946 was 108.6 percent of GDP. So, by
historic standards, even at the end of the next decade, the United States will still have some distance
to go before it reaches prior peak levels of indebtedness. There are also many other advanced
countries at present that have considerably higher debt levels, as shown in Figure 4. According to
the data from the International Monetary Fund, France and Germany will have ratios of net debt-to-
GDP of 67.0 percent and 70.3 percent, respectively, at the end of this year. Japan will have a ratio of
net debt-to-GDP of 104.6 percent and Italy will have a ratio of 112.8 percent.

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3 CBO (2010), Summary Table 1.
5 International Monetary Fund, World Economic Outlook Database, available at
While high debt-to-GDP ratios can impose a burden on government finances and the economy, the point of these comparisons is that there is no reason to believe that the United States faces any imminent danger of a flight from its debt. It has carried a considerably larger debt burden in the past and had no difficulty finding willing lenders at the time. Other countries that currently carry much higher debt burdens are still able to borrow at relatively low cost in financial markets. In short, there is no reason to believe that the United States faces any near-term or even mid-term loss of confidence based on its debt levels.

As a practical matter, it is also not even clear what a crisis in confidence could look like. If domestic and foreign investors lost confidence in the government’s ability to service its debt, then presumably this would lead to a flight from the dollar. This is turn would put downward pressure on the dollar relative to other currencies. Of course, it has been official policy of both the Bush and Obama administrations that the dollar should fall against the Chinese yuan. So perhaps the flight from the dollar would bring about this longstanding policy goal and thereby make U.S. goods more competitive in world markets.

If investors were to flee the dollar because of the indebtedness of U.S. government, which country could they turn to as a safe haven, since most other wealthy countries have comparable or higher levels of indebtedness? Furthermore, if there were a large-scale flight from the dollar, would our trading partners tolerate a very low and therefore hypercompetitive value of the dollar? How large would Europe’s trade deficit with the United States be if the euro bought 2.5 dollars? Would Canada
let the U.S. dollar fall to the point where it was only worth 50 Canadian cents? Would the U.K. let the dollar fall to the point where the exchange rate was 3 dollars for a pound?

A moment’s reflection should indicate the absurdity of the scenario of a flight from the dollar. Our trading partners would have no choice except to intervene to keep the dollar from falling too low; otherwise they would see large sectors of their economies destroyed by competition from much lower-cost U.S. exports. This is not an argument for pursuing reckless fiscal policies. However, the scenario of a full-fledged collapse of the dollar, in a world where the U.S. economy is otherwise healthy, is absurd on its face.

There is one final point in this picture that deserves attention. Many analysts have highlighted the longer-term fiscal deficit picture, which is indeed bleak. However, these disastrous deficit projections are driven almost entirely by the assumption that per person costs of the U.S. health care system continue to get ever further out of line with costs in other wealthy countries. Figure 5 shows the Congressional Budget Office’s long-term deficit projections. It also shows projections that assume that per person health care costs (adjusted for aging) follow the path of per person costs in the United Kingdom, Germany, or Canada. In each of these three scenarios, the country would be looking at a future of enormous surpluses under CBO’s assumptions, instead of exploding deficits.

FIGURE 5
Projected Budget Deficit as Percent of GDP under Alternate Scenarios

This graph should make clear that the United States really does not have a long-term deficit problem. Rather, it has a long-term health care problem, which is a problem of the private health

care system. It becomes a deficit problem because more than half of all health care is paid for through public sector programs like Medicare and Medicaid.

This suggests the urgency of fixing the U.S. health care system. The reforms put forward by President Obama last year were obviously a step in this direction, although it is not clear what reforms will actually be approved (if any) and the extent to which they will control costs. In the event that reform of the domestic health care system proves politically impossible, the alternative would be to rely increasingly on more efficient foreign health care systems. It is not difficult to design mechanisms that would facilitate international trade in medical services. It is surprising that either fixes to the health care system or the promotion of greater reliance on foreign health care systems have not received greater attention from those raising concerns about budget deficits.

Reducing the Budget Deficit: Who Gets Hit?

Almost invariably, efforts to trim the budget deficit focus on Social Security, Medicare, and Medicaid, programs that primarily serve the elderly population. Remarkably, these discussions rarely seem to examine the well-being of the groups that will be most affected by proposed cuts. While most proposals for deficit reduction would leave current retirees unharmed, they often do propose substantial cuts in benefits for near-retirees, workers who are currently in their fifties or late forties.

It is important to recognize that this was precisely the age-cohort that was hit hardest by the collapse of the housing bubble. For most middle-income families, their primary source of wealth is their home. These workers were old enough to have accumulated some equity in their home, but in most cases were still highly leveraged, since they were far from having paid off their mortgage. This meant that the plunge in house prices that resulted from the collapse of the bubble largely wiped out their equity.

This point can be seen with a simple example. If a worker has fully paid off a mortgage on a $300,000 home and it falls in price by one-third, she has lost one-third of the equity in her home. However, if she only has $100,000 in equity in a home that is worth $300,000 and the price falls by one-third, then she has lost 100 percent of her equity.

This describes the situation faced by many workers who are now within 10-15 years of retirement. Many of them had accrued substantial equity in their homes, but saw most or all of it wiped out with the collapse of the housing bubble. Figure 6 shows the net worth for the middle quintile of the cohorts ages 45-54 and ages 55-64 in 2007 and in 2009. As can be seen, much of their wealth was eliminated with the collapse of the housing bubble. The average net worth for the middle quintile of households age 55-64 is approximately $180,000, a bit more than the $170,000 price of the median

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8 It is worth noting that the Congressional Budget Office projects that Social Security benefits will be fully funded by its designated tax through the year 2044. This makes the quest to cut Social Security rather peculiar since it implies a desire to finance defense and other parts of the budget through a tax that is designated as a “Social Security” tax. This sort of measure may seriously undermine public confidence in government and perhaps its willingness to voluntarily comply with the tax code.
In other words, a typical household in this age group could use all of their wealth to pay down the mortgage on their home and then would have essentially nothing other than Social Security benefits to support them in retirement.

FIGURE 6
Net Worth of Near-Retirees

The average wealth for the middle quintile of the 45-54 age group is just $81,000, a bit less than half of the cost of the median house. This group still has some time left in the labor force before retirement, so they may be able to accumulate enough to be able to pay off the mortgage on the median house, but it is difficult to see how they can save sufficiently in their remaining years in the workforce to be able to provide a substantial supplement to their Social Security. In other words, as a result of the collapse of the housing bubble, this group also is likely to be almost entirely dependent on Social Security for their retirement income.

In this context, plans to cut Social Security and/or Medicare benefits for near-retirees seem especially perverse. The housing bubble was allowed to grow unchecked as a result of incredible economic mismanagement. Now, many of the people who share the blame for this mismanagement propose to cut the benefits for the victims of their mistakes.

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9 These projections are taken from an analysis of the Federal Reserve Board’s Survey of Consumer Finance. See Rosnick and Baker (2010).
The Foreign Debt Scare Stories

Many of the papers that discuss the problem of the deficit and debt highlight the fact that a large and growing portion of the debt is held by foreigners, especially the government of China. Focus groups may show that raising the fear of foreign or Chinese ownership of debt is effective politics, but this scare tactic completely misrepresents the relevant policy issues.

On its face, there is no obvious reason that we should care who owns the government debt. The dumping of government bonds by a hostile government would cause the interest rate on these bonds to rise. That would mean that holders of other debt that had previously offered somewhat higher interest rates than government bonds, such as mortgage-backed securities guaranteed by Fannie Mae or Freddie Mac, would decide to switch to government bonds to take advantage of the higher interest rate. Similarly, investors might switch from holding debt of safe and long-established corporations, like Verizon and General Electric, to holding government debt, if the interest rate on government bonds had risen. They may also switch from holding the debt of other countries, if interest rates on U.S. government debt suddenly became higher than the interest rates on countries viewed as less safe.

Because these markets are so huge, it is likely that the substitutions from other assets to U.S. government bonds would eliminate most of the interest rate hike that immediately resulted from an initial sell-off by China or any other investor that might be politically motivated. While a sell-off could lead to a short-term increase in U.S. interest rates, it is unlikely that any substantial increase would be sustained through time, unless there were fundamental problems in the U.S. economy. In that case, interest rates would likely rise, regardless of who owned the debt.

There is an issue about foreign ownership of U.S. financial assets more generally, since this means that the income from these assets will be paid out to foreigners, thereby reducing the resources available for domestic consumption and investment. However, the extent to which foreign investors purchase U.S. assets depends on the trade deficit, not the budget deficit. The trade deficit in turn depends on the value of the dollar, an issue that is almost never discussed by those complaining about foreign ownership of the debt.

The logic here is very simple. A high dollar makes imports to the United States relatively cheap; therefore people in the United States will buy more imported goods and services. Similarly, a high dollar makes our exports more expensive to people living in other countries, so they will buy fewer U.S. exports. The over-valued dollar leads to a trade deficit, which gives China and other foreign countries the means to buy up large amounts of U.S. financial assets.

There is no particular reason to care whether foreigners opt to buy U.S. government debt or private assets like stocks and bonds. In either case, there will be an outflow of future income generated in the U.S. economy to foreign investors, leaving less to be consumed domestically.

Furthermore, if we are concerned for political reasons that foreigners hold large amounts of U.S. government bonds, then we should also be concerned if they hold large amounts of private sector stock and bonds. Any time they choose, they can sell off their holdings of stock and bonds, and use the money to buy U.S. government debt. (Foreign investors are smart enough to know this.) So, the point made by the deficit hawks about the share of the government debt held by foreigners is utterly
meaningless from a policy standpoint, even if it may be a useful point to advance their political agenda.

The budget deficit is irrelevant to the trade deficit, apart from its potential impact in raising the value of the dollar. At any given level of output and value of the dollar, our trade deficit would be the same regardless of whether the government is running a huge surplus or a huge deficit. Of course, a budget deficit can stimulate GDP, as it is doing now, which does lead to higher imports, but few deficit hawks argue that we should lower output in order to reduce our trade deficit.

In short, the issue about the foreign ownership of the government debt is entirely a political ploy. It has nothing to do with the fundamental economic or policy issues around either the budget or trade deficit. The debate over the budget deficit should be focused on serious issues and not crude scare tactics.

Conclusion

The recent debate over the budget deficit has been driven largely by unfounded fears and misrepresentations of basic economic relationships. The most often asserted claims of the leading deficit hawks are simply untrue. The surge in the deficit in the last two fiscal years was not the result of an irresponsible Congress or a broken political system. It was a direct result of the crash of the housing bubble. The failure by policymakers was to not rein in this bubble before it grew to a size where its inevitable collapse would devastate the economy.

Insofar as there is any notable increase in the deficit over the next decade due to policy changes rather than economic circumstances, it is primarily the result of higher defense spending associated with the wars in Afghanistan and Iraq. Arguably, Congress can be blamed for being unwilling to pay for the wars that it supports, but it is worth noting that Congress is not suffering from a general pattern of reckless spending or tax cuts.

It is also important to note that the projections of a longer term deficit crisis are driven entirely by exploding private sector health care costs. If the country can repair its health care system, or promote trade to allow people to take advantage of more efficient health care systems in other countries, then future deficits will be quite manageable.

Finally, the discussion of foreign ownership of government debt fundamentally misrepresents its cause and importance in a way that seems intended to exploit xenophobic fears. There is a legitimate concern about the drain of future income that results from foreign ownership of U.S. financial assets, but this is a completely separate issue from the percentage of the government debt held by foreigners. Furthermore, foreign ownership of U.S. assets depends on the trade deficit. It has no direct relationship to the government deficit. Apparently, the deficit hawks who take this route do not feel that they can gain public support if they base their argument on real issues.
References


