Back to Full Employment post #1 by Tom Weisskopf (Dec. 17, 2012)

Why Worry About the "Fiscal Cliff"?

As we approach the end of the calendar year, we are hearing more and more expressions of alarm about the "fiscal cliff," over which the country could tumble on January 1, 2013. As I will argue below, there is indeed reason to be worried about this cliff; but the reason is actually the opposite of that expressed by many of the alarmists.

The biggest obstacle to a pro-employment policy in the United States today is widespread fear about running Federal Government budget deficits, which add to the national debt – the sum of all past deficits minus all past surpluses. Most politicians, not only Republicans but also many Democrats, believe that reducing the national debt is now our single most important economic task. So they call for policy-makers to focus single-mindedly on reducing the annual Federal Government deficit. And they have been encouraged in such beliefs by all too many economists.

The kind of budgetary policy being pushed is one of fiscal *austerity,* as distinct from a policy of fiscal *stimulus* in which a government deliberately undertakes to spend more than it receives in revenues. Such stimulus calls for government borrowing to finance expenditures in excess of revenues, which increases the national debt in the short run. Nonetheless, there are many reasons why the right fiscal policy is one of stimulus rather than austerity, under current recessionary conditions of continuing high unemployment.

First of all, what is holding back businesses from expanding employment and output in the U.S. is primarily the lack of sufficient demand for goods and services. In recessionary times, with much idle productive capacity and high unemployment, businesses will expand their activity only if they have reason to expect rising demand for their products. By far the biggest source of overall demand is consumer spending; but consumers both at home and abroad are still being weighed down by the adverse impact of the worldwide economic crisis that began in 2008. Most of them are saddled with debt, and many have less purchasing power than before the crisis – if they still have any income at all. Investment spending is also a key source of overall demand, though considerably smaller than consumer spending. Businesses operating in the U.S. have access to plenty of cheap credit with which to invest, as interest rates are at historically low levels, but most firms are holding back because they do not see much likelihood of increased demand for their products.

The one source of overall demand for U.S. goods and services that can be significantly increased under worldwide recessionary conditions is the Federal Government. Overall demand can be significantly boosted if the Government increases its own spending, or if it raises consumer demand by reducing taxation of people likely to use most of any increase in disposable income for consumption. The stimulus package passed by Congress and signed by President Obama in 2009 did both of these things, and this prevented the "Great Recession" in the U.S. from turning into another Great Depression, with a loss of several million more jobs. Because the U.S. economy is still in recession four years later, despite some job growth in the past few years, further stimulus by the Federal Government is needed to bring about a full economic recovery.

Many of the people who are sounding the greatest alarm about the fiscal cliff these days are using that alarm to push the Federal Government to pursue a fiscal policy of greater austerity, so as to reduce deficits and stop adding to the national debt. Yet the real problem with the cliff is precisely the opposite. If nothing is done about it, Federal Government expenditures will decrease significantly, via the "sequestration" of funds otherwise going to domestic government programs and to the military, and Federal Government revenues will increase significantly, via an increase in taxes on all U.S. income-tax payers and the ending of the social-security- tax reduction. In other words, if we go over the fiscal cliff, the Federal Government will be pursuing a new policy of much greater fiscal austerity than before. The nonpartisan Congressional Budget Office estimates that going over the fiscal cliff would reduce the growth of U.S. GDP by 3 percentage points in 2013, pulling back the expected growth of employment and output into negative territory and causing the loss of several million jobs.

What we need instead of such an austerity shock is a fiscal stimulus of similar proportions, which can only be achieved by some combination of increased Federal Government spending, reduced taxation of low- and middle-income earners, and expansion of unemployment benefits. Such expansionary fiscal policies will of course increase the Government budget deficit in the short run, thereby adding to the national debt. But by stimulating the economy to expand employment and output much more than would otherwise be possible, such policies also serve to increase future tax receipts, which will make it easier for the Government to reduce its deficit in the long run.

The case for expansionary fiscal policies is all the stronger these days because the interest rates at which the U.S. Government can borrow to finance budget deficits have been at historically low levels in recent years. This reflects both strong worldwide trust that the U.S. can be counted upon to pay its bills and the fact that the U.S. economy is still in recession, so that Government borrowing does not crowd out private borrowing and thereby push up interest rates. Output and employment in the U.S. will have to rise a great deal over the next few years in order for the U.S. economy to emerge from recession and begin to push up interest rates. Only at that point will it make sense to begin shifting from a policy of fiscal stimulus toward one of more austerity.

Finally, we have strong empirical evidence from Europe that the pursuit of fiscal policies of austerity under recessionary conditions works to reduce employment and output growth, thereby making it more difficult to reduce national debt. The latest annual World Outlook report by the International Monetary Fund (IMF), released in October 2012, shows that the countries pursing the most austere budgetary polices in recent years – in particular, the biggest spending cuts – are those that have also experienced the deepest economic slumps, such as Great Britain, Ireland, Spain, Portugal and Greece.

Back to Full Employment post #2 by Tom Weisskopf (Dec. 18, 2012)

Why the Deficit Hawks Are Wrong

Many contributors to the "Back to Full Employment" blog have pointed out that the current national focus on reducing U.S. government deficits and debt is completely misguided. I thought it might be useful to identify the major arguments raised by the "deficit hawks" and to show why, in each case, they are simply wrong.

1. *The U.S. national debt at the end of 2012 came to almost 16½ trillion dollars, amounting to more than $50,000 per citizen. Since we will have to pay off that debt, each of us is really $50,000 poorer than we realize.*

First of all: there is no need to pay off the national debt. Hardly any country ever pays off all of its national debt, because carrying that debt can cause a problem only if the burden of servicing the debt becomes too onerous. That burden in any given year depends on the relationship between (1) the amount of debt service payments that must be paid out that year by the Federal Government and (2) the size of the national economy that year. The smaller is (1) relative to (2), the easier it is to raise the tax revenues needed to make the debt service payments.

Let's calculate the relative size of the current U.S. debt service burden – i.e., (1) divided by (2). The debt service payments that the Federal Government must make in a given year are determined by the amount of national debt held by the non-governmental public, multiplied by the average interest rate paid to the debt-holders. Although the total U.S. national debt is indeed about $16½ trillion, roughly $5 trillion is held by branches of the Federal Government itself – such as the Social Security System. This part of the debt does not impose any repayment burden on the non-governmental public, because the government in effect repays itself to service it. The non-governmental part of the U.S. national debt – held by U.S. citizens, foreign citizens & governments, and the Federal Reserve System – amounts now to about $11½ trillion. The interest rate at which the U.S. Government services its debt to non-governmental debt-holders has been in the neighborhood of 2% over the past four years, and it was just below that in 2012. Multiplying these two figures, the amount that the Government must pay out for debt service was roughly $0.23 trillion in 2012. The size of the U.S. economy is best measured by the gross domestic income or product (GDP), which was roughly $15½ trillion in 2012. Thus the relative size of the current U.S. debt service burden is currently 0.23 divided by 15½, or about 1.5%.

What this means is that U.S. taxpayers must currently be taxed at an economy-wide average rate of 1.5% in order to service the U.S. national debt. This is a lighter debt service burden than in almost any of the last 30 years, when the burden averaged 2.5%. And it constitutes just under 6% of total Federal spending – the lowest figure since the end of World War II.

2. *The debt service burden may not be very onerous now, but interest rates are not going to remain very long at their current unusually low levels. So the debt service burden is likely to increase very soon, as interest rates return to their normal higher levels.*

As long as the U.S. economy remains in recession, with employment and output well short of their potential levels, there is no reason to expect interest rates to rise much at all. Only when an economy recovers, to the point that shortages begin to develop in labor and product markets, will strong upward pressures on prices and interest rates begin to develop. As and when that does begin to happen, we will be thankful that unemployment has come down significantly and that GDP gone up significantly. The higher level of GDP will itself help to reduce the debt service burden, because it depends on the relationship between debt service payments and GDP.

If and when interest rates, and/or the size of the national debt, begin to rise more rapidly than GDP, then the debt service burden would indeed begin to increase. At that point one would need to consider whether or not the rising trend was likely to persist. If so, policy-makers would have reason to be concerned about continuing to run Federal Government deficits and thereby adding further to the national debt. Dealing with the problem then, however, would be far easier than now, because the economy would be operating close to full steam. As long as that is not the case – and it is certainly not now – then it is foolhardy to focus attention on reducing deficits and debt rather than on increasing employment and GDP.

3. *By running budgetary deficits and increasing the national debt, the U.S. Federal Government is passing on a huge burden of debt that will ultimately have to be paid back by our children and grandchildren – thus reducing significantly their well-being.*

As noted above, there is no need to pay off the national debt; it just has to be managed so as not to impose too heavy a burden of debt service on taxpayers. And when the U.S. economy is in recession, priority must be given to reducing unemployment and raising the rate of utilization of productive capacity, which will raise GDP and thereby also help to reduce the debt burden. What is preventing this from happening now is not the growing national debt, but a lack of overall demand for the goods and services the economy is capable of producing. The Federal Government is uniquely well-placed to provide the needed aggregate demand stimulus, which it can do precisely by spending more than it receives in revenues. This means running a budget deficit in the short run; but it makes it easier to manage the national debt in the long run.

For future generations of Americans there is a much bigger threat than higher national debt. The much bigger threat is that global warming, and consequent rises in sea levels and in the frequency and intensity of storms and droughts, will significantly reduce economic growth and impair the quality of life in the U.S. and the world as a whole. Bequeathing a higher national debt is far less of a problem for our children and grandchildren than bequeathing a world whose climate has been compromised by global warming.

4. *Households should not spend more than they receive, so the U.S. Federal Government shouldn't either. (Recall that in summer 2011 President Obama asserted that* "we must live within our means." *And during the presidential campaign of 2012 Mitt Romney declared that:* "we have a moral responsibility not to spend more than we take in.")

Neither in the case of individuals or households, nor in the case of private businesses, nor in the case of governments, does it make sense to rule out borrowing. Borrowing makes perfect sense if it is used for investment that increases future output and income, out of which the debt incurred by borrowing can be managed – or, if necessary, paid in full. Just as a private business will borrow heavily to finance investments that are likely to yield a real rate of return greater than the real cost of borrowing, so individuals, households and governments should borrow for purposes of investments that are likely to result in future streams of income that are greater than the streams of payments that must be made to service the corresponding debt.

Interest rates on U.S. Government bonds are currently at historically low levels (actually less than zero in real terms, taking account of price inflation), largely because of the current recessionary conditions. So now is an ideal time for the Federal Government to borrow in order to be able to spend more than it takes in, to achieve two important objectives. In the short run, such deficit spending increases the demand for U.S. goods and services and thereby raises employment, incomes and output – all of which are currently held back by insufficient aggregate demand. And in the long run, insofar as Federal Government spending takes the form of investments in education, R&D, transport, communications, and more efficient ways to produce and consume energy – all areas that have been much neglected in recent decades – deficit spending also strengthens the national economy and helps to forestall global warming, thereby raising GDP and general well-being well into the future.

5. *But government spending, unlike private spending, can't do much to make the economy stronger.*

Whether or not spending strengthens the economy depends not on whether it is public or private, but on whether it adds to the productive capacity of the economy. Government expenditures on education, R&D, transport and communications, energy efficiency, etc., involve investments that enhance people's skills, that add to the nation's stock of productive assets, that improve technology, and/or that prevent environmental deterioration. It is true that, at times, public investments have proven inefficient or wasteful; but the historical record shows that government investment has been crucial to the development of all modern economies. In the case of the U.S., think of the Erie Canal, the agricultural land-grant program, the post-World-War-II G.I. education program, the interstate highway system, and government-funded scientific research and development that have led to countless technological improvements – such as the world-wide web.

Back to Full Employment post #3 by Tom Weisskopf (May 16, 2013)

Second-best Policies to Stimulate the U.S. Economy

To combat the continuing recession in the U.S. and to move toward full employment, the clearly optimal policy is for the Federal Government to increase spending now on programs that contribute to economic growth while improving the quality of life, such as education, infrastructure, R&D, and – not least – reduction of emissions of heat-trapping gases. President Obama as well as Federal Reserve Bank Chairman Bernanke appear to be well aware of this.

However, the current constellation of political forces in the U.S. – in particular, Congressional Republican hostility to deficit-financing and obsession with reducing the national debt, along with their power to obstruct fiscally expansionary policies – makes it virtually impossible to stimulate the U.S. economy by means of fiscal measures. Even now, when the austerity policies favored by deficit hawks have come under mounting criticism in the wake of the Reinhart-Rogoff debacle (see the PERI blog posts of April 18, 23 and 30, 2013), the prospects for anything but continuing fiscal austerity are meager at best. Under such circumstances, it makes sense to consider second-best policy proposals that have a stimulatory effect on a recessionary economy without adding much to the national debt.

In a recent article, "The Great U.S. Liquidity Trap of 2009-2011: Are We Stuck Pushing on Strings," (Review of Keynesian Economics, Autumn 2012), Bob Pollin proposed and elaborated on two innovative second-best proposals for stimulating aggregate demand in the recessionary U.S. economy without having to go to Congress to enact new expansionary fiscal policies. His first proposal is for the Fed to set a ceiling on and/or tax bank excess reserves, which are now being held in huge amounts, so that more credit would be made available to business borrowers. His second proposal is to expand the existing Federal Government business loan guarantee program so that it covers many more small business borrowers, who have found it very difficult to get access to needed credit because banks perceive them to be somewhat risky. (For a discussion of these proposals, see also the PERI blog post of March 4, 2013.)

In this post I would like to draw attention to two additional second-best proposals along these lines that have been suggested by my University of Michigan colleague Miles Kimball in his blog, "Confessions of a Supply-Side Liberal" (http://blog.supplysideliberal.com/). Each of these proposals is designed to stimulate aggregate demand during a recession, while adding far less to the national debt than a fiscally expansionary policy of equal stimulatory power.

Federal Lines of Credit

Kimball's first proposal is to provide every taxpayer a federal line of credit (a "FLOC"), i.e., a credit card issued by the Federal Reserve with a line of credit of – say – $2,000 for individual taxpayers or $4,000 for couples. This credit would be available at a low interest rate characteristic of an economy in recession, and anyone drawing on it would not have to pay back most of the loan until the economy had largely recovered from the recession. A FLOC would be much more effective as a stimulus measure than alternatives like tax rebates, because consumers would not get any benefit from it unless they actually used the credit to make purchases, whereas a significant fraction of tax rebates are typically go into saving rather than consumption. Moreover, a FLOC is much less costly to the government than a tax rebate, because borrowers ultimately have to pay back whatever they borrow. Even though some FLOC users might eventually default and the Federal Government might be called upon to make up the difference, the ultimate cost to the Government budget – and hence the addition to the national debt—would be much smaller than in the case of a tax rebate with a comparable stimulatory effect. (For further details, see http://blog.supplysideliberal.com/post/24014550541/getting-the-biggest-bang-for-the-buck-in-fiscal-policy.

As William Greider has noted, in a column in The Nation supportive of this proposal (http://www.thenation.com/blog/168812/new-way-recharge-economy), "the provocative kicker in Kimball's proposal is that the Federal Reserve would itself provide the financing, not Congress or the president through the federal budget." Because the Fed's balance sheet is separate from that of the Federal Government, FLOCs could provide a boost to a stagnant economy while adding little to federal deficits. The proposal amounts to giving consumers what was given to banks at the height of the economic crisis – not free money, but a loan that can immediately help economically needy families and boost aggregate demand in a context of high unemployment, housing foreclosure threats, and predatory lenders. The same argument justifying the Fed's largesse to the banks can justify its largesse to individual citizens: FLOCs help to restore the economy to good health, providing tangible economic returns out of which borrowers can repay their loans.

Negative Interest Rates via Electronic Money

Kimball's second proposal to stimulate the U.S. economy without raising the national debt is considerably more radical, and potentially even more effective. It provides a new way for the Federal Reserve to overcome the barrier to deploying a more expansionary monetary policy imposed by a "liquidity trap," when there is plenty of credit available at nominal interest rates already close to zero, with no room to lower them further, in an environment of low inflation. Thus far the Fed has tried to overcome the ongoing liquidity trap of the U.S. economy by various forms of "quantitative easing," such as buying mortgage-backed securities; but the stimulatory effect has not been impressive. What would really make a difference is for the Fed to be able to pursue a strongly expansionary monetary policy by lowering interest rates well into negative territory. But economists have long regarded this as an impossible task, since the alternative of simply hoarding money provided a better return than lending it out at a negative interest rate.

Kimball's proposal hinges on the now widespread use of money in electronic form: he proposes to make a legal distinction between paper currency and electronic money in bank accounts, with the former subordinated to the latter. The Fed is perfectly capable of lowering the federal funds rate below zero, but it can't drive short-term nominal interest rates below zero as long as people can get an interest rate of close to zero. People can do this by hoarding paper bills, but they can't do so with electronic money, because they can't pull such money out of their accounts and literally store it without first exchanging it for paper bills. To overcome this obstacle, the Fed needs to find a way for the value of paper money to decline when it is hoarded. This it could do by separating paper currency from electronic money, making the latter the "real" money in which prices would be accounted and contracts established, and requiring that paper dollars be exchanged at a discount compared to electronic dollars. That discount would need to be adjusted periodically to reflect the extent to which the nominal interest rate on electronic money had been reduced below zero.

All this might sound pretty fanciful, but the fact is that people have in any case been increasingly making use of electronic money – in credit and debit cards, automatic bank account withdrawals, etc. To the extent that people continue to use paper currency, they would simply need to understand that, during times of negative nominal interest rates, the true value of their bills would be less than the face value; the difference in value would be widely publicized. In a recession the discount for paper dollars would gradually widen, while in good times the discount would shrink until the paper dollar was again at par with electronic dollars. As Kimball has put it: "The bottom line is that all we have to do to give the Fed…unlimited power to lower short-term interest rates is to demote paper currency from its role as a yardstick for prices and other economic values—what economists call the "unit of account" function of money." (For further details, and the source of this quotation, see http://qz.com/21797/the-case-for-electric-money-the-end-of-inflation-and-recessions-as-we-know-it/.

No doubt there are some potential downsides to each of the above proposals, as there are for any new policy prescription. But the upsides of these proposals, in a context of damaging fiscal austerity imposed by Right-wing political forces, are surely promising enough for Kimball's proposals to merit serious attention.