POLITICAL ECONOMY RESEARCH INSTITUTE
PERI
University of Massachusetts Amherst

A World Upside Down?
Deficit Fantasies in the Great Recession

Thomas Ferguson and Robert Johnson

Published in

International Journal of Political Economy

Spring 2011

POLITICAL
ECONOMY
RESEARCH
INSTITUTE

Gordon Hall
418 North Pleasant Street
Amherst, MA 01002

Phone: 413.545.6355
Fax: 413.577.0261
peri@econs.umass.edu
www.peri.umass.edu

International Journal of Political Economy, vol. 40, no. 1, Spring 2011, pp. 3–47.
© 2011 M.E. Sharpe, Inc. All rights reserved.
ISSN 0891–1916/2011 $9.50 + 0.00.
DOI 10.2753/IJP0891-1916400101

THOMAS FERGUSON AND ROBERT JOHNSON

A World Upside Down?

Deficit Fantasies in the Great Recession

Abstract: *This paper analyzes U.S. budget debates in the context of the G-20's turn toward austerity at the 2010 Toronto Summit. It begins by looking at claims by Reinhart and Rogoff and the International Monetary Fund that rising ratios of government debt/gross domestic product pose serious threats to economic growth. Then the paper considers Alesina and Ardagna's contention that deep cuts in deficits somehow stimulate economies. The paper shows that none of these arguments is empirically well founded, especially for major reserve currency countries like the United States, which cannot depreciate without crushing the rest of the world.*

The paper analyzes competing accounts of how to measure the deficit over time and draw special attention to the Congressional Budget Office's unheralded

---

Thomas Ferguson is a professor of political science at the University of Massachusetts, Boston; senior fellow at the Roosevelt Institute; and a member of the Advisory Board of INET (University of Massachusetts, Boston, Wheatley Hall, 5th floor, room 102; tel.: (617) 287-6928; e-mail: thomas.ferguson@umb.edu). Robert Johnson is the executive director of INET; is a senior fellow and the director of the Project on Global Finance at the Roosevelt Institute; and was formerly managing director at Soros Funds Management and a chief economist of the U.S. Senate Banking Committee (INET, 570 Lexington Avenue, 39th floor, New York, NY 10022; tel.: (212) 444-9132; e-mail: rajshaman@mac.com).

This paper is a revised version of our earlier paper of the same name for the Roosevelt Institute listed in the references. The authors are grateful for discussions or other forms of assistance from many individuals, including Marshall Auerback, Josh Bliven, Olivier Giovannoni, Arjun Jaydev, Edward Kane, Mike Konczal, Alain Parguez, Lynn Parramore, Peter Temin, and the editor of the *International Journal of Political Economy.* Perhaps, more than is normal, it is necessary to observe that none of them necessarily agrees with us.

acknowledgment in August 2010 that financial assets held by the government should be netted out of U.S. debt calculations. The paper argues that not entitlement spending or Social Security but the excessive costs of oligopoly in health care, defense spending, and another possible financial crisis are the major threats to the budgetary position. In an era of unbridled money politics, concentrated interests in the military, financial, and medical industries pose much more significant dangers to U.S. public finances than broad-based popular programs like Social Security, which is itself in good shape for as many years as one can make credible forecasts.

The paper compares several different simulations and concludes that the risk to U.S. public finances, as measured by the debt/GDP ratio in 2020, is much greater on a trajectory of austerity than from any risks incurred by the very low public cost of borrowing to spur investment in infrastructure, education, and science that would generate large social and private gains in productivity.

Keywords: *budgets, entitlements, financial crisis, fiscal austerity, government deficits, health care, public infrastructure, Social Security*

In the summer of 2010, in the midst of the greatest economic crisis since the Great Depression, economic policy turned upside down. Instead of promoting recovery and expanding employment, central banks and political elites suddenly focused on cutting budget deficits and raising interest rates.

Forget the famous "conservative counterrevolution" in policy-making since the late 1970s—the break with past practice was real and dramatic. Save for a handful of exceptions, such as those of Margaret Thatcher and, far more equivocally, Ronald Reagan, from the end of World War II until a little more than a year ago, even conservative governments threw in the towel when they saw the Invisible Hand waving good-bye. At that point, instead of just cutting interest rates and waiting for Godot, policymakers would swallow hard and sigh. Following ritual dances of purity, they would directly expand aggregate demand by a mixture of public spending, tax cuts, and subsidies to big business, while taking care that that premature monetary tightening did not choke off the upturn.[1]

These short-lived triumphs of Keynesian realism over free market fundamentalism also compelled policymakers to call off long-running crusades to whittle away unemployment benefits. Indeed, in crises governments were often forced to broaden jobless assistance, at least for a while. From the late 1970s onward, countries embraced such emergency policies with more and more reluctance. But when the economy really tanked, they pursued them nonetheless—even in right-thinking bastions of economic orthodoxy like Germany as late as 2009.[2]

The declaration that accompanied the 2009 G-20 summit in Pittsburgh stood squarely in this tradition. The only surprise was that the summiteers dispensed with atonement rites and frankly admitted what they were doing—doubtless a reflection of how deeply the financial crisis had tarnished the prestige of conventional economics:

> We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that when growth returns, jobs do too. We will avoid any premature withdrawal of stimulus. (G-20 2009)

At the Toronto summit in early July 2010, though, all this suddenly became, in the legendary words of Richard Nixon's press secretary "inoperative" ("The Nation" 1973). The G-20 radically changed course. Leaders decided to act as if prosperity were just around the corner. Endorsing calls for macroeconomic austerity promoted by Germany, the European Central Bank (ECB), and the International Monetary Fund (IMF), the group abandoned focusing on employment in favor of curbing deficits, raising interest rates, and reeling in special central bank programs for monetary ease.[3]

Backsliding is certain. We do not for a minute believe that many countries will meet the summit goal of cutting their deficits in half by 2013—for reasons that Herbert Hoover and a succession of hapless German chancellors in the 1930s all eventually came to appreciate: Trimming deficits in the face of feeble growth in incomes is a futile exercise in chasing a moving target, as tax collections fall with declines in national income. Indeed, signs of revolt are cropping up around the globe: The U.S. Federal Reserve's (the Fed, the U.S. central bank) recent switch to "quantitative easing" and talk of similar policies in the United Kingdom and Japan are plainly inspired by anxiety that the new austerity has already gone too far.

Still, the post-Toronto line is not just smoke and mirrors. The world appears to be on the cusp of a "great inversion": The small, mortally threatened countries stretching along Europe's new "crescent of crisis" from Ireland through Iberia to Greece are taking chainsaws to their budgets, and powerhouses like the United Kingdom, France, and Germany are doing the same. And while governments hack away at expenditures, the president of the ECB, financial market spokespersons, and aspiring politicians take turns deriding each new round of cuts as insufficient.[4]

The oddity is that the United States has joined the parade. In the run-up to Toronto, the administration of President Barack Obama championed a globalized version of St. Augustine's famous appeal, "Lord, make me pure, but not yet": It sought economic expansion in the rest of the world to offset the contraction in the U.S. rate of economic growth. But even as the euro crisis sent the dollar higher and thus snuffed out hopes for an export revival, the administration finally signed on to a version of Toronto-lite.[5]

Throughout the spring and early summer of 2010, it tiptoed away from proposals to extend unemployment benefits and help states stave off mass layoffs of teachers, police, and social workers as their fiscal years turned over, which for most happened on July 1. Both notions represent core Democratic Party values, and neither carried any implication for long-term deficits, because they represent one-time emergency responses. But, stunningly, for many months, the administration and Congress froze at any mention of the word "deficit." Democrats and Republicans took turns dragging their feet in the face of what even administration staffers conceded was a halfhearted presidential push.[6] As it became clear that the November 2010 congres-

sional elections were turning into a disaster for Democrats, the president finally jumped in—but only on behalf of extending unemployment benefits through the end of November, when the election would be safely over. Early in the summer of 2010, aid for the states, even for promised reimbursements of Medicare expenses, was allowed to die. Economists at Goldman Sachs estimated that the lost funds might subtract up to a three-quarters of a percentage point from the growth rate through the rest of the year (see, e.g., MoneyNews.com 2010; Selway 2010).[7]

As bad economic news piled up and election polls became ever gloomier, the president and congressional Democratic leaders relented. They mobilized and finally passed a bill providing for both the reimbursements and emergency aid to the states. The latter was quite modest—despite its passage analysts estimated that more than 360,000 workers would lose their jobs by the end of summer 2011 (Aversa 2010). And the legislation was supposed to be "deficit neutral," which it might actually have been—much of the money came out of the food stamp program, now stretched by rising demands from homeless and unemployed Americans (Green 2010).

In the face of polls showing overwhelming public opposition, the administration also grimly convened a special bipartisan National Commission on Fiscal Responsibility and Reform (hereafter the "Deficit Commission") to consider cuts in Social Security and other programs. The commission itself was overweighted with deficit hawks and shadowed by some obvious conflicts of interest. Its staff was paid in part by private interests long associated with attacks on Social Security. Its report, carefully timed for a lame duck session of Congress, came out at the beginning of December 2010. Thanks to an unheralded proviso inserted into legislation by Democratic leaders, the U.S. House of Representatives committed itself to vote on the Deficit Commission's regulations if the Senate did likewise.[8]

In the end, however, after a massive propaganda buildup, neither the president nor Congress could come around to addressing entitlements in 2010. Instead, as discussed in the conclusion to this paper, the president proposed a two-year extension of tax cuts originally enacted under the previous administration of George W. Bush. Congress finally agreed, leaving the deficit issue to be dealt with in the next Congress, in which Republicans control the House and gained strength in the Senate.

A Two-Speed Global Economy

With interest rates at virtually zero, the ability of the Fed and other central banks to bolster the economy by further cuts in interest rates is limited, regardless of hopes for its much ballyhooed "quantitative easing" in monetary policy. In this context, the Obama administration's decision to join with the rest of the G-20 amounts to repeating the historic mistake made by Franklin Roosevelt—cutting government spending after the 1936 election—this time on a world scale.[9]

The global economy is adjusting to three big new shocks: the rise of China as an economic power, the euro crisis, and the ebbing of the administration's original,

truncated stimulus. The three together are creating a deadly economic policy trap for economies in the developed world. In sharp contrast to the austerity policies pursued in the West, Keynesian economics is alive and well in China. Its government has implemented gigantic government-led stimulus programs, which have produced vigorous economic growth. More problematically, its policymakers have also only reluctantly sought to restrain a bourgeoning supply of credit supercharged by an emerging "shadow banking system" that is increasingly hard for them to control. China has thus pulled up the economies of many emerging markets that supply it and bid up raw materials prices worldwide (Krugman 2011).[10]

Sensing the tidal pull, financial speculators in the developed world (who, despite the financial crisis, continue to operate with few checks) have sometimes also piled on, pushing commodities prices even higher. In normal economies, rising commodity prices are widely interpreted as signaling a broad rise in economic activity. Many investors also see them, however, as presaging inflation. The result has been to redouble pressure on policymakers in developed countries for austerity, despite their stunningly high levels of unemployment (Krugman 2011).

Even with the temporary extension of the Bush tax cuts and additional unemployment payments that the United States enacted after the 2010 congressional elections, this is probably more than the United States (and other developed countries) can stand. Banks in both the United States and Europe are still choking from bad loans that indulgent banking regulators pretend not to see. Regulators continue to allow bankers to devote earnings on bonuses and to lobby against financial regulation, instead of writing off bad loans and shoring up bank capital. As a consequence, the developed world's financial system resembles Japan's in the 1990s. It is destined to be "deleveraging"—that is, reducing total lending—for a long time and, in the United States, at least, imposing all kinds of steep new fees on consumers.[11]

Nor is this all. The world financial meltdown triggered by the decision to let Lehman Brothers go bankrupt in 2008 burned up the retirement savings of millions of people, while decimating pension fund holdings. Markets for housing, which in the United States and some other countries represent a major form of savings by ordinary people, have almost dried up, supported only by inflows of money from governments and central banks. As evidence mounts that many mortgage lenders never bothered to fill out the paperwork on mortgages they sold, prices of U.S. houses seem likely to spiral down further, inflicting more punishment on both consumers and the banking system.

Here and elsewhere, high unemployment and tighter conditions for consumer credit guarantee that many consumers will not soon start spending again either. As Richard Koo of Nomura Research Institute in Tokyo, an expert on Japan's "lost decade" of the 1990s, has argued, many private businesses are likely to remain mired in a "balance sheet recession," preferring to use their positive cash flows and profits to continue paying down debts and shunning new investments. A recent attempt to quantify the amount of corporate "deleveraging" still facing American

corporations is sobering: The study suggested that it could be more than a decade before deleveraging eases for U.S. nonfinancial corporations.[12]

To the extent that the euro crisis holds down the currency's value, a floor under incomes in that region—or at least Germany's—should exist, as long as the financial system does not collapse or the Fed's quantitative easing policy succeeds in bolstering the euro. And exchange rates keyed to the dollar can safeguard export shares of many Asian countries. But both stratagems are "beggar-thy-neighbor" policies. They simply rob Peter to profit Paul and do nothing to expand total world demand. The world as a whole cannot devalue against itself, and a sharp, sustained depreciation of the U.S. currency is likely to depress the rest of a world, which still depends heavily on sales to American consumers. Any rise in oil prices from turmoil in the Middle East will only make matters worse.

The scale and duration of the human misery this quagmire implies is almost beyond reckoning. As of December 2010, almost 15 million people in the United States were unemployed. Millions more were either underemployed or became so discouraged that they stopped looking for work and thus are no longer counted among the "unemployed." A whole generation of young people is being reduced to begging for chances to work free in "internships" in the hope of getting a foot inside doors that are otherwise slammed shut. Crusades to cut Social Security threaten to remove a basic underpinning of the living standards of millions of people who first lost their savings in the financial crash and then paid with their taxes to bail out the financial system. And the Obama administration's reluctance to extend aid to states means further deadly rounds of state cuts are inevitable. Just as in the Great Depression, these will neutralize federal efforts to stimulate the economy. They will also lay waste to enormous amounts of public capital built up over many years by the states, especially in their educational systems. The other developed countries that are now frantically cutting budgets are showing the same deadly syndromes.

Why, then, have so many leaders in business and politics, even in the United States, suddenly become fixated on the new twin terrors of deficits and inflation?

Financial Deregulation and Keynesian Economic Policies

In some countries, local factors are plainly important. Given the gigantic sums spent on rescuing the UK financial sector, weaknesses in the British economic position, and the collapse of New Labor, anyone could predict that pressures to cut the budget would intensify in the United Kingdom.

But in the United Kingdom and most other countries, the fiscal and monetary about-face is also rooted in broader changes in economic structure. One in particular is paramount: Over the past thirty years, in country after country, the very largest financial institutions became gigantic in size. Their size and complexity made them literally too big to fail, as the decision by U.S. regulators let Lehman Brothers fail taught the whole world. But many of the giants also became too big to bail, in that

rescues required plenary shares of national budgets and even, in some cases, national income (Ferguson and Johnson 2009a; Johnson and Kwak 2010).

Only now are the implications of this towering fact coming to be appreciated outside financial markets. But careful studies of bank stock prices show that markets grasped the key point much earlier: Beginning in the summer of 2007, fears multiplied that one or more big banks might fail. Share values of the largest banks fluctuated with perceptions that other emergency claims on national resources might empty national treasuries of the funds required to bail out the giants. That is, whereas financial bailouts (on favorable terms to the banks, which most were) had positive effects on bank stock prices, wider deficit spending packages drove big bank stocks down relative to the market as a whole (Demirguc-Kunt and Huizinga 2010). Here was a form of "crowding out" beyond the imagination of both Keynesians and free market enthusiasts: The need to preserve financial resources for a contingent fund that would be available for further bailouts was killing the Keynesian revolution in economic policy-making.

Over the past thirty years, the biggest U.S. banks have swelled to enormous size. But so has the national economy. The Bush administration's blank refusal to put forward any stimulus package and the small size of the Obama administration's stimulus plan are consistent with such pressures, but the relevant research has not yet been done. By contrast, the evidence for Europe and some other countries is quite strong: Increases in government deficits pushed down bank stocks (Demirguc-Kunt and Huizinga 2010).

In the early stages of the crisis, however, powerful political and economic counterpressures worked against immediate austerity. In an earlier paper, we showed that higher than average voting turnouts and the strength of socialist parties significantly influenced national policies toward bank bailouts (Ferguson and Johnson 2010a). It was surely no accident that the British Labour government led the international campaign that embarrassed the Bush administration into convening the G-20 (Ferguson and Johnson 2009a). The surge of popular enthusiasm and hope that carried Obama into the White House further militated against immediate austerity, as did outrage over the rescue of the large banks and pressures from other parts of big business.

But once the combination of public money, loan guarantees, and regulatory forbearance stabilized financial sectors in the short run, the political balance quickly shifted. The brittle consensus in favor of demand expansion unraveled in the face of a new wave of peripheral defaults threatening banks in the developed world. In late 2009, Dubai World, a state-owned corporation, sought a moratorium on interest payments from its creditors. With markets reeling, neighboring Abu Dhabi stepped in and bankrolled a rescue. With financial markets on edge, anxiety about Greece triggered a broad sell-off of the debt of other small countries in the eurozone. The tardy, grudging responses of the European Union and the ECB transformed a bad situation into a new crisis, heightening concerns about debt loads of both the private and public sectors.

But debt-selling problems of the smaller European countries can account only in part for the wave of hysteria that is breaking over the United States and, for that matter, larger European countries. Although the subject is too big for this paper, it seems plain that the ECB and the eurozone as a whole could resolve their crisis if the political will for enhanced integration existed. Despite the swelling size of European bailouts, there is little evidence that financial markets think that the crisis is likely to mortally threaten the solvency and credit ratings of most major European countries. Indeed, it is precisely the strong credit ratings of Germany and other major European countries on which rests the AAA rating of the new European Union bailout fund.[13]

When investors as a group fear default or inflation, interest rates rise. In particular, long-term interest rates skyrocket. In the jargon of finance, the "yield curve"—the array of interest rates stretched out over time to maturity—steepens. If anxieties about inflation in the next couple of years are minimal but markets are seized with fears for the more distant future, rates rise *at once* on longer term bonds, making the yield curve very steep indeed.[14]

But in the United Kingdom, Europe's other largest countries, and the United States, yield curves have not been steepening to any significant degree. On the contrary, despite some gyrations that are plainly traceable to fears about the Fed's quantitative easing program and the euro crisis, interest rates in most of these countries remain very low. The Bank of England, for example, recently lowered short rates to the lowest level since 1694, whereas UK long-term rates are unremarkable. Germany and France also have no trouble issuing longer-term debt; indeed, German long-term debt is selling at its lowest rates ever. The case of the United States is clearest of all: Short-term rates are virtually zero, whereas long-term rates have steadily fallen, to the obvious discomfiture of deficit doomsayers and inflation hawks. Corporations have rushed to issue new, long-term debt, with a few corporations and countries even successfully issuing 100-year bonds (Bullock 2010; Burne 2010).

Yet erstwhile Fed chairman Alan Greenspan, ECB governors, and many economists who kept insisting that bubbles in housing markets were impossible to perceive before 2008 and who still claim that policy is helpless against such developments now rue a bubble in government bond markets. Some also profess to foresee catastrophic inflation just ahead—never mind the blatant contradiction between what actual yield curves say about future rates of inflation and their faith that markets reflect available information. With the media hanging on these policymakers' every word, as though it were still 2005, the result is a public discussion about deficit reduction uncomfortably reminiscent of the propaganda campaign that prepared the way for the U.S. invasion of Iraq.[15]

Conjectures, guesses, cherry-picked examples, and bold hypotheses are swirled together with striking, but perilously incomplete data to produce potted narratives that are simple, powerful, and—at first sight—compelling but that have not received nearly the critical scrutiny they should.

Consider, for example, what is perhaps the most widely touted claim of all—the assertion by economists Carmen Reinhart and Kenneth Rogoff that growth rates fall off in countries that have levels of government debt as a proportion of GDP that are above 90 percent (Reinhart and Rogoff 2010). Their claim derives much of its authority from the luster of their recently published historical survey of financial collapses (Reinhart and Rogoff 2009). There is no question that this work is immensely valuable for the wealth of data that it assembles. The authors' many gifts as analysts are also plain. But although their book is a great achievement, it is a long way from being the definitive history of financial crises that some analysts have declared it to be.

Its treatment of some major crises—including the German crisis of 1931, arguably the most fateful of all—is cursory. And, as Reinhart and Rogoff themselves observe, many of their data series are incomplete or uneven, stitched together from what admirers like us would hail as the pioneering extrapolations of other scholars. Nor does it help that although the book is out, the data are not; so critical assessments are possible only if one is conversant with their data sources.

The data unevenness creates unique pitfalls with respect to the United States. Reinhart and Rogoff's warnings about U.S. deficits lose a great deal of force when one realizes that for most countries they analyze, they rely on measures of debt held outside the government—"net debt" in economic jargon. For the United States and Canada, though, they use "gross debt," which includes claims held by parts of the government on each other, such as the government bonds held within the Social Security system. That number towers much higher (Horney et al. 2010; Irons and Bivens 2010). Using it makes little sense—if you want to understand a family's financial position, you need to net out Mom and Dad's loans to each other or the kids, not add them up with the outside debts.

The much touted 90 percent rule, though, is not in the book; it comes from subsequent articles (Reinhart and Rogoff 2010). And never mind confusions of gross with net debt; their case for the "rule" is completely unpersuasive. Part of the problem is that, like many other papers purporting to derive lessons relevant for U.S. deficit policy, they adopt an excessively liberal approach to statistical panel design. They jumble big and small countries together, sometimes from different eras, into a single dataset.

This is exhilarating on first reading, but it is too broad a gauge to guide policy reliably. For the United States, the number of really useful historical and comparative cases is much smaller because of its unique situation in the world economy. Even in a globalized economy, for example, the U.S. economy stands out for its sheer size. Smaller economies, by contrast, frequently bob like corks on waves generated by their larger neighbors. Drawing policy lessons from samples replete with such cases is likely to be misleading. The true effects of the small fry's policy choices get lost in the backwash of policies adopted by their bigger neighbors.

Many deficit hawks, for example, rush to cite the apparently beneficial effects of fiscal consolidation in Canada in the 1990s. But the Canadian economy's

outperformance in that period also reflected the tidal pull of the U.S. bubble economy. Raising taxes and cutting social spending in Canada was important for upper-bracket taxpayers and the poor there, but the influence of the U.S. boom is obvious (Baumol et al. 2010).[16]

Political choices in smaller countries also frequently reflect external factors. Many things happen, not because anyone in the country wants them to but because outside forces—foreign multinationals, larger neighbors, eccentric billionaires, kleptomaniac rulers, and even hierarchal structures in the international system, for example, military alliances leading to wars—compel them. When economic policies reflect such forces, spurious causal inferences readily follow. Some U.S.-supported Latin American dictatorships, for instance, surely protected the position of economic elites in those countries at the expense of economic growth that would have benefited the whole population. To help keep social peace, or simply please insistent militaries, some of these countries piled up debts. The true lesson of such cases is nothing so simple as high debt/GDP ratios hold back growth rates.

This problem is first cousin to the broader problem of "reverse causality" highlighted by Paul Krugman (2010c). He observes that the causal relationship might well run "largely" from "growth to debt rather than the other way round." Krugman explains, "That is, it's not so much that bad things happen to growth when debt is high, it's that bad things happen to debt when growth is low." He cites the United States as an obvious example of this pattern:

> This is definitely the case for the United States: the only period when debt was over 90 percent of GDP was in the early postwar years, when real GDP was falling, not because of debt problems, but because wartime mobilization was winding down and Rosie the Riveter was becoming a suburban housewife. It is also clearly true for Japan, where debt rose after growth slowed sharply in the 1990s. And European debt levels did not get high until after Eurosclerosis set in. (Krugman 2010c)

Issues about the direction of causality, however, are not the only, or even perhaps the major, challenge to Reinhart and Rogoff's 90 percent rule. The obvious, outstanding fact about the United States today is that it is not only a big country but also a global financial center. And the plain fact is that financial centers, whose currency is widely desired outside the country, occupy an entirely different space from everyone else when it comes to handling deficits.

The United States issues debt in its own currency. Its situation thus differs sharply from, say, Greece, which cannot issue euros to pay its debts, and from small countries that typically borrow in dollars, not their own currencies. For a country in the situation of the United States, default in a strict sense simply cannot happen. No matter what the Chinese or anyone else does with their dollars, the United States cannot run out of them. As discussed below, this does not mean that the United States can limitlessly issue debt without eventually suffering adverse consequences, but it does mean that the usual scary scenarios are fairytales.

For now, however, the key point is that in assessing the 90 percent rule, histori-

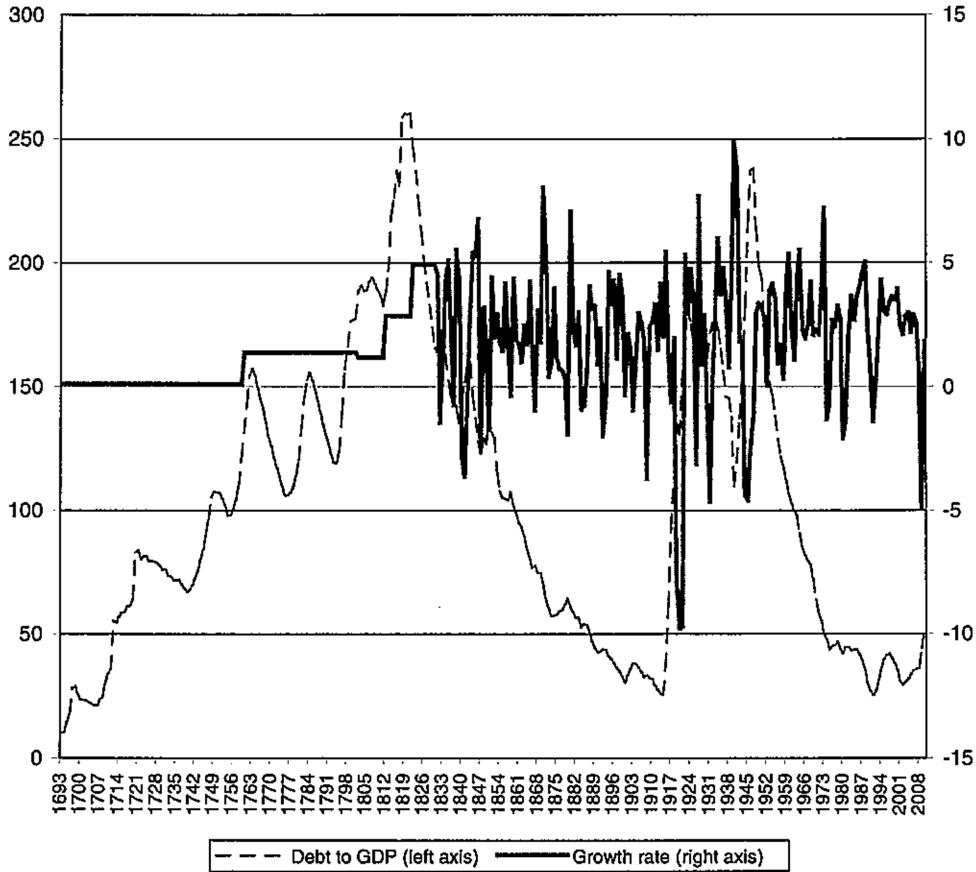

Figure 1. **Britain Industrialized with Rates of Debt to GDP Far Higher Than 90 Percent**

Source: Christopher Chantrill, www.ukpublicspending.co.uk/downloadmult_ukgs.php?year=1692_2015&state=UK&view=1&expand=&units=p&fy=2010&chart=F0-total&bar=1&stack=1&size=m&color=c&title=/.

cal cases involving financial centers merit especially careful review. In addition to the United States, there has really been only one in the past three hundred years: Great Britain.

The British record is disastrous for Reinhart and Rogoff's claim. Figure 1 plots the UK debt/GDP ratio since 1694, along with real rates of economic growth.[17] Regardless of where you stand on the endless arguments about exactly when the Industrial Revolution began (or even whether there was one) or whether wartime demands for finance might have crowded out some private investment from time to time, the facts are clear: The British economy forged ahead decade after decade while carrying far higher ratios of debt to GDP than Reinhart and Rogoff's magic number.[18]

The point can be put even more forcefully: The United Kingdom made its epochal breakthrough to industrialization—leaving the rest of the world far behind—while

carrying a debt load that should have crushed it, not only in the eighteenth century but also many decades into the nineteenth. And it was precisely as the debt/GDP ratio soared that the rate of growth finally picked up.[19] Of course, British debt levels through most of the twentieth century remained almost as high because of expenditures run up for World Wars I and II.

Why does this pattern go unremarked by Reinhart and Rogoff? Part of the answer is simple: In their paper announcing the 90 percent rule, they start their UK data series with 1830. It is true that British GDP data for the period before then are surely less reliable, but they are certainly no worse than the data for many other countries in the paper. The pre-1830 data were also good enough for the book, which did reference them.[20]

One might respond, as many deficit hawks do when talk turns to the glorious postwar booms in both the United States and the United Kingdom, that those mountainous deficits were incurred during wars. So they were. But so what? The excuse that growth in the face of debts run up in wartime somehow should not count against the 90 percent rule makes little sense.

Suggestions that wartime debts did not hobble the economy because they were broadly accepted across all levels of society rest on misconceptions. It is perhaps true that in the wake of a "national patriotic" struggle for survival, which is how most Britons and Americans experienced World War II, citizens might be less likely to succumb to temptations to default or inflate the debt away, although weighty historical counterexamples exist. But few, if any, earlier British wars resembled World War II in that respect. We doubt that even World War I did by its close, which is presumably decisive for debt policy. Eighteenth-century wars, with their press gangs, taxes, and other discomforts for average citizens, were widely detested among both the middle and lower classes. Although some episodes in the Napoleonic Wars might qualify, whatever "national feelings" those struggles generated almost certainly did not survive the Peterloo Massacre and other repressive measures enforced by a succession of British governments that eventually drew scorn from even literary types fashionable in high society, such as Shelley and Byron.[21]

One might respond that after a war is over, budgetary baselines and trends no longer embed projections of continuing war, so debts can be consolidated at lower cost. But this is hardly persuasive. First, many peace treaties have simply marked brief breaks in a whole series of wars, and both bankers and strategists recognized it. Certainly that was the case in the eighteenth century and, indeed, the Napoleonic period, with, for example, the ill-fated Treaty of Amiens displaying a half-life approaching that of an atomic particle. Even World War II represents such a case, since the war's end was followed almost immediately by the onset of the cold war, with vast new demands for military spending. In the end, our view is that either there is an empirical claim about debt/GDP ratios or there is not. If a debt consolidation can whisk away the effects of, say, a debt/GDP ratio of 225 percent, there is something wrong with the whole approach.

A simple question of Krugman's should banish any notion that war or peace are

critical factors in debts' effects: In wartime, much of the money goes to pay for junk that will ultimately be left rusting on some battlefield. Why is that supposed to be so much better for the economy than producing useful things via deficit spending? (Krugman 2010d). That Britain flourished for decades with debt/GDP ratios of more than 200 percent is therefore devastating to Reinhart and Rogoff's claims.[22]

The British case, however, raises other pointed questions for deficit hawks today. The most common case against government deficits rests on their alleged effects on interest rates.[23] Deficits are supposed to push interest rates higher, because the government competes with private business for scarce capital. Higher interest rates mean less investment and thus lower rates of growth. The implication for rising debt/GDP ratios is straightforward, and we have seen it defended by at least one Nobel Prize–winning economist: They are supposed to drive up rates in the long run, as investors demand higher returns as prospects for repayment darken, because either growth slows or public sentiments for default intensify.

The British experience, though, suggests that fears about interest rates are overblown, at least when a country is the financial center of the world. Eighteenth-century usury laws may have led to credit rationing instead of surges in interest rates; so studies that focus on the level of rates may miss evidence of credit stringency (Temin and Voth 2005).[24] As Figure 1 indicates, British debt/GDP ratios towered far above 90 percent for decades in the eighteenth century, reaching stratospheric levels during the Napoleonic Wars. They remained far above 90 percent for decades after 1815, when even staunch defenders of wartime crowding out do not suggest that high interest rates chronically hampered economic growth. Yet the bank rate, the Bank of England's basic interest rate, stood at 4 percent in 1716. In 1719, it rose to 5 percent. It remained there until 1822, when it was lowered to 4 percent. Throughout the rest of the century, the Bank of England allowed the rate to fluctuate. But rates remained generally very low, rising sharply only during periods of extreme crises—and never for long. After 1815, bank rate touched 10 percent for one month during the Crisis of 1857 before falling to 3 percent only three months later. To be sure, comparisons between the United States now and the United Kingdom then are necessarily tricky, but the conclusion has to be that British interest rates simply did not behave as many deficit hawks believe they should have. Rates stayed low in the face of levels of debt to GDP several times larger than in most advanced economies today.[25]

Not to be deterred, the indefatigable IMF has produced several studies of its own claiming to show that high debt/GDP ratios crimp growth rates. They have the merit of making serious stabs at sorting out the direction of causality and influences from unobserved variables. But they also have a fatal flaw. Their guiding idea is to trace how increases in debt/GDP ratios affect growth over time. But all their samples begin in 1970 and go forward to the recent past. They thus coincide almost perfectly with the rise of free market fundamentalism in the West (Kumar and Woo 2010; Ostry et al. 2010).

This was precisely the period in which central banks either threatened or actually did raise interest rates (or refused to lower them) when parliaments declined

to shrink budgets as business leaders and central bankers thought they should or, especially in Europe, when trade unions refused to agree to wage cuts (Glyn 2007; Halevi and Kriesler 2005). American readers might recall the 1993 media frenzy over whether the incoming Clinton administration's proposed budget cuts would be enough to satisfy Fed chairman Greenspan and induce the Fed to cut interest rates (Ferguson 2001; Stiglitz 2004). These IMF works simply ignore the large literature that relates slow growth to high interest rates in advanced countries. They fail to consider how a pattern of such threats, even if not invariably carried out, might paralyze investment. For sure, the stop/go pattern the IMF studies find are exactly what one would expect given what is known about central banks' preferences for budget cuts, but this testifies more to the role that ideology and politics play in central bank behavior than to any effect of rising deficits on growth (see, e.g., Alexiou 2001; Stockhammer 2004).

Taking Away the Cake and Eating It, Too

Republican senator Arthur Vandenberg famously advised President Harry Truman that if he wanted to generate public support for a vast new program of aid for Greece and Turkey, he would have to "scare hell out of the American people" (Pastor 1980). Alarms about deficits killing growth suggest that policymakers in the United States and elsewhere still borrow from this playbook. But in an age that celebrates extravagant self-indulgence in its movies, news, and ads, some economists have begun to promote a different line: Angst about the political and economic costs of budget cuts and tax rises—fiscal "consolidation" or "adjustment"—is way overblown.

In a series of papers, Alberto Alesina and colleagues have argued that countries can have their cake and eat it, too, because cutting deficits does not necessarily cause aggregate demand to fall. Instead, they assert, by some kind of black magic whose nature is simply hypothesized rather than clarified, "large" and "decisive" cuts in public spending fire up the energies of the private sector, leading to an economic expansion. For this reason, they also argue, sponsoring such policies is not even very risky for politicians' reelection chances (Alesina 2010; Alesina and Ardagna 2009).

Not surprisingly, these "something for nothing" claims have thrilled *New York Times* columnist David Brooks (2010) and other commentators. But their enthusiasm is valuable mainly for pointing up how a conservative media establishment exploits serious and original, but still speculative, academic work to manufacture worthless political arguments by ignoring the small print.

The basic idea behind Alesina's most recent major study, with Silvia Ardagna (2009) is, surely, a good one: to survey what actually happened in many countries over a generation during which governments actually cut budgets or raised taxes in "major" ways. The pitfalls in such efforts are well known; they arise from the need to translate into statistical terms outcomes and processes that at their heart are institutionally specific. Politics and economics intertwine in strange ways and

sometimes with lags. Often something goes pop because of a dramatic shift in the midst of deep crises, but on other occasions it does not; changes instead reflect the cumulative impact of seemingly tiny events or shifts in political coalitions that occurred several years before. Margaret Thatcher's victory in 1979, for example, was a pivotal moment in UK policies toward deficits, regardless of the size of budgetary tightening that followed immediately thereafter. Roughly the same appears to be true of 1982 in Dutch politics, although that changeover involved far less acrimony and drama and differed importantly in its distributional consequences.

It thus bothers us, as it bothered Paul Krugman, that some famous examples of fiscal adjustments in Japan, the United Kingdom, and other countries do not make Alesina and Ardagna's list (Krugman 2010a). It is also worrisome that perhaps the most successful fiscal consolidation of recent history—the literal elimination of the U.S. deficit during the Clinton years—did not qualify for their roster of successes.[26] But these are just reservations, albeit ones that Brooks (2010) and other enthusiasts should have noted. Alesina and Ardagna's decision to pick a swing of 1.5 percent of GDP as the threshold for a "large" change in fiscal policy is surely reasonable, as is their idea of seeing what happens over a maximum of four years later and benchmarking policy successes by whether they pushed down debt/GDP ratios by at least 4.5 percent (Alesina and Ardagna 2009).

Real jokers start cropping up, however, when one takes a close look at what they count as successful examples of "growth" in the wake of the big budget cuts. They eschew the obvious, commonsensical standard: Did the country's own growth rate slow down or accelerate after it downsized its deficit? Instead, Alesina and Ardagna take refuge in a definition that is highly technical and very curious. It gives a good part of the game away; basically, it turns on how the country fares relative to the rest of the Organization for Economic Cooperation and Development (OECD), not on the change in its own growth trajectory. If a country cuts its budget and growth falls sharply but it still succeeds in growing faster than three-quarters of the rest of the OECD, they hail the country for producing growth via budget cuts!

This is Alice in Wonderland math. It provides no real support for magical effects on growth from budget cuts. Standard postwar Keynesian doctrine recommended that economies that appeared to be growing at an "unsustainable" pace—one that was likely to produce bottlenecks, shortages, or, perhaps, inflation—should be cooled down by throttling back government spending if raising interest rates was awkward or impossible. No one ever suggested that such cases infringed any tenet of Keynes about the key role of aggregate demand. And shrinking debt/GDP ratios when growth is simply slowing down from unsustainable levels is radically different from making further cuts in aggregate demand at the bottom of a recession. The difference for public life is night and day.[27]

Such cases comprise at least three of the nine cases between 1970 and 2007 that Alesina and Ardagna instance as those in which policymakers squared the circle and not only engineered fiscal contraction with growth but also succeeded in reducing debt/GDP ratios by 4.5 percent of GDP in the longer run. But the budget cuts

did not produce the growth—it was already in process—and they were not what made cutting the deficit so easy. That was accomplished the old-fashioned way, by paying down deficits out of revenues from growth, just as the United States and Britain did after World War II.[28] In the other six cases on their list, a recent paper by Jayadev and Konczal (2010a) shows that every one posted positive rates of growth in the year preceding the budgetary consolidation; so although these others may not have been booming, they were far from comparable to the United States now, which is in deep recession.

Their tortured definition of growth is not the only problem with Alesina and Ardagna's list of winners. Every country on it is a small, open economy, where performance, as we have seen, is hugely affected by external forces. Such economies, in particular, can often compensate for fiscal contractions by currency devaluation or simply let strength in the world economy elsewhere offset falls in domestic demand by increasing exports.

After 1970, alas, bungled efforts at financial deregulation put all too many countries into situations in which falling exchange rates stimulated exports for a while. The basic plot is drearily familiar: First, governments gave in to pressures from financial and business opinion and threw open financial markets. Deregulation attracted huge inflows of hot money. This drove up the exchange rate and killed exports while fueling a financial bubble. Eventually the bubble burst, leading to huge increases in debt/GDP ratios as states were forced to bail out their banks. As exchange rates fell back to more normal levels, exports surged while the country struggled to get its finances under control. Exchange rate depreciation played roles in the success of at least two countries on their list, Finland in 1998 and Sweden in 2004, and strong world demand for exports also benefited the Netherlands as its growth rate fell from high levels in the manner described above.[29]

The performance of small economies frequently hinges on the fate of a handful of large firms or dominant sectors that are anything but representative of other economies. Both budgets and economic growth in Norway, for example, are strongly affected by the heavy influence of the petroleum industry there. When oil prices or production are high, as they were in 1979, 1980, and (locally) 1996, Norway's public finances can hardly help improving. But the three cases Norway supplies to Alesina and Ardagna's list (one of which also qualifies as a clear case of growth deceleration as described above, since 1996 was, as Statistics Norway commented, a "golden" year in this Land of the Midnight Sun) shed little light on how to shrink deficits in less fortuitously circumstanced economies.[30]

That leaves only the two New Zealand cases of 1993 and 1994 on Alesina and Ardagna's list of successes. Although New Zealand is plainly a small, open economy, it does not appear to have benefited materially from prior devaluations or oil price windfalls or even world demand for exports. In neither year, however, was it in recession, as mentioned above. But its value as a successful case of "something for nothing" is even more limited: Comparative studies suggest that New Zealand's big drop in its debt/GDP ratio coincides with a sharp decline in its

relative economic performance vis-à-vis nearby Australia, which, until 1993–94, it closely tracked (Dalziel 2002).

If one steps back and surveys Alesina and Ardagna's data as a whole, the weakness of their case stands out in bold relief. Set aside all questions about New Zealand and the other seven cases they reckon as successes. Now just ask the obvious question that a citizen or politician who had any choice would before embarking on the austerity route to budgetary consolidation: What are the chances that the policy will work, that is, actually reduce the deficit while also stimulating growth?

The striking fact that emerges from their tables is the meager number of successes. They identify 107 separate cases of major fiscal contraction in the OECD between 1970 and 2007. Only 26 of these 107 qualify by even their Rube Goldbergian definition as leading to "growth." Now also set aside all qualms about definitions and whether countries were booming or in recession when they started cutting the budget. Just focus on the overarching pattern: Only nine of those "growth" cases actually achieved major reductions in debt/GDP ratios. That shouts out a demoralizing result: 92 percent of the time that countries tried fiscal contraction, it did not lead to growth with big reductions in debt/GDP ratios. We are not surprised that even a recent IMF study has now repudiated Alesina and Ardagna's core argument (IMF 2010: chap. 3). As Ireland has now discovered, the road to reducing debt/GDP ratios leads elsewhere. Arguments that current levels of debt to GDP profoundly threaten future U.S. economic growth are assertions crying out for empirical evidence. They should carry no weight in national policy debates.

The Deficit "Problem"

If no magic number yokes together debt/GDP ratios and growth rates, at least in large, developed economies, and claims that budget cuts stimulate aggregate demand are the twenty-first century's equivalent of the Laffer curve, then how should one think about deficits and, more broadly, the Toronto consensus?

Our discussion begins with some cautionary notes. First, the absence of a magic number has a paradoxical implication for debates about fiscal sustainability. If high debt/GDP ratios are not necessarily toxic, it also follows that lower levels will not offer guaranteed protection. In theory, at least, a country could get into trouble at almost any level of debt to GDP. Waiving cases in which the level of debt is insignificant, that is the conclusion we come to from the variegated histories of debt and crises produced by Reinhart and Rogoff, Marc Flandreau, Charles Kindleberger, and other economic historians (see, inter alia, Flandreau and Zumer 2004; Kindleberger 1984).

The reason is straightforward although economic historians customarily hurry past the evidence. Debt crises are not purely economic events; virtually all crucially involve political factors.[31] The relationship between the politics and the economics is typically complex. The political party considerations and factional rivalries that entrance most historians are invariably linked with dense networks of investor, firm,

and sectoral interest groups. The parties and these investor blocs normally interact with broader, mass-based interest groups in contexts suffused with ideologies of varying ages and tendencies. If the state structure is also complex (e.g., federal rather than centralized, parliamentary rather than presidential), then the variations can become Byzantine (see, e.g., Ferguson 1995b). But our guess is that if a valid 90 percent rule is ever discovered to hold for debt crises, it will refer to the way short-run political and economic factors combine to trump long-run economic considerations: When none dare call it reason and political stalemate develops, rising debts or slow growth can trigger crises at even comparatively low levels of debt to GDP, as Spain is now discovering. Conversely, as long as the political system continues grinding away—either because, like Great Britain for most of its history, it is dominated by financial interests in coalition with other business groups or because it balances social groups successfully through institutionalized compromises—even very high rates of debt to GDP will be shrugged off if grandiose policy failures (such as losing wars) do not discredit the regime.

This "unsafe at any speed" quality of debt buildup makes it important to underline just how disastrously off-course debt crises can propel countries when they do occur. We are impressed by the devastation that ensues when governments cannot roll over their debts. Especially when real depreciations of the currency are involved, such disasters typically have far-reaching political consequences, almost invariably involving huge shifts to the political right. In more than a few instances, they have shattering consequences for society as a whole.

Some analysts have recently questioned whether a country the size of the United States could actually confront such an event. They argue that banks have no alternative to buying the debt of the government if cash is legal tender and they want a return on their reserves. Some versions of the argument add cheerfully that the U.S. currency's continuing predominance in the world economy precludes damaging runs out of the dollar, allegedly for lack of better alternatives. We do not share this confidence. This experiment has been run. Its results were discouraging. In 1978–79, long before the euro and at a time when the yen was heavily regulated—in other words, under conditions probably far more favorable than those of the dollar today—the United States endured a genuine dollar crisis. The sharp rise in interest rates this precipitated sent shockwaves around the world. Life for most Americans and citizens of many other countries immediately became markedly worse. For many, especially in the third world, it became almost unendurable for years (Ferguson and Rogers 1986; Galbraith 2002). We do not doubt that such crises are possible or that taking reasonable precautions against them is the height of wisdom.

But the shrill claims of looming disaster advanced by proponents of the Toronto consensus are overblown. For centuries, the herald of impending disaster was the appearance of a truly spectacular comet. Listening to deficit hawks, one would think that the giant recent upward lurch in U.S. deficits and debt/GDP ratios—most of which reflects the impact of the financial crisis and not "exploding entitlements"—amounts to the Great Comet of 2010, portending all kinds of woes.

This is silly. We have already observed that evidence from financial markets, notably the yield curve for U.S. government debt, points strongly in the other direction. But given the clamor about an impending financial Armageddon, it is worth tracing the case in more detail. Most discussions of U.S. debt take the Congressional Budget Office's (CBO's) studies as their point of departure. For reasons explained below, we are skeptical of parts of the CBO's analysis. It is not obvious why the agency's figures are to be preferred to, for example, the Office of Management and Budget, at least when the latter reports to presidents who are, in the famous words of a Bush administration spokesperson, fundamentally "reality based." But the CBO is formally nonpartisan and its studies, in sharp contrast to some IMF presentations, almost invariably report "government debt held by the public." This statistic consolidates the holdings of the Social Security Trust into one figure along with the rest of the government's own debt. If one then subtracts financial assets the government holds from its financial liabilities, the result is "debt held by the public net of financial assets," which is the economically appropriate figure to worry about (see, e.g., Congressional Budget Office 2010b and the discussion below).

Deficit superhawks often get carried away. They throw around many other numbers with abandon. Popular Web sites and, on occasion, some official sites, including the IMF's, occasionally post "gross debt." This double-counts U.S. government bonds held by the U.S. government in the Social Security Trust. As observed above, the practice is roughly like failing to net out loans parents make to each other or their children in calculating the family's external debt position. Some bank analysts argue for including all the debts of Freddie Mac and Fannie Mae. We are more sympathetic to this, but doing it right would not take the critics very far down the road they want to go: The two giant government-sponsored enterprises certainly hold many mortgages that are underwater and destined to fail. But they also hold an enormous number of mortgages that will eventually pay off in full or in significant part. Rolling their gross debts into the usual government net debt figures thus ridiculously exaggerates the dimensions of the problem (Buiter 2010).

We think the same is true of proposals to treat all state and municipal debts as future liabilities of the federal government. There is no question that some states and cities face acute funding problems, although many of the most celebrated cases owe as much to the economy's disastrous cyclical condition as to mismanagement. And if the government does nothing to stimulate the economy, many more will face problems in the future. But the misconceptions about valuing pensions, discount rates, and state and municipal indebtedness are almost endless; many claims are outright nonsense (see, e.g., Lav and McNichol 2011). Plenty of remedies exist for these problems short of federal government assumption of their debts. The recent demand by the Securities and Exchange Commission (SEC) for adequate disclosure by the New Jersey state pension fund, for example, will go far toward fixing the problem if the SEC does not back off (Walsh 2010).[32] Even better would be a wholesale reform of the lax financial regulations that currently govern this market and a complete prohibition of political contributions to everyone involved

in decision making on state and municipal debts. There is time for such remedies, because the looming issue is commonly pensions.

We are equally skeptical that it makes sense to roll other vast "contingent liabilities" into published federal government deficit totals. Contingent liabilities are financial claims that the federal government has agreed to guarantee, so pleas that they should be included appear on the surface to make sense. But contingent liabilities are mostly quite different animals from the entries in regular government debt accounts. Analysts classically distinguish guarantees of liquidity from those involving basic solvency; the suggestion is customarily that the former are fairly safe, but the latter are risky. But this distinction mostly slides past the realities of modern national income theory. As the discussion below shows, the state of aggregate demand and the growth rate of the economy over time fundamentally determine how many and what kinds of contingent liabilities the government is forced to take on. Depending on what you assume about these drivers, realized contingent liabilities—the total that will have to be made good—will vary wildly. Swelling deficit estimates by piling on worst-case scenarios are more rhetorical steps in a political argument than exercises in economic analysis. We are struck, for example, that deficit hawks who exuberantly pile on hypothetical liabilities from state pension funds and such typically pass over any mention that the biggest unfunded liability the federal government is likely to face sometime in the future is the bill for yet another banking crisis, given the inadequacies of recently enacted financial reforms.

The CBO is right to concentrate on basic budgetary numbers and forego chasing wild hares. We, accordingly, take their work as our point of departure. As mentioned above, however, we do this with some qualms. Of late the CBO has been almost insouciant about its calculations of federal government "net debt." The agency routinely issues its own estimates of federal government finances. It also frequently analyzes administration proposals. But for all its vaunted independence and nonpartisan character, in recent years it has taken to subtly promoting alarmist accounts. It has promoted both Reinhart and Rogoff's 90 percent rule and Alesina and Ardagna's "something for nothing" approach.[33] Because it, like other federal agencies, is ultimately financed by taxpayers, we have the rather odd circumstance that the people's funds are being use to propagandize the press and the people.

The propaganda and the projections recently combined to manufacture an intimation of impending U.S. financial mortality out of whole cloth. The CBO's March analysis of the Obama administration's proposed budget for 2010 (including its proposals to sunset the Bush tax cuts for the top 2 percent of high-income Americans) turned heads by publishing deficit projections that had the United States reaching the magic 90 percent level of debt to GDP by 2020 in the event that the president's proposals were enacted. The announcement had a predictable effect: a rolling wave of handwringing and cries of impending doom that also pumped up the 90 percent threshold (Congressional Budget Office 2011).[34]

In mid-August 2010, however, when official Washington sinks into a seasonal

Bermuda Triangle in which news announcements vanish without a trace, the CBO issued a reanalysis of its "baseline" budget projections from now until 2020. Buried without notice in one table is an entirely new row of figures that subtracts out from the CBO's earlier published figures for net debt, as should have been done all along, many financial assets owned by the federal government that are not held by the Social Security Trust. The correction is huge, amounting to a drop in the projected debt/GDP ratios of about 8 percent of GDP (Congressional Budget Office 2010b: 23). The CBO did not revise its estimates of the impact of the president's 2010 program. But the size of the adjustment that it needed to make is obvious from the new baseline forecast.[35]

The ubiquitous 90 percent figure has since reappeared in a *New York Times* editorial ("A Real Debate on Taxes," 2010), but the frisson over an imminent slide of the U.S. economy into rigor mortis is entirely chimerical. A faulty estimate of net government debt became a story because a bad economic theory that the CBO (along with the IMF) was promoting made a nonfact suddenly look significant.

Table 1 displays the magnitude of the differences. The first two columns compare the CBO baseline budget projection, as slightly revised in August 2010, with the revised figures taking account of the U.S. government's financial assets.[36] The third column displays the differences between the first two, which are substantial. The fourth column shows the CBO's March 2010 estimates of the impact of the president's program; these figures also need to be adjusted by the amount of the government's financial assets that the CBO at last recognizes. This can be approximated by simply marking down each entry in the estimates of the president's budget by the corresponding figure in column 3. Enacting the president's fiscal program would not, in fact, push the United States across the mythical 90 percent threshold. In 2020 the United States would be operating within the range of debt ratios at which other large countries function successfully right now.

The conclusion has to be that if nothing else changed and the Bush tax cuts were extended for everyone except the superrich (i.e., the top 2 percent of American income earners) as the president was then proposing, the sky is unlikely to fall. Quite possibly nothing would happen in markets for U.S. debt—a conclusion these markets appear to have reached as well. The endlessly repeated claim by deficit hawks and the media that not just the rich, but all Americans, need to pay much higher taxes to make a real dent in a debt that has ballooned to dangerous proportions is a gross exaggeration.[37]

But there is more to be said. First, there are some grounds for suspecting that the situation is even more favorable than the revised CBO estimates suggest. When one looks under the hood of its January 2010 projections, several assumptions it makes look problematic. The rates of productivity growth the CBO assumes is perhaps a bit low by recent historical standards. This is of real importance. If you raised productivity or made other adjustments to increase the economy's rate of growth by half a percentage point above what the CBO assumes, the cumulative effects over ten years are substantial. Already relatively benign debt/GDP ratios

Table 1

Projections of CBO debt/GDP ratios compared

	Base, August	Net of financial assets	Diff. base and net	CBO presidential budget, March	High growth	Low growth
2009	53.02%	45.90%	–7.10	53.00%	53.02%	53.02%
2010	61.58%	54.10%	–7.50	63.20%	60.41%	61.58%
2011	66.06%	59.40%	–6.70	70.10%	63.63%	66.06%
2012	68.45%	61.40%	–7.10	73.60%	65.11%	68.45%
2013	68.37%	61.10%	–7.30	74.80%	65.31%	69.84%
2014	67.29%	60.00%	–7.30	75.70%	64.64%	71.47%
2015	67.33%	60.00%	–7.30	77.40%	64.08%	73.25%
2016	67.74%	60.40%	–7.30	79.60%	63.65%	75.00%
2017	68.07%	60.70%	–7.40	81.80%	62.95%	76.62%
2018	68.31%	60.80%	–7.50	84.30%	61.95%	78.10%
2019	68.82%	61.10%	–7.70	87.10%	61.03%	79.80%
2020	69.42%	61.50%	–7.90	90.00%	60.10%	81.56%

turn even more auspicious, as the "high growth" column indicates.[38] (This column, too, should properly be adjusted by subtracting the financial assets, just like the CBO's estimate of the president's budget, so the actual debt/GDP figures would all drop further.)[39] For comparison, we include a final column that estimates the effect of lower growth rate (on which, more below).[40]

By contrast, the CBO's treatment of unemployment rates raises more complex questions, with implications that cut both ways. The CBO forecast has unemployment remaining level at very high levels until 2013, whereupon it drops steeply, arriving at 5 percent by 2015. The agency takes the latter figure to represent full employment, which it then projects to remain unchanged until 2020.

We have deep misgivings that the 5 percent figure represents anything more than a convention with regard to the true rate of "full" employment in the U.S. economy. But that is for later; for the moment, the important question is whether the 5 percent figure can possibly be consistent with the rest of the CBO's projections. The assumption of a relatively swift return to full employment reduces deficit estimates in later years, because tax revenues swell mightily with rising employment levels. But the CBO assumes inflation rates of 2 percent in those years of "full employment," along with short-term interest rates of 5 percent. As several analysts have noted, the combination is hard to justify (e.g., Galbraith 2010). Nobody doubts that the Fed controls short-term interest rates—quibbles about what happens when it pays interest on bank deposits as it does now can be set aside. But short rates that high can arise only from the Fed's concern about inflation—which the 2 percent assumption rules out. Higher

rates run up interest costs on the debt, which inflates deficit projections.

Raising the question about unemployment, however, brings up a more ominous possibility. The recent burst of publicity about the "new normal" may in part represent a public relations campaign designed to lower popular expectations, but it points to something real. We are persuaded by research indicating that recoveries from financial crises take far longer than the average cyclical upswing, and we are convinced that the U.S. economy is undergoing structural shifts (Reinhart and Rogoff 2009). Our best guess, accordingly, is that U.S. unemployment rates are destined to remain very high for a long time. If not brought down by vigorous government action, higher rates of unemployment will increase outlays for unemployment and social welfare, while squeezing state finances still more. The deficit will thus swell beyond projections.

Conservative economists and business analysts are also waging a campaign to persuade the Fed that "full employment" should be redefined upward to perhaps 7.0 to 7.5 percent (Courtois 2010). If that campaign succeeds, big trouble is inevitable. Accepting 7.5 percent unemployment as "full employment," for example, would have ruinous effects on the deficit, because tax revenues would run far lower year after year. The last column of Table 1 can be used to glean a rough estimate of how higher unemployment could affect the deficit. It is for a "low-growth" economy in which unemployment remains at 7.5 percent instead of falling to the 5.0 percent the CBO assumes in its projections. The impact on deficits is substantial, and we return to this point at the conclusion of the paper.[41]

Prolonged unemployment would also generate other pressures that would cloud the deficit picture. American corporations are laying off massive numbers of older workers, whose retirement, thanks to the financial meltdown and changing pension practices (i.e., simply paying none or using them to prop up company stock values), is precarious in the extreme. Although free market fundamentalists will continue to deny the obvious, many out-of-work Americans are unlikely to find work ever again—and not because they mysteriously lost job skills that kept them steadily employed before the financial crisis.[42]

Other minor threats to the budget might arise from efforts to fix shortcomings in various federal programs. Social Security, for example, was designed for a different world than the one we live in. As Bing Chen has lucidly emphasized, the program's failure to adjust historic benefit practices to contemporary demographic realities imposes hardships on some groups of beneficiaries, notably widowed spouses, mostly women (Chen 2010). These problems have relatively simple fixes that do not threaten either the program's solvency or U.S. finances, but remedying them might add marginally to deficits.

Through the Looking Glass: The Far Future

Mention of Social Security transports us to the heart of current debates about the deficit. Most readers will have seen newspaper or Web reproductions of charts from

studies—many financed directly or indirectly by the Peterson Foundation—tracing out scary curves of the time path of U.S. debt/GDP ratios. These typically ascend gradually to about 2020, when the usual CBO projections stop, then start rising explosively. The precise date of Apocalypse varies. A recent study by Pew, which works closely with the Peterson Foundation, suggested 2035 or thereabouts—but the impression is always of a system spiraling out of control and lurching to the brink of collapse (Pew Economic Policy Group 2010).[43]

What should one think of these doomsday scenarios?

The answer, alas, is not edifying. We think that all discussions of the budget should begin by taking to heart how easily even very gifted people can lose all sense of proportion when they start to reflect on things in the very long run.

The problem is not simply that many reach their scary conclusions by adding apples to oranges, or that they draw indiscriminately from economic history and experience. It is that in laying out detailed projections of budgets and the economy in the far future, they pretend to speak authoritatively about things that cannot possibly be forecast with precision. And on the basis of these airy projections, they promote sweeping recommendations that would dramatically affect the livelihoods of millions.

If the shattering events of 2008 have taught us anything, it is the fragility of economic forecasts that simply spin trends remorselessly out into an indefinite future. Most central bankers, economists, and business leaders failed not only to foresee but even to imagine the colossal dimensions of the 2008 catastrophe. Why should anyone repose much faith in their clairvoyance? Particularly when they continue to rely on notions like "rational expectations" or dynamic, stochastic general equilibrium models that ignore feedbacks from the political system and society?

Current discussions of Social Security point up the dangers of proceeding in this manner. These sort mostly into two groups: one rails on about how "runaway entitlements" are leading to a deficit explosion; whereas the other advises patronizingly that Social Security can be saved in the long run by timely changes, typically involving a mix of taxes and benefit cuts, including, notably, yet another rise in the age of eligibility for the program.

Neither point of view is persuasive. The entitlement "explosion" canard can be immediately dismissed. The simple fact is that the deficit did not swell tidally until the financial crisis hit. Although George W. Bush's tax cuts destroyed the Clinton budget surpluses, tax revenues accumulated at a rate that kept the deficit from ballooning until the economic equivalent of Hurricane Katrina hit. It was the one-two punch of the bank bailouts and the Great Recession that led to the current giant gap between general revenues and expenditures (Baker 2010; see also Feldstein 2010). But even with this, there is no near-term threat to Social Security's solvency. Our earlier point about the undramatic implications of the CBO's deficit projections through 2020 holds for Social Security, too, because those estimates include the program.

It is true that Social Security tax receipts declined during the Great Recession;

so for the first time since 1983, the program's outlays exceeded revenues by a small amount. And that enactment after the 2010 election of a one-year cut in the Social Security tax rate from 6.2 percent to 4.2 percent must turn the apparent trail of red ink a tad more scarlet (which is the idea; see below). But this in no way threatens the program's basic solvency. In 1983, Congress enacted into law recommendations of the Greenspan Commission to raise Social Security taxes to cover the retirement bulge coming from baby boomers. Since then, the program has piled up enormous surpluses. These have been invested in government bonds, thus helping to finance the rest of the government. As the baby boomers mature, the surplus funds will be drawn down. The 2010 Report of the Trustees of the Social Security Trust Fund projects that the trust fund and interest earnings from it will suffice to cover all benefit payments until 2037. Even then, the fund will not be empty—the trustees report projects that the trust fund would still cover 75 percent of all benefits due (Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds 2010).

The year 2037 is a long way off. The argument in 2011 is about whether there is any reason to do anything at all right now. The case pressed by self-proclaimed rescuers of Social Security such as Peter Orzag, who not long ago resigned as the head of the Obama administration's Office of Management and Budget and has just accepted a position with Citigroup, is unpersuasive (Orzag 2010). The first yellow flag is Orzag's frank acknowledgment that Social Security features barely at all in any putative budget short fall. "Social Security is not the key fiscal problem facing the nation. Payments to its beneficiaries amount to 5 percent of the economy now; by 2050, they're projected to rise to about 6 percent" (Orzag 2010). A rise of 1 percent! Even from the perspective of Reinhart and Rogoff's 90 percent threshold, this is a drop in the bucket. Former senator Alan K. Simpson, cochair of the president's National Commission on Fiscal Responsibility and Reform, claims that his group's upcoming deficit report "harpooned all the whales in the ocean, and some of the minnows" (R. Wolf 2010). Lost in the blaze of publicity about the commission is the crucial fact that Social Security is plainly one of the minnows.

The whole discussion, in fact, strikes us as even fishier. In the event any shortfall does materialize, it could easily be made up by transfers from general tax revenues, although that would breach the long maintained fiction that Social Security is a contributory system on the model of most private insurance. (It is actually a pay as you go system, in which current taxes pay benefits to current beneficiaries, with the final guarantee of the whole system's soundness being, in the last analysis, the success of the economy as a whole.) But if fears about 2037 are unbearable, plenty of ways exist that would fix the program without threatening anyone's life-support system.

Between 2002 and 2007, for example, the richest 1 percent of Americans garnered 62 percent of all income gains, whereas the bottom 90 percent of the population saw their incomes grow by 4 percent (Feller and Stone 2009). At the same time, thanks to the Bush tax cuts, most affluent Americans were also paying

proportionately less in taxes. Considering that ordinary Americans fronted most of the money for the bank bailouts and have endured most of the recession's "collateral damage," it seems only simple justice that if the program needs fixing, the best way to do it is to raise the ceilings on earnings subject to the Social Security tax, which is currently only $106,800.[44] That would put the burden on people who cannot plausibly claim to be suffering.

Even here, though, our skepticism gives us pause. Some caution is in order before everyone swallows any more recommendations from analysts who often spent the last decade insisting that they could not recognize a stock market bubble even when price earnings ratios soared past 100 to 1. If, for example, productivity runs even slightly higher than in the forecasts, there may be no shortfall of any kind. Considering that the projected shortfall is still twenty-six years away, it strikes us as more prudent not to rush to tinker with a program that in 2005 provided the majority of income "for nearly two-thirds of the elderly . . . [and] the only source of income for one-fifth of all elderly people, for 25 percent of non-married elderly women, and for 38 percent of elderly African Americans and Hispanics" ("Social Security" 2005).

Orzag and others, however, who agree that the program makes at most a minor dent in the budget, nevertheless argue for "fixing" it now. Their reason is remarkable: "Even though Social Security is not a major contributor to our long-term deficits, reforming it could help the federal government establish much-needed credibility on solving out-year fiscal problems" (Orzag 2010).[45] Cut benefits, in other words, simply to prove to financial markets that the government can do it. As Krugman observes, this position is tantamount to claiming that we should cut Social Security now because we might have to do it in the future (Krugman 2010b). In light of the financial crisis' disastrous impact on the home values and pensions of ordinary Americans, it takes a certain amount of nerve to put forward such views, even given the one-sided incentives that America's plutocracy provides to "experts."

The Far Future: Whale Watch—Health Care

Social Security is not, of course, the only program usually singled out as a budgetary "whale." Other programs exist, including some with better claim to that title. But once again, caution is in order. The real nature of the problems is almost entirely lost amid all the handwringing in the academy and the media: in the money-dominated U.S. political system, problems of out-of-control expenditures rarely arise from programs that confer benefits on large numbers of ordinary Americans. Political leaders responsive to major investors normally take extreme care to design such programs so the burden of financing them falls heavily on precisely the people who receive the benefits. The famously regressive Social Security taxes, with their caps on incomes subject to any tax at all are a case in point.

The nature of what we take to be the real threats to deficits—the budgetary "whales" as former senator Simpson calls them—is quite different. It is that pow-

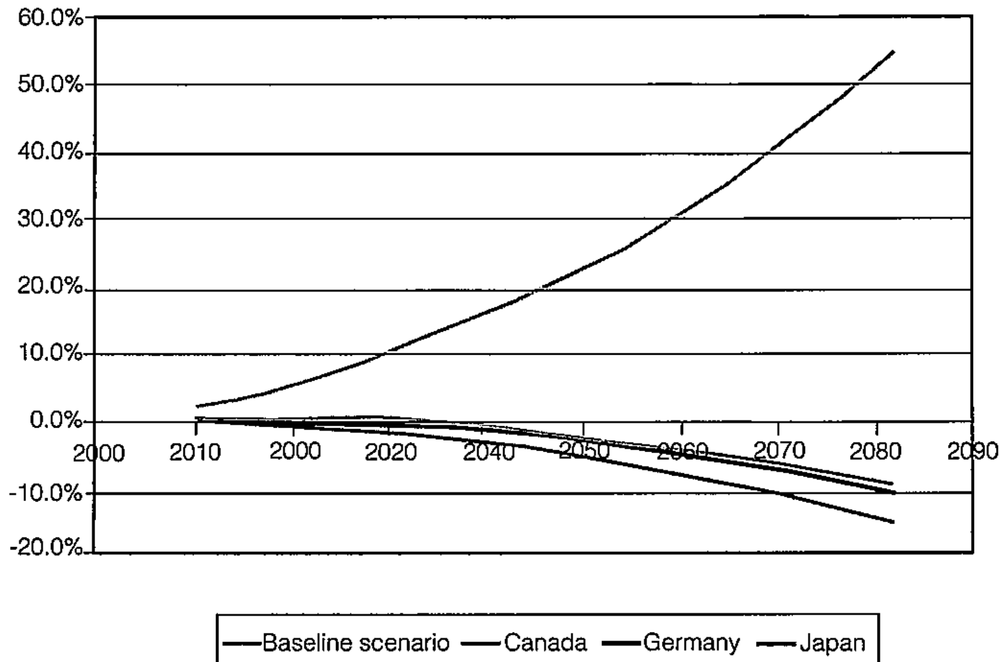

Figure 2. **What If U.S. Health-Care Costs Grew Like Other High Income Countries? How That Would Affect the Deficit as a Percentage of GDP**

Source: D. Baker and D. Rosnick, "Iousa Not OK: An Analysis of the Deficit Disaster Story in the Film *IOUSA*," Economic Policy Institute, Washington, DC, 2008..

erful blocs of corporations and investors have extensively captured the process of making public policy in key areas. They have used policy to reinforce oligopoly or even monopoly, promoting demands for service that defy rational assessments. Such areas require wholesale regulatory reform, serious antitrust restrictions, and cost–benefit systems that are not shaped by big money; controlling them by simply cutting expenditures, as deficit hawks usually propose, is like shooting at pigeons with a blunderbuss.

By far the most important such area is health care. When one examines the rocket-like trajectories of future budget deficits in alarmist studies of deficits, the hair-raising conclusions derive almost entirely from simple extrapolations of one driver: health-care costs.

Here, one picture is worth a thousand words. We, accordingly, borrow from Dean Baker's admirable discussion of some months ago (Figure 2). The United States spends a far higher percentage of its gross domestic product (GDP) on health care than any other country. It also gets less health for it than any other major country, in the sense that many other countries do just as well or better on most health indicators even though they spend much less.

Why is no mystery, despite all the sound and fury of the health-care "debate." The U.S. health-care system is in no sense a competitive marketplace. Instead, it

is a chain of private oligopolies connected to each other by streams of payments administered by a vast, noncompetitive private insurance network and the federal government. Producers and insurers together dominate government policy-making at both federal and most state levels. Basically, health-care regulation is like banking regulation: it is subject to the deadly syndromes we identified in an earlier paper on the financial crisis. Besides the tidal wave of direct and indirect political contributions, think tanks working in the area are virtually all dominated by producers. Perhaps even more devastating, a gap the size of the Grand Canyon yawns between the compensation of regulators and the regulated, creating a pronounced tendency for regulatory agencies to function mostly as employment agencies for the regulated firms.[46]

The new health-care reform law vastly extended coverage but did little to control the oligopolies, not least because the administration relied on key parts of precisely that network to supply the political muscle to put over its program. The danger this creates for the future is obvious: some way has to be found to control the oligopolies just entrenched. Arguments about how health care affects the deficit are really bets on this and nothing else.

In the debate over the deficit, health care now functions rather like weapons of mass destruction in the run up to the invasion of Iraq. It is the device of choice to terrify the public. Current long-term deficit projections, including the CBO's, are just guesses. Those for the long term make little sense and have been powerful instruments for sowing fear among the public. They project past rates of the growth of costs out year after year. Not surprisingly, over a generation, health care looks like Pac-Man, eating up much of the economy. That appetites on this scale are certain to bring forth powerful opposition does not cross the official mind.

Figure 2, which is taken from a study by Dean Baker and Peter Rosnick, shows how simply limiting health care costs to the same percentage of GDP as that of several countries that enjoy better health care than the United States would hold down deficits. Plainly, with health care there is no "deficit problem" per se; there is an imperative for effective regulation and antitrust. There are at least two quick fixes that would represent giant steps toward reducing deficits, although there is little chance either will be adopted or even discussed in the national debates over the deficit. The first is to just adopt Canadian-style "single-payer" health care and get rid of the insurers. Or, if that sounds too harsh and "socialistic," relabel it as generalizing Medicare to the whole population. Whatever one calls it, getting rid of the enormously wasteful and duplicative private insurers would shrink health-care expenses spectacularly—by at least 20 to 25 percent—without detracting from anyone's care. As a fallback, even putting in a viable "public option" would mark a giant step forward. The other measure is to let the federal government bargain with pharmaceutical concerns over health care costs. As our colleague Joseph Stiglitz suggests, savings from this measure would likely mount into the trillions of dollars—which is why the recently passed health-care law mostly blocks this (Stiglitz 2010b).

Whale Watch: Defense

A certain irony surrounds the second whale in the budget debate, defense spending. Once upon a time, the proposition that nothing could be more dangerous to a country's finances than war was a shibboleth of conservative business opinion. In the interwar period, indeed, pressure from financial circles for arms limitation was intense and at times decisive (see, e.g., Ferguson 1995a). In the United States, if not Europe, however, this has gone by the boards. Remarkably few deficit discussions direct much attention to military spending although, to its credit, the President's Deficit Commission discussed the issue.

But it is disconcerting that neither the commission nor most other analysts appear to recognize the dimensions of the problem. Most summaries of total U.S. spending on defense and the military seriously undercount. The CBO, most think tanks, and major media routinely use figures suggesting that military spending makes up perhaps 20 percent of the budget (Cordesman et al. 2010).[47] But as Chalmers Johnson and Robert Higgs each noted some years ago, spending in this area is scattered across a maze of agencies (Higgs 2007; Johnson 2006). Spending on homeland security, which has clearly grown without much rational direction, for example, should be counted, along with parts of the budget for the departments of state, energy, and even transportation, obviously along with all spending by defense and the intelligence agencies. Less obviously, interest on the debt for this part of the budget properly belongs in the totals. One careful effort at a more comprehensive reckoning suggests that perhaps 39 percent of the proposed fiscal year 2011 budget goes toward defense.[48]

But the astronomical totals obscure the central problem for the future, which is the question of national strategy. We suspect that future historians will regard September 15, 2008, the date U.S. authorities allowed Lehman Brothers to slide into bankruptcy, as one of the great turning points in the history of international relations, as well as finance. The subject, though, is too big for this paper. But the implications for future deficits can be dealt with summarily. For a year or so after the financial collapse, most U.S. policymakers lowered their profiles and talked up a more cooperative, internationalist line. Now, however, they increasingly acknowledge their aim of restoring the status quo ante. They are matching their words with deeds, notably in the western Pacific, where civilian leaders seem disinclined to acknowledge how shore to ship missiles are destined to reshape U.S. naval deployment patterns.

We think this posture is delusory and that imperial overstretch once again looms as a real temptation for the United States. The notion that bluster and military power can reverse major shifts in the balance of economic power between regions and countries is a disastrous error. Yes, it is possible for the dispatch of a carrier battle group to make countries think twice about embarking on risky strategies in, for example, the western Pacific. But five years from now the internal politics of many of those countries will be profoundly different, as indigenous interest groups watch the relative economic

slide of a United States that seems unable to harness the state for national economic growth on a scale routinely achieved by countries in that region.

Developing this point would require a separate paper. For now, it will have to suffice to draw attention to the obvious: both Afghanistan and Iraq, even with the reduced force levels now projected, are sure to consume enormous resources. So will the larger U.S. buildup in the Indian Ocean basin, even if, as recently proposed, the Afghan commitment were to be cut back to the northern, non-Pashtun areas. As the last-minute attempt to hold up the nuclear arms treaty with Russia after the 2010 election by Jon Kyl, senator from Arizona, and other Republicans vividly illustrates, pressures for more defense spending, including immensely costly programs of nuclear weapons modernization, are likely to threaten CBO's estimates. And any new wars, such as an attack on Iran, assuredly would bust the budget unless financed by new taxes—precisely what the biggest Senate champions of an attack on Iran most stridently oppose.

Whale Watch: The White Whale—Another Financial Crisis

Last, but hardly least, among the whales that threaten U.S. budget estimates is another financial crisis. Despite the trumpets and flourishes that accompanied passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act in the United States and the brave talk that surrounds the preparation of a "Basel III" revision of international banking capital standards, the plain fact is that the "too big to fail" problem has not been resolved in either the United States or the rest of the world. We could develop this theme in any degree of detail; here, we simply observe that neither off balance sheet practices, nor derivatives, nor bank compensation practices, nor cross-border resolution practices for failed institutions, nor most of the other key factors in the last disaster have changed all that much. Dodd–Frank was watered down to a point that would be comic if the issues were less serious, while the Basel guidelines are plainly being adulterated by concentrated bank lobbying (Dash and Schwartz 2010; Johnson and Kwak 2010). With short-term interest rates near zero in the United States and other developed countries, speculative excesses, high bank bonuses, and other touchstones of an out-of-control system are recurring. And, like many other observers, we are hardly persuaded by brave-sounding official declarations that the financial sector is at all likely to be left to its own devices when the next Lehman strikes. To anyone with the eyes to see, the course of the euro crisis is once again underlining the critical role state guarantees and public subsidies play in bank stock prices.

The unpleasant truth is that institutions the size of Bank of America, Citigroup, or, a fortiori, Goldman Sachs, simply cannot be allowed to fail. It simply does not matter if they are formally considered banks or how many times officials proclaim that they will not be bailed out. If they are permitted to exist at all, the only policy question is whether, as happened last time, not only the banks but also the bankers will be rescued at public expense. That prospect, however, ranks right up there with another major war as a megathreat to the budget because of the gigantic collateral

damage that financial crises wreak. These costs go way beyond the direct outlays for the Troubled Asset Relief Program (TARP), "ring fences," public–private partnerships, and guarantees that were pivotal in the recent crisis. The now notorious costs of bailing out Freddie Mac and Fannie Mae, for example, are actually disguised subsidies to the financial sector, although public debates create the impression that some unique "government" failure is at issue. The losses on all the mortgage-backed securities that the Fed bought will be passed on to the Treasury via Fed debits of its normal payments to the U.S. government (see Ferguson and Johnson 2009b).

Most of the increase in the federal deficit, however, stems from the conjunction of falling tax revenues, bank bailouts, and countercyclical spending mounted to head off the downward economic spiral that financial collapses customarily trigger. The increases in the deficit that result are gigantic: in 2007, the U.S. deficit amounted to just over 1 percent of GDP. After the financial crisis, it ballooned—in both 2009 and 2010—to approximately 10 percent of GDP.[49]

It is clear that the euro crisis is moving into a new stage in which risks to countries from potential bailout costs are rising to the point at which some sovereign credit ratings are coming under pressure. In turn, this is squeezing some countries, notably Germany, to throw back risk on the private sector, thus heightening chances that private banks will eventually fail. If sovereign defaults in peripheral Europe eventually trigger a banking crisis in the euro area, as is quite possible, the risks of international contagion are serious. Such a "Lehman in reverse" is likely to have roughly the same impact on some major U.S. banks that Lehman had on financial institutions in Europe. Should the worst occur, the U.S. government will again intervene to save them. The only open question is whether major parts of the bailout will once again be disguised as bailouts for some particular financial institutions like AIG or, next time, a derivatives clearinghouse, or paid out directly, as with TARP, the Citigroup and Bank of America "ring fences," public–private partnerships, and the Federal Deposit Insurance Corporation payouts and guarantees. Whatever form the bailouts take, they will wreak havoc with the CBO's deficit estimates.

The World Right Side Up? Or the Killer Whale?

There is a sense in which all this might justify a cautiously optimistic assessment. If the sky is not falling—that is, if the United States is not about to bump into some magic limit on its rate of growth and continuing the Bush-era tax cuts for all but the top 2 percent of American taxpayers as the president originally proposed would be unlikely to stir up financial markets—then the hue and cry about the federal deficit might be mostly beside the point. Existing "entitlements" do not threaten national insolvency, nor is there any real threat to Social Security (whose effects are fully subsumed in the budget projections just discussed, despite all the propaganda about how the system is "going broke"). Even at the tepid rates of recovery that are normal after financial collapses, the U.S. debt/GDP ratio could stabilize over

time at a somewhat higher, but still nonthreatening level.

But, as a medieval adage reminds us, if wishes were horses, paupers would ride. It has always been clear that all such calculations are fragile because of the ease with which big money ties the U.S. political system up in knots.

On the expenditure side, not one, but three powerful sets of interest groups—finance, the defense establishment, and the "medical–industrial" complex—all require controlling for things to work out well. One can always hope for the best, but the prospects of a successful triple play strike us as about as likely as they are in baseball. Most deficit hawks are thumping their tubs in favor of simple rationing strategies—arbitrary limits on total expenditures or program ceilings. These are virtually guaranteed to have disastrous consequences. Imposing ceilings on health care expenditures, for example, is likely only to lead to quantity rationing by oligopolies to the detriment of the public's health and sweeping denials of care. In health care, the task of controlling expenditures requires strategies akin to those in finance: make markets be markets, break up oligopolies, or, where competition is unlikely to be feasible (which is to say, many parts of the "market"), regulate them as intelligently as other countries do.

As earlier discussed, it is already apparent that the U.S. government has dropped the ball on financial regulation, for familiar reasons of money politics. Neither are we holding our breath on defense policy, where commitments to two ongoing wars and a steady drumbeat by various interested parties for one or two more shadow all discussions of budget reduction.

But the dramatic events that followed the 2010 congressional election suggest that the gravest long-run threats to budgetary "normalization" probably lie on the tax side. The president's party normally takes losses in midterm elections. In 2010, however, the swing against the Democrats (measured in terms of the shift in the party's percentage of the two-party vote) was the second largest in American history (Walter Dean Burnham, personal communication, January 2010). The reversal's staggering dimensions shook the administration and the party to their foundations. For several weeks, speculation in the media ran riot about the president's ability to govern, his chances for reelection, even whether he might face a primary challenge.

Just as that wave was peaking, another outpouring of media commentary welled up, as the president's deficit commission geared up to report. Although polls showed that most Americans did not believe the deficit was the country's most important problem, absolutely opposed cuts in Social Security, and wanted taxes raised on the rich to close the deficit instead of budget cuts, Republicans and even many Democrats talked as though the election had been about deficits and tax cuts instead of the president's failure to act effectively to relieve unemployment and the housing and mortgage crisis (see, e.g., Gelman 2010).[50] Almost as though they were medieval monks reciting sacred litanies, press commentators reeled off one staggering long-term deficit projection after another, talked breathlessly about financial "time bombs," and competed to proclaim reducing the deficit to be the

most urgent public policy problem for the United States. Business spokespersons, some military spokespersons, even Secretary of State Hillary Clinton chimed in.

Then, shockingly, as the old Congress convened for one last "lame duck" session, everything changed. To the astonishment of members of his own party in and out of Congress, the president announced he had reached agreement with Republican congressional leaders on a "compromise" tax package that would extend the Bush era tax cuts to all taxpayers, including the superrich, as Republicans had demanded all through the campaign. The deal also scaled back the planned rise in the estate tax from 55 percent to 35 percent, cut Social Security taxes by 2 percent for one year, and gave businesses special one-year tax incentives for new investments. Angry House Democrats denounced the package as capitulation, citing calculations that the compromise was worth $77,000 to the richest 1 percent of income earners, who would garner fully 25 percent of all the tax relief in 2011 while leaving barely 7 percent of all tax relief for the bottom 40 percent of income earners. The administration replied by pointing to the extension of unemployment benefits for a year.

During the fall election campaign, the media ran one story after another about how insurgent Republicans and the Tea Party would push Republican leaders to make deficit reduction their top priority. But no sooner was the plan announced than virtually the entire Republican leadership stampeded to endorse it. Eventually, many despondent, sometimes bitter Democrats came grudgingly to support it. But the big story was the dramatic turn in the president's press coverage. Suddenly, conservative commentators such as Charles Krauthammer, whose turnabout was so dizzying that it attracted some derision, and David Brooks (2010) abruptly switched back to statesman mode in discussing the president. Exuberant business leaders met with the administration, with many pausing to hail the willingness to "listen" and open-mindedness of the man whom so many had recently been denouncing as a socialist. When, barely a year after TARP was established, the president named a top banker as his new chief of staff and a policy analyst with close ties to Goldman Sachs, Gene Sperling, to head the National Economic Council, the chorus of praise reached a crescendo, as pundits celebrated the president's oratorical skill, willingness to engage opponents on the right, and instinct for the political "middle."

The lesson for the future that not only the administration but also many other figures in American public life are certain to draw from this episode is clear: If you cut taxes on the wealthy, almost anything else you do wrong can be forgiven. And to judge from the campaign that is revving up over raising the debt ceiling as this paper goes to press, most of the American political elite and mass media now adhere to norms of behavior that are right out of a Latin American magic realist novel. With no sense of embarrassment or irony, they immediately turned back to banging the gong for the importance of reducing the deficit.

By itself, the two-year extension of the tax cuts does not have withering implications for long-term budget stability—it expires in two years. The one-year cut in Social Security taxes will, as the Republicans who promoted this provision assuredly recognize, fan misleading impressions that Social Security is headed for serious

trouble, because revenues from the tax will drop off for the year. And because so much of the new short-term "stimulus" takes the form of tax cuts, the package reduces the likelihood that the federal government will do anything to relieve the distress of the states whose tax revenues have plunged because of the Great Recession. Another massive round of state budget cuts is therefore likely, with all that that implies for long-term investments in education and other vital areas in which states are major players, as well as the short-term course of national income.

But it is the longer run implications for tax policy that make the lame duck session's handiwork so problematic. Who would now confidently predict that the upper-class tax cuts will be allowed to expire in 2012? Although right after the bill passed, the president pledged to oppose making them permanent, the plain fact is that 2012 is a presidential election year. Republican leaders sometimes talk tea, but mostly they count money. As the Republican party girds for what, thanks to the Supreme Court's notorious Citizens United decision, is now guaranteed to be the most expensive election in U.S. history, the party is certain to plump for making the cuts permanent. In 2008, the Obama campaign broke all fundraising records. To prevail in 2012, it will have to do even better than it did in 2008. Probably it will try to raise something like a billion dollars. Its rapid and very public tilt toward big business, and especially Obama's 2008 base, finance, since the drubbing in the off year elections, shows the shape of things to come.

Indeed, the fork in the forest path for the administration may come even sooner. As many analysts have observed, the decision to cut Social Security taxes for only one year opens the administration to the charge that it is raising taxes—allowing Social Security taxes to go back to their old level—just as the 2012 campaign goes into high gear.

Throughout this paper, our view has been that the U.S. deficit is problematic but not as threatening as commonly said. There are some reasons for thinking that even making the upper-income tax cuts permanent would not mortally wound the economy or lead to an eventual debt crisis. But there is also little doubt that permanently extending the Bush tax cuts for the superrich is a gamble of colossal proportions. First, because the revenue loss over a decade is gigantic. As this paper goes to press, a new CBO estimate suggests that extending the reductions in income, gift, and estate taxes through 2021 would lead to revenue losses of approximately $2.5 trillion (Congressional Budget Office 2011: 24).[51] It is not necessary to buy into any 90 percent rule to wonder if this makes sense.

An increase on this scale leaves no room for new shocks of any kind—war, another financial crisis, or even just slower growth. But that is hardly the end of the mischief. By insisting on cutting taxes, American business and political elites are signaling that talk about deficit reduction is simply cant. To anyone who can think even one move ahead, the conclusion has to be that any cuts in Social Security or programs that aid ordinary Americans will simply be swallowed by more tax cuts or additional expenditures benefiting the defense establishment, finance, or the medical–industrial complex. We suspect that few Americans will see any point to playing such a game.

Conclusion: A Better Way

So is there nothing to be done?

With the Republicans trying to turn the extension of the debt ceiling into a sound-and-light show on behalf of precisely the free market economics that brought the world to the brink of disaster in 2008 and the administration wobbly on even core Democratic programs from the New Deal, it may not seem a very propitious moment to consider what government can do that would actually improve the situation. But at least in theory, this is not as difficult as it sounds.

Most current analyses of the U.S. deficit badly misdirect by considering only the liability side of the government's balance sheet. That is, they are interested only in what the government owes. But governments not only run up debts, they also build up or acquire assets—assets that are in many cases vital to the functioning of the national economy and that greatly raise productivity.

Any serious analysis of the modern pharmaceutical industry, for example, will show that federally supported research, particularly that of the National Institutes of Health, drives that industry's development. "Competition" in that sector extensively takes the form of scheming to get close to government-supported researchers and inveigling them or their students to pursue later stages of their research within particular firms. This pattern is fabulously profitable for the companies. It also has major benefits for the economy as a whole (Lazonick 2009). Similar phenomena mark parts of the defense industry as well as telecommunications and many other sectors. In 2000, many Republican analysts were happy to remind everyone that Al Gore did not invent the Internet; they are less vocal about the fact that free enterprise did not either.

Yet most discussions of deficits, including those of the International Monetary Fund, pay almost no attention to the productivity of government assets and the difference between social and private rates of return on investment. Disregarding quantitative historical studies that show economies with low rates of public investment grow slower than economies with higher rates, they keep repeating silly "crowding out" arguments that imply that a dollar of private investment has roughly the same social rate of return as a dollar of public investment (Lindert 2004).[52] Current national income accounting facilitates this nonsense by neglecting all calculations of returns on investment and treating profits in pharmaceuticals and other industries as though they originate there. So does the common econometric practice of testing for crowding out by relying on short-run models that have virtually no hope of picking up cumulative effects of government investment.

Several economists and financiers have argued in favor of longer term investment programs designed to raise rates of growth and productivity while also promoting full internalization of energy ("carbon") costs. The usual suggestions include policies designed to further "green" energy and industry, along with major investments in education and infrastructure. That some claim, incoherently, that such programs are alternatives, rather than complements, to traditional Keynesian demand stimulus

policies in periods of high unemployment does not make them bad ideas. Our Table 2 earlier showed how simply substituting a slightly higher rate of growth for the CBO's lower rates vastly improves the U.S. deficit outlook.

In the 1990s, the Clinton administration demonstrated once again how approaches to full employment shrink budget deficits by swelling tax revenues and reducing cyclical outlays of such "built-in stabilizers" as remain from the halcyon days of the New Deal. The Obama administration's failure to mount a stimulus program that was big enough to drive down unemployment has discredited the whole approach politically. But in fact our earlier simulations in Table 1 of how "high" and "low" growth scenarios affect the CBO's deficit projections show that the notion remains compelling. Setting aside all questions about tax cut extensions, under the high-growth scenario, the debt/GDP ratio in 2020 drops by nearly 10 percent from what it would be under the CBO's 2010 baseline projection—from 69 percent to 60 percent of GDP (or approximately 61 percent to 52 percent of GDP when financial assets owned by the government are taken into account).[53] This would bring the ratio right back to approximately where it is in 2010! Under the low-growth scenario, the ratio rises from 69 percent to 82 percent (or from 61 percent to 73 percent when financial assets are recognized). The latter, dismal projection can be taken as a measure of the downside risk if nothing is done, whereas the former benchmarks what might be achieved with effective government action.

Both potential gains and losses are gigantic, amounting to trillions of dollars. In the slow growth case, the implication is that one could invest roughly $2 trillion in a program of public investment. If the program raised growth by half of 1 percent a year over the next ten years, then one would have no worse a debt/GDP ratio than the baseline, but many more people would be employed and GDP would be far higher. It hardly requires John Maynard Keynes to see the obvious implication for government action. Especially when the government can borrow at almost zero rates of interest, it is easy to have one's deficit cake and eat it too. The upside down world of the Great Recession needs to be put right side up. There is no excuse for failing to move vigorously to put America back to work, in the long run *lowering* the deficit and preserving the vital government programs that are now the only thing separating many ordinary Americans from a lifetime of poor education, untreated illness, and poverty.

Notes

1. A standard source on the earlier phases of the Keynesian revolution is Collins (1981).

2. For policy after the 1970s, see Glyn (2007); for the statistics on "real government consumption" in Germany, see Krugman (2010e). Joseph Halevi (2010) has drawn attention to the gap between the popular perceptions and the reality of German economic policy.

3. On the changed stance of the IMF, see Giles (2010). On Germany and the ECB, see Bibow (2010).

4. See, e.g., M. Wolf (2010). A striking example of demands for more cuts is Kennedy (2010).

5. As the summit approached, the discord between the United States and others was obvious; see, e.g., Wallace (2010).

6. See the plainly stated acknowledgments in Leonhardt (2010).

7. Ever since the January 2010 special election held in Massachusetts to elect a successor to the U.S. Senate seat held for decades by Edward Kennedy after his death, it had been clear that the Democrats faced major electoral problems (see Ferguson and Chen 2010).

8. The Peterson Foundation made yeoman efforts in the summer of 2010 to create the impression that public opinion favored cuts in Social Security and other programs. The claims were nonsense (Page and Jacobs 2010). More broadly on the Peterson Foundation and the Deficit Commission, see Auerback (2010), Covert (2010), Dayen (2010a, 2010b), and Galbraith (2010).

9. The Roosevelt administration also raised interest rates as part of a deal with leaders of the banking community struck during the 1936 election (see the discussion in Ferguson 1995a). The Fed is unlikely to repeat this error again, but it has resisted pressures to do more to combat unemployment, and in any case, the chorus of opposition from the right is clearly going to crimp the program.

10. Blaming the rise on the Fed's quantitative easing is popular, but the program is just too small to have such massive effects. But along with lax margin requirements and the absence of meaningful position limits, the extra liquidity helps make speculation very easy. Speculators can thus play a significant role. The rise of the Chinese "shadow banking" system is not widely appreciated in the West. But the topic is too big for this paper.

11. We lack space for a detailed review of the administration's record on financial legislation; but see our earlier two-part study (Ferguson and Johnson 2009a, 2009b) as well as Johnson and Kwak (2010). On credit and debit card fees, see especially Silver-Greenburg (2010).

12. See Koo (2009); for the study, which was not based directly on Koo's analysis, see Wilder (2010), which is a discussion of Smith and Parenteau (2010).

13. As this essay nears completion, anxiety over the European Union's handling of bailouts is rising. We share the view that this has been maladroit, but the text's statement remains true. On the other hand, there may be a limit to how foolish policymakers can be in prolonging debates about bank bailouts and indulging bank excesses (see our earlier discussion in Ferguson and Johnson 2010a).

14. Markets for credit default swaps (CDS) on sovereign bonds also exist and should also reflect such pressures. But the CDS market in such debt is thin and subject to possible manipulation, making its evidence rather more ambiguous.

15. See, e.g., Reuters (2010). For the earlier lack of warnings, see, inter alia, (Ferguson and Johnson 2009a).

16. Changes in terms of trade may also have exerted some influence.

17. Our figure depicts both items in the same year; depending on one's economic theory, it might be reasonable to prefer a number that lagged one of the series by a year. Nothing in our argument will change with such a device.

18. The literature is enormous. All short statements about the Industrial Revolution require extreme care. Mokyr (1998) provides a convenient, well-written recent discussion of many of the classic debates. Whether crowding out actually happened has been intensely debated. Temin and Voth (2005) give a recent discussion with much new evidence, arguing that it did.

19. This is not to say it "took off," which has been a long, bitter discussion, or that correlation is necessarily causation. But the result flies in the face of 90 percent warnings.

20. Compare the discussions of data in the two works. For other data problems, see Nersisyan and Wray 2010.

21. Both Shelley and Byron wrote bitterly about Castlereagh. Shelley's lines after Pe-

terloo, where British cavalry rode down a crowd of orderly, unarmed citizens listening to speeches about parliamentary reform, remain famous:

I met Murder on the way –
He had a face like Castlereagh –
Very smooth he looked, yet grim;
Seven bloodhounds followed him.

22. Note that Temin and Voth (2005) limit their claims about crowding out to wartime; they believe British growth was relatively robust after 1815 and use that fact to try to square several circles about growth in the Industrial Revolution (see p. 346). We wonder if their proposals are compatible with Temin's earlier findings about the technological change that they discuss, but that is another paper.

23. Proponents of "Ricardian equivalence," of course, claim people lower their spending to save for future taxes they supposedly know are coming. Anyone familiar with patterns of U.S. political finance will entertain a radically different idea of what affluent people do with part of their income if they suspect taxes might be raised on them.

24. Note that they doubt that movements of funds from abroad relieved the congestion they argue characterized the money markets during wartime.

25. See the Bank of England's Excel file of bank rate changes, www.bankofengland.co.uk/mfsd/iadb/Index.asp?first=yes&SectionRequired=I&HideNums=-1&ExtraInfo=true&Travel=Nix/.

26. Probably because it was so drawn out.

27. See the discussion and tables in Alesina and Ardagna (2009).

28. Ireland in 2000, Netherlands in 1996, and Norway in 1996.

29. Sometimes the fall in the exchange rate represents simply a recovery to more normal levels following disastrous capital inflows as a result of foolish financial deregulation.

30. On the "golden year," see Statistics Norway (1997).

31. Cf. Ferguson and Temin (2003, 2004) with previous discussions of what is still perhaps the most fateful of all financial crises, that of 1931 in Germany.

32. Our view that the sky is not falling on most states appears to be shared by Ben Bernanke, among others (see Hume and Ackerman 2011).

33. For Alesina and Ardagna, see, e.g., p. 8, note 20 of Congressional Budget Office (2010d); the same report invokes the debt/GDP ratio of 90 percent. For Reinhart and Rogoff, see below, where the issue is the publication of an estimate of the president's budget that just happens to hit 90 percent exactly.

34. For the explicit linkage with Reinhart and Rogoff, see, e.g., Committee for a Responsible Federal Budget (2010).

35. So are the adjustments required in the torrent of alarmist papers now rolling out of Washington think tanks, which virtually all ignore this unheralded correction.

36. The original budget projection came out in January 2010 See Congressional Budget Office 2010c); the August revision is presented in Congressional Budget Office (2010b).

37. In the wake of the 2010 congressional elections, the president struck a deal with the Republicans over the bitter protests of many in his own party to extend the Bush tax cuts for everyone, including top income earners. See the discussion below.

38. The higher growth scenario uses the CBO rule of thumb from appendix C in the CBO's January 2010 Budget and Economic Outlook (not revised in August), which shows what happens to the deficit for a 0.1 percent change in the growth rate of GDP. GDP is assumed to rise by 0.5 percent, and then its impact is traced out over the years on GDP (higher) and deficits (lower) using the appendix C schedule for 2010 to 2020 multiplied by 5. The cumulative reduction in deficits leads to a lower debt in 2020 to accompany the higher GDP level.

39. Higher or lower growth would doubtless affect the assets values in practice.

40. The column, too, should be adjusted for the financial assets.

41. The lower levels of economic activity and higher deficits lead to cumulative debt. The exercise relies on several rules of thumb based on regressions by Josh Bivens at the Economic Policy Institute. A 2.5 percent unemployment gap that persists appears to correlate with about a 4.0 percent output gap relative to potential GDP. So baseline GDP is reduced in each year by the difference between the unemployment rate and the CBO's 5.0 percent rate. The exercise is not directly saying that any "natural rate" has shifted but that an output gap persists. A second rule of thumb is that a 1.0 percent GDP output gap leads to a 0.375 percent GDP rise in the budget deficit due to cyclical adjustment. So a 4.0 percent decline in GDP relative to potential leads to a 1.4 percent of GDP increase in the deficit. The cumulative deficits are then used to change the numerator in the debt/GDP ratio, and the denominator is also lower by the persistent output gap.

42. The reference is to debates about "structural" unemployment and higher natural rates of unemployment (cf., inter alia, Jaydev and Konczal 2010b).

43. Pew and Peterson have cosponsored several initiatives in this area.

44. Indeed, the ceiling could be raised substantially and the rate cut for everyone; on equity grounds, this is very attractive.

45. This view is widely shared within the financial community. See the quotation from Paul Volcker in Greider (2010); this fine article also cites John Podesta of the Center for American Progress making the same point.

As this paper goes to press, the trustees of the Social Security Trust Fund have released their annual report for 2011, available at www.ssa.gov/OACT/TR/2011/tr2011.pdf. They now project exhaustion of the Social Security Trust fund in 2036, instead of 2037. This latest estimate underscores our point about the flimsiness and the manipulative character of these long-term exercises and the folly of letting them drive policy now. There is no good reason to tinker with Social Security yet, as we emphasize. We are glad, however, to see the report's frank acknowledgment that, even by its assumptions, tax revenues will still cover approximately 75 percent of promised benefits until 2085. Talk of the "bankruptcy" of Social Security remains nonsense.

46. For think tanks and regulatory agencies as employment agencies for the industry, see Ferguson and Johnson (2010a).The example there is finance, but the situation in health care is similar. See also Ferguson (1995b).

47. Note that this study prefers to report U.S. defense spending as a percentage of GDP, which looks much smaller. Its charts also exclude veterans, space, and some other spending from defense, which is precisely our point here.

48. See the Web site of the Friends Committee on National Legislation, especially the pie chart at www.fcnl.org/pdfs/budget/FY2011PieChart.pdf.

49. The figures come from the corresponding tables at the Web site of the Office of Management and Budget: www.whitehouse.gov/omb/budget/Historicals/. One point of our paper, of course, is that the deficit would have been less if the Obama administration's stimulus policy had been more aggressive.

50. Until recently most public polls did not give respondents a chance to indicate a preference for higher taxes specifically on the rich; either explicitly (as in some *New York Times* polls) or by implication, they asked about taxes that would fall on the respondent. One poll that did offer an explicit option found that 61 percent of the public preferred to close deficits by higher taxes on the rich. This was taken by *Sixty Minutes/Vanity Fair* (see Reuters 2011). As this paper goes to press, other polls have begun offering that option and finding similar results.

51. The CBO's discussion, however, does not separately break out the value of the tax cuts for the top 2 percent of America's wealthiest citizens; given the role this proposal has played in public discussion, we think it should have. Instead it rolls all the tax extensions

into a package with other policy measures involving more spending to suggest that enacting them all through 2021 would push up the debt/GDP ratio to 97 percent—as usual, without subtracting out financial assets owned by the government. As Atkinson, Piketty, and Saez (2009) note, given the gigantic rises in income inequality in the United States, it is impossible to go on pretending that taxation of the wealthy would not by itself be a major step to fixing budget problems.

52. We lack the space for a discussion of the controversy over multipliers; we agree with our colleague Joseph Stiglitz and others that the multiplier for the United States right now is positive and high enough for such a policy to succeed (see, e.g., Stiglitz [2010a, 2010b]; see also the excellent discussion in Seccareccia [2010]).

53. Note that these results are based on the CBO projections for 2010 cited above. These projections are regularly revised on a rolling basis. The 2010 tax bill passed after the November elections altered them, for example—though, as we discuss, not seriously in the long run. Obviously, if the tax cuts were all extended past 2012, the numbers would require revision, although our point about the advantages of social investment would stand.

References

Alesina, A. 2010. "Fiscal Adjustments: Lessons from Recent History." Paper presented at Econfin Meeting, Madrid, April 15.

Alesina, A., and S. Ardagna. 2009. "Large Changes in Fiscal Policy: Taxes vs. Spending." Working Paper 15438, National Bureau of Economic Research, Cambridge, MA.

Alexiou, C. 2001. "Crafting a Post-Keynesian Macroeconomic Framework to Explain European Unemployment: Econometric Evidence from the European Countries." *Journal of Post-Keynesian Economics* 24, no. 1: 59–80.

Atkinson, A.; T. Piketty; and E. Saez. 2009. "Top Incomes in the Long Run of History," Working Paper 15408, National Bureau of Economic Research, Cambridge, MA.

Auerback, M. 2010. "Which Party Poses the Real Risk to Social Security's Future?" *New Deal 2.0,* www.newdeal20.org/2010/08/16/which-party-poses-the-real-risk-to-social-securitys-future-17610/, accessed May 8, 2011.

Aversa, J. 2010. "More Layoffs Expected at State and Local Levels—Federal Aid Won't Staunch Job Losses." *Boston Globe* (August 9), http://articles.boston.com/2010-08-09/news/29305712_1_job-losses-government-spending-jobs-last-month/, accessed May 8, 2011.

Baker, D. 2010. *The Budget Deficit Scare Story and the Great Recession.* Washington, DC: Economic Policy Institute.

Baker, D., and D. Rosnick. 2008. "Iousa Not OK: An Analysis of the Deficit Disaster Story in the Film *IOUSA.*" Economic Policy Institute, Washington, DC.

Baumol, W.J.; A. Blinder; M. Lavoie; and M. Seccareccia. 2010. *Macroeconomics: First Canadian Edition.* Toronto: Nelson.

Bibow, J. 2010. "It Is Worrying That the German View of Austerity Is Now Europe's." *Financial Times* (June 28), www.ft.com/cms/s/0/982e2216-824d-11df-9467-00144feabdc0.html#axzz1LnUYZSCD/, accessed May 8, 2011.

Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds. 2010. *The 2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.* Washington, DC: U.S. Government Printing Office.

Brooks, D. 2010. "Prune and Grow." *New York Times* (June 10), www.nytimes.com/2010/06/11/opinion/11brooks.html; accessed May 8, 2011.

Buiter, W. 2010. *Citi Global Economics View: Sovereign Debt Problems in Advanced Industrial Countries.* New York: Citigroup.

Bullock, N. 2010. "Norfolk-Southern in 100-Year Issue." *Financial Times* (August 24), http://cachef.ft.com/cms/s/0/965d37ea-af09-11df-8e45-00144feabdc0.html#axzz1LnWEMDca/, accessed May 8, 2011.
Burne, K. 2010. "Bankers Pitch 100 Year Bonds." *Wall Street Journal* (August 23), http://online.wsj.com/article/SB10001424052748704488404575442021845873594.html, accessed May 8, 2011.
Chen, B. 2010. "Social Security's Family Benefits and the Fiscal Commission." *New Deal 2.0* (June 24), www.rooseveltinstitute.org/new-roosevelt/social-security-s-family-benefits-and-fiscal-commission, accessed May 8, 2011.
Collins, R. 1981. *Business Response to Keynes.* New York: Columbia University Press.
Committee for a Responsible Federal Budget. 2010. "The 90% Debt-to-GDP Threshold and the CBO's New Debt Estimates." Committee for a Responsible Federal Budget, Washington, DC, March 9.
Congressional Budget Office. 2010a. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2011." Washington, DC, March.
———. 2010b . "The Budget and Economic Outlook: An Update." Washington, DC, August.
———. 2010c. "The Budget and Economic Outlook: Fiscal Years 2010 to 2020." Washington, DC, January.
———. 2010d. "Federal Debt and the Risk of a Fiscal Crisis." Washington, DC.
———. 2011. "The Budget and Economic Outlook: Fiscal Years 2011 to 2021." Washington, DC.
Cordesman, A.; R. Hammond; and J. D'Amato. 2010. "The Macroeconomics of U.S. Defense Spending." Center for Strategic and International Studies, Washington, DC.
Courtois, R. 2010. "The 'New Normal': Economists Ponder Whether the 'Natural' Rate of Unemployment Has Risen." *Federal Reserve Bank of Richmond: Region Focus* 14, no. 1: 12–16.
Covert, B. 2010. "Peterson Is to the Dangers of Deficit Spending as Hugh Hefner Is to Sex?" *New Deal 2.0,* May 11, www.newdeal20.org/2010/05/page/7/, accessed May 8, 2011.
Dalziel, P. 2002. "New Zealand's Economic Reforms: An Assessment." *Review of Political Economy* 14, No. 1: 31–46.
Dash, E., and N. Schwartz. 2010. "As Reform Takes Shape, Some Relief on Wall Street." *New York Times* (May 23), www.nytimes.com/2010/05/24/business/24reform.html; May 8, 2011.
Dayen, D. 2010a. "Pete Peterson's Purchase of Cat Food Commission, Media Pays Off." FiredogLake.com (November 11), http://news.firedoglake.com/2010/11/11/pete-petersons-purchase-of-cat-food-commission-media-pays-off/, accessed May 8, 2011.
———. 2010b. "The War Supplemental: A Rundown." FiredogLake.com (July 2), http://news.firedoglake.com/2010/07/02/the-war-supplemental-a-rundown/, accessed May 8, 2011.
Demirguc-Kunt, A., and H. Huizinga. 2010. "Are Banks To Big to Fail or Too Big to Save? International Evidence from Equity Prices and CDS Spreads." Policy Research Working Paper no. 5360, World Bank, Washington, DC.
Feldstein, M. 2010. "Preventing a National Debt Explosion." National Bureau of Economic Research, Cambridge, MA.
Feller, A., and C. Stone. 2009. "Top 1% of Americans Reaped Two-Thirds of Income Gains in Last Expansion." Center for Budget and Policy Priorities, Washington, DC.
Ferguson, T. 1995a. "From 'Normalcy' to New Deal: Industrial Structure, Party Competition and American Public Policy in the Great Depression." In *Golden Rule: The Investment Theory of Party Competition and the Logic of Money-Driven Political*

Systems, ed. T. Ferguson, 113–172. Chicago: University of Chicago Press.
———. 1995b. *Golden Rule: The Investment Theory of Party Competition and the Logic of Money-Driven Political Systems.* Chicago: University of Chicago Press.
———. 2001. "Blowing Smoke: Impeachment, the Clinton Presidency, and the Political Economy." In *The State of Democracy in America,* ed. William Crotty, 195–254. Washington, DC: Georgetown University Press.
Ferguson, T., and J. Chen. 2010. "1, 2, 3 Many Tea Parties? A Closer Look at the 2010 Massachusetts Senate Race." Roosevelt Institute Working Paper, no. 1, April, www.rooseveltinstitute.org/sites/all/files/FergusonFinal_0.pdf, accessed May 8, 2011.
Ferguson, T., and R. Johnson. 2009a. "Too Big to Bail: The 'Paulson Put,' Presidential Politics, and the Global Financial Meltdown, Part I: From Shadow Banking System to Shadow Bailout." *International Journal of Political Economy* 38, no. 1: 3–34.
———. 2009b. "Too Big to Bail: The 'Paulson Put,' Presidential Politics, and the Global Financial Meltdown Part II: Fatal Reversal—Single Payer and Back." *International Journal of Political Economy* 38, no. 2: 5–45.
———. 2010a. "When Wolves Cry 'Wolf': Systemic Financial Crisis and the Myth of the Danaid Jar." In *Institute for New Economic Thinking Inaugural Conference.* King's College, Cambridge, http://ineteconomics.org/sites/inet.civicactions.net/files/INET%20C@K%20Paper%20Session%208%20-%20Ferguson%20%28Rob%20Johnson%29_0.pdf, accessed May 8, 2011.
———. 2010b. "A World Upside Down? Deficit Fantasies in the Great Recession." Roosevelt Institute Working Paper no. 7 (December 1), www.newdeal20.org/wp-content/uploads/2010/12/a-world-upside-down, accessed May 8, 2011.
Ferguson, T., and J. Rogers. 1986. *Right Turn: The Decline of the Democrats and the Future of American Politics.* New York: Hill & Wang.
Ferguson, T., and P. Temin. 2003. "Made in Germany: The Germany Currency Crisis of July 1931." In *Research in Economic History 21,* ed. Alexander J. Field, 1–53. Oxford: Elsevier Science.
———. 2004. "Comment on 'the German Twin Crises of 1931.'" *Journal of Economic History* 64, no. 3: 872–76.
Flandreau, M., and F. Zumer. 2004. *The Making of Global Finance 1880–1913.* Paris: Organization for Economic Cooperation and Development.
G-20. 2009. *Leaders' Statement, the Pittsburgh Summit.* Pittsburgh: G-20 Media Center.
Galbraith, J.K. 2002. "A Perfect Crime: Inequality in an Age of Globalization." *Daedalus* 131, no. 1: 11–25.
———. 2010. "Statement to the Commission on Deficit Reduction." *New Deal 2.0* (June 30), www.newdeal20.org/wp-content/uploads/2010/06/deficitcommissionrv.pdf, accessed May 8, 2011.
Gelman, A. 2010. "Exit Polls Claim Deficit a Top Priority: Why That's Wrong." *Monkey Cage* (November 5), www.themonkeycage.org/2010/11/exit_polls_claim_deficit_a_top.html, accessed May 8, 2011.
Giles, C. 2010. "Strategy: Focus Switches from Exit to Growth." *Financial Times* (June 25), http://cachef.ft.com/cms/s/0/3f42f390-7d8c-11df-a0f5-00144feabdc0.html#axzz1LnWEMDca, accessed May 8, 2011.
Glyn, A. 2007. *Capitalism Unleashed.* New York: Oxford University Press.
Green, J. 2010. "The Raid on Food Stamps." *Boston Globe* (August 12), http://articles.boston.com/2010-08-12/bostonglobe/29286300_1_food-stamps-stimulus-package-recipients, accessed May 8, 2011.
Greider, W. 2010. "Whacking the Old Folks." *The Nation* (June 7), www.thenation.com/article/whacking-old-folks/, accessed May 8, 2011.
Halevi, J. 2010. "Germany: The Shadows of Recovery." *Monthly Review Magazine*

(September 14), http://mrzine.monthlyreview.org/2010/halevi140910.html, accessed May 8, 2011.

Halevi, J., and P. Kriesler. 2005. "Stagnation and Economic Conflict in Europe." *International Journal of Political Economy* 32, no. 2: 19–45.

Higgs, R. 2007. "The Trillion Dollar Defense Budget Is Already Here." Independent Institute, March 15, www.independent.org/newsroom/article.asp?id=1941/, accessed May 8, 2011.

Horney, J.R.; K.A. Ruffing; and P.N. Van de Water. 2010. "Fiscal Commission Should Not Focus on Gross Debt." Center for Budget and Policy Priorities, Washington, DC.

Hume, L., and A. Ackerman. 2011. "Senators Seek Ways to Assist Failed States." *Bond Buyer* (January 10), www.bondbuyer.com/issues/120_6/-1021925-1.html, accessed May 8, 2011.

International Monetary Fund. 2010. *World Economic Outlook.* Washington, DC.

Irons, J., and J. Bivens. 2010. "Government Debt and Economic Growth." Economic Policy Institute, Washington, DC.

Jaydev, A., and M. Konczal. 2010a. "The Boom Not the Slump: The Right Time for Austerity." Working Paper no. 3, Roosevelt Institute, New York, www.newdeal20.org/wp-content/uploads/2010/08/not_the_time_for_austerity.pdf, accessed May 8, 2011.

———. 2010b. "The Stagnating Labor Market." Working Paper no. 4, Roosevelt Institute, New York, www.newdeal20.org/wp-content/uploads/2010/09/stagnant_labor_market.pdf, accessed May 8, 2011.

Johnson, C. 2006. *Nemesis.* New York: Henry Holt.

Johnson, S., and J. Kwak. 2010. *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown.* New York: Pantheon.

Kennedy, S. 2010. "Trichet Says Failure to Cut Government Debt Risks 'Lost Decade.'" Bloomberg.com (August 27), www.bloomberg.com/news/2010-08-27/trichet-says-failure-to-cut-public-debt-risks-lost-decade-of-weak-growth.html, accessed May 8, 2011.

Kindleberger, C. 1984. *A Financial History of Western Europe.* Boston: Allen & Unwin.

Koo, R. 2009. *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession.* Rev. ed. Singapore: Wiley.

Krugman, P. 2010a. "Alesina on Stimulus." New York Times Blog (February 6), http://krugman.blogs.nytimes.com/2010/02/06/alesina-on-stimulus/, accessed May 8, 2011.

———. 2010b. "Attacking Social Security." *New York Times* (August 15), www.nytimes.com/2010/08/16/opinion/16krugman.html, accessed May 8, 2011.

———. 2010c. "Debt and Transfiguration." New York Times Blog (March 12), http://krugman.blogs.nytimes.com/2010/03/12/debt-and-transfiguration/, accessed May 8, 2011.

———. 2010d. "A Far Away Country of Which We Know Nothing." New York Times Blog (October 25), http://krugman.blogs.nytimes.com/2010/10/25/a-far-away-country-of-which-we-know-nothing/, accessed May 8, 2011.

———. 2010e. "The Strange Death of Fiscal Policy." New York Times Blog (November 26), http://krugman.blogs.nytimes.com/2010/11/03/the-strange-death-of-fiscal-policy/, accessed May 8, 2011.

———. 2011. "A Cross of Rubber." New York Times Blog (January 30), www.nytimes.com/2011/01/31/opinion/31krugman.html, accessed May 8, 2011.

Kumar, M., and J. Woo. 2010. "Public Debt and Growth." International Monetary Fund, Washington, DC.

Lav, I.J., and E. McNichol. 2011. "Misunderstandings Regarding State Debt, Pensions, and Retiree Health Benefits, Create Unnecessary Alarm." Center for Budget and Policy Priorities, Washington, DC, January 20, www.cbpp.org/files/1-20-11sfp.pdf, accessed May 8, 2011.

Lazonick, W. 2009. *Sustainable Prosperity in the New Economy: Business Organization*

and High Tech Employment in the United States. Kalamazoo: Upjohn Institute.

Leonhardt, D. 2010. "A Few Steps Short on Jobs." *New York Times* (June 8), www.nytimes.com/2010/06/09/business/economy/09leonhardt.html, accessed May 9, 2011.

Lindert, P. 2004. *Growing Public: Social Spending and Economic Growth Since the Eighteenth Century.* Cambridge: Cambridge University Press.

Mokyr, J., ed. 1998. *The British Industrial Revolution: An Economic Perspective.* 2d ed. Boulder: Westview.

MoneyNews.com. 2010. "Broke U.S. States Pose Growing Threat to Recover." August 8, www.moneynews.com/Economy/broke-US-recovery/2010/08/08/id/366923, accessed May 9, 2011.

"The Nation: It's Inoperative: They Misspoke Themselves." 1973. *Time* (April 30), www.time.com/time/magazine/article/0,9171,907098,00.html.

Nersisyan, Y., and R. Wray. 2010. "Does Excessive Sovereign Debt Really Hurt Growth? A Critique of *This Time Is Different* by Reinhart and Rogoff." Levy Economics Institute of Bard College, Annandale-on-Hudson, NY.

Orzag, P. 2010. "Safer Social Security." *New York Times* (November 14), www.nytimes.com/2010/11/15/opinion/15orszag.html, accessed May 9, 2011.

Ostry, J.; A.R. Ghosh; J.I. Kim; and M.S. Quershi. 2010. *Fiscal Space.* Washington, DC: International Monetary Fund.

Page, B., and L. Jacobs. 2010. "Understanding Public Opinion on Deficits and Social Security." Working Paper no. 2, Roosevelt Institute, New York (June 27), www.newdeal20.org/wp-content/uploads/2010/06/tuespage-and-jacobs-public-opinion.pdf, accessed May 9, 2011.

Pastor, R. 1980. *Congress and the Politics of U.S. Foreign Economic Policy, 1929–1976.* Berkeley: University of California Press.

Pew Economic Policy Group. 2010. "No Silver Bullet." Washington, DC.

"A Real Debate on Taxes." 2010. *New York Times,* August 23.

Reuters. 2010. "Greenspan: High Deficits Could Spark Bond Crisis." *Yahoo News* (November 14), www.reuters.com/article/2010/11/14/us-usa-economy-greenspan-idUSTRE6AD1QX20101114/, accessed May 9, 2011.

———. 2011. "Most Americans Say Tax Rich to Close Deficit." January 3, www.reuters.com/article/2011/01/03/us-usa-taxes-poll-idUSTRE7022AK20110103/, accessed May 9, 2011.

Reinhart, C., and K. Rogoff. 2009. *This Time Is Different: Eight Centuries of Financial Folly.* Princeton: Princeton University Press.

———. 2010. "Growth in a Time of Debt." Working Paper 15639, National Bureau of Economic Research, Cambridge, MA.

Seccareccia, M. 2010. "The Role of Public Investment in a Coordinated 'Exit Strategy' to Promote Long Term Growth." Paper presented at the European Investment Bank, Luxemburg, June 10.

Selway, W. 2010. "Most U.S. States Cut Jobs as Tax Collections Erode, Study Says." Bloomberg.com (July 23), www.bloomberg.com/news/2010-07-23/most-u-s-states-cut-jobs-as-tax-collections-erode-rockefeller-study-says.html, accessed May 9, 2011.

Silver-Greenburg, J. 2010. "The New Credit Card Tricks." *Wall Street Journal* (July 31), http://online.wsj.com/article/SB10001424052748704895004575395823497473064.html, accessed May 9, 2011.

Smith, Y., and R. Parenteau. 2010. "Are Profits Hurting Capitalism?" *New York Times* (July 5), www.nytimes.com/2010/07/06/opinion/06smith.html, accessed May 9, 2011.

"Social Security." 2005. *Washington Post* (January 17), www.washingtonpost.com/wp-dyn/articles/A14663-2005Jan16.html.

Statistics Norway. 1997. *Economic Survey 1/97.* Oslo.
Stiglitz, J. 2004. *The Roaring Nineties.* New York: W.W. Norton.
———. 2010a. *Freefall.* New York: W.W. Norton.
———. 2010b. *Principles and Guidelines for Deficit Reduction.* New York: Roosevelt Insitute.
Stockhammer, E. 2004. *The Rise of Unemployment in Europe: A Keynesian Approach.* Camberley, UK: Edward Elgar.
Temin, P., and H.-J. Voth. 2005. "Credit Rationing and Crowding Out During the Industrial Revolution: Evidence from Hoare's Bank, 1702–1862." *Explorations in Economic History* 42, no. 3: 325–48.
Wallace, C. 2010. "U.S.-European Discord Could Hamper G-20 Financial Reforms." *Daily Finance* (June 25), www.dailyfinance.com/2010/06/25/us-european-discord-at-g20-summit/, accessed May 9, 2011.
Walsh, M.W. 2010. "Pension Fraud by New Jersey Is Cited by S.E.C." *New York Times* (August 19), http://query.nytimes.com/gst/fullpage.html?res=9E0DE5DC163CF93AA2575BC0A9669D8B63/, accessed May 9, 2011.
Wilder, R. 2010. "Evaluating the 'Excess' in the U.S. Corporate Financial Balance." *Roubini Global Economics Economonitor* (September 20), www.roubini.com/us-monitor/259652/evaluating_the_excess_in_the_u_s_corporate_financial_balance/, accessed May 9, 2011.
Wolf, M. 2010. "Why the Battle Is Joined over Tightening." *Financial Times* (July 18), www.ft.com/cms/s/0/f3eb2596-9296-11df-9142-00144feab49a.html#axzz1LnUYZSCD/, accessed May 9, 2011.
Wolf, R. 2010. "Task Force Faces an Uphill Battle on Plan to Cut 3.8t." *USA Today* (November 11), www.usatoday.com/news/washington/2010-11-10-federal-savings-social-security_N.htm, accessed May 9, 2011.

To order reprints, call 1-800-352-2210; outside the United States, call 717-632-3535.