# Reflections on Fiscal Policy and Economic Strategy

**"Reflections on Fiscal Policy and Economic Strategy"**
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**1. The Fiscal and Economic Challenge We Face Today**

There is an old joke about economics exams. The questions never change, but the answers always do.

Economists at some points seem to be saying that budget deficits need to be reduced in order to grow the economy, prevent financial Armageddon, or to keep the country solvent – and, at other times, to be asserting that budget deficits need to be expanded to prevent depression, permit public investment, and promote growth.

And then there are, of course, there are Harry Truman's legendary two-handed economists who offer one list on the one hand and another list on the other hand.

These questions about fiscal policy are especially pressing right now. Fiscal issues are at the center of the economic concerns in Europe, and while almost everything about fiscal policy is debatable and debated, I suspect that a wide array of observers across the political spectrum would agree that the fiscal policy choices that the United States makes over the next several years will be as consequential as any we have made in a very long time.

I say this in part of because of the cyclical position of the American economy and in part because of the magnitude of projected deficits and the nature of fiscal trends.

We can be heartened by the fact that due in part to the strong fiscal actions taken through the Recovery Act, the American economy is growing and creating jobs once again. The combination of tax cuts, emergency support for the newly unemployed, fiscal support for states, and a range of catalyzing investments from infrastructure improvements to energy have played their intended role.

The depression scenario that appeared a very real threat a year ago now appears remote. And by and large, forecasters debate the likely pace of recovery rather than the magnitude of double-dip risk.

Yet the observation that the economy is again ascending does not mean that we are out of a very deep valley.

Far from it when we are nearly 8 million jobs short of normal employment and about $1 trillion – or $10,000 per family – short of the economy's potential output and income and when recent events in Europe have introduced uncertainty into the prospects for global growth.

Shortfalls in output and employment stunt the economy's future potential as investment projects are put off and as the skills and work habits of the unemployed atrophy.

This last point is especially important when for the first time since the Second World War the typical unemployed worker has already been out of work for more than six months.

And behind these statistics lie millions of stories of Americans who have seen the basic foundations of their economic security erode. Beyond the economic projections and equations we economists make lie the struggles of communities devastated by the impact of this recession.

Whatever the judgments of groups of economists about the official parameters of the recession and the growing signs of recovery, for millions of Americans the economic emergency grinds on.

The challenge we must thus confront is the imperative both to do everything in our power to accelerate the momentum behind recovery so that it addresses the imperative of job creation and also addressing the challenge to growth and prosperity of budget deficits in the medium to long term that cannot be ignored.

The Federal budget deficit this year is projected to be $1.5 trillion. To be sure, over the next two to three years, a recovering economy and the President's policy choices – like the freeze in non-security spending and the expiration of the high-income tax cuts – will cut this budget deficit in half as a share of the economy.

Measured relative to GDP, we will enjoy since the Second World War.

But deficits, on current projections, will still be in the 4 to 5 percent range of GDP implying steady and unsustainable and unacceptable increases in the ratio of our national debt to our income.

So in the tradition of the two-handed economists, I emphasize both the seriousness of our current cyclical situation and the magnitude of the budget challenge we face because I am convinced that is impossible to sensibly address either challenge in isolation.

**2. The Economics of Budget Deficits**

Many commentators focus either on the need for strong fiscal actions to ensure economic growth and job creation over the next several years or the need for strong measures to reduce the budget deficit. And a largely sterile debate continues about brakes versus accelerators or opening wallets versus tightening purse strings.

I want to begin by laying out what I believe represents a set of views on fiscal policy that would command assent from a wide cross-section of economists by stating three propositions.

First, in normal economic times – or more precisely over any horizon at which output is determined by supply factors, or equivalently at which the Federal Reserve's monetary policy is able to achieve its desired level of output – government budget deficits will impact the composition but not the level of GDP.

Budget policies in this medium term can influence the productivity of the national economy and its success in creating jobs, the distribution of income, and much else. But they are unlikely to have an immediate impact on aggregate demand or GDP.

Why?

Deficits under these conditions will raise private and or public consumption but because interest rates adjust upward to balance supply and demand at full employment or at the Federal Reserve's desired level of output, these increases in consumption will be offset by reduced investment and net exports so that fiscal policy will have little contemporaneous impact on output or employment and over time will reduce national income.

Financing government spending through deficits should not be viewed as an alternative to raising taxes or cutting alternative spending in such circumstances. Because of compound interest, it only delays and eventually magnifies the need for these steps.

In settings such as those that arise in emerging markets or have arisen recently in Southern Europe where there is doubt about the ability of government to subsequently raise taxes or cut expenditures to repay newly incurred budget debts, increased budget deficits raise the prospect of inflation or default, with dire consequences for financial markets.

And in these kinds of normal circumstances, there are further considerations militating in favor of sustainable budgets in economies not suffering significant output gaps:

- Excessive budget deficits force reliance on external borrowing. They raise the question for the United States as they did through much of the last decade of how long the world's greatest borrower can remain its greatest power.
- Excessive budget deficits limit the ability to respond with fiscal policy when circumstances require it in an economic downturn.
- And excessive budget deficits, when associated with spending that is wasteful, erode confidence in government and trust in public institutions. Ironically, this may make it more difficult to bring about reforms that are necessary to make the public sector function better and enhance our long-term productive capacity.
  The second proposition about fiscal policy is equally important.

In settings where an economy's level of output is constrained by demand and where the Federal Reserve is unable to relax that constraint, fiscal policy will through the multiplier process have significant impacts on output and employment. Either direct government spending or tax cuts that promote private spending will raise demand directly and then, as increased demand raises incomes, further raise spending. The result will be economic growth and reduced joblessness.

Moments like the present – when the economy faces a liquidity trap and when the Federal Reserve is constrained by a zero bound on interest rates, and when the financial system is functioning imperfectly because of credit problems in financial intermediaries and because of overleveraged borrowers – are moments when these conditions, for fiscal policy to have an expansionary impact, are especially likely to obtain.

Most economists believe that in demand-constrained economies a dollar of extra government spending generates between $1 and $1.50 in extra output, and believe in quite similar or possibly slightly smaller figures for tax cuts, assuming that they do not have any major effect one way or the other on the confidence of consumers and businesses.

Fiscal actions that add to confidence by increasing expectations of economic recovery or reducing tail risks associated with depression are likely to have larger-than-normal positive impacts on demand and benefits that may persist for a significant period of time.

Conversely, fiscal actions that raise questions about future government taxing and spending policy or ultimate sustainability can reduce confidence and so can actually depress output.

Third, while the impact of contemporaneous deficits on an economy depends on circumstances, there is a very strong presumption that reductions in the budget deficits expected after an economy has recovered and is no longer demand constrained are likely to have beneficial economic effects.

They increase confidence. They reduce long-term capital costs by reducing the prospect of federal borrowing on interest rates and tend to encourage investment, raising the economy's long-run potential.

I belabor the macroeconomic analysis of budget deficits because it points up the broadly correct path for fiscal policy in these years. It has in recent years been essential for the federal deficit to increase as the economy has gone into recession and has been severely constrained by demand.

And I cannot agree with those who suggest that it somehow threatens the future to provide truly temporary, high-bang-for-the-buck jobs and growth measures.

Rather, assuring as rapid a recovery as possible strengthens our future economy, our future prosperity, with many benefits, including a greater ability to manage our debts.

On the other hand, those who recognize the fiscal and growth benefits of strong expansionary policies must also recognize that it is simultaneously desirable to provide confidence that deficits will come down to sustainable levels as recovery is achieved. Such confidence both spurs recovery by reducing capital costs and reduces the risk of financial accidents.

To put the point differently: It is not possible to imagine sound budgets in the absence of economic growth and solid economic performance.

Equally, assurances that deficits will come down once an economy recovers are integral to the maintenance of confidence that is essential for economic recovery.

**3. Our Fiscal Situation and Outlook**

In the year 2000, at the end of my last tour in government under President Clinton, the United States ran a budget surplus. Projected surpluses would have grown even larger had the country remained on the fiscal policy course we bequeathed in the year 2000.

But in the eight years that followed, the budget swung markedly from surplus to deficit. By the time President Obama took office, the Congressional Budget Office was projecting an annual deficit of $1.3 trillion in 2009.

After accounting fully for the full impact of the economic crisis, the Administration faced cumulative deficits in the range of $10 trillion over the 2010 to 2020 decade.

This deterioration happened for a combination of reasons. The most consequential and fundamental was the break during those eight years from the commonsense principle of paying for new initiatives from tax cuts to new benefit programs to the war in Iraq.

The 2001/2003 tax cuts and the unpaid-for prescription drug benefits alone are projected to add nearly $6 trillion to the deficit over the next decade.

The recession and the necessary response contributed an additional $3 trillion of those $10 trillion of projected deficits.

These factors are at one level the dominant reason for our unsustainable fiscal situation. Because of the power of compound interest, success in fiscal policy begets success and failure begets failure.

Remove these factors – the unpaid-for major steps taken in the 2001 to 2008 period – and our deficits would be well within the range to reduce the debt-to-GDP ratio over the medium term.

Yet as we look out beyond the next decade, deeper structural issues in our economy will play a larger and larger role in our nation's fiscal challenges.  These challenges are profound and entrenched because they reflect structural changes that have taken place over the last several decades.

We as a country, Democrats and Republicans, have chosen to make a commitment to the elderly and to health care.

These commitments reflect our values as a society.  We believe the elderly must be kept from living in poverty, as so many did before the enactment of Social Security.  And we believe that illness and suffering should be minimized.  These are commitments that found expression even before President Obama's health care reform program.

They are the right values, and we have accepted that they have costs.

The costs of these commitments are growing more rapidly than the rest of the economy, not because government is doing more but simply because of changing demographics and rising health care costs.

Consider the following: The share of health care in our GDP is now rising by about half of one percentage point per year.  Since the federal government pays for about 40 percent of health care costs, it follows that the federal government's spending on health care is rising by about two-tenths of a percentage point per year, or by about one percentage point every five years.

In other words, if there are no policy changes and we simply maintain the programs that we have, the federal share of GDP spent on health care rises by one percentage point every five years.

What appears to be an increase in spending as a share of the economy does not reflect government bloat or inefficiency.  It simply reflects changing demographics and, on current policies, an increase in the cost of health care throughout the economy.

**4.  The Obama Administration's Strategy**

The nexus between economic growth and our fiscal prospects – along with a recognition of the structural and demographic factors driving our long-term fiscal challenge – has shaped the Administration's strategy toward both.

As we look ahead from our position today – a position that is far stronger than anyone would have anticipated a year ago – there are four key components to our strategy to putting the budget on a fiscally sustainable path.

First: Promoting a sound economic recovery.

Consider three ways to reduce the debt as a share of GDP by half a percent:

- We could cut spending by $75 billion;
- We could raise revenues by $75 billion;
- Or we could enjoy an extra three-quarters of percent of GDP growth, resulting in more tax collections, lower benefit spending, and higher incomes relative to debts.
  To make the arithmetic comparison is to point up the importance of economic growth.  Spurring growth, if we can achieve it, is by far the best way to improve our fiscal position.  That is why job creation and economic recovery were and remain President Obama's top priority.

It is important to recognize that the ultimate consequences of stimulus for indebtedness depend critically on the macroeconomic conditions.  When the economy is demand constrained, the impact of a dollar of tax cuts or expansionary investment will be at its highest and the impact on deficits at its lowest.

That is the defining characteristic of our current economic environment. It is importantly different from the economic challenges that our country faced in the early 1990s.

At that time, investment was held back by high capital costs associated with prospective budget deficits rather than low capacity utilization associated with lack of demand. At that time, productivity growth was lagging systematically due to inadequate investment.

In contrast, over the last several years, our problems have been on the demand side.

In areas where the government has a significant opportunity for impact, it would be pennywise and pound foolish not to take advantage of our capacity to encourage near-term job creation. This explains the logic of the Recovery Act's success and the rationale for taking additional targeted actions to increase confidence in our economic recovery.

Consider the package currently under consideration in Congress to extend unemployment and health benefits to those out of work and support to states to avoid budget cuts as a case in point.

It would be an act of fiscal shortsightedness to break from the longstanding practice of extending these provisions at a moment when sustained economic recovery is so crucial to our medium-term fiscal prospects.

At the same time, the legislation properly emphasizes the importance of taking additional measures, including higher matches on Medicaid to avoid dramatic cuts in state budgets that would not only contract the economy but hurt the most vulnerable, additional subsidies through the TANF Emergency Fund for parents looking for work, a summer jobs initiative that will help tens of thousands work through the summer, and continued funding for SBA lending initiatives that will help support tens of billions of dollars in credit for these small businesses.

In addition to these important measures, the President would like to see Congress move quickly to prevent the layoffs of hundreds of thousands of teachers.

First, do everything we can to ensure economic recovery.

Look at the situation in Japan over the last 20 years. Look at the budget picture in Spain or in Ireland, countries that were in surplus just a few years ago and then experienced profound slowdowns.

The first step in any sound fiscal strategy has to be doing everything we can to ensure recovery.

Second: Proposing and taking tough steps to bring down the deficit.

Much of the deficit reduction – the fastest deficit reduction since the Second World War that will take place over the next five years – will stem from the economy's return to growth and from the phasing out of Recovery Act programs.

But President Obama has made several other important commitments to bring down the deficit by an additional $1 trillion:

- He has proposed a three-year freeze on discretionary spending outside national security.
- He supports letting the 2001/2003 tax cuts expire for the very richest Americans – and will oppose any exceptions to this.

- He has put forward budgets that would root out wasteful and outdated spending in every area, particularly defense. Secretary Gates has suggested that his procurement reforms would save $330 billion over the life of the eliminated programs.
- Financial fee and international tax provisions together save $200 billion.
- The President has also proposed – at a time of these kinds of challenges, proposals of this kind are, I believe, very important – a number of steps to restore faith in the federal government's capacity to use money wisely. Contrary to what you hear about Keynesian economists filling up empty holes, let me be absolutely clear: there is no macroeconomic rationale for wasteful spending. That is why the President has challenged administrators across the government to cut waste and duplication and find innovative and more cost-effective ways to deliver needed services. In addition, today the Administration is sending to Congress a proposal to make it easier for the President to identify and eliminate wasteful spending from appropriations bills passed by Congress.
- And working with the Congress, we have restored at long last pay-as-you-go rules requiring that new mandatory spending or tax cuts be fully paid for. We are living by those rules with respect to any permanent legislation.

Third: Putting in place a framework that offers the potential to contain health care costs.

Health care costs are at the center of the federal budget challenge.

Total spending on health care in 2009 exceeded $2.5 trillion. That is 18 percent of GDP – twice the share of GDP in 1980.

Last year, the Congressional Budget Office estimated that health care spending would comprise a quarter of GDP by 2025 and a third by 2040.

As I mentioned earlier, the growth of health care represents the daunting calculus that federal health spending as a share of GDP rises by one percentage point every five years.

It is for these reasons that the President believed and acted on the conviction that reforming our health insurance system had to be the top priority in renewing our national economy.

The legislation enacted earlier this year represents the most serious prospect for addressing health care costs through public policy in more than four decades. A prerequisite for any serious attempt at cost control is ensuring universal coverage. Otherwise, cost constraints will have manifestly unacceptable human impacts as they are shifted from one provider to another. And the easiest way to reduce your costs is to stop providing uncompensated care.

If you look carefully at the legislation, it embodies essentially all the ideas, ranging from encouraging prevention to cost-effectiveness research to reimbursement reform to altered insurance incentives, that experts have put forward for containing health care costs.

We are under no illusions. This legislation is not self-executing. Its impact will depend on decisions made going forward. The legislation takes an important step by establishing the Independent Payment Advisory Board, a kind of permanent Medicare commission specifically empowered with the ability to bring about the presumptive implementation of its recommendations, so that a Congressional veto rather than Congressional action is necessary to stop its recommendations from taking effect. We have made a very important start.

But success will depend ultimately on our ability not just to contain federal health care costs, but also to contain all health care costs, because a situation in which federal payments come to lag far behind private insurance payments would be unacceptable for our seniors.

Fourth: We will follow through on a bipartisan process centered around a bipartisan fiscal commission.

Deficit forecasts are uncertain. No one ever looks at these numbers, but one of the most striking numbers in the federal budget projections made by the Congressional Budget Office or made by the Office of Management and Budget is the width of the confidence interval – the range of uncertainty – surrounding budget deficits even five years away. That range can exceed three to four percentage points of GDP. And that's taking no account of any policy choices we make between then and now.

We have to live with and plan for the reality that these deficit projections will in all likelihood change substantially over the years. It's just that we do not know in which direction. They could change in substantially positive directions, as they did during the 1990s. They could change in substantially negative directions, as they have in recent years.

But we must also recognize that the current projections suggest the preponderant probability that major changes affecting the way government spends and collects money will be necessary, even after the measures I described.

Experience suggests that the tough choices that are necessary to put the budget into what economists call "primary balance" – a situation where taxes and expenditures cover each other, excluding interest payments, or what is essentially equivalent, a situation where the debt-to-GDP ratio can stabilize – will require the cooperation of both political parties. Experience suggests that achieving this kind of cooperation will require deliberation outside the immediate cut and thrust of political debate.

That is why President Obama has convened a bipartisan commission, with leaders from both parties and with private citizens, tasked with producing clear recommendations to cover the costs of all federal programs by 2015 and to meaningfully improve the long-run fiscal outlook.

That's why he has won agreement from Congressional leaders to bring forward to the floor of the Senate and the floor of the House any recommendations the commission makes.

For the commission, everything is on the table. The President has stressed the importance of maintaining the space for the commission to consider all possible options to achieve its objectives.

We should not downplay the magnitude of the challenge the commission faces.

Its proper functioning will weigh heavily on confidence in our country's capacity to make the tough choices necessary to confront our fiscal challenge.

**5. Conclusion: Our Fiscal Outlook**

Remember this: The question is not whether excessive deficits will be sustained indefinitely. We know the answer to that question. As Herb Stein famously observed, "The unsustainable will not be sustained."

The question is whether the adjustment will take place in a planned, strategic way directed at increasing confidence, reducing capital costs, and motivating future investment, or whether it will take place in a lurch, with wrenching costs that will disrupt economic activity and performance.

A final thought.

I've spoken about the necessity for sound management of macroeconomic policy both in the short run and the long run – about the reality that sound short-run and long-run policy are not, as many believe, opposed but, in fact, complementary.

But let us be under no illusion.  No matter how wisely fiscal policies are set, no matter how wisely the dials of monetary policy are turned, a nation's prosperity depends on much more.

Misguided fiscal or monetary policies can do enormous damage.  But they cannot of themselves create prosperity or opportunity.

That is why the much broader agenda of economic renewal – embracing health care reform, energy policy, education, and much more – that President Obama has spoken of is so urgent for us as a country.