March 4, 2011

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Posted: March 3, 2011 01:23 PM

Deficit Impasse: What Should We Cut?

It looks like Washington will grant a two week reprieve, allowing Congress and the president time to identify spending areas where it can cut to "rein in" its "runaway" budget deficits. Let us take a look at budget realities.

First, it is useful to examine current spending by the federal government. Social Security spending is about 20% of the budget; Medicare and Medicaid total 23%; interest is 6%; other "mandated" spending is 12%; and "discretionary spending" amounts to 19%. These percentages are all predicated on a narrow definition of "defense" spending, limited to Department of Defense outlays that total 20% of the budget. Using a broader definition that would eat into some of the areas enumerated above (including discretionary spending), defense is really 28% to 38% of the budget. By official classification, something over 60% of the budget is nondiscretionary (defense is included as discretionary for these purposes). If we leave to the side defense, it is clear that cuts to discretionary spending, alone, will not make much of a difference so far as budget cutting goes. That is why there is so much focus on "entitlements" like medical care and Social Security.

Yesterday Michael Tanner -- from the CATO institute -- and I were invited to discuss on Public Radio the impact of the "big three" (medical care, Social Security, and defense) on the federal budget, and the desirability of cuts in these programs to reduce the deficit and growth of the federal government's debt. (See here for the audio tape.)

(I will leave to the side the irony of the fact that CATO was invited to expound its views on publicly-supported radio, particularly after Congress has followed the free marketeer's desire to eliminate public funding to the main alternative to Fox news. Presumably, Fox and the rest of the mainstream for-profit media already allocates ample time to CATO, so it is interesting that CATO would not "put its money where its mouth is" -- so to speak -- by staying off government-funded radio.)

I began by noting that "money" and "funding" cannot be an issue for our federal government, which is the issuer of our sovereign currency. It spends through "keystrokes" -- by crediting bank accounts -- and hence could never "run out of money".

I am not alone in this argument. In March 2005, in response to a question by Rep. Paul Ryan ("Do you believe that personal retirement accounts can help us achieve solvency for the system [Social Security] and make those future retiree benefits more secure?"), Chairman Greenspan said: "Well I wouldn't say that the pay-as-you-go benefits are insecure, in the sense that there's nothing to prevent the federal government from creating as much money as it wants and paying it to somebody.

The question is, how do you set up a system which assures that the real assets are created which those benefits are employed to purchase." This statement is particularly important, given that Alan Greenspan had headed the commission under President Reagan that transformed Social Security from "pay-as-you-go" to "advance funding" -- from a system in which tax revenues were set to just match benefit payments to one in which tax revenues were one-third larger than benefits in order to build up trillions of dollars in a "Trust Fund" to be used later. Greenspan admitted in 2005 that trust funds are not at all necessary to secure the benefit payments, because government can always "create money" to meet benefit payments. In other words, the change to the program that he had pushed back in 1983 was totally unnecessary. All it did was to reduce worker's take-home paychecks for the past three decades.

Much later, in a *60 Minutes* interview by Scott Pelley, Chairman Bernanke said much the same thing. When asked about the Fed's bailout of Wall Street, Pelley asked "Is that tax money that the Fed is spending?", Bernanke (correctly) responded: "It's not tax money. The banks have -- accounts with the Fed, much the same way that you have an account in a commercial bank. So, to lend to a bank we simply use the computer to mark up the size of the account that they have with the Fed." That is true, and it applies equally well to Fed purchases of assets (Fed "lending" is really just the purchase of a bank's IOU; the Fed can -- and does -- also buy toxic waste mortgage backed securities from banks by crediting their reserve accounts.) In truth, both Bernanke and Greenspan have accurately described the way both the Fed and the Treasury spend -- they credit bank accounts. And as Thatcher said: TINA (there is no alternative)! The sovereign government only spends that way. All it needs is Congressional authorization to credit the accounts.

With that preface, we turn the debate to the "real economy". There is no question about government ability to spend, about government "solvency" or "sustainability" of budget deficits or of the possibility of sovereign government "bankruptcy". Sovereign government is not like a firm or household. It can buy anything for sale in its own currency. It can never run out of its own "money" -- its own IOUs -- and can always create more by crediting bank accounts. It can never be forced to default on its commitments, and it can never be forced into bankruptcy court. So what matters is not the "impact on the budget" but rather the impact on the economy of spending on the "big three" categories: medical care, Social Security, and defense. Let us look at each in turn.

1. Medical care. US medical care spending is equal to nearly 18% of US GDP, or well over $8,000 per person per year. In the UK the relevant figure is 8%; it is around 10% in Canada and Germany. Clearly, the US is unusually high. I have looked at this in some detail in previous work. Our high spending has (mostly) to do with two main factors: our population is less healthy (a euphemism for more likely to be obese) and we send a much higher percent of every healthcare dollar to insurance companies. Focusing only on Medicare and Medicaid spending is a huge mistake -- the total federal government share of health care spending is 27%; Medicare spending is about a fifth and Medicaid is about 15%. Private health insurance is a third; and out-of-pocket expenditure is 12%. The total household share is 28%, the private business share is 21%, and the state and local government share is 16%.

I provide these details only to indicate that rising health care costs (again, largely due to obesity of the population as well as to the greed of Wall Street's insurance industry) are a burden on every sector of our economy. The right wing is right: the situation is unsustainable, with health care costs growing at a 6%-9% annual rate (depending on sector) -- much faster than GDP. Simple math shows that health care will amount to 100% of GDP before long at that pace. Reform is necessary and inevitable. But it is not just the government's programs that must be reformed. Both households and firms will be bankrupted by health care costs long before health care spending reaches 100% of GDP.

We need sensible reform. What makes the most sense is to get the insurance industry out of health care, and to deal with obesity and all of its associated health care problems directly. Dare I say it? Yes. We need a national single payer system.

2. Social Security. It now absorbs just under 4.5% of GDP, and it amounts to a fifth of the federal budget. There are currently 50 million recipients and 154 million workers subject to payroll taxes. That ratio will get "worse" as we age. Still, the total demand on our nation's output will peak at somewhere just north of 6% of GDP, and will settle down to just under that ratio for the infinite future. Hence, as we age as a society we will need to shift somewhere between 1% and 1.5% more of GDP toward Social Security to provide a decent safety net to tomorrow's retirees. Note that we have achieved a much bigger shift than that over the past two generations -- without financial Armageddon, and without excessive burdens on the working population.

Indeed, when one looks at the real world projections, one wonders what all the hysteria is about. Can our nation "afford" to shift a measly one percent more of GDP toward the elderly over the next two generations? Of course it can. Note that workers in 1965 supported more dependents (young+old) than any generation will ever support again. Were they miserable? It was the golden age of US capitalism, an era of rapidly rising living standards. Yes, I do agree that it is much more exciting to support lots of young people than it will be to support a nation of old geezers. (I can say that because I was both -- I was one of those protesting and revolting teens of the 1960s, and I'll be one of the toothless geezers that workers of 2030 will have to support with titanium hips -- but I'm not so sure that the excitement of the 1960s should be preferred to the quiescent 2030s when the babyboomers are mostly wheel-chair bound or safely planted in their permanent places of rest.)

3. Defense accounts for either 5% of GDP or 10%, depending on the classification of spending. The smaller figure counts only Department of Defense spending; the broader classification includes estimates of (somewhat hidden) spending outside DOD. Between 2000 and 2009 that has been growing at a 9% annual pace -- much above GDP. It accounts for half of all discretionary spending, hence, is a natural target for cuts. US defense spending amounts to 40% of global spending on military, and is six times Chinese spending.

Again, the question is not "can the US government afford to continue to spend somewhere between $1 trillion and $1.35 trillion per year on defense"? Of course it can. It buys bombs of mass destruction in exactly the same way it buys financial instruments of mass destruction (toxic MBSs): by crediting bank accounts. It cannot "run out of money". So the real question is this: do we really want to devote perhaps a tenth of our nation's output to the military? Moreover, the defense sector tends to be the most high-tech, utilizing the most advanced plant and equipment and the most highly skilled workers. It competes with other areas that are critical to US development -- sophisticated production like the bullet trains and the solar energy plants the US will need. As President Obama argued in his State of the Union address, the US will need to invest much more in our high tech sectors to keep up with China. So the real question is whether it makes more sense for the US to devote 10% of its GDP to produce bombs and jet fighters that are sent off to war in Afghanistan, or would it be better to shift real resources to projects that would move our economy into the 21st century?

In all these three areas, single-minded focus on the budget deficit and growth of the government's debt is not only a diversion, but is completely counterproductive. It does not let us move toward a solution to the real problems that are posed by a growing problem of obesity (and an associated explosion of diabetes), by an aging population, and by allocation of too many of our nation's resources to the military.