

## **The Future of the American Economy**

James K. Galbraith

Let me first praise Martin Baily for his wide-ranging and ultimately optimistic vision of the American future. We have areas of policy agreement: for instance we both think that a National Infrastructure Bank would be useful – as I have since I helped draft the Hamilton-Howard bill of 1983 that first proposed one. We also agree that our present focus should be on solving real economic problems rather than balancing financial accounts. By the standards of the current debate neither of us is a deficit hawk.

Yet we have major differences, and I think the basic one is that Martin places production at the center of his framework, while I do not. In my view manufacturing has become part of a world system that has to be analyzed at the global level, and the sector has largely lost its centrality to a discussion of national policy. It therefore becomes necessary to focus on everything else: on the systems that supply education, health care, local public goods, infrastructure, housing, cultural life and retirement security – using energy and affecting the environment as these systems do. In Martin's view I daresay these systems are peripheral, in a supporting role to enterprise, to profit-making capital; he does not believe economists have much to say about them. But in a world where mere goods are plentiful and cheap, they come to embody the final goals of economic policy and to be an important part of the ultimate test of economic performance.

Further I see the economy as an organic or structured whole, with certain functions, especially government and finance, playing strategic roles. It thus matters a great deal whether these sectors serve or undermine the function of the quasi-public systems just mentioned. In particular it matters whether the financial sector serves these systems or preys upon them. In *The Predator State* I outline the consequences of passing regulatory power to predators, and explain why in the final analysis modern markets collapse when they are not effectively regulated. In finance the consequences are especially grave, since finance is a general-purpose machine, necessary to every other part of the private economy. A financial crash is therefore not just an injury to that one sector. It's more like a heart attack or a stroke.

### *The Role of Finance in the Crisis*

Baily brushes past the financial crisis. To him it was a largely unforeseeable shock, from which adroit policies – the Troubled Asset Relief Program (TARP), the stress tests (SCAP), quantitative easing and the American Recovery and Reinvestment Act (ARRA) are helping us now to recover. He thus moves quickly to a discussion of the scale of the real effects of the crisis, and thence to policy. There is no discussion here of the role played by credit markets and the financial sector in economic growth, and therefore no consideration given to the structural consequences – if any – of the financial collapse.

My understanding is different. I see the hyper-financialization of the economy as a key structural fact of our time, beginning with financial deregulation from the mid-1970s, developing into the savings and loan debacle in the 1980s and accelerating in the 1990s when it gave us, under President Clinton, the information technology boom and bust, the repeal of Glass-Steagall and the Commodity Futures Modernization Act, which surreptitiously legalized and therefore fostered an unlimited market in naked credit default swaps. These have been justly called (by Warren Buffett) financial weapons of mass destruction, and they have now been detonated as such -- a point to which we'll return.

The effect of the 1990s bubble was strong economic growth, high apparent productivity growth (thanks to the Verdoorn Law and to the prevalence of hedonic price indices in the technology sector) and full employment thanks to strong investment demand. The pay distribution got better thanks mainly to increased hours for low-wage workers, while the income distribution became far worse, ultimately matching levels not seen since 1929. Economic growth was driven by private debt accumulation – mostly in the business sector – while increased tax revenues drove the federal budget into surplus. This created “fiscal drag” of which I warned at the White House meeting on the New Economy in April 2000, as Martin perhaps recalls since he was Chair of the Council of Economic Advisers at that time. The momentum of growth could therefore not be sustained without policy changes that did not occur, and it wasn't. Projections entertained at the time by authorities not less than the Treasury Secretary, to the effect that the entire federal debt could be made to disappear in thirteen years or so, began very quickly to look foolish.<sup>1</sup>

The information technology collapse left the incoming Bush administration with a shortfall of demand, at which they threw a sequence of measures over their entire eight years in office. First came tax cuts, whose effectiveness was somewhat (but not totally) diminished by their orientation toward the rich. Then came the wars in Afghanistan and Iraq, the latter especially contributing to growth in 2003 but not thereafter. In 2004, President Bush relied on domestic public spending, and signaled to the Republican Congress (and to the perplexity of conservatives) that no appropriations bill, however well-endowed, would be vetoed that year.

But what impelled the economy forward after 2004 was mainly housing. The housing bubble was not accidental. It was fostered by public policy, which encouraged private-label origination of sub-prime mortgages by relaxing underwriting standards and conspicuously desupervising the industry. This was done, in part, by signaling, as when the Director of the Office of Thrift Supervision, James Gilleran, brought the Federal Register to a press conference with a chain saw. It was done in part by reassigning 500 FBI agents from fraud to counter-terrorism in 2001 and then refusing to replace them. It was done in part by promoting the most incompetent and deferential regulators from the S&L era – well known to Team Bush in this area from their own

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<sup>1</sup> Luckily some people know when it is time to leave the world of economics for new vistas in academic administration.

activities at that time – so that one of them ended up directing the Western District and therefore with responsibility for Washington Mutual, IndyMac, Ameriquest and similar outfits.

### *The Role of Fraud in Finance*

As the national political leadership surely understood, a mature industry like housing cannot suddenly be made to start growing rapidly on the basis of good loans. The good loans have, for the most part, already been made. The great untapped market was therefore in bad loans – loans that would, for the most part, not be repaid. The Ownership Society consisted in finding ways to make such lending profitable for those who did it.

The consequence was already identified by the FBI in a public warning in September 2004 as “an epidemic of mortgage fraud.” Millions of mortgages were being made, quite deliberately, to people who could or would not document their incomes, who had bad or nonexistent credit histories, against houses whose appraisals were deliberately inflated. Consider briefly this last point. For what honest purpose could a lender ever encourage an appraiser to inflate an appraisal? There is none: the entire purpose was to inflate the fees earned on the deal.

The loans were structured with teaser rates that the lenders knew would generate sharply increased payments in two or three years. Since the borrowers were already at or above the limits of their capacity to pay, the mortgages would therefore have either to be renegotiated (earning the originators another fee), or they would default. The lenders knew this, but the ratings agencies were either too stupid – or indifferent, given the scale of the business – to catch on. The raters therefore deemed the cash flow on the mortgages to include the post-reset payments – a financial never-never land – and this plus the elaborate scheme of over-collateralization for the senior tranches of the resulting mortgage-backed-securities was said to justify the AAA ratings that were then bestowed. Finally a AAA company stupid enough to issue CDS on the whole stinking mess was found. That was the Financial Products division of AIG.

What actually happened can be described in the precise language of a criminal ring:

– the mortgage originators were, in effect, *counterfeiters*. They produced documents that resembled mortgages but which were known, by those who made them, to be fakes – destined either to be renegotiated or to default. An entire underworld lexicon described this craft: liars’ loans, NINJA loans (no income, no job or assets), neutron loans (that would destroy the people but leave the buildings intact), toxic waste. This fact alone reveals clearly that the participants knew what they were about. And there is other information, such as the fact that virtually all appraisers in some areas reported being pressured to inflate their appraisals so as to justify larger loans. There is no honest reason for an inflated appraisal.

– The counterfeit mortgages were then bundled and *laundered* – in the sense known to the drug trade – by the ratings agencies, who relabeled BBB- paper as AAA without ever looking for, or at, the underlying documentation. This was (again) despite the public FBI warning of

September 2004 of an “epidemic of mortgage fraud.” When Fitch Ratings (2007) conducted a small survey of highly-rated residential mortgage backed securities, they found “startling” evidence of “fraud, abuse or missing documentation in virtually every file.”

– The laundered paper was then *fenced*, again in the sense known to purveyors of stolen goods, by the large investment banks. Lehman Brothers for instance did the biggest trade in liars’ loans (Black 2010). Goldman Sachs was long in toxic bonds until the end was nigh, at which point that firm went massively short, dumping its holdings on trusting clients, to their later chagrin (Lewis 2010).

– The *mark* – basically anyone with money to invest and trust in the investment banks and in the ratings agencies – was apparently known generically in the industry as “Düsseldorf” (Lewis 2010). In this way, when the collapse came, major losses fell on Europe, triggering the flight-to-safety that became the European sovereign debt crisis. This is globalization with a criminal face, and with victims largely in denial about the nature of the crime – perhaps this is because they do not wish to be exposed as fools.

We might have learned from all of this that the line between bankers and crooks can be quite thin. It is imperative to police that neighborhood. Following the savings and loan crisis over a thousand industry insiders faced federal prosecution, were convicted, and went to prison (Black, 2005). In this crisis, far larger and more aggressive perpetrators remain at large.

Baily states that “with the benefit of hindsight” we can date the financial crisis to “the decline in median home prices that started in 2006.” In fact we should date it at least to the repeal of Glass-Steagall in 1999, to the CFMA of 2000, and to the Gilleran chainsaw conference in 2003. By September 2004, when the FBI issued its “epidemic” warning, a major crisis was already inevitable. It was also foreseen in real time – by Dean Baker notably, but in much more concrete form by people like Steven Eisman of FrontPoint Partners, who ended up making about \$550 million by shorting the market in RMBS and synthetic CDOs (Lewis 2010).

It didn’t really take that much – an independent mind, nerve, and a bit of money – to buck the consensus and to see that loans made on unoccupied houses in empty Florida subdivisions would default. What takes courage now is to recognize that government encouraged – no, *it fostered* – the largest financial swindle in world history. The economics profession remains, to this day, willfully deaf, dumb and blind to the implications of this fact.

### *The Political Economy of the 2008 Collapse*

The collapse was met in late September 2008 by an official panic, and I have considerable sympathy for Members of Congress who were obliged to judge the situation and the proposals in a climate of rush, fear and misinformation. The Treasury Department, headed at the time by a former CEO of Goldman Sachs, demanded in a three-page bill draft unlimited and unsupervised authority for \$700 billion of financial transactions, mainly to buy toxic assets from the banking

system. Was this a desperate measure, necessary to save the system in an extreme situation? Was it a calculated rip-off by and for the undeserving rich? Or was it a punt – a fourth-down handoff of power to the Democratic Congress by a panicked, incompetent and disintegrating Republican administration?

Members of Congress did not know. I was one of three outsiders invited on the Sunday before the vote on the Troubled Asset Relief Program, to speak with some forty members – the skeptics’ caucus – in a basement room in the Capitol building. It was an extraordinary sort of seminar -- but as an alternative to standard legislative practice, it was appalling. I heard all three viewpoints expressed – depending partly on how close a member was to the leadership, partly on how badly burned by the Bush gang on other matters. Ultimately Democratic Members voted, I think, on instinct and on politics, on a desire not to be seen responsible for the final crash of the system and a desire not to take a step that might have elected John McCain to the Presidency. Republican Members, having heard from William Isaac, former chairman of the FDIC in the Reagan administration, that relaxation of mark-to-market accounting standards would solve the problem, voted against their own White House. They defeated the bill on the first vote, and in the process inadvertently decided the election. (Bless them.)

In a persuasive post-mortem, Ferguson and Johnson (2009) have argued that the Treasury understood from mid 2007 at least that it was facing financial Armageddon, and that the purpose of their policy – the “Paulson Put” – was to delay public recognition of this until after the presidential election. This was done in part by suborning loans from the FHA and in part by encouraging Fannie Mae and Freddie Mac to loosen their underwriting standards and to make a market in sub-prime RMBS. Fannie and Freddie, it should be noted, were easily suborned. Paulson’s agenda aligned with that of their executives, which was largely to maximize executive pay. Conservative focus on the abusive practices at the two companies is not misplaced, though it typically overlooks the salient facts that (a) these were private companies, (b) that they did not invent or originate the fraudulent sub-prime mortgages, and (c) that they loaded up on the toxic RMBS late in the game and in cooperation with the highest public authorities then in power. When the crisis hit, Ferguson and Johnson argue that purpose of TARP was mainly to engage (and therefore implicate) the Democratic Congress in the response – technically it could all have been done by the Fed. But this was far from clear at that moment.

In the end, necessary decisions to extend deposit insurance and to backstop the money market funds<sup>2</sup> were taken. The chimerical notion that the market for counterfeit mortgages could be revived with reverse auctions or some similar device was scrapped – a footnote in the disintegration of the neoliberal policy vision. What replaced it – government equity purchases in the banks – was functionally the same as regulatory forbearance, in the form of a reduced capital requirement. Fannie Mae, Freddie Mac and AIG were nationalized, and AIG’s

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<sup>2</sup> Both of which I recommended in an Op-Ed in the *Washington Post* on September 25, 2008, the day of the fateful White House summit on the crisis.

counterparties were paid in full – a controversial and suspect decision. Otherwise the Federal Reserve did the heavy lifting by nationalizing the commercial paper market and providing currency swaps to relieve a worldwide excess demand for dollar assets. The moment of most severe crisis passed. TARP never took the form originally prescribed – a friend suggested that to do so would have been like “trying to fill the Pacific Ocean with basketballs” – and various later schemes to coax private money into toxic securities (“P-PIP” for example) also came to little. Many of the mortgage assets were taken onto the balance sheet of the Federal Reserve – on terms still largely out of public view (Mehrling, forthcoming) – and while exit strategies were discussed from the beginning, these too have so far proved to be “all hat and no cattle.”<sup>3</sup>

### *Obama’s Choice: Sweden or Japan?*

The next distinct moment of policy decision came at the start of the Obama presidency in early 2009. The alternative models were by then fairly well-defined: Sweden or Japan? In Sweden in 1993 major insolvent banks were turned over to the government – in accordance with Swedish banking law – and restructured before being refloated. The Japanese failure to do likewise preserved existing banks at the price of contributing to a lost decade for economic growth. The new administration chose the Japanese route.

Baily praises the “stress tests” (SCAP) instituted at the start of Obama’s presidency for having “revealed that the banking industry was not as troubled as many had feared.” Senior former bank regulators with whom I have spoken are skeptical: it is not normal practice to negotiate the outcome of a stress test with a bank before the results are finalized. Further, assets can be “stressed” only if their behavior under varying market conditions can be modeled, but this is not true of the toxic mortgage-backed securities, for which the holders do not have – and never did have – the underlying documentation. Only that documentation could have revealed the full extent of fraud. Requests in early 2009 (notably by Representative Lloyd Doggett, D-TX, in Budget Committee hearings) that Treasury investigate and report on this matter were ignored. It remains unclear how one can justify attributing any market value whatever to assets deeply infected by fraud or even suspected of being so – no independent investor would buy such stuff for more than the financial equivalent of scrap value.

An alternative view holds that SCAP succeeded as an exercise in political communication. Together with the relaxation of mark-to-market accounting for counterfeit mortgages, the stress tests sent an unmistakable signal that the new administration would back the big banks no matter what. Loss recognition could therefore be deferred, perhaps forever. Stock prices recovered, earnings statements turned rosy, and bonuses were restored. Meanwhile as the Federal Reserve provided a market for synthetic CDO’s, banks apparently went on producing

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<sup>3</sup> A significant exception being the currency swaps, which were largely unwound as the euro stabilized, though they later had to be reactivated to some degree in the more recent crisis of Mediterranean sovereign debt.

them to supply that one customer. More tangible forms of manufacturing faced no similar substitute for their ordinary markets, and could not recover so quickly.

### *The Missed Chance and Its Consequences*

Was there a viable alternative path? In compliance with the Prompt Corrective Action law, the largest rotten banks, especially by most accounts Citigroup and Bank of America, should have been turned over to the FDIC. They would have closed on Friday and reopened on Monday with the top echelon gone, with middle-managers in control and with federal examiners all around. A deep-insolvency insurance fund would have reassured depositors and forestalled a run. Subordinated debt holders would have lost out, and common shareholders, who had (in the case of Citi) already lost fifty-nine dollars per share, would have lost one dollar more. The banks would have stayed open but they would have been forbidden to grow, and therefore the potential losses to the public from frauds, scams and reckless business judgments would have immediately stopped increasing.

Decisions on how to reorganize, divide and downsize the big banks would then have followed in due course. Presumably divisions devoted to proprietary trading would have been sold, while those focused on exotic tax evasion and regulatory arbitrage would have closed -- and their personnel perhaps reassigned to the renegotiation of retail mortgages. The lobbyists would have been fired, and the banking sector would not have been able to fight regulatory reform to a near-standstill. The performance of commercial and industrial lending – which could not have been worse than it actually was – would not have been worse than it actually was. Funds devoted to TARP and the shadow bailout could have been appropriated instead to the FDIC, protecting ordinary depositors from loss. Smaller banks, not so deeply implicated in the sub-prime debacle, would then have been able to grow into the market space (if any) vacated by the large failures, and it seems very likely that those banks would not have been as difficult to supervise or as arrogant about circumventing the spirit of prudential regulation.

The mishandling of the big banks and their flamboyant return to business-as-usual was a political disaster for the new administration, revealing as it did the brazen realities of financial power in America – and especially the hold of Wall Street over the Democratic Party. But it also had two serious economic effects. The first was to make impossible an early recovery of credit via either the emergence of undamaged private lenders or the creation of new para-public lending institutions. A recovered Wall Street would never countenance competition from a new Reconstruction Finance Corporation, for instance; still less a Home Owners' Loan Corporation for which Paul Davidson has called. To the contrary, the financial sector and its allies have since concentrated their fire on the RFC's surviving spin-off, Fannie Mae and its cousin Freddie Mac. In the emerging political climate this is, no doubt, a shrewd business move. Second, a revived Wall Street meant a new political focus on the federal budget deficit, and a wave of hysteria swept the media on that topic, fueled in part by a billion-dollar propaganda campaign directed by Peter G. Peterson of the Nixon administration and Blackstone Group. Forced onto the defensive and facing difficulties passing vital short-term palliatives like

extended unemployment insurance, the administration gave ground to the deficit hawks on the longer term. In particular the President agreed to establish a closed-door Deficit Reduction Commission, co-chaired by former White House Chief of Staff Erskine Bowles (a man with very close Wall Street connections) and by former Republican Senator (and past Fellow of the Institute of Politics at the Kennedy School of Government) Alan Simpson. This group, unaffectionately known to some as the Catfood Commission, was stacked with deficit hawks and has set about preparing the ground for deep cuts in Social Security, most likely via the device of a proposed increase in the retirement age. Senator Simpson has made no secret of his disdain for Social Security, describing it in an August email to an official of the Older Women's League as "a cow with 310 million tits."<sup>4</sup>

### *A "Greece Moment" for the United States?*

As Baily notes, deficit hawkery is even more intense in Europe. There, those imposing it (mainly, the Germans) have the vast advantage of a competitive manufacturing sector and a depreciated currency, generating economic growth in the face of fiscal contraction, while those bearing the burden (in Greece, Portugal, Ireland and elsewhere) are often in small countries whose prospects depend heavily on not making the great powers of Berlin and Frankfurt overly angry. For this reason, austerity plans imposed on Greece do not include sharp cuts in the purchase of German battle tanks -- or French submarines for that matter. Greece continues to bear one of the highest per capita burdens of military expenditure in the developed world, despite having zero prospect of armed conflict, with Turkey or anyone else.

The politics and economics of budget deficits and public debt are so deeply muddled in most discourse that economists have a special duty to think and speak rigorously on this subject, and above all to avoid the Delphic utterance. What Baily offers instead is a bit of ideological compromise, of on-the-one-hand-on-the-other-hand-ism. He sensibly points out that the notion that deficit credibility will generate growth by "reassurance to markets" is without foundation in "normal economic logic." He might have added that the usual historical precedents for this idea, notably the 1920s and the 1990s in the United States, are gone and will not again apply for many years. And he should, at the least, have stated flatly that the application of the Greek argument to the United States at present is beyond absurd.

But Baily doesn't say this. On the contrary he concedes that "fears of renewed financial turmoil are real" in Europe and that Europeans should "be mindful of the limits they face on sovereign borrowing." When he comes to the U.S. he states that "no one knows if or when the U.S. Treasury might have its Greece moment. Surely, this will not happen over the next year or two, but quite possibly it could happen over the next five years if nothing is done."

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<sup>4</sup> Professor Randall Wray of the University of Missouri - Kansas City, one of the few remaining economists with a background in agriculture, has pointed out that the normal usage in the dairy industry is not "tits" but "teats." Though, of course, Wyoming is a beef state.

No. It couldn't. It won't. The statement is undefended. It is indefensible.

Greece's "moment" - along with those of Portugal, Spain and Ireland (but not the UK) began in late 2008 with the failure of Lehman Brothers. In the weeks that followed global investors sold weak assets to buy safe ones. Yields on Greek bonds began to rise, those on US Treasuries fell, even as the dollar rose and the euro went down. Quite soon the Greek problem was massively compounded by the speculative purchase of credit default swaps on Greek sovereign debt and Greek banks. Those purchases are functionally identical to bond sales except that one does not need first to own the underlying asset. Similar attacks occurred on the debt and banks of other small countries, and on Spain – notwithstanding the fact that these countries had little to none of Greece's well-known fiscal disorders. They also occurred against Ireland, whose debt was ultimately downgraded despite a conservative government and the most radical program of "fiscal austerity" in Europe.

As noted previously, CDS have been called "financial weapons of mass destruction." Their use in the European sovereign debt crisis was the financial equivalent of tactical nuclear war. In the event, the sovereign debt market for small eurozone countries wasn't merely disrupted. It was destroyed. The speculative test, as of now, is not whether Greece (or any country) can "reform" sufficiently to merit the favor of the markets and "restore confidence." Spain proves that the *ex ante* budget deficit doesn't matter, and the Irish example demonstrates that radical budget cuts do not reassure markets. Instead, the fate of each country is tied to that of all the others – an irreversible change in sovereign credit conditions in Europe.

The speculative test, therefore, was whether the leadership of Europe – in Berlin, Paris and Frankfurt – would or would not act in time to save (at best) borderline solvent banks, especially in Germany and France, from the consequences of loss recognition on their Mediterranean (and Irish) debts. The only way for this to happen was for the European Central Bank to buy the paper -- and in so doing to abandon its previous ideological commitment to "market discipline" and its refusal to serve as a sovereign lender of last resort. In the end-game the brutal realities of financial politics prevailed, the ECB blinked and started buying the bonds, and a big fund was put in place to signal the solidarity of the eurozone. The threat to the core European institutions immediately began to ease and the euro stabilized. The blood price for this was exacted from Mediterranean taxpayers (those who could be reached by VAT rates) and civil servants, suitably demonized by their well-paid and protected betters in the financial world.

Can something similar happen in the United States? Of course not. The Federal Reserve already buys U.S. government debt as needed, though lately private demand for that debt is so high that it has been largely unnecessary for the Fed to do so. And if for some reason the Treasury chose not to issue bonds, they could simply not do it. Government spending would go on as before, in the form of checks issued to the banking system.

The dollars so created would end up as excess reserves on the balance sheets of the banks – a fact that creates the demand for Treasury bonds in the first place. This reflects the reality that in

the modern monetary system what we call Treasury bonds are just a bookkeeping entry, permitting banks to earn a bit more interest than the Federal Reserve pays on reserves. There are no bond demons who could cause a Treasury auction to fail, for the simple reason that the Treasury does not issue bonds unless the demand for them has already been created by writing checks to the banking system. Without new bonds, banks would simply pile up excess reserves, and in a deflationary environment they would do exactly that.

Correspondingly, the notion of “confidence in global markets that future deficits will be controlled” is metaphysical. It means nothing. If “global markets” had any enforceable concerns on that score – which obviously they do not – the thirty-year Treasury bond rate would not be brushing against four percent. And if it were true, as Baily states, that markets thought the U.S. could face a “Greece moment” *within five years*, then the ten year Treasury bond rate would certainly not be below three percent.

On present evidence you may believe that the markets are irrational, and that they irrationally fail to appreciate the unsoundness of U.S. government debt. Or you can believe that the markets are impotent, unable to influence the interest rate, at least for now – which is tantamount to saying that autonomous “global markets” do not really exist. In either case, of course, “better policy” is unnecessary. But you cannot logically argue that powerful, rational markets are spooked by fears of future inflation or a falling dollar, or fear that the U.S. Treasury will become unable to increase the numbers in dollar bank accounts to the extent of interest and principal due on Treasury bonds. Something that has never happened in the history of the Republic, that is expressly forbidden by the Constitution of the United States, and that is fully within the power of the Treasury Department to prevent – *whatever the deficit may be*.

Having disposed of these issues I do not plan to follow the Baily template further into this essay. Our frameworks overlap too little. I agree with Martin that the U.S. retains a strong position in the most advanced sectors for tradeable goods, and I hope we both accept that the Chinese position in the manufacture (especially) of consumer goods is a fact of life which it is not in the power of U.S. policy to change. The Chinese run a trade surplus and accumulate US Treasuries for the same reason that domestic banks do: they see no useful alternative policy, and they prefer having the interest to not having it.<sup>5</sup> Meanwhile, within our manufacturing sector, Silicon Valley, Big Pharma, Big Oil and the military-industrial complex have largely worked out how to fend for themselves. As have the banks, of course, far too well. Conservatives who advocate a principled separation of the economy and the state would do well to begin with the sectors that actually control the state.

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<sup>5</sup> Therefore, the U.S. will run a trade deficit and should relax about that. The notion in some quarters that a revaluation of the renminbi would somehow “fix” this “problem” strikes me as deeply ignorant of how China works, but that’s an argument for a different essay.

## *Looking Forward: What Are the Issues?*

It's all the rest of the economy that requires our attention. Let us therefore turn to the major issues going forward. The fiscal condition of the United States government is not, in fact, one of those major issues. But since a great many people are preoccupied with the question, we may as well begin with it. I shall do so by close reading and analysis of the Congressional Budget Office's medium-term projections, an important official source on which much of discussion of budget policy is based.

### *The Budget Projections.*<sup>6</sup>

A first economic question is, what caused the deficits and rising public debt? The answer comes in two parts: present deficits and projected future deficits.

Overwhelmingly, *the present deficits are caused by the financial crisis*. The financial crisis, the fall in asset (especially housing) values, and withdrawal of bank lending to business and households has meant a sharp decline in economic activity, and therefore a sharp decrease in tax revenues and an increase in automatic payments for unemployment insurance and the like. According to a recent IMF staff analysis (IMF 2010, p 14, Box 1), fully half of the large increase in budget deficits in major economies around the world is due to collapsing tax revenues, and a further large share to low (often negative) growth in relation to interest payments on existing debt. Less than ten percent is due to increased discretionary public expenditure, as in stimulus packages. This point is important because it shows that the claim that deficits have resulted from "overspending" is false, both in the United States and abroad.

Unlike the present deficits, expected future deficits are *not* usually considered to be due to continued recession and high unemployment. To understand how the discussion of future deficits is being framed, it is necessary to grasp the work of the principal forecasting authority, the Congressional Budget Office. CBO's projections proceed in two steps. First, they wipe out the current deficits, over a very short time horizon, by *assuming* a full economic recovery. Second, they create an entirely new source of future deficits, essentially out of whole cloth.

The critical near-term assumption in the CBO baseline concerns employment. CBO claims to expect a relatively rapid return, over five years, to high levels of employment, and the baseline incorporates a correspondingly high rate of real growth in the early recovery from the great crisis. If this were to happen, then tax revenues would recover, and ordinarily the projected deficits would disappear. This is what did happen under full employment in the late 1990s.

But under present financial conditions this scenario of a rapid return to high employment is

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<sup>6</sup> This section is adapted from testimony given to the Bowles-Simpson Commission on Deficit Reduction, June 30, 2010.

highly unrealistic. It can only happen if the credit system finances economic growth, which implies a rising level of *private* (household and company) debt relative to GDP. And that clearly is not going to happen. On the contrary, de-leveraging in the private sector is sure to remain the rule for a long time, as mortgages and other debts default or are paid down, and as many households remain effectively insolvent due to their mortgage debt.

*With high unemployment, high public deficits are inevitable.* The only choice is between an active deficit, incurred by putting people to work or otherwise serving national needs – such as providing a decent retirement and health care to the aged – and a passive deficit, incurred because at high unemployment tax revenues necessarily fail to cover public spending. Cutting public spending or raising taxes, now or in the future, by any amount, cannot reduce a deficit due to high unemployment. The only fiscal effect is to convert an active deficit into a passive one – with disastrous economic and social effects.

Having cured the deficits with an unrealistic forecast, CBO then recreates them with another, very different, but equally unrealistic forecast. In the CBO models, high future deficits and rising debt relative to GDP are expected. But the source is not a weak economy. It is a set of assumptions describing an economy after full recovery from the present crisis. In the CBO forecasts, big future deficits arise from a combination of (a) rapidly rising health care costs and (b) rising short-term interest rates, in the context of (c) a rapid return to high employment and (d) continued low overall inflation. This combination produces, mechanically, a very large net interest payout and a rapidly rising public debt in relation to a slowly rising nominal GDP.

Even if CBO were right about recovery, which it is not, this projection is internally inconsistent and wholly implausible. It isn't going to happen. Low overall inflation (at two percent) is inconsistent with the projected rise of short-term interest rates to nearly five percent. Why would the central bank carry out such a policy when no threat of inflation justifies it? But the assumed rise in interest rates drives the projected debt-to-GDP dynamic.

Similarly, the rise in projected interest payments is inconsistent with low nominal inflation. Interest payments rising to over 20 percent of GDP by mid-century would constitute new federal spending similar in scale to the mobilization for World War II. Obviously this cannot happen with two percent inflation. And although a higher inflation rate is undesirable, arithmetically it means a lower debt-to-GDP ratio.

Finally, rapidly rising health care costs and low overall inflation are mutually consistent only if all prices except health care are rising at less than that low overall inflation rate – including energy and food prices in a time of increasing scarcity. This too is extremely unlikely. Either overall health care costs will decelerate (relieving the so-called Medicare funding problem) or the overall inflation rate will accelerate – reducing the debt-to-GDP ratio.

In sum: the economic forecasts of the Congressional Budget Office, on which plans for reducing deficits over the medium term are based, are a mess. The unemployment and growth

forecasts are implausibly optimistic, while the inflation and interest rates projections are implausibly pessimistic and mutually inconsistent.

The conclusion to draw is that large deficits going forward are likely to have the same source as they do right now: stubbornly high unemployment.

### *Reducing Deficits Requires Financial Reform*

*The only way to reduce a deficit caused by unemployment is to reduce unemployment. And this must be done with a substantial component of private financing, which is to say by bank credit, if the public deficit is going to be reduced. This is a fact of accounting. It is not a matter of theory or ideology; it is merely a fact. The only way to grow out of our deficit is to cure the financial crisis.*

To cure the financial crisis would require two comprehensive measures. The first is debt restructuring for the entire household sector, to restore private borrowing power. The second is a reconstruction of the banking system, effectively purging the toxic assets from bank balance sheets and also reforming the bank personnel and compensation and other practices that produced the financial crisis in the first place. To repeat: this is the only way to generate deficit-reducing, privately-funded growth and employment.

To be clear: unemployment can be cured without private-sector financing, if public deficits are large enough – as was done during World War II. But if the objective is to reduce public deficits, for whatever reason, then a large contribution from private credit is essential. Without private credit, deficit reduction plans through fiscal austerity, now or in the future, will fail. They cannot succeed. If at the time the cuts take effect the economy is still relying on public expenditure to fund economic activity, then reducing expenditure (or increasing taxes) will simply reduce GDP and the deficits will not go away.

Further, if the finances of the private sector could be fixed, then an austerity program would be entirely unnecessary to reduce public debt. The national experience from 1946 to 1980, when public debt fell from 121 to about 33 percent of GDP and again from 1994 to 2000, proves this. In those years the debt-to-GDP ratio fell mainly because of credit-driven economic growth -- certainly not because of public-sector austerity programs. And this is why the deficits returned, in 1980-2 and in 2000, once the credit markets froze up and the private economy entered recession.

Thus until the private financial sector is fully reformed -- or supplemented by parallel financing institutions as was done in the New Deal – high deficits and a high public-debt-to-GDP ratio are inevitable. In the limit, if there is no private financial recovery, debt-to-GDP will converge to some steady-state value, probably near 100 percent - a normal number in some countries - and at that point the public deficit will be the sole engine of new economic growth going forward. Only when the private sector steps up, will the debt-to-GDP ratio begin to decline.

But for private credit to be restored, something would have to be done about the stock of existing household debt. Much of that, of course, is based on housing, and results from the lending practices that fueled the housing bubble.

*Housing, Private Debt Restructuring, and the Banks.*

The creation of a middle-class, home-owning, suburban and in consequence for a time largely Republican nation was perhaps the crowning achievement of the post-war period. It was and remains the foundation of the social structure – such as it is – of the United States as it exists today. And during the long run-up in housing prices, the home became the principal source of financial security for middle-class Americans – well ahead of financial savings and at least on a par, in many cases, with the value of Social Security and Medicare.

However, what was true under a situation of net excess demand for homes – fueled by cheap credit and after 1986 by uniquely favorable tax treatment of mortgage interest – would no longer be true under conditions of net excess supply. When house prices are rising, any owner can cash out at a price that yields net equity, or (what is functionally the same thing) they can borrow against the potential sales price and consume the equity while remaining in the house. Once prices fall, net equity disappears very quickly. Cash is then king, but it becomes very difficult to obtain.

As anyone who has lived through a housing bust knows, buyers and sellers have very different perspectives. Buyers experience the cross-section: they are out looking around, comparison shopping, and they have an acute sense of the glut of properties on the market. They know prices will fall, and therefore have an incentive to wait until they are lower. Sellers, on the other hand, tend not to know this. Their experience is time-series: they remember what that other house in the neighborhood sold for six months or a year back. Presented with a low-ball offer, their incentive is to reject it, in the hope that a better one may come along. Housing markets clear only when buyer and seller reach agreement, and this can happen, as a rule, only when the sellers come to their senses. Typically this takes a long time. And by the time it finally happens, prices have fallen very far. Since even an end to construction does not mean that the overstock disappears, there is no natural floor on the price of a house. It is not unusual for houses to be abandoned rather than sold.

The financial tragedy facing the American middle class is therefore the destruction of the notion that houses embody net wealth. And this is true even though current sales prices still indicate positive equity for a large majority of homeowners. Given the foreclosures and abandonments already in the pipeline, or certain to occur, the situation is almost certain to get worse rather than better, and to stay worse for a considerable time.

This is a Fisher-Minsky debt deflation. It will end only when the debts have been restructured, repudiated or paid down. And the relevant question is, which of these is the fastest way out?

Clearly, waiting for the debts to be paid down is the slowest possible solution, though it is the solution preferred by lenders. Many debts will never be paid down. In many cases, moreover, borrowers who cease making payments will not be foreclosed, at least not for a long time, because the lenders do not wish to recognize their losses and do not wish to incur the cost of repossessing, maintaining and reselling the home. The lenders simply add the deferred payments to the balance due, with interest, and the debt burden continues to rise.

The choice is therefore between restructuring and repudiation, and in that contest, repudiation wins almost every time. The reason again is quite simple: restructuring requires negotiation, and is therefore subject to delay, which serves the interest of the lender. Repudiation is unilateral. Moreover under legal arrangements in most states, it is nearly painless to the borrower: the bank takes the house, the deficiency cannot be pursued, and the former owner rents a comparable (or even better) property at a rental rate below his previous payments. In some cases, we even read of homeowners taking the precaution of buying and financing a second house before defaulting on the mortgage for the one in which they presently live.

Lenders (and the editorial page of *The New York Times*) purport to find this behavior shocking, which is amusing given that the behavior of the lenders over the past decade scarcely qualifies them as paragons of virtue. But moral judgments are quite beside the point. The fact is that debt repudiation is always the way out of debt crisis, because it is always the only strategy that a borrower can actually implement without the cooperation of any other party. Default can, sometimes, lead to negotiations later, as happened with Mexico and Brazil in the 1980s – though not in the case of Argentina after 2002. In the case of housing, however, with millions of borrowers and mortgages torn to shreds by securitization, negotiations are extremely costly. Repudiation is therefore the stand-alone remedy of choice. It will, over time, come to be taken by an increasing number of homeowners.

The interest of public policy in this matter is two-fold: first to preserve the built housing stock and neighborhoods as much as possible, and second to speed the process so that an end-state can be reached sooner and the recovery of the housing sector can finally begin. A Neighborhood Conservation Corps would be a useful innovation, putting young people to work maintaining, protecting or as appropriate demolishing abandoned properties, so as to minimize the spread of blight and the development of subdivision slums.

Beyond this, the appropriate way forward (which I owe to discussions with Warren Mosler and Dean Baker) is to proceed with foreclosures but allow those who have been foreclosed to remain in their homes, if they choose, as renters at a fair market rent set by an outside party, and with an option to repurchase after two or three years. This will minimize transition costs for lenders and disruption for foreclosees, maximize the care and maintenance of homes, and without disrupting the established course of the legal procedure it would give lenders an incentive to make attractive restructuring offers in advance of foreclosure. (Separately, authority for cram-down of mortgages in personal bankruptcy proceedings would also be a good idea.)

None of this can, of course, avoid the necessity for loss recognition by the banking system and by those who purchased the fraudulent derivative instruments. Dealing with that problem requires a separate discussion.

*Preserving State and Local Public Services.*

State and local public finance has been hit extremely hard by falling incomes and asset values, and ARRA managed only to offset the deep cuts that would otherwise have been made in state and local jobs. Very often the cuts and the offsets were in different areas, so that libraries and parks closed even as road crews were out repainting lines and filling potholes.

There is a simple fix for this: more money. As state and local governments grow in responsibility and competence, the federal fiscal system has become unable to cope adequately with the fiscal consequences of economic downturns. The need, therefore, is for a more powerful counter-cyclical force at the federal level to offset the powerful pro-cyclical force of state and local finance.

The concept and economic logic here are very simple. State and local public services – public schools and city hospitals, police and fire, parks and libraries, water and sewer – are part of the fabric of social life. Local governments are not for-profit enterprises; they are steady-state activities whose scale should be determined by the needs and preferences of their constituents. Preferences depend, of course, on willingness to pay – and that willingness should be judged at a normal level of economic prosperity. They should be immune – as the Pentagon is immune – to fluctuations based on sales of passenger cars or the value of the local housing stock.

The direct way to achieve this is to re-institute counter-cyclical revenue sharing, tied to the national unemployment rate – not local unemployment since structural jobless rates will always differ from place to place. On condition that states and localities neither raise nor lower their tax rates, the federal government would supply the difference between actual tax collections and the normal value, permitting the full preservation of existing local public services for the duration of the national crisis. When the crisis ends, the aid would be phased out – but in most cases it would by then be a moot question anyway, as local revenues and therefore the budget positions of the states and localities would have recovered.

General revenue sharing was a Republican program, introduced by Richard Nixon as an alternative to categorical grants. It was ended by Ronald Reagan in the general repression of non-defense public spending in the early 1980s. But with the rising role of states and localities, their increased weight in a fragile economy, and the high value placed by most people on local public services, the case for this program is now stronger than it ever was.

Should a revival of general revenue sharing not be feasible, then the full federalization of Medicaid would provide a reasonable and effective alternative, achieving much of the same final purpose of stabilizing the operating budgets of sub-federal units of government, in most cases.

## *Creating Jobs and Reducing the Need for Them*

Job loss in the Great Crisis came to some eight million, with a marked fall in labor force participation masking the effect on the unemployment rate. Given normal population growth and immigration, new job creation would have to be in the range of 250,000 to 300,000 per month, without interruption, for five full years before the employment-to-population ratio would reach its pre-crisis highs, let alone the full employment levels of the late 1990s.

The problem of jobs has practically nothing to do with the condition of manufacturing. In absolute terms, manufacturing employment in the United States has not increased since the late 1950s, despite a doubling of the population since that time, and the fall since 2000 in this sector has been precipitous, to less than nine percent of total employment today. Jobs are lost in manufacturing due to productivity gains, to foreign competition and to off-shoring, initially to Mexico and later to China. Nothing can be done about this and nothing will be done about it.

Job creation is about services. It's a matter of finding useful things for people to do, providing them with income and the companies that employ them with a fair profit. However the role of profit-making in job creation should not be overstated. Some seventeen percent of total employment is in government. Another large part is in the not-for-profit sector, fueled by philanthropic donations, incentivized by the charitable deduction and the estate tax.

A major advantage that the United States has enjoyed over Europe is the presence of soft budget constraints in sectors that absorb labor. The soft budget constraint is a concept first applied by the economist Janos Kornai to the communist economies of Eastern Europe, to describe how loss-making heavy industries could draw on the state for unlimited replenishment of their funds; the result was a waste of capital on uncompetitive manufacturing and over-investment in heavy equipment. (At the time it collapsed, the Soviet Union was devoting some forty percent of total output to investment, most of it worthless.) A soft budget constraint enables an institution to plan expenditures first and look for funding later – rather than seeking funds first and planning expenses on the basis of what is provided. Public services in Europe, being entirely provided by public budgets, are entirely hard-budget-constrained.

In the United States fifteen percent of employment is in education and health care alone, much of that in public or non-profit institutions and much of it paid for directly by government or indirectly with government support, in the form of grants, subsidized loans, tax-favored insurance premiums, tax-favored philanthropy and so forth. This is more than are employed in retail trade or leisure and hospitality, more than in professional and business services, and more than twice as many as work in financial services.

With multiple funding sources, administrators spend first and fund second; when one funding source runs dry, they try all the others before cutting back on spending. Thus great advantage of a “soft-budget” environment is employment stability: education and health services employment rose sharply in the past decade and has not fallen at all in the crisis. In this, it is

unique among all employment sectors. In fact employment in these two sectors is up over 25 percent since 2001, whereas in nearly all the profit-making sectors it is lower today than it was then.

It's now likely that many jobs created in retail trade, suburban homebuilding and other sectors servicing the great American debt-fueled household consumption boom of the late twentieth and early twenty-first centuries will never return, just as jobs being lost in goods production, information processing and the financial sector will never return. There is no reason to think that the employment patterns of the future will resemble those of the immediate past in that respect. Therefore planning for future employment should ask the question: what is it that we need people to do, and how can we go about creating the jobs that will permit them to do the work that needs to be done?

Parts of the answer are entirely obvious. We face the enormous challenge of energy security and climate change. Some of the work required involves scientific, engineering, design and planning talent. Much does not. Large parts of the conservation and mitigation task are a matters of weatherizing buildings, tuning engines, reforestation, the construction of seawalls and levees, and similar labor-intensive (though often technically demanding) tasks. A considerable part will be in construction and reconstruction of infrastructure, engineered for energy saving and reduced greenhouse gas emissions. All of this will provide jobs – or could provide jobs, if the right institutional framework for getting the work done can be established.

Another obvious area of need is care for the aging. As people get older they need care, and the proportion of the working population employed in providing it must rise. Further, training is necessary, and standards must be imposed, maintained and enforced. There is the potential here for a large, labor-intensive, not-for-profit sector, aimed at helping the elderly to remain in their own homes for as long as possible.

However, when all the good ideas have been put to use, a basic reality will remain: eight million lost jobs is a lot. And many of them were lost by older workers, who are physically past their peak and accustomed by habit and training to working in particular sectors or in the particular places they call home. For many of these people, another job is not going to appear, as employers have better options among the young. Subjecting them to the requirement of job search is a frustrating, pointless, debilitating waste of time and effort.

Further, there are many more older people still working, despite the fact that their work is unpleasant, tiresome, and physically uncomfortable if not painful. They work because they need the income, because one must continue to work to receive a full Social Security benefit, and because they cannot afford to go without health insurance before Medicare eligibility kicks in. Meanwhile younger workers, with fresh skills, ambitions and hopes, wait for positions to open. And wait. And wait.

The solution to this problem is retirement.

When universities wish to get rid of a declining cohort of elderly professors, they offer an incentive in the form of extra contributions to the pension plan. The same principle can and should be applied to Social Security. Let Congress enact a three-year window during which full Social Security benefits could be obtained by anyone retiring at the age of (say) 62, and following which the full-benefit threshold will return to present law. The ages and dates can be tinkered with as conditions and response rates dictate.

In this way, those for whom earlier retirement is attractive would have an opportunity to take it. The decision to do so would be entirely voluntary, and employers could of course offer counter-incentives to especially valuable workers. But the general principle would be to invite departure from the labor force for those workers who would gain the most by not being obliged to work or search for work, and thus opening positions for those workers who have the greatest need for jobs. The unemployment rate would decline.

As a further step, the age of eligibility for Medicare should be cut to 55. This proposal – which narrowly did not make it into the Senate health reform bill in 2009 – would permit those with medical reasons to retire even earlier to do so, provided they had the financial capacity in other respects. Further, the effect on medical insurance costs for firms' older workers would be substantial, as would the effect on insurance premiums for the entire population, since the 55-65 age cohort has higher medical costs than younger echelons. The only losers from this proposal would be health care providers, who would have to accept Medicare's lower reimbursement rates for a larger share of their services. But in that case, of course, total social resources devoted to health care would decline, at least in money terms.

We turn in the next section to discuss the fiscal issues raised by these proposals.

### *Financing Retirement Security and Health Care*

The topic of "entitlements" is one of the most benighted in American public discourse, and one to which certain economists have contributed vast quantities of obfuscation. The concept of "inter-generational accounting" is part of this debacle, and recently it appears that the Financial Accounting Standards Advisory Board (FASAB) has compounded the confusion by recommending that inter-generational accounting procedures be implemented formally by the United States government. In February 2009, Warren Mosler, Randall Wray and I presented full testimony to the FASAB, which the following discussion reproduces. We wrote:

In recent years we have been subjected to a rising cacophony of nonsense about a looming financial crisis. No, we are not referring to the current, very real, meltdown of private financial markets. Rather, we are told, future unfunded entitlements will bankrupt our government as the baby boomers retire. Social Security and Medicare are the main source of what former Comptroller General David Walker has called the "super sub-prime crisis."

Social Security and Medicare have always had enemies, closely allied to private insurance companies who would like the business, and to fund managers and others who would profit from privatization of the associated revenue streams. But recently, these enemies have been given a boost, and a claim to respectability, by the creation of "intergenerational accounting," an economic method that purports to calculate the debt burden our generation will leave for future generations. This testimony assesses intergenerational accounting and related aspects of what we call "the accounting campaign against Social Security and Medicare."

In intergenerational accounting, federal government revenue and expenditure streams are compared over very long periods—even over infinite time. "Deficit gaps" are then used to measure the financial burden of these commitments, and therefore the alleged solvency or insolvency of the government. Discounting the sum of the differences back to the present permits infinite sums to be translated into very large, but finite numbers. The results, amounting to tens of trillions of dollars, are headline-grabbing and scary-looking. Evidently this combination makes them irresistible. Even the Board of Trustees of the Social Security Administration began ago to dabble in such arithmetic several years ago.

We next considered some basic principles of federal budgeting, and explained why they differ from the principles that apply to the budgets of ordinary households and business enterprise:

Even though some principles of accounting are universal, federal budget accounting has never followed and should not follow the exact procedures adopted by households or business firms. There are several reasons why this is true.

First, the government's interest is the public interest. The government is there to provide for the general welfare, and there is no correlation between this interest and a position of surplus or deficit, nor of indebtedness, in the government's books.

Second, the government is sovereign. This fact gives to government authority that households and firms do not have. In particular, government has the power to tax and to issue money. The power to tax means that government does not need to sell products, and the power to issue currency means that it can make purchases by emitting IOUs. No private firm can require that markets buy its products or its debt. Indeed taxation creates a demand for public spending, in order to make available the currency required to pay the taxes. No private firm can generate demand for its output in this way.

Neither of these statements is controversial; both are matters of fact. Nor should

they be construed to imply that government should raise taxes or spend without limit. However, they do imply that federal budgeting is different from private budgeting, and should be considered in its proper, public context.

While it is common to regard government tax revenue as income, this income is not comparable to that of firms or households. Government can choose to exact greater tax revenues by imposing new taxes or raising tax rates. No firm can do this; even firms with market power know that consumers will find substitutes if prices are raised too much. Moreover firms, households, and even state and local governments require income or borrowings in order to spend. The federal government's spending is not constrained by revenues or borrowing. This is, again, a fact, completely non-controversial, but very poorly understood.

The federal government spends by cutting checks - or, what is functionally the same thing, by directly crediting private bank accounts. This is a matter of typing numbers into a machine. That is all federal spending is. Unlike private firms, the federal government maintains no stock of cash-on-hand and no credit balance at the bank. It doesn't need to do so. There are surely limits of wisdom and prudence on federal spending, as well as numerous checks, balances, and self-imposed constraints, but there is no operational limit. The federal government can, and does, spend what it wants.

Tax receipts debit bank accounts. So does borrowing from the public. These are operationally distinct from spending. There is no operational procedure through which federal government "uses" tax receipts or borrowings for its spending. If, perchance, one chooses to pay taxes in cash, the Treasury simply issues a receipt and shreds the cash. It has no need for the income in order to spend. This is why it is a mistake to look at federal tax receipts as an equivalent concept to income of households or firms.

...federal government spending has exceeded tax revenues, with only brief exceptions, since the founding. There is no evidence, nor any economic theory, behind the proposition that federal government spending ever needs to match federal government tax receipts-over any period, short or long. The deficit per unit time is the difference between taxing and spending over that time. To repeat, the taxing on the one hand and the spending on the other are operationally independent. Any reasonable observer should conclude that federal government spending is not, and need not be, dependent on, constrained by... tax revenues in the way that the spending of households or firms is related to their incomes.

Following this discussion, it was necessary to explain how an appropriate balance sheet for the nation as a whole might be constructed:

In our understanding, a statement of "financial condition" is, in general, a balance sheet. These are constructed with two columns: one for liabilities, and the other for assets. This very basic principle is no different for the public sector, and for the nation as a whole, than it is for private sector accounting.

The "nation's financial condition" ... is a combination of the financial condition of the government and that of its citizens. Yet the proposed "federal financial reporting" contains no mention of the assets that correspond to the liabilities that would be reported when accounting for "the nation." For example, it would treat the obligations of the Social Security system as a liability. That same Social Security benefit liability is, of course, an asset to the public. The Social Security wealth of the current population is just as real as the liabilities that support it. Yet nowhere is this Social Security wealth reported or even remarked on. Put another way, a transfer program, from one group of citizens to another, via the government or otherwise, merely transfers resources. It does not increase or diminish them. This is an economic reality, and a financial statement for "the nation" should reflect it.

The picture is further confused by treating the forecast difference between Social Security benefits and FICA tax revenues, projected over time and discounted to the present, as a "net liability" of the government - and, by implication, of "the nation" as well. In this way, intergenerational accounting purports to show an "unfunded burden" on the government, for the benefit of the future retired population. This overlooks the fact that the underlying citizens, who support the government, are the same people: today's workers will become, eventually, tomorrow's retirees. It is therefore hard to see why workers should object if the burden of payroll taxes does not, in present value terms, equal the value of social security benefits.

... Here our point is a matter of accounting: the asset of payroll tax revenues to the government is just a liability to the working population, just as the liability of future benefits is an asset to the public. In both cases, the books balance, between the public and the private sector - taken together, "the nation." And if the public's books taken alone don't balance, it merely means that the private sector's books, taken alone, don't balance either: the deficit of the one is the surplus of the other. There is nothing alarming about this. Just as the public debt can be eternal, and need never be paid off, a net debt position for Social Security and Medicare can likewise be eternal as well, since the government's net deficit is balanced by the nongovernment sector's net surplus. Spelling out the balance sheet in full for "the nation" would be good financial-reporting practice. And in this case, it would usefully reduce the scare-content of claims that focus on liabilities without acknowledging the corresponding assets.

Next, it became necessary to explain why it is pointless and foolish to treat Social Security and Medicare as separated entities within the federal fisc:

The FASAB proposes a minimum level of disaggregation for the basic financial statement. For example, projected receipts and spending for major programs such as Medicare and Social Security would be shown separately from those of the rest of government. This proposal also reflects a substantial misunderstanding of the purposes of federal budgeting.

The purpose of a program budget is to discipline the program. It is to hold managers accountable, and to discourage fraud. This is why specific amounts of funds are appropriated to specific programs. ... [I]t is certainly appropriate to hold programs accountable to ensure that they do what they are supposed to do.

However, there is little public or governmental interest in reporting long range projections of the "fiscal balance" of particular portions of the budget. And while officials in any program should be held accountable after the fact, there is little public purpose, and no economic interest, served by reporting the resulting, after-the-fact fiscal balance of particular portions of the federal budget. For example, if Congress appropriates \$100 billion for a transportation project, those in charge should provide an ex post accounting for all spending. They should explain reasons for cost overruns, and their careers should depend on acceptable performance. However, whether the total tax revenue received from any particular source (for example, from gasoline taxes) equals spending on transportation over some arbitrary period adds nothing to this.

...

By extension, the long-term success of Social Security should not depend on, nor be assessed by, matching spending on that program with some portion of federal tax revenue. The economic effects of budget deficits are the same whether they result from Social Security spending that exceeds payroll tax revenue or from transportation spending that exceeds transportation taxes. If, over time, we should find that projected payroll tax receipts fall significantly short of desired Social Security spending, then it would no longer make sense to adopt a budgeting procedure that dedicates-in a purely planning sense-payroll tax receipts to the Social Security program. In other words, whether we are setting fuel taxes or payroll taxes, the tax rate should be administered in such a manner that it achieves the public interest, not with a view to matching spending in any particular federal program. Likewise, when deciding how much to spend on transportation or Social Security, the program budget should be set to achieve the public purpose, rather than constraining spending to projected receipts from a specific tax.

Finally, we explained the implications of these arguments for the practice of making long-range projections for the financial condition of Social Security and Medicare:

An example is the assumption of current Medicare forecasts that health care costs will continue to rise indefinitely more rapidly than nominal GDP, so that the share of health care in GDP rises without limit. While the focus of [public policy discussion is usually] on implications for the federal budget, the effect on the private sector would be worse. In the limit, there would be few or no resources left to produce food, shelter, industrial goods or education, and the health care burden on households and firms would become intolerable. This cannot happen, therefore it will not happen. Stein's Law applies: when a trend cannot continue, it will stop.

No understanding of the issues is gained by a procedure that necessarily incorporates unrealistic assumptions of this type. Since the time horizons are arbitrary, the present value of future "liabilities" can be blown up to any size, simply by changing time horizons and discount rates. Most readers of the proposed budgetary documents are unlikely to be aware that the exercise is purely arithmetic in this sense.

For Social Security and other permanent programs, what matters for long-range projections are demographics, technology and economic growth. Financing is virtually irrelevant. If by 2083 everyone is over age 67, no financing scheme will allow us to meet our commitment to let people retire at a decent living standard at age 67. This, however, is most unlikely. Indeed, all plausible projections of demographic trends show only gradual and moderately rising real burdens on those of normal working age in terms of numbers of dependents (aged plus young) per worker. The OASDI part of Social Security currently moves less than 4.5 % of GDP to beneficiaries and that rises to about 6.5% over the next 75 years. On one hand, this is a significant increase, but on the other, similar shifts have occurred in the past without generating economic crisis or intolerable burdens. And it still leaves over 93% of GDP outside OASDI.

Moreover, in economic terms a rise in this burden is substantially less worrisome, when considered in the context of a falling stock market, which reduces dividend income and capital gains available to wealthier elderly. The current crisis drives home the necessity of having the Social Security leg of the retirement stool—a leg that promises to deliver benefits no matter how poorly the economy performs. While the promise is in financial terms, because of the manner in which benefits are calculated, benefits will tend to rise in real terms as the economy's capacity to produce rises. As the population ages, there will necessarily be a rise in the real burden of supporting them. The other legs of

the retirement stool (private pensions and individual savings) cannot guarantee that the real needs of elders will be met. First, this is because financial markets are subject to wild swings-so that many will retire at inopportune times (when assets are falling in value). Second, there is no mechanism operating in financial markets to ensure that asset values rise sufficiently faster than prices of consumer goods to shift a larger share of the nation's output to the retired. Indeed, it is precisely the ability of Social Security to increase the share of output going to beneficiaries (that is, to raise the real burden) that will be required as the nation ages. Finally, if all of our projections turn out to be incorrect, Social Security benefits can be changed (increased or reduced as necessary) as a matter of public policy-rather than as a result of the performance of financial markets.

The growing "real burden" of providing for an aging population is captured by the projection that while we have three workers today "supporting" each beneficiary, that will fall to only two workers sometime around mid-century. Two questions follow from this. First, can we expect productivity to rise enough over the next half-century to ensure that two workers will, indeed, produce as much as three today? All reasonable projections-including those of the Trustees-do assume this. Indeed, over the past half-century, productivities of workers in manufacturing have doubled or tripled, depending on the industry-far more than what is necessary to guarantee that we will have enough output to raise the living standards of retirees, workers, and other dependents.

Suppose (however unlikely the event) that productivity does not rise by the necessary amount. Is there any purely financial change we can make to the program -- including privatization -- that will avoid a "crisis"? The answer is clearly no. Getting more money into the hands of future retirees would just mean that they'd bid more of tomorrow's production away from workers and other dependents, leaving those groups worse off. To be sure, there would be policy actions that could attenuate the crisis by raising the ratio of workers to retirees (immigration in 2050 of workers, for example)-but financial expedients are not among them. If worse comes to the worst, so that we have fewer workers per beneficiary and no increase in productivity, then in 2050 taxes will have to be raised or benefits cut -- or some combination of the two to share the pain of lower living standards. But it is best left to voters in 2050 to make such a decision.

In short, it serves no useful purpose to project financial shortfalls for Social Security and Medicare into a far distant future, and no purpose whatever to revise those programs today on the basis of such projections.

I have nothing to add to that conclusion. It answers, in full, the "financial objections" that might

be raised to proposals for expanded Medicare and early retirement under Social Security. The issue is whether these measures would be good policy right now, and not whether they pose some mysterious financial risk in ten, twenty or forty years.

### *Capital Markets and Economic Inequality*

Let us return to the strategic issue. Given the financial crisis, what is the future role of the banking system and the capital markets?

Presently the banks are practically dysfunctional. The illusion that economic policy could work by getting them to lend again has been exposed as a fallacy. Commercial and industrial loans in particular peaked in 2008, and have continued to fall through the first half of 2010. The banks are comfortably adding to their portfolios of Treasuries and other guaranteed securities, funding their activities (including proprietary trading) with loans from the Federal Reserve at zero cost – and adding nothing to the financing of real activity on which economic growth relies.

For what, exactly, do we need these institutions in their present form? In their present role, they are predators-in-hibernation. No social or economic problem is being solved with their assistance. None will be, when they return to active participation in economic life. Their top executives remain overpaid and exposed (for example in the recent televised hearings of the Financial Crisis Inquiry Commission) as the inadequate people they clearly are. The mathematicians and financial geniuses have returned – one hopes – to the academic world, to puzzle over the deficiencies of the efficient markets hypothesis.<sup>7</sup>

The strategic question, therefore, is how best to reduce the political and economic leadership role of the financial sector, and to establish an economy in which the utilitarian functions of the financial sector are performed without the uncontrolled depredations recently observed, and with a reasonable degree of control over the phase transitions from hedge to speculative to Ponzi finance long ago identified by Hyman Minsky as characteristic of the evolution of the sector?

The answer begins where it should have begun in January 2009: with full and accurate audits of the books of the banks --and of the books of the Federal Reserve, as now required by law, to

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<sup>7</sup> At a meeting in Umbria in summer 2009, presided over by President Gorbachev, I made the following comment: “When Homer returns to tell the story of our epoch, he may say that the Russian mathematicians swept out of Muscovy in 1991, and presented themselves before the gates of Wall Street bearing the gift of quantitative risk management models. They were received with joy, went to work and in less than twenty years, destroyed the place entirely. It was, he will say, the greatest Trojan Horse operation since Troy.”

establish on what terms exactly the banks were relieved of toxic mortgage assets now held by the central bank. Criminal referrals should be made as appropriate and required by law, and the full resources of the Justice Department and of the FBI in particular should be directed to establishing the extent of and responsibility for the financial frauds that destroyed the system.

At the peak of the financial bubble, the banking sector paid about ten percent of all wages and earned over forty percent of all profits. For a sector that provides no element of final product – neither capital investment nor consumption – this is wildly excessive. The U.S. economy prospered for decades with a banking sector less than half as large, and there is no good reason why it could not do so again. The first clear priority for finance, therefore, is to shrink it.

A restructuring of banks should proceed in two directions. First, smaller and regional banks have great advantages over the large conglomerates that now dominate the industry. They are more manageable, and they are therefore easier to regulate. Their CEO's earn less. They can be encouraged, and restructured as necessary, to return to the essential functions of the banker: judgment of commercial and industrial credit risk -- a current goal of Fed policy as made clear in Chairman Bernanke's recent Jackson Hole remarks (Bernanke 2010). Being smaller and more regional, their influence over the political process – while not negligible, unfortunately – is necessarily less. These considerations all suggest that the necessary downsizing of the financial sector should begin by reducing the scale and number of the largest banks.

Second, specific financial functions not undertaken by the private banking sector should be assigned to new public and para-public institutions. In the Great Depression, the Reconstruction Finance Corporation provided support to practically all major American corporations, and its Director Jesse Jones held (and used) the power to change their managements if need be. RFC spin-offs included the Home Owners' Loan Corporation, the FHA, and Fannie Mae, while additional capital-market facilities were provided by regional authorities and by such entities as the Rural Electrification Administration and the Agricultural Adjustment Administration. Similar dedicated-purpose financial institutions formed the back-bone of post-war economic development strategies in France, Japan and Korea, building on the New Deal model. If needed again – as it is – this model should be deployed again. The National Infrastructure Bank would be a very good place to begin.

Obviously, for that to happen, the abusive past managements of the existing (and now once-again government-run) companies, especially Fannie Mae and Freddie Mac, also need to be cleared out and made an example of.

A thorough reform, right-sizing and clean-up of the financial sector would have a major effect on a widely-remarked but poorly-understood social phenomenon: the rise of economic inequality in America. Oceans of academic ink have been spilled on this topic, mostly attempting to relate rising inequality in the workplace to shifts in the demand for labor, owing to technology and trade, or shifts in supply owing to education.

It is however straightforward to demonstrate, as I have done in work with Travis Hale, that the overall distribution of income in the United States (as measured by tax data) closely tracks the performance of the stock market. This is for the simple reason that the incomes (and therefore taxes) of rich people are highly dependent on capital asset valuations; when stock prices go up inequality increases almost *pari passu*.

Further, Hale and I demonstrated that the geographical and sectoral distribution of the top incomes is extremely concentrated. Removing the single county of New York NY from the distribution makes a significant difference. Removing just five counties – New York, Santa Clara, San Mateo and San Francisco in CA and King County in WA - from the distribution would reduce the increase in the between-counties inequality of income in late 1990s America by half. After 2000, inequality declined with the NASDAQ, but then rose again after 2003, largely on the strength of income gains in just one metropolitan region: Washington, DC.

So much for small government under the conservatives.

It is equally true that the increased sectoral inequality of income is driven very heavily by the financial sector, both directly and through the knock-on effects of cheap credit on technology, real estate, energy and commodities at various moments in recent years. The extraordinarily high incomes earned by corporate executives were of course dominated by financiers. The distortions generated by those incomes for corporate governance are a topic I have treated in *The Predator State*. The effects on the incentives facing college undergraduates in elite institutions, as they weigh finance against the law, medicine and other forms of honest work, are of course well known to everyone who teaches in such a place.

### *Energy and Climate Change - a brief closing word*

Finally, we come to the largest strategic question of all: how to adapt ourselves to the onrushing challenges of oil depletion, energy insecurity and above all climate change, which threatens the survival of a civilized framework for humanity on an orderly planet? At the end of a long paper focused on preliminaries, I cannot treat this question in detail here.

Suffice to say: to do so will require a competent national framework for long-term planning, strict, credible and enforceable standards, a vast strengthening of the research effort in both production and conservation, a vast increase in the capacity to redesign local and regional urban and suburban environments and the transportation systems on which they rely, and the capacity to fight off cranks, crackpots and rent-seekers of every description. Success is very far from assured. In fact, on present trends failure is more likely than not; the recent decision of the Senate to kill the President's climate bill is especially discouraging.

However, ultimately one must ask, what is the point of being an economist? If it is not to help address the most important challenges facing the human race – perhaps the most important challenge ever to face the human race – the credential is not worth very much.

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### **Note on the Author**

James K. Galbraith holds the Lloyd M. Bentsen, jr. Chair in Government/Business Relations at the Lyndon B. Johnson School of Public Affairs, The University of Texas at Austin. He is a Senior Scholar of the Levy Economics Institute. His most recent book is *The Predator State: How Conservatives Abandoned the Free Market and Why Liberals Should Too*.

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