Deficits, debt, spending – myths and misconceptions

DELAWARE VOICE

SAUL D. HOFFMAN

Now that both the White House and the House Republicans have issued budget proposals and with yet another debt ceiling confrontation looming this summer or fall, there is a lot of talk about the federal deficit, the debt and government spending.

Alas, not all of it is helpful and much of it is flat-out bad economics. Here is a selection of misinformation and some help in seeing the issues more clearly.

» Deficits are always bad.

During the presidential campaign, Mitt Romney's website proclaimed: "We have a moral responsibility not to spend more than we take in." The recent budget proposal from former vice presidential candidate Paul Ryan makes cutting the deficit its highest priority. Are they right?

No. They are dead wrong for two reasons.

First, when private sector demand for goods and services falls, as it did in the recent Great Recession, the government should act aggressively to replace that demand by increasing its spending. Deficit spending is the prescribed medicine to lessen the severity of a downturn.

Economists have understood this since the 1930s, but the message has been forgotten by some. Cutting government spending during a recession to balance the budget – a policy of austerity – is exactly the wrong thing to do. Many European countries adopted this strategy and are now paying the price in terms of continuing high unemployment and low economic growth.

Second, far from being immoral, deficit spending for investments that benefit the next generation are quite appropriate. When the investments are in infrastructure or human capital, the next generation inherits not just the debt, but also the assets. They benefit from the improved bridges, roads, airports and schools.

Deficit spending to support current consumption (not investment) except during a recession is inappropriate. And so is spending for unproductive government programs, whether or not they lead to a deficit. But we will have done the next generation no favor by skimping on infrastructure investment now in order to balance the budget.

» Government should behave like a household, living within its means and cutting back spending in tough times.

True? Definitely false.

First, it is not even true for households. Most households do go into debt during their lifetime, usually by obtaining a mortgage to purchase a home. Just like the argument about government spending on infrastructure, they end up with a debt, but also a valuable asset.

Second, and more importantly, a household's spending by itself does not have any kind of macroeconomic impact. But government spending does. That is the whole point of stimulus spending during a recession. Households and government can and should operate by different spending rules.

» We are Greece or will be soon.

Wrong again.

Greece ran large, regular budget deficits that would have existed even if its economy was at full employment. Too much of its government spending was for current consumption, rather than for investments that would raise future living standards. It lacks the institutional capacity to raise tax revenues and it does not control its currency. None of those things apply to the U.S.

» Government spending is out of control.

Definitely false.

In 1996, government spending was 20.2 percent of gross domestic product. In 2008, the year before the Great Recession, it was 20.8 percent, even with the costs of two wars. No trend there. And government spending in the 1980s and 1990s was quite similar.

Government spending did shoot up in 2009 due to the recession, rising to 25 percent of GDP, and it remained well above normal in 2010 and 2011, because of the slow recovery from the recession. But government spending is now on the wane and is expected to reach its pre-recession level by 2016. Spending on non-defense discretionary programs is at its lowest level since the 1950s.

» We can sit back and do nothing.

OK, maybe no one is advocating this, but it is also false.

The nonpartisan Congressional Budget Office forecasts that government spending as a percent of GDP will begin to rise later this decade as an aging population and rising health care costs increase the cost of programs currently on the books. And the government budget situation looks even worse a few decades out.

The culprit here is health care costs in general, not government spending on health care through Medicaid and Medicare, which are actually less expensive than comparable private health care. We currently spend 18 percent of GDP on health care, while no other country in the world, many with health outcomes better than ours, spends more than 12 percent.

What should we do?

While the Affordable Care Act focused primarily on improving access to health care, it included funding for a broad set of experimental ways of paying physicians and hospitals to rein in costs. It also created an Outcomes Research Center to evaluate clinical effectiveness and provide improved practice guidelines for physicians.

We need to look very carefully at all of these ideas and others as well, in order to "bend the health care cost curve." My University of Delaware colleague Larry Seidman advocates "Medicare for All," extending Medicare to the below-age 65 population. Switzerland and Germany have effective hybrid public-private systems that may be worth emulating.

In the coming months, political debate about the federal deficit, debt and spending will intensify. Not all of what you read and hear will be sensible and some will be utter nonsense.

Effective policy reforms will require not only an understanding of the economic challenges we face, but also the application of sound economic analysis.

Saul D. Hoffman is professor of economics at the University of Delaware.

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