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Background to Our Report

America today stands at a critical juncture. Despite the severity of the current economic crisis, the nation has within its grasp the ability to right its economy and travel down a new road of prosperity and opportunity for all. It can do what it often did before: choose a forward-looking, pro-growth set of policies that rebuilds the economy and reignites the natural optimism and creativity of the American people. Or it can repeat the costly mistakes of the past and adopt policies that ensure a decade of lost growth, jobs, and business opportunities.

The recent sharp rise in the federal budget deficit is being used by many policymakers and political organizations to urge America to travel the wrong path again and repeat almost precisely the tragic errors of the past. This is alarming. The current deficit is less the result of national profligacy than of the recession itself.

Three decades of economic mismanagement led to a completely preventable economic disaster. Tens of millions of people are suffering due to the failures of economic policy. And the federal budget deficit began to rise rapidly as tax revenues fell with incomes.

Emergency stimulus policies here and around the world broke the fall, but did not bring us to full recovery. Today, the economy is growing only weakly. Eight million jobs were lost in the recession and not yet regained. Consumers, having suffered huge losses in home values and retirement savings, are still tightening belts to pay down debt and prepare for what they worry may be worse to come. The business sector, uncertain about consumer spending yet with balance sheets top-heavy with \$2 trillion of cash, is reluctant to invest in expansion or job creation, leaving the economy trapped on a path of slow growth or stagnation. Over 25 million American workers are now unemployed, underemployed or simply have given up looking for a job.

Worse, this severe economic crisis follows a decade that witnessed the worst job creation in the post-war period, growing inequality, a hemorrhaging of manufacturing jobs, and declining wages for average working families. We do not nearly have a full recovery yet, but even “full recovery” is not enough. We have to build a new foundation for long-term growth and prosperity.

Instead, fear over the short-term rise in the deficit is being used by many political leaders to encourage austerity policies in Washington. They claim that such austerity – cutting public spending to slash budget deficits – is the pathway to job growth and economic recovery. Nothing could be further from the truth. In fact, deficit spending now and sustained, affordable investments over the long term are necessary to return the economy to self-sustaining growth. But the view has won influential converts. Earlier in 2010, President Obama created a National Commission on Fiscal Responsibility and Reform focused on reducing deficits, and at least two privately financed and influential deficit commissions are attempting to push the national discussion further in the direction of austerity. Sweeping gains in the recent election for Republicans will raise the pressure to cut government spending. The right choices will ensure a future of growth, jobs, and prosperity. But we are deeply concerned that the proposals such as the one prepared by the deficit commission’s co-chairs could consign the nation to a lost economic decade while failing to address the real cause of either past or future deficits.

We must truly understand what has caused the current deficit and what is likely to cause future deficits if we are to plan wisely for the future. Today's deficit can be attributed to tax cuts, military spending, and a recession caused to reckless and under-regulated bank behavior, while future deficits will be driven by unchecked health care costs until we take further action now. Proposals such as that presented by the deficit commission's co-chairs fail to address the true causes of deficits, target areas that don't cause deficits, and propose actions that would damage the overall economy. The result would be less prosperity, even fewer jobs, and lost tax revenue.

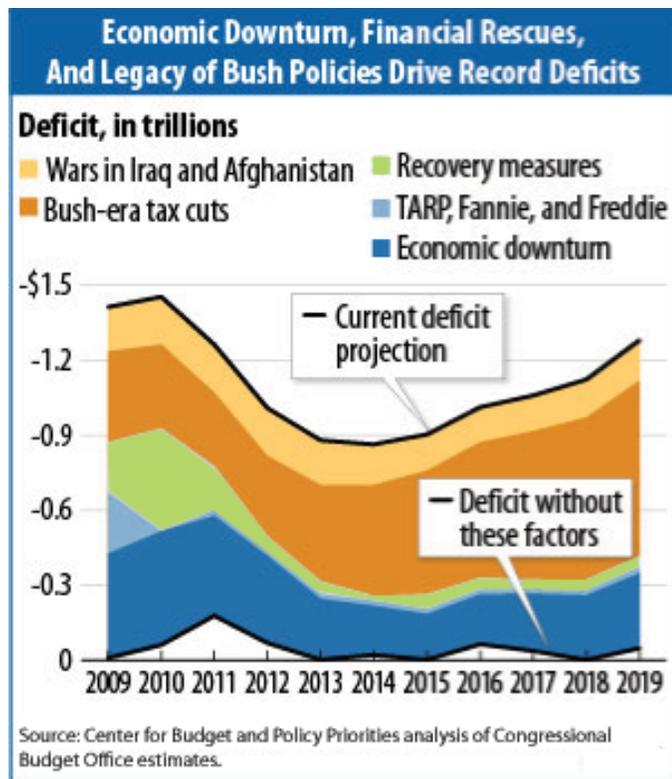
We have formed the Citizens' Commission on Jobs, Deficits and America's Economic Future to provide clarity and leadership as we prepare to make momentous decisions. Our goal is to explain how deficits arise, how they can be addressed effectively, and how to design a government budget that balances debt concerns with a healthy and growing economy. We present practical and achievable alternatives to the proposals currently being advanced by the deficit commission and similar groups. Our plan would restrain the deficit at manageable levels by addressing its true causes, while preserving government's vital role in society and ensuring continued jobs and growth.

An Economy in Peril

Many current deficit proposals fail to adequately recognize the weakness of the American economy. A second recession remains a highly realistic possibility. Given the stressed finances of typical Americans, the level of questionable debts that remain in the financial system, and the misguided and dangerous austerity policies being carried out in other developed countries, like the UK, a "double-dip" could again lead to crisis and a sharp fall in incomes.

The job shortage provides a stunning marker of the poor economic recovery. The unemployment rate stands at 9.6 percent at this writing. Together the unemployed and the underemployed—Americans who want a full-time job but can't find one—equal more than 17 percent of the work force. We are neither creating enough jobs to re-employ those who lost them nor hiring all the new entrants in the market. As noted, some 8 million payroll jobs were lost since the start of the recession at the end of 2007. Another 3.5 million jobs were needed to provide jobs for those entering the workplace. The Economic Policy Institute computed that the economy has to produce 300,000 jobs a month over several years to return to the unemployment rate that preceded the recession.² This requires a much faster rate of growth than currently anticipated if the unemployment rate is to fall adequately in the next few years—on balance, at least 3 percent a year.

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² Heidi Shierholz, "Fifteen months since recession's official end, economy short 11.5 million jobs," Economic Policy Institute, October 8, 2010, http://www.epi.org/publications/entry/september_jobs_picture/

banks to lend after the devastating losses of 2008, even while the banks now hold approximately \$1 trillion in cash reserves, most of which they obtained through borrowing at near-zero rates from the Federal Reserve. Consumer debt levels still exceed 120 percent of their income. To reduce them to the levels of 2000 would require consumers to cut \$3 trillion dollars of their debt. The nation's savings rate is now rising as consumers hunker down and pay off debt. This necessarily reduces consumption, and will continue to suppress it. Consumption is the main driver of the economy in the short run.³ Given the widely accepted “wealth effect”—that consumer spending is directly related to personal wealth-- the \$12 trillion loss of wealth alone could have caused a loss of \$400 to \$500 billion in purchasing power.

Meantime, the Obama recovery package has mostly been spent and will largely taper off by the end of 2010. Congressional hesitancy to maintain transfer payments such as unemployment insurance could also restrain growth.

The financial system is also still fragile. The recent estimate of future bailout funding that will be required by Fannie Mae and Freddie Mac is one example of the potential disarray another recession could cause is the recent estimate of future bailout funding that will be required by Fannie Mae and Freddie Mac. The Federal Housing Authority concluded recently that the bailout would cost \$6 billion at a minimum if the economy recovers and housing prices begin to stabilize. If there is ongoing weak growth or another recession, causing a continued decline in housing prices, the cost could rise to \$124 billion.⁴ There are similar, still larger potential catastrophes awaiting us in the private financial sector if there is another recession.

Causes of the Current Deficit

In fiscal year 2009, ending September 30, the annual budget deficit tripled from its level in 2008 to \$1.5 trillion, or roughly 10 percent of the nation's total gross domestic product. The annual deficit grew somewhat in fiscal year 2010 as a share of GDP. The debt-to-GDP level rose to 60 percent, compared to 40 percent a short time earlier. The sudden, spectacular surge raised alarms about government spending and was used by long-term advocates for fiscal austerity as proof of America's fiscal irresponsibility.

But, as noted, the current level of federal budget deficits is not the result of long-standing national profligacy. It is the result of the recession itself, which sharply reduced incomes (and therefore tax revenues) and raised necessary spending on unemployment insurance, nutrition programs and similar automatic stabilizers. In coming years, high budget deficits will also be the result of the tax cuts proposed by President George W. Bush in the early 2000s and war spending in Iraq and Afghanistan. As the Center for Budget and Policy Priorities points out, these three factors account for almost the entire projected budget deficit over the next 10 years (Figure 1)⁵. The deficit is simply not the result of spending on such social programs as Social Security or Medicare.

Austerity advocates confuse two different issues—short-term deficits generated by the recession, the Bush tax cuts and the war spending, with more disturbing long-term projections of deficits and debt driven by rising health care costs. America does not have an entitlements crisis. America has a broken health care system with excessive costs and inferior outcomes. Efforts to merely reduce public sector expenditures—such as caps on Medicare and Medicaid spending, cutbacks in veteran's health care, increases in out-of-pocket health care costs, raising premiums or voucher systems—will undermine the effectiveness of these

3 Sherle R. Schwenninger and Samuel Sherraden, *A Nation At Risk*, New America Foundation, October 2010, http://www.newamerica.net/sites/newamerica.net/files/policydocs/Recovery_At_Risk_Oct_2010.pdf.

4 Benjamin Appelbaum, “Fannie and Freddie: 3 Bailout Forecasts,” *The New York Times*, October 22, 2010, p. B1.

5 Kathy Ruffing and James R. Horney, “Critics Still Wrong on What's Driving Deficits in Coming Years: Economic Downturn, Financial Rescues, and Bush-Era Policies Drive the Numbers,” Center on Budget and Policy Priorities, June 28, 2010, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3036>

programs without lowering overall health costs. These measures would shift much more of the cost burden onto individuals while failing to fix the fundamental defects in our system. The health care reform bill passed earlier this year may be a first step towards repairing the health care system, but much more will need to be done.

Any meaningful long-term deficit program must take an objective look at the flaws in our current system and then act accordingly. That means taking advantage of the ability of publicly funded health insurance to control overall costs, negotiating effectively, and thoroughly reviewing other techniques, such as all-payer payment rates and evidence-based medicine, that may play an essential role in reducing costs while protecting or even improving the quality of care.

Social Programs Are Not the Problem

Many observers carelessly combine Medicare, Medicaid and Social Security as principal causes of the long-term deficit. Consider this statement by the Peterson-Pew Commission's report, cited earlier: "...the combination of population aging and growing health care costs will lead to an unprecedented expansion of Medicare, Medicaid, and Social Security in particular. Under the Commissions' fiscal baseline, these three programs will likely grow from less than 8.5 percent of GDP in 2008 to 11 percent by 2018 and 17 percent in 2038."

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The lumping together of the three programs is misleading and, in truth, irresponsible. Social Security is an insurance program paid for by the contributions of workers and their employers and the interest earned on the investment of the Social Security surplus. Most Americans would probably be stunned to know that Medicare and Medicaid will account for 85 percent of the increase in these percentages, Social Security only 15 percent. In its June 2010 budget outlook, the Congressional Budget Office concluded that,

"If current laws do not change, federal spending on major mandatory health care programs will grow from roughly 5 percent of GDP today to about 10 percent in 2035 and will continue to increase thereafter. Those projections include all of the effects of the recently enacted health care legislation, which is expected to increase federal spending in the next 10 years and for most of the following decade... Under current law, spending on Social Security is also projected to rise over time as a share of GDP, albeit much less dramatically. CBO projects that Social Security spending will increase from less than 5 percent of GDP today to about 6 percent in 2030. And then it will stabilize at roughly that level." ⁶

The increase of roughly 1 percentage point (1.3 percent, to be precise), may surprise readers but most of the increased payments due to an aging population were already anticipated in reforms undertaken in the 1980s, mostly with the gradual increase in the retirement age to 67. The remaining gap is relatively easy to close. In fact, raising taxes by 0.6 percent of GDP would do it because there are already Social Security assets in a trust fund for future benefits.⁷

Yet the sudden rise in federal budget deficits has once again made Social Security the favorite target of deficit cutters. Most of these would sharply reduce benefits for a large proportion of the elderly. Retirement savings, including 401(k)s, into which many retirees were required to place their funds in

6 The Congressional Budget Office, "The Long-Term Budget Outlook," June 2010, http://www.cbo.gov/ftpdocs/115xx/doc11579/SummaryforWeb_LTBO.pdf.

7 Ibid., Chapter 3, <http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>

lieu of guaranteed pension benefits, have fallen sharply in value. More important, for most middle-class households, the collapse of the housing bubble destroyed much of their home equity, for most the major source of their wealth.

Social Security has played no role in our current deficit and will play only a minor role in the future. Even under current projections, Social Security spending will rise by only one percent of GDP over the next 75 years without major changes. The Social Security program is forbidden by law from drawing on the general budget, and the Social Security Trust Fund currently has a surplus of \$2.6 trillion. Social Security is supported by payroll taxes specifically imposed for its use and dedicated strictly for that purpose. The baby boom population was already addressed in changes devised in 1983 by the National Commission on Social Security Reform (led by former Federal Reserve chairman Alan Greenspan and usually referred to as the “Greenspan commission”) and incorporated during the Reagan presidency.

Ensuring long-term actuarial balance for Social Security is and should be a separate exercise from deficit reduction, and can be accomplished with minor adjustments, which we describe later in this document.

Finally, it is critical to find new sources of tax revenues. The Bush tax cuts undermined the nation’s ability to meet its obligations and invest in itself. Except for those Americans at the top of the income distribution, they should be extended until the economic recovery is fully underway. Once the nation is growing rapidly again, a variety of taxes can and should be thoughtfully raised to meet the nation’s needs while maintaining its fiscal integrity.

The Wrong Direction

Some policymakers are using the recent sharp rise in the federal budget deficit to propose repeating the tragic errors of the past. This is alarming. The current deficit was not caused by national profligacy or excessive reliance on government. It arose after a decade of lavish tax cuts for the wealthy, a steep increase in military spending and a severe recession brought on by unchecked speculation and inadequate government regulation.

Emergency stimulus policies here and around the world broke the fall, but were not enough to bring about a full recovery. Economic growth remains weak and the pace of job creation is far too slow. Eight million jobs were lost in the recession, and job creation is barely keeping up with the pace of new entrants into the job market. Consumers who suffered huge losses in home values and retirement savings are struggling to pay down debt and prepare for what they fear may be worse to come. The business sector, uncertain about consumer spending, is holding \$2 trillion in cash reserves. Businesses are reluctant to invest in expansion or job creation under current conditions, leaving the economy trapped on a path of slow growth or stagnation. Over 25 million American workers are now either unemployed, underemployed or have simply given up looking for work.

Worse, this severe economic crisis comes on top of a decade that witnessed the worst job creation in the post-war period, growing inequality, the collapse of the manufacturing sector and declining wages for average working families. We do not have a full recovery yet, but “full recovery” is not enough. We have to build a new foundation for long-term growth and prosperity.

Instead, fear about the short-term rise in the deficit is being used by many political leaders to encourage austerity policies in Washington. They claim that such austerity—cutting public spending to slash budget deficits—is the only path to achieving job growth and economic recovery. We believe, and the economic record demonstrates, that this is precisely the wrong approach. Deficit spending—especially sustained, affordable investments—is urgently needed in the long-short term to return the economy to self-sustaining growth.

We understand there is a natural human response to tighten the fiscal belt when the nation's budget deficit rises. In the name of prudence and a misleading sense of self-discipline, however, the wrong policies are already being followed again today. Austerity economics is discredited by history and unsubstantiated by any new facts or theory. If the advocates of austerity now prevail, they will consign American citizens to a decade or more of stagnating income, millions of lost jobs, social inequity, inadequate investment, and deteriorating morale. (See Appendix I, The Danger of Austerity Economics.)

Despite the evidence, which we discuss at greater length later in this proposal, the austerity view has won influential converts. Earlier in 2010, President Obama created a National Commission on Fiscal Responsibility and Reform focused on reducing deficits. In addition, at least two privately financed and influential deficit commissions are attempting to push the national discussion further in the direction of austerity. Sweeping Republican gains in the recent election will increase the pressure to cut government spending.

A premature emphasis on deficit reduction will slow, rather than stimulate, growth. It will increase unemployment rather than put people back to work. This could well push our still-fragile economy back into recession. It will lead to unnecessary and painful changes in America's social safety net deficits. It will short-circuit the investments vital to rebuilding America and erecting a new foundation for long term prosperity, while failing to achieve the goal of meaningful deficit reduction.

Many in America—in government, in the media, and in business—fail to understand the causes of our deficit concern, or the economic and political risks posed by the austerity approach. The current crisis is occurring after a generation of disappointing economic performance for most Americans. Earnings have grown at historically slow rates, stagnated or fallen for most working people, amid rapidly rising costs of education and health care. The sense of insecurity over jobs and health insurance is widespread. Policies that increase unemployment and cut cherished and necessary social programs will inevitably add to the public's increasing expressions of frustration and anger, emotions we've seen expressed at the ballot box and in public demonstrations.

We are in a period of tenuous recovery which for many Americans is a time of great hardship. This is no time to practice austerity. Austerity economics is pessimistic economics. It is based on fear not faith. We must forge ahead as we have done time and time and again in our history.

We are not a poor nation. Despite what the austerity advocates say, we need not behave like one. We can and will return to growth and prosperity, if we have the courage and resolve to pursue bold policies based on wisdom and optimism.

Attacking the Root Causes of Deficits

The current deficit was not caused by Social Security, Medicare or Medicaid. The record surpluses of the 1990's were turned into large deficits by the Bush tax cuts and the cost of waging two wars. The effects of this deficit spending were then made much worse by a devastating recession caused by runaway speculation and inadequate government regulation. The recession created the need for major government programs to repair the damage. These expenditures added significantly to the deficit, as did the loss of revenue created by millions of lost jobs. The recession also led to a collapse of demand by consumers and business,⁸ creating additional lost government revenue.

Over the next 10 years, anticipated deficits will similarly not be caused by rising costs of social programs. Rather, the principal sources of the deficits, and growing public debt, remain the recession, war spending, and the tax cuts of the early 2000s under George W. Bush.

⁸ The Obama stimulus package of roughly \$800 billion technically added to the deficit but contributed to ending the recession. Had it not been implemented, the deficit would be substantially higher in 2011 and 2012.

After 2020, however, the deficit will indeed grow rapidly, as will the level of federal debt. Assuming we can succeed after 2020 in avoiding another financial meltdown similar to 2008-09, the central cause of large federal deficits will be the rising costs of American health care. If we can reduce our health care costs to levels similar to other rich nations, the U.S. Medicare and Medicaid benefits will grow at rates that will not cause a significant long-term deficit problem. If we do not control our health care costs, the economy will be devastated. Along with insuring a stable, well-functioning financial system through effective regulations, we must focus our long-term concerns with fiscal deficits on reforming our health-care system.

Investing in the Future

A robust and fast-growing economy with its benefits widely shared is the way to reduce budget deficits and maintain fiscal strength. It is, indeed, the American way. Coupled with significant health care reform, such robustness will enable us to enhance not erode social policies. And it will generate the funds necessary to renew vigorous public investment, including in support of building a viable clean energy economy over the next generation. These priorities have been badly neglected for a generation and we believe is essential if the nation is to have a prosperous economy again.

Our objective is to show that doing so is entirely practical. We present a pro-growth plan to be put in place in 2015 (provided there is sufficient recovery at that time) that will place sensible, sustainable ceilings on the federal deficit and the level of debt-to-GDP while maintaining the nation's social programs and also raising public investment adequately to build the foundation the nation needs to maintain its prosperity.

America must reinvest in itself. After years of neglect, the nation requires rebuilding. Civil engineers grade our infrastructure a C or a D. They say we must invest \$200 billion a year to repair and update for a new century.

College attendance levels stopped rising in the 1990s. Public education, in some cases good, is tragically inadequate for too many young Americans, especially those who live in poorer neighborhoods. We are not even doing the basics. For example, the nation has no accessible universal system of pre-school education despite its vital importance to learning.

The nation's dependence on fossil fuel energy cannot continue. Investments in energy efficiency—including retrofitting our existing building stock, expanding public transportation and upgrading our electrical grid transmission system—as well as in renewable energy sources, such as wind, solar, and geothermal power—can reduce that dependence. These and related green investment projects can also be a major new engine of job creation in both the short and long runs.

This is not the place to summarize in depth America's public investment needs. Our objective is to stress that with careful management, we can meet them. Enough studies suggest that such investment can pay for itself with faster economic growth.

There is no reason to believe that a 3 percent annual growth rate is the best we can accomplish. Even if it is, we will do well. But if we invest adequately, we may be able to do better.