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### **Addressing Long-Term Deficits: When and How? - Opening Remarks**

Alan Blinder already used my favorite quote but not quite in the version I prefer. It is St. Augustine, and at least one of the translations is: “Oh Lord make me chaste and continent, but not yet.” This is a really bad time to engage in fiscal retrenchment. It is a bad time on almost every dimension. Where we are is we have in effect a global excess of savings, the amount that people around the world want to save or would want to save if we were anywhere near full employment, is greater than the amount people around the world are willing to invest, even at zero short-term interest rates. So we have in essence this excess saving problem in the world. In that world, government spending does not crowd out private investments—they crowd private investments in. Think about what would happen if we cancelled the rest of the stimulus program. The economy would shrink. It would be more depressed and private investment would fall because we are in a situation in which private investment has already fallen sharply not because interest rates have risen because obviously they haven’t. To some extent maybe because of constraints owed to the financial crisis but mainly because businesses don’t want to invest because they are awash in excess capacity.

This is a situation in which everything we can do support the economy actually tends to increase investment. Again, deficits right now crowd private investment in; they don’t crowd investments out, which means that—people talk about trading current benefits at the cost of hurting future generations—right now government deficits are actually helping the future generations as well as the present by helping to sustain investment.

This is where the normal tradeoffs do not apply. I like to say we’re in this situation where interest rates are up against the zero lower bound. It is for the time being a Alice through the looking glass world, where none of the usual rules apply; where virtue is vice; where prudent is folly; where doing the prudent thing about deficits now would be an extremely foolish thing, even from the point of view of the fiscal situation. Because if you try to retrench fiscally now, you shrink the economy, which means that some, not all, but some of the savings are offset by reductions in revenues. And you also shrink the future economy, which means you hurt future revenues as well.

The IMF just recently released one of the chapters from their upcoming report World Economic Outlook, in which they found first of all evidence that financial crises not only lead to very severe recessions, but tend to leave a put a large crimp in the economy a number of years out—7 years out, that the medium—even long-term—growth of the economy is badly hurt by financial crises. And the evidence suggests you can reduce that impact by having strong, effective fiscal and monetary policy to limit the extent of the recession. So that doing deficit spending, though we don’t like deficits, but that deficit spending right now is the right thing to do, not just right now but for the future. It would be total folly to retrench now.

That said, eventually we have to do something. And the question is when we get onto the right side of the looking glass? Once we're back to the world where the Taylor Rule says what the Fed's funds rate should be—is not where it is right now, which says that it should be minus-500 basis points—but back into positive territory, so that monetary policy is playing its role, and we're in a situation where we are back in the world where fiscal deficits crowd out private investment, where we are back in a world where prudence is prudence instead of being folly. When that will happen? If you believe the official forecast, we're still several years from that point. We're still going to be in a world with very high unemployment. Right now the official forecasts all say that we will finally return to full employment about 5 years from now. The reason they say that is because it's a convention of projections that you always assume that we return to normal in 5 years. The reality is we really have no idea, but it could be quite a long time.

Assume that at some point we're back to normal—someday we will, what does the longer-term issue look like and what do we have to do? I've been trying to think this through. I've been blogging a bit. I've been thinking about 2019 just because that's the longest out date for which we have official projections. In 2019, we have several choices of official projections here. OMB is the most optimistic, CBO is worse depending which one of the two CBPP pieces we just got here, it's somewhere in between. Let me take OMB and you can mark it down accordingly. OMB predicts that as of 2019, we will have a deficit of 4 percent of GDP and federal debt net of financial assets acquired through the TARP program and all that about 70 percent of GDP. The typical assessment of fiscal sustainability—one criteria anyways is can we stabilize or reduce the ratio of debt-to-GDP? Are we on a path that will make that go down? If 2019 looks like that, we will fail to meet that criterion although not by a lot. If we have debt that's 70 percent of GDP, real growth 2.5 percent GDP, which is our best guess, if inflation is 2 percent which is the target, then that means you can have a deficit of a little over 3 percent of GDP while stabilizing the debt-to-GDP ratio. So we'll be a little bit out. The important thing to remember about this prediction or this analysis, is that all those numbers are totally wrong. The only problem is we don't know which direction. But anyways, this is a sort of guess. But I think we can say that a reasonable assessment is that in 2019 we will not be in a fiscally sustainable position but if that was the end of the story then not too far off either, then a moderate amount of spending cuts or additional revenue will appear to stabilize the budget around then.

Now of course that's not the end of the story because other stuff happens. Other stuff predictably is going to happen in 2019. The other two things that are going to happen are demography for sure, unless we actually do have some death panels, and health care costs. By 2019, as Alan said, 2010 is just around the corner; actually the baby boomers are already hitting the retirement programs, certainly already hitting their social security programs because of early retirement. By 2019, the demographic transition will be about half over, which means there won't be that much—although still a significant—push from the aging population. If that was the whole story, then we're looking at another 2.5 percent of GDP expenditures towards programs like Social Security, Medicare, Medicaid—Medicaid being not a program for the elderly, not on paper but in practice, a program about 75 percent for the elderly. That would bring us to about 3.5 or 4 percent of

GDP or if you buy the more pessimistic projections 5-6 percent of GDP has to come from somewhere eventually to bring us into a sustainable fiscal position.

The other thing is health care costs, and if we continue to have excess cost growth—if health care costs continues to grow faster than GDP per capita, well then it's hopeless. Then just forget it. The sine qua non of any of this is you have to assume that somewhere along there we have to get health care costs under control. Which means that if we can do that—and that is a tremendous if—then we have 4-6 percentage of GDP over the long run. That's big but it's not huge. That's the way I would put it. You can always throw around these presented discounted values of entitlement programs to come up with these gigantic numbers which sounds like we're doomed. If it's actually 4 percent of GDP, that's a number that could be, given a political—I put this on the blog—given a halfway sane political process, that's not an impossible number. We could do that.

We could do it entirely from taxes. Even if we did that, we would still have overall taxation in the United States as a share of GDP well below that of most other advanced countries. So it could be done entirely through taxes. One thing we could think about if we're going to think about these longer-run outlooks is that the other big long-term issue, which is climate change, actually does intersect with this. If we get around to the situation where emission permits are actually auctioned off, which by the way under Waxman-Markley that's supposed to happen eventually, then that could become a significant source of revenue just by itself. But still, there could be other things—maybe a VAT on top of that. All that would still be taxes that are well within the range that other advanced countries are bale to do fine with.

Spending cuts, what if we could do more than rollback, more than freeze excess cost growth? Other advanced countries get better health care outcomes than we do, spending 10 percent not just 16 percent of GDP on health care. Maybe there's something there. Social Security—I've been on this many times—people talk as if there's a program called Social Security, Medicare, and Medicaid—one word. In truth, it's Medicare and Medicaid that are the big stuff. Social Security—even if you go on some radical downscale, there just isn't much there. We spend around 6 percent or less of GDP on social security. We can't do much about cutting spending without emasculating the program entirely. Defense—maybe if it's a more peaceful world and we could spend less on defense. I think the point of all this is—I think this came out of the previous panel as well—but the economics of this are not easy but they're not spectacularly difficult. It's not at all hard to tell story of a combination of health care reform, tax increases that still leave us as a relatively low tax country, and maybe some other cuts in preferred spending, that could put us on a fiscally sustainable path. If all of this sounds like a pipe dream, it's because of our political deadlock. What we have to hope, what we have to assume, if we're going to get through the day, is that 10 years from now we will have a much saner political landscape than we do right now. And sometimes, if I'm feeling especially optimistic, I can even believe that that might happen.