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THE 'FISCAL CLIFF' AND BEYOND

Principles for upcoming budget debates

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As policymakers begin negotiations on addressing the nation's fiscal challenges, it is crucial that they clearly understand the economic context of the choices they face. The Economic Policy Institute has provided analyses and recommendations for specific actions regarding both the impending so-called fiscal cliff and future projected budget deficits. This policy memo lays out the broader principles that inform our specific recommendations.

- **The goal is full economic recovery**. The highest priority for fiscal policymakers should be a return to full economic recovery. This requires not just reducing the *drag* on growth and jobs coming from the fiscal cliff, but actually allowing fiscal policy to *boost* economic activity and employment in the next two years. To be clear, this means policymakers should aim for larger budget deficits in the next three years to finance job-creating public investments and transfer payments. Without a return to full employment—which is by no means guaranteed without aggressive policy actions—budget deficits will exceed current long-term forecasts because large cyclical budget deficits will persist as long as the economy remains depressed. But these larger deficits will signal only that more work needs to be done to achieve a full recovery, not that policymakers should begin rapid fiscal contraction.

- **Deficit reduction does not have to be part of addressing the fiscal cliff**. The near-term economic recovery measures that we must take do *not* need to be immediately paired with concrete steps to reduce projected budget deficits. The conventional wisdom that "addressing the fiscal cliff requires a bill that provides for stimulus now and deficit reduction later" could

deeply damage our economy if it poses an insurmountable hurdle to solving what should be a clearly nonpartisan problem of chronic unemployment. In short, adhering to this misguided conventional wisdom would force a debate on long-contested ideological questions such as the progressivity of taxation and the strength and breadth of social insurance programs. Inability to immediately resolve that debate would preclude attending to the more immediate need to create jobs.

- **Right now, we should be more worried about damaging economic recovery through fiscal contraction than theoretical future budget deficits**. The danger posed by a damaged recovery in the near term is both larger and far more immediate than the theoretical dangers posed by future budget deficits that may emerge when the economy has recovered. The textbook macroeconomic case for worrying about budget deficits in an economy at full employment is that increased government borrowing will "crowd out" private investment projects by bidding up interest rates throughout the economy. However, until the economy makes a full recovery, federal borrowing will *not* crowd out private investment, because interest rates will not rise in response to the increased public borrowing. It is important to realize that reducing long-term deficits will only raise future living standards if done in the context of a full-employment recovery—which we do not have today and will not have for some time. And increasing present and future living standards should, of course, be the goal of *all* economic policy, including fiscal policy.

If and only if the economy returns to full employment, policymakers should look for ways to close projected long-run budget deficits, and as they do so, they should keep the following in mind:

First, the overwhelming driver of large projected long-run budget deficits is excessive growth in costs of privately provided (if publicly financed) health care. If per capita health care costs rose in line with overall economic growth, then future long-run budget deficits would be completely manageable with much less dramatic changes to other spending and/or revenues.

- Reducing projected long-run budget deficits by simply shifting health care costs from the federal government to private households, businesses, and state and local governments would do nothing to improve living standards of Americans and would simply amount to an accounting gimmick. In fact, evidence over the last few decades demonstrates that the public sector does a better job than the private sector of restraining costs of the health care it purchases. Hence, simple cost-shifting would actually *reduce* living-standards growth going forward, running counter to what should be the underlying goal of fiscal and economic policy: boosting living standards for present and future American households.
- Both the level as well as the pace of growth of U.S. per capita health care costs in recent decades make the United States an outlier among advanced nations. Future projected budget deficits would be significantly smaller if the United States were simply able to match the performance of its industrialized peers in restraining health care cost growth.
- There is much evidence that the pace of health care cost growth has been moderating over the past decade or more, a decline not yet reflected in many health care cost projections, notably those undertaken by the Congressional Budget Office. Crucially, this deceleration of health care costs has occurred even before the (promising) cost-control initiatives embedded in the recently passed health reform have come into effect. Further, promising health care cost-control options not included as part of health reform could be implemented to prevent future cost growth from increasing budget deficits as a share of the economy; many of these cost-control measures are proposed in *Investing in America's Economy: A Budget Blueprint for Economic*

Recovery, a budget plan created by EPI for the Peter G. Peterson Foundation's 2012 Fiscal Solutions initiative.

Second, by far the most significant economic trend in recent decades has been the extraordinary rise in income inequality. To take just one example, the top 1 percent of households accounted for a larger share of average income growth between 1979 and 2007 (the last year before the Great Recession) than the entire bottom 90 percent of households. Further, federal budget policy actually contributed less to reducing inequalities in 2007 than it did in 1979. And tax policy changes have particularly exacerbated widening inequality over the last decade.

- Given this rise in inequality, it makes sense that much of the future burden of reducing budget deficits should be borne by those who have benefited the most from economic trends in recent decades. The conventional wisdom that taxing the rich can't raise enough money to help significantly reduce the deficit is just not true, as it fails to account for both the extent that overall national income growth has concentrated at the top and the variety of different tax policies available to achieve higher levels of progressively raised revenue. As *Investing in America's Economy* documents, there are a number of tax changes that would both raise substantial amounts of revenue from progressive sources and provide ample incentives to increase economic growth and efficiencies.
- The rise in inequality has been the primary barrier to decent income growth for low- and moderate-income households in recent decades. Crucially, as rising inequality has flattened growth of their "market-based" incomes what little income growth they have achieved has been due to the contribution of the key social insurance programs such as Social Security, Medicare, and Medicaid. Given that these crucial programs have been by far the most reliable source of income growth for low- and moderate-income families in recent years, measures to balance projected long-run budget deficits should not include benefit cuts to these key social insurance programs. To put it simply, we should not cut what has been the only source of real economic strength and security for low- and moderate-income families in recent decades.

Third, the textbook economic case for fiscal restraint when the economy is at full employment is to ensure that rising deficits do not crowd out productive *private* investment when the government competes with private borrowers for fixed supplies of economy-wide savings. However, if the rush to close future budget deficits leads to cuts to productive *public* investment, then this entire economic rationale collapses. A growing body of research indicates that returns to public investment exceed those from private investment, and that these returns are surely more equitably distributed. Given the high returns to public investment, deficit reductions gained from cuts to public investment are outright damaging to the broader economy.

In conclusion, simply bending revenue and expenditure trajectories closer together should not be the main goal of economic policy. Instead, policymakers must seek to boost economic growth and ensure that equitable shares of this growth reach low- and moderate-income households. EPI's policy analyses and recommendations are built around this simple, but too-often ignored, principle.