Deficits and the Rapidly Increasing Federal Debt in the Age of Coronavirus

James A. Kyprios / Originally published by LA Progressive April 6, 2020

In 1996, President Bill Clinton declared that "the era of big government is over." With these words he ratified the Reagan Revolution. For those too young to remember, Ronald Reagan, who became President in 1981, said more than once that "government is the problem" and "the government should go on a diet."

The Era of Big Government Came Roaring Back Under a Republican Administration

In 1996, the Federal Budget deficit was 1.3% of GDP and heading downward for the first time in many years. Clinton was so successful in his mission to balance the budget that by the end of his term, it appeared that the United States would do just that. When George W Bush became President, the country was not only on the road to balancing the budget but heading in the direction of having sufficient surpluses to meaningfully reduce U.S. Federal Debt. That all changed when the Bush Administration decided on a major tax cut to stimulate an economy hobbled by 9/11, and then followed with the invasion of Iraq.

Massive expenses for security and wars in Iraq and then Afghanistan dramatically increased government expenses and also (in part because of the tax cuts) resulted in large increases in deficits. There is only one way to "finance" such deficits and that is by the government issuing bonds—in other words by increasing the national debt.

An Economic Collapse is Avoided in 2008 by Huge Government Intervention: Government then Increased under both Republican and Democratic Administrations

When the economy collapsed in 2008, necessary actions taken by the Bush and then Obama Administrations to rescue the economy drastically increased government spending without increasing taxes. This in turn led to deficits financed by government debt.

This was a classic example of Keynesian economics at work: the idea behind the deficits was to stimulate the economy which would lead to a large increase in tax revenues therefore greatly reducing the deficit. That is the idea of a Keynesian stimulus under difficult conditions and that is exactly what happened.

At the time, huge deficits were decried by some conservative politicians and economists who feared that these deficits would lead to a new round of hyperinflation. (Those who have lived through the 1970s understood how painful inflation can be). Inflation never occurred.

At the same time, the Federal Reserve headed by Ben Bernanke unveiled a new set of tools to assist the economy and to make sure there was sufficient liquidity in the system. These new tools were called "Quantitative Easing" - a major portion of this consisting of large monthly purchases of Government Debt from the market by the Fed.

The loose fiscal and monetary policies pursued led eventually to full employment (defined traditionally by economists as 4% or less). As the economy continued to expand and unemployment went down, there was still no inflation but in time growth did not meet expectations and became sluggish. The recovery after the 2008 crisis was slow by historical standards.

Although there was very little inflation and slower growth than expected, there was a major increase in the stock market over a sustained period of time and also a decrease in interest rates. Real estate values also appreciated handsomely. In some circles there was a fear of a bubble which might burst unexpectedly.

Massive Tax Cut Passed by a Republican Administration in 2017

When Donald Trump became President, he engineered a large tax cut which, among other things, decreased taxes on corporations, capital gains and on wealthy individuals. At the time, the Administration indicated that this tax cut would lead to a surge in the economy causing large increases in government revenues (i.e., larger profits and higher incomes even with lower tax rates were supposed to increase total government tax revenues).

For a while, growth rates of the economy increased but eventually the growth rates slowed down. The deficit was not reduced. The tax cut left the economy with a $1 trillion deficit by the beginning of 2020.

But the tax cuts did help power a major stock rally.

Unexpected Events in 2020 Prompt Emergency Action

The $1 trillion deficit represented a large amount for a country during peacetime. This deficit was close to 5% of GDP and caused concern that the U.S. would continue to have major, and possibly unsustainable deficits in the future.

Now with the passage of the Cares Act, the deficit will increase to over $3 trillion, about 15% of GDP. It is understood that during protracted wars the government can run huge deficits. But this (hopefully) is not a protracted war time. Discussions are already beginning about increasing more assistance to the economy during this difficult period. Janet Yellen, the former head of the Fed thinks that it may take the economy two years to fully recover.

It seems likely (based on current information) that during this year another $2 trillion in government expenses will be authorized thus increasing the deficit to about $5 trillion, or close to 25% of GDP.

Because we are now experiencing what has been described as a "medically induced coma" of the patient (i.e., the U.S), the economy will slow down drastically while unemployment will continue to grow to frightening levels. We most likely will see Depression type numbers soon: GDP may go down in the second quarter perhaps by as much as 25%. In that case, the deficit as a percentage of GDP would increase to over 30%. This would be the highest percentage in the history of the country exceeding the 27% figure during the dark days of

World War II. Also, unemployment likely will exceed the 25% figure during the Depression in the 1930s.

Deficits are Financed by Increases in Debt

We need to emphasize that these huge but crucial government expenditures are financed by increases in government debt, not by tax increases. At the end of 2019, total Federal debt stood at $22.8 trillion, which is about 108% of GDP for 2019. With the Cares Act and expected additional expenditures (totaling about $4 billion for the year and financed by debt) the Federal debt level is likely to increase to $26.8 trillion.

According to economic authorities, any ratio above 60% (national government debt/GDP) is considered "problematic". No other country except Japan has a ratio in excess of 100%. The U.S. is now joining this exclusive club. Ratios in excess of 100% are considered "serious". The exact numbers are of course arbitrary. Nevertheless, by common consensus, the government debt has now become "too high."

The fear is that once debt levels rise beyond a certain level, it will be harder to sell future debt without increasing interest rates. In more extreme cases, the government would not be able to sell debt at all to finance continuing budget deficits.

It may seem counterintuitive, but the higher debt levels in the U.S. so far do not seem to be a problem. It is true that some of the rating agencies are getting nervous and may very well decrease the USA's AAA bond rating. This was decreased (temporarily) in 2011 to AA because of the paralysis on budget matters in Congress. In spite of this the markets did not penalize the country by demanding higher rates.

The interesting thing is that in times of crisis, there is a "flight to safety" where investors put money in safe places - the safe haven of choice always being U.S. bonds. Borrowing costs go down.

Economic Issues from Massive Spending Programs Financed by Debt

What cannot be known now is what the economic effects of these massive spending programs financed by debt will lead to:

Economists today believe that these programs will not lead to inflation despite past history to the contrary: after every major war in the last 500 years in the western world, huge deficits financed by debt have led to inflation. Economists now believe that these deficits will eventually stimulate the economy to a full recovery and not lead to an inflation at least in the short run. We will see.

There is a fear that the increasing interest payments (from ever increasing large debt levels) will eventually overwhelm the Federal budget. Some years ago, I was at a conference where Paul Volcker, the late Federal Reserve Chairman (who slayed the dragon of inflation in the 1980s) was interviewed.

Volcker was clearly worried about increasing debt levels. He said that he could imagine that in 20 years or so a situation would arise where interest payments might comprise a very large percentage of the government budget, very possibly over 50%. This would be a very dangerous situation, he said, because the government would not be able to continue financing programs by debt but would either have to cut essential government expenditures and/or need to resort to punishing tax increases.

Volcker's warning was very clear - we must not allow ourselves to be in such a position in the future.

Is a National Value Added Tax the Answer?

With the foregoing in mind, is there a sure-fire way to finance increasing government expenditures by an effective tax system? It turns out that there is, and it is known by both the Democrat and Republican leaders in the Congress. This system works very well in certain European countries.

This system is called VAT - the Value Added Tax. This is very simply a central government sales tax. In the U.S., we are used to states and localities charging sales taxes; but there is no sales tax levied by the U.S. government as there is in Europe.

If both Democrats and Republicans know that the VAT "works" it should be easy to get it passed, correct? Answer: NO! The Democrats will not support it because they believe it is "regressive" - that is it disproportionately taxes the poor. The Republicans will not support it because they believe that the Democrats have never met a social spending program they did not like and that the passage of a VAT would give the Democrats all the money they need to fund programs that Republicans do not always support.

Political Issues

We also cannot know now what the political reactions will be to the latest government actions to keep the economy afloat following this medically induced coma.

Several thoughts come to mind:

Elizabeth Warren and Bernie Sanders have proposed radical changes to our economy such as Medicare For All including coverage of undocumented aliens. Can anyone now argue against coverage for everyone including undocumented aliens given the nature of the Coronavirus which knows no borders nor boundaries? Also, there may very well be bankruptcies of companies some of which are covered with "Cadillac" health care plans which the workers would not have wanted to give up. Now the workers will be uninsured and they may very well have no choice but to seek government coverage.

Sanders was mocked by Joe Biden for the cost of Medicare For All because it would bust the budget. All of a sudden there is no problem at all in busting the budget by amounts undoubtedly much more than Medicare For All would cost.

Which is It — Monetizing the Debt, Modern Monetary Theory or Quantitative Easing Infinity?

When I studied economics, the idea of financing budget deficits by having the Fed buy government bonds was called "monetizing the debt." This technique was used from time to time to smooth out market irregularities and to make sure that not too much debt was dumped in the market at one time. The idea was for the Fed to buy some of the latest Bond issue and "warehouse it" and gradually sell part or all of it to the market at appropriate times. These operations assured a relative stability in interest rates in the economy.

The reason these operations by the Fed were called "monetizing the debt" is because the Fed pays for buying debt by creating money through the banking system. I would like to repeat this - when the Fed buys debt, it pays for it by creating money. (The details are complex and are irrelevant to this discussion).

We have seen that in response to the 2008 crisis, the Fed instituted a policy of buying government debt from the market on a monthly basis calling this "Quantitative Easing". This was a more expansive view of "monetizing the debt."

Now the Head of the Federal Reserve and a Republican President have no problem at all with expanding such an idea if it is needed to finance some of the massive budget deficits being created at this time. The Fed has recently stated that it has an unlimited appetite for government debt in what is now called "Quantitative Easing Infinity." This policy also includes buying without limit various types of corporate and state and local government debt from the money and capital markets in order to provide liquidity to such markets in very difficult times. Again, the Fed pays for its purchases of financial assets by creating money.

In recent times, we note that some liberals (including prominently Alexandria - Ocasio-Cortez) advocate what has come to be called "Modern Monetary Theory." The idea is to counteract the notion that we cannot afford, for budgetary reasons, some social programs. The proponents of Modern Monetary Theory say "yes we can." They argue that a country which controls its own currency will never run out of money. We can create money to pay for any government programs that we deem necessary is what they seem to be saying. The proponents of Modern Monetary Theory appear to be in favor of drastically increasing social programs and obviously have a different agenda than the Fed which wants to save the economy from catastrophe.

The proponents of Modern Monetary Theory have been met with derision not only by conservatives and Republicans but also by prominent liberal economists (e.g., Larry Sommers, former Secretary of the Treasury under Obama, and former President of Harvard) and also by people like Bill Gates.

By creating Quantitative Easing Infinity, it may be that the Fed has given a certain amount of credence (unwittingly of course) to the arguments of the proponents of Modern Monetary Theory. These proponents can now say with more conviction: we can pay for any program by creating government debt which can be purchased by the Fed - after all the Fed is doing that now.

The problem of course with Modern Monetary Theory or Quantitative Easing Infinity is that it has never been tried before and no one knows what the effects will be. Quantitative Easing was tried with success after the 2008 crisis but now the Fed is talking about no limit on how much debt it can buy. Modern Monetary Theory advocates envision all sorts of government social programs that many had agreed we could not afford. The proponents of Modern Monetary Theory envision this as a blank check.

Will Modern Monetary Policy and/or Quantitative Easing Infinity be inflationary; will this cause asset bubbles in real estate and the stock market; will it drive down interest rates or increase them? No one knows because operations of this size have never been tried.

What might be the unintended consequences of such policies? Again, nobody knows. As the conservative economists have said more than once: "There is no such thing as a free lunch." The Modern Monetary Theory advocates seem to be arguing that there is indeed a free lunch so let's eat as much as we can.

The Coronavirus and the resultant economic consequences have created a Brave New World where Republicans are doing things that they very recently had heavily criticized and even ridiculed. They now have had no choice but to join the Democrats in not only pushing but actually forcing the government to a leftist position which may not be easy to reverse.

To many, what Bernie Sanders preached was nonsense and politically impossible. Today, his view of the world, to a certain extent, is becoming more plausible. It took a Republican (Nixon) to go to China. It has now taken another Republican (Trump) to make America more of a Social Democracy where the government has much more control of the economy than perhaps any time in our history except for major wars. Just the other day, President Trump was heard to say that Medicare For More (my words) may not be a bad idea that bears looking into.

The Democratic convention should be interesting. And the discussions during the Presidential campaign in the Fall should be fascinating.

Of course, we must hope that by then the Coronavirus will be just a painful memory.

As Dr. Anthony Fauci has so eloquently put it: *"The virus sets the time limit."*