

ECONOMICS USA
21st Century Edition

PROGRAM #24

FEDERAL DEFICITS:
CAN WE LIVE WITH THEM?

AIRSCRIPT

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FEDERAL DEFICITS: CAN WE LIVE WITH THEM?

Final Transcript

Annenberg Learner (Logo and Music)

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(EFC LOGO appears on screen)

FRANKLIN D. ROOSEVELT: "Our war program for the coming fiscal year will cost 56
billion dollars..."

DAVID SCHOUMACHER: 1945... By the war's end, the price tag will pass 200 billion
dollars. How will we pay for World War II?

1960. As President Eisenhower talks of paying off the national debt, the economy
stumbles into a recession. How can a budget surplus hurt the economy?

In 2011. Crisis was at hand.

BARACK OBAMA: "There's no doubt that we're going to have to also address the long
term quandary of a government that routinely and extravagantly spends more than it takes
in."

DAVID SCHOUMACHER: Just how would the Government respond? For almost every year in the last 50 years the Federal Government has spent more money than it takes in. Year after year the tide of red ink rolls in. Federal deficits: Can we still live with them? We'll investigate that question with the help of economic analysts Nariman Behravesh and Richard Gill on this 21st Century edition of Economics U\$A. I'm David Schoumacher.

(MUSIC PLAYS – OPENING TITLES)

(FEDERAL DEFICITS: Can We Live With Them? Appears on the screen)

PART I

DAVID SCHOUMACHER: Most of us have been taught that to spend more money than we earn is to court financial disaster, but the federal government seems to play by a different set of rules. Almost every year the country runs a deficit. Yet we're told that deficit is necessary. Even beneficial. But deficits piled one on top of another create a growing national debt. And the interest payments on that debt add more dollars to the next year's deficit. During a five-year span back in the 1940's, our national debt more than quadrupled as we fought World War II. How did we pay for that war? And why didn't it bankrupt us?

Early in the morning of September 1, 1939, German armies marched into Poland and the world exploded into war. By 1940, the Germans controlled Europe and were poised to attack Britain. A frightened American Congress appropriated 37 billion dollars for defense, more than the entire cost of World War I. How would the government raise these huge sums?

FRANKLIN D. ROOSEVELT: "That means taxes and bonds, and bonds and taxes..."

DAVID SCHOUMACHER: Treasury official, Roy Blough, remembers.

ROY BLOUGH: “Now The Treasury view, and I shared it, was you get as much out of taxes as you can, and up to 100 percent. Now of course we never succeeded in doing that. You take the whole war period. The tax revenues for the war period were a little less than half of the total. The rest of it was borrowed.”

DAVID SCHOUMACHER: In England, economist John Maynard Keynes urged the American government to borrow from a pool of money created by a compulsory savings program. But a group of young American economists had a better idea, as Richard Gilbert recalls.

RICHARD GILBERT: “The group which I led proposed to finance the war through borrowing, in itself not different from the Keynesian proposal, but with a direct control of prices and wages to prevent the kind of inflation that had always been associated with war in the past; and to bring to full employment, as rapidly as possible, the enormous energies of the American public, once harnessed to the effort.”

STEWARDESS: “As an airplane worker, I ask all of you to help to support our armed forces by buying more war bonds and stamps. As our boys would say: ‘You buy 'em... we'll fly 'em.’ “

INTERVIEWEE: “This is a working man's country and I'm doing my part to keep it that way. Buy more bonds today.”

DAVID SCHOUMACHER: Fresh from a decade of hunger and deprivation, the American people cheerfully loaned dollars by the billions to their government. As the war intensified, the economy boomed. Fifteen million Americans went to war. 66 million more went to work. For the first time in ten years Americans had money to spend, but little to spend it on. Not only were luxuries unavailable, but such basics as housing were hard to come by.

RICHARD GILBERT: “All construction was limited except by license. The production of cars and other durables was totally eliminated for the war period. In other words, there could be no private investment other than that required for the war effort. And the result was that if the government had not borrowed these sums that were being saved in the community and not invested, the result would have been not full employment, but another depression.”

DAVID SCHOUMACHER: Government tax revenues increased dramatically throughout the war, but government expenditures increased even more. By the war's end, the federal government had borrowed almost 200 billion dollars, 1/4 of it from private individuals, most of the rest from the banking system. The deficits were huge. The national debt quadrupled in only four years.

Dr. Blough, what would have happened if we had tried to pay, as we went, for World War II?

ROY BLOUGH: “I think it would have probably been rather harmful to the economy. I sometimes extravagantly said we would have lost the war. If we had tried to do it by pay-as-you-go, we would have had to impose very much more of a dictatorship on the community than we did have to.”

DAVID SCHOUMACHER: The end of the war found the country facing a huge national debt. Yet, somehow, the 260 billion dollars we owed in 1945 did not seem as terrifying as the 40 billion we'd owed in 1939. The nation was prosperous. As the economy grew, tax revenues increased and government expenses declined. And years later, as all those billions of dollars of World War II bonds came due, the government simply borrowed new money to pay the old obligation. The nation had gone deeply into debt to pay for the war. The debt never really went away. It just seemed to shrink in size compared to the total GNP. We asked economic analyst Richard Gill if this meant that we had passed on the cost of the war to future generations?

(MUSIC PLAYS—COMMENT & ANALYSIS I)

Economics U\$A Logo

RICHARD GILL: The simple answer is no: the basic costs of World War II were borne by the generation that lived and worked during World War II. Look at it in terms of the old standbys, guns and butter. We start before the war with an economy that is producing only butter. That is, civilian goods. Now when the war comes, we have to divert some of our resources to gun production. The economic cost of the war is borne right then and there and is basically the amount of butter we have to give up because we are producing armaments.

The cost of the war in terms of lost butter production was minimal because we entered the war from the Great Depression, with enormous unused capacity and unemployment in the economy. To a great degree, we were able to add gun production onto our previous butter production by simply employing these unused resources. In one basic way, the war did impose direct costs on the next generation.

Our civilian production is composed not only of consumption goods, like butter, but also investment goods: factories, machines and the like, to increase future production. Insofar as the war replaced investment (I) with guns (G), we left a smaller productive capacity to the next generation. But what about the interest payments on the debt? Aren't these a cost to future generations? They are, and we'll indicate how later on. For the moment, we should bear in mind that because of the enormous growth of the American economy in the decades following the war, federal interest payments as a percentage of our GNP remained low, around one and one half percent. And this percentage was actually falling from 1946 to the mid 1960s.

It was for this reason that most of the economists of the time took the line: "The national debt? No problem! Our growing economy will take care of it!"

PART II

DAVID SCHOUMACHER: 1960 would be President Eisenhower's last year in office. He had just run the biggest peacetime deficit in U.S. history, a result of the recession of 1958. He promised the American people a budget surplus in 1960, and on that rock the presidential aspirations of Richard Nixon would soon founder. What could possibly be wrong with a budget surplus?

The prosperity that began with the end of World War II continued through the Eisenhower years with only minor interruptions. But 1958 seemed to be a sharp step backwards, the deepest recession since the 1930s. The government pumped money into the economy to stimulate a quick recovery, spending on such projects as the Interstate Highways Program. This spending during a recession was called a counter-cyclical policy, and it worked. By 1959 the economy was improving.

President Eisenhower wanted to leave office with a balanced budget, so he began to push hard for a surplus in 1960. But Vice-President Nixon was running for president that year. He wanted a growing economy, so he argued for a deficit. Many economists agreed with Nixon, but Ike stuck to his guns. His Chairman of the Council of Economic Advisors, Raymond Saulnier, remembers the pressure.

RAYMOND SAULNIER: "You don't have any problem with how much money is going to be spent. You are surrounded by people prepared, at the drop of a hat, to spend untold amounts of money. That's never a problem. What the problem is, to raise the funds to meet that. So, if we were pushing hard in 1960, and my recollection is that we were, we were pushing hard to reach this equivalence of income and outgo."

DAVID SCHOUMACHER: Many of his advisors thought Eisenhower did not have time to oversee a complete recovery from the recession of 1958, that his drive for a budget surplus was premature. They urged him to continue spending to fuel the recovery. 1960

was Ike's last year in office. Perhaps he thought inflation was a more serious threat than unemployment. But, as the economy stalled, the President did not seem worried.

HERBERT STEIN: "1960, he was leaving office, he was not running again. The pains of the recession that we were having in 1960 were not so evident to him as the pains of the 1954 recession had been. They were pretty evident to Mr. Nixon, who was running, and he was very unhappy about the situation."

RAYMOND SAULNIER: "We didn't expect that the next president was going to be John Kennedy. The next president was going to be Richard Nixon. I think that was pretty generally the expectation in the Republican family. It certainly was my expectation. So Eisenhower went out in that message with a strategy that left tax reduction for the next president."

DAVID SCHOUMACHER: Nixon urged Eisenhower to stimulate the economy with an immediate tax cut. Ike declined. By mid-summer the economy had ground to a halt well short of full-employment. The budget surplus was holding money out of the economy and costing workers their jobs. While John Kennedy campaigned on a promise to get the country moving again, Richard Nixon was forced to publicly support a policy he privately opposed. The country hit bottom just two weeks before the election. For Nixon, the damage had been done.

NIXON: "If the present trend continues, Mr. Kennedy, Senator Kennedy, will be the next President of the United States."

DAVID SCHOUMACHER: Kennedy won with a margin so narrow that people still argue over what tipped the balance. But Nixon had no doubt. He blamed the Recession of 1960 for costing him the election. Historians still argue over the significance of the Recession of 1960, but economists at the time were convinced that the budget surplus cost the economy jobs and growth by keeping dollars in the hands of the government rather than consumers. Had Eisenhower been willing to end his presidency with a deficit,

he might have presented his successor with more growth and the prospect of even larger surpluses in the future. We asked economic analyst Richard Gill to explain why economists might be opposed to budget surpluses.

(MUSIC PLAYS—COMMENT & ANALYSIS II)

Economics U\$A Logo

RICHARD GILL: I've already pointed out that the federal interest payments and the national debt itself were falling all through the 1950s as a percentage of our national income. Thus there seemed no urgent reason to try for a budget surplus at this time. More significantly, the predominant Keynesian view of the time said that the government ought to pursue a counter-cyclical policy. This would involve budget deficits in bad times to expand the economy, and budget surpluses in good times to keep things in check.

Suppose the economy is experiencing a business cycle, and GNP is going up and then down. What the government ought to do, most economists in 1960 were saying, is follow this course: Budget deficits during the recessions; budget surpluses during the booms. The idea was that this would lead to a much smoother path, so smooth in fact that many economists began asking the question: "Is the business cycle a thing of the past?"... a question, sadly, which proved to be a bit premature, as, indeed, did our complacency about the national debt.

PART III

BILL CLINTON: "We are on course for budget surpluses for the next twenty-five years."

DAVID SCHOUMACHER: Well, not exactly! President Clinton's 1998 projection could not have been more optimistic. In 2010 the Federal Deficit was 1.3 trillion dollars, and the national debt stood at 14 trillion dollars. That was more than 96 percent of GDP.

Everyone on Capitol Hill agreed that the deficit had to be cut and the budget balanced. But would lawmakers be able to find a bipartisan solution?

DAVID SCHOUMACHER: America has fought four wars --Vietnam, Iraq I and II and Afghanistan – almost entirely without raising taxes to pay for them. In addition, while entitlement programs devour an ever-increasing chunk of the budget, politicians continue to use tax cuts as a great way to get re-elected. So, how have these increases in spending and decreases in taxes been funded? Through borrowing. But borrowing has a cost to it. Interest! In 2011, almost half a trillion dollars. How to fix the deficit and how to balance the budget are complicated questions.

BARACK OBAMA: “There’s no doubt we are going to also have to address the long term quandary of a government that routinely and extravagantly spends more than it takes in.”

DAVID SCHOUMACHER: America’s runaway deficit prompted President Barack Obama to establish a bi-partisan National Commission on Fiscal Responsibility and Reform. There were 18 members, including the Co-Chairs, former Republican Senator Alan Simpson and Democrat Erskine Bowles, Chief of staff in the Clinton Administration. But, in 2010, politicians from both sides of the aisle agreed, it was time for answers, time for solutions, as “The Moment of Truth” had arrived.

ALAN SIMPSON: “It is 67 pages, it’s written in English. It wasn’t written for pedants or panderers or politicians or journalists. It was written for the American people. It uses terms like going broke, shared sacrifice and where we are. If you spend more than you earn you lose your butt, and secondly if for every buck you spend you borrow 40 cents to do it, you’ve got to be stupid and that’s your country right now.”

DAVID SCHOUMACHER: Economist Alice Rivlin also sat on the Commission.

ALICE RIVLIN: “Well, when any group of people sits down and looks at the federal budget going forward over the next ten years, they see, first we can’t go on like this. We are borrowing more and more every year.”

DAVID SCHOUMACHER: Rivlin says we are borrowing more because spending is rising rapidly for the health care entitlement programs--Medicare and Medicaid. To compound the problem, these health care costs will soar even higher as the baby boom generation retires.

ALICE RIVLIN: “When you take more older people, higher health care, and you multiply the two, it means that without changing the law, or changing anything, federal spending is going to grow faster than the economy can possibly grow, and the revenues won’t, so that is the problem.”

DAVID SCHOUMACHER: So we are back to the question, how do we fix the problem? After a year of hard work and compromise, the Simpson-Bowles Commission came up with a daring proposal to cut the deficit by \$4 trillion over the next decade. Daring...because nothing was off limits. It called for \$200 billion from all agencies, including the Pentagon, \$100 billion squeezed out of the tax code, and, most important...It called for reform of the entitlement programs -- both health care spending and Social Security, to ensure long term solvency.

ALAN SIMPSON: “The fun and games is over. The BS is over. The crap... When you hear a politician of either stripe or either sex on their hind legs, they say, ‘We can get this done. Thank god it came up. We’re gonna get rid of waste fraud and abuse, all foreign aid, all ear marks, Nancy Pelosi’s airplane, Air Force One, all Congressional Pensions, and all the rest.’ Great, that will get us about six percent out of the hole we’re in. So then you say to that person, ‘Thank you so much for that drivel you just gave us, now what the hell are you going to do with Medicare, Medicaid, and the solvency of Social

Security?’ Not balancing the budget on the backs of poor old seniors and calling this the cat food commission. To make it solvent and then do something with the defense budget, which is two-thirds of the discretionary budget in the United States.”

DAVID SCHOUMACHER: The Report was supported by eleven of the eighteen members of the Commission, including both Simpson and Bowles, but it did not get the fourteen votes required for passage by the full Commission.

DOUGLAS HOLTZ EAKIN: “I thought it was a remarkable moment. Everyone had very low expectations for the commission. I had perhaps the lowest; I’ll be honest about that, because commissions don’t have a great track record in the United States. Instead, they came out and produced a bipartisan report, substantial support on both sides of the aisle. They said four important things. This problem is big. I certainly agree with that. This problem is spending. You can’t say this is just the military. You can’t just say it’s welfare programs. It is everything the federal government is doing. And number four, if you want more revenue, this system is so broken you need tax reform to get it.”

DAVID SCHOUMACHER: But did the Simpson-Bowles recommendations fall on deaf ears at the highest level? When President Obama announced his fiscal 2012 budget, it reduced the deficit by only \$1 trillion dollars, not four trillion.

BARACK OBAMA: “What we’ve done is taken a scalpel to the discretionary budget rather than a machete. That side of the ledger only accounts for about 12 percent of our budget. So we’ve got a whole bunch of other stuff that we’re going to have to do, including entitlements... Medicare and Medicaid are huge problems... I’m prepared to work with Democrats and Republicans to start dealing with that in a serious way.”

DAVID SCHOUMACHER: Obama’s budget ignored many of the panel’s proposals regarding the entitlement programs, including raising the retirement age for Social Security and charging wealthy seniors more for Medicare. Was Simpson disappointed in Obama’s budget? Did it fly in the face of all his commission proposed? Simpson insists

the president's budget was driven by politics, not policy. He was not surprised the president avoided entitlements.

ALAN SIMPSON: "That is what he had to do. It is too fragile right now. That is why the Republicans, a week later, did the same thing. Played dodge 'em. Reason is because Obama knew that if he came out with the big stuff in this recommendation he would be torn to bits. And then the fun would start."

DAVID SCHOUMACHER: And politics is what makes reducing the deficit so tricky because no one wants to see cuts in the programs that benefit their own lives. Whether it's for AARP or veterans, special interest groups continue to lobby Congress hard to keep their funding intact. Everyone has to sacrifice, but no one wants to.

Given the deep pockets of special interests, and the polarization in Congress, can a compromise on the budget be reached? Economists say yes, because the alternative is not an option. The deficit is staggering and the mission to find a solution is urgent.

ALICE RIVLIN: "This is the moment because we are in dire straights. This is very serious stuff. We might torpedo our economy if we don't get this solved."

DOUGLAS HOLTZ-EAKIN: "The bad news scenario is one where people actually say, oh my God, they are absolutely not changing their trajectory. We know it doesn't add up and you get sharp withdrawal of credit from the United States. The kinds of things we saw in Greece, and Ireland, and what we lived through in 2008. We have it in our capacity to change course...and I think we should. "

DAVID SCHOUMACHER: Faced with a last minute government shutdown, the President and Congressional leaders reached a compromise: 38 Billion Dollars to be cut from the 2011 budget. A figure Simpson & Bowles declared "won't amount to a hill of beans when it comes to controlling the spiraling debt."

DAVID SCHOUMACHER: When Senator Alan Simpson announced the committee's recommendations in the document "The Moment of Truth," he jokingly said that he and Erskine Bowles will "be on the witness-protection list when this is over." But in this case shooting the messenger just wouldn't help. What would be the ramifications if we fail to act? We asked that of Economic Analyst Nariman Behravesh.

MUSIC PLAYS (COMMENT AND ANALYSIS III):

NARIMAN BEHRAVESH: Few countries have survived the steady rise of their government debt levels unscathed. Circumstances may differ, but most countries that have seen the ratio of their government debt to GDP rise over 100% have suffered some kind of crisis of confidence. This usually means that investors flee the country, pushing up interest rates and pushing down the value of the currency. It is hard to say when something like this could happen to the United States, which, after all, does have something of a unique role in the global economy. Nevertheless, even the U.S. can't write IOUs indefinitely.

At some point investors will begin to worry that the American government may have some trouble repaying its debt. These investors will then do one of two things: either sell U.S. government bonds and/or demand higher interest rates to hold those bonds. The resulting higher interest rates could do a lot of economic damage. So, in the end, inaction is not an option when it comes to the large and growing U.S. national debt.

DAVID SCHOUMACHER: Every year we use a good part of our annual budget just to pay the interest on the debt. And still we continue accumulating debt. In 2011 the Treasury Department asked Congress to increase the nation's debt ceiling (that's a cap set by Congress on the amount of debt the federal government can legally borrow...). Increase it, to over 14.3 trillion dollars. And that set off another brouhaha. So, do deficits always hurt us? Not always. But can we continue to live with them? Today the answer is a resounding NO! For this 21st Century edition of Economics USA, I'm David Schoumacher.

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