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How to Recover from the Great Recession and Reduce the Government Debt

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How to Recover from the Great Recession and Reduce the Government Debt

-After Reading selected excerpts of Miller et al's *Real World Macro* and Goodwin et al's *Macroeconomics in Context*

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EC 2050-03: Principles of Macroeconomics
Fall 2013
Dr. Hee Young Shin

Dr. Shin notes that students are required to write an essay after reading a couple of required texts. Hunter's essay shows critical analysis of the required texts and their policy relevance. Appropriate sources are used in context to reinforce the position and argument.

INTRODUCTION

The Great Recession is the worst economic event since the Great Depression. It is a general consensus among the authors of articles relating to fiscal policy in *Real World Macro* (Miller et al 2013: 130-166) that government needs to play an increasing role during these times of recession. Furthermore, they contend that the government is not to blame and that government spending and taxing can be the solution so long as they are not wasteful. Keynesian theory is most prevalent among these authors, stating that government intervention is necessary to recover the United States economy.

In this essay I will discuss the main points introduced by the authors in their articles regarding fiscal policy. This will include the nature of the Great Recession and its immediate effects. I will also look at the longer-lasting effects which are still felt today. Furthermore, I will use the articles' information to propose possible solutions to recovering the economy as well as to reduce the government recession, as I agree with the authors that government needs to embrace an expansionary fiscal policy, and that the government is important in stabilizing the economy.

DEFINING THE GREAT RECESSION

A. How It Happened and Immediate Effects

The Great Recession was caused by a substantial amount of losses from house mortgages given to subprime borrowers who were unable to pay back the loans, causing them to default. This caused fear among investors who didn't want to see their investments fail, so they withdrew their money from the banks (Bernanke 2010: 1). This caused banks to lose their funding and they could not lend as much money out to other borrowers. This was worsened by the fact that American households and businesses had taken out too much credit in loans they could not pay back. This was evident in the housing market where, in many cases, down payments were no longer required. Therefore, the most immediate results of the recession were foreclosures of many homes and repossessions by the banks. One in forty-five Americans had defaulted on their mortgage payments and had received filings for foreclosure (Christie 2010: 1). The banks were then owners of bad debts. Some two million jobs were lost, raising the unemployment rate to 7.2% (Goldman 2009: 1). And since people were without their homes and jobs, tax revenue had also greatly decreased. The economy was facing the worst conditions it had seen in decades.

The Obama administration responded with the Troubled Asset Relief Program, or TARP, and American Recovery and Reinvestment Act (ARRA), which gave relief to the banks who were holding onto these bad debts. It was also used to give support to those who had lost their homes and help those in danger to keep their homes. By doing this the government hoped to stimulate domestic spending (Miller et al 2013: 127). The government had also cut taxes, and these measures together increased the deficit by $700 billion. However, this spending did produce desirable results, as nearly nine million jobs were recovered by TARP and other relief programs, and foreclosures were stalled. The government was able to prevent the recession from transforming into a depression, but there were still many long-term effects which would be felt long after the initial collapse.

B. Long-Term Effects

Currently, the unemployment rate sits at about 7%. Interest rates are very low in an attempt to get people to borrow money and circulate it into the economy. Median family income has decreased, and the poverty level has increased. However, stock prices have increased, and so has the GDP by about 7.5% by the end of 2012 (Danziger 2013: 13). Government expenditures for safety net programs such as SNAP have more than doubled with the Great Recession. Surprisingly, enrollment for secondary education has increased despite falling funding from state governments. This may arise from the fact that the ARRA increased the amounts given through Pell grants.

In sum, the economy is slowly emerging from the Great Recession, although economic conditions are sluggish in improving. People's confidence in the economy has been undermined, and people's marginal propensity to consume has fallen as income for most families has fallen due to the recession. In order to reverse this trend and recover the economy, the government needs to adapt expansionary fiscal policy to stimulate the economy once more.

RECOVERY

A. How to Fix the Great Recession

Recessions are caused by a fall in aggregate demand, which results from a fall in consumption or intended investment. In order to spur aggregate demand, government spending is introduced to increase these factors of aggregate demand (Goodwin et al 2009: 234). Increased government spending works during a recession because some resources are not being fully utilized, as the economy is not working at full-employment capacity. Furthermore, government outlays are being directly injected to the public to increase consumption.

When it comes to the investment side of aggregate demand, Wolfson argues in "The Ideological Attack on Job Creation" for the fact that government investing doesn't displace private investment. Furthermore, he maintains that the government can create jobs and that government spending is not wasteful (Miller et al 2013: 131). In order to repair the recession, the government needs to create jobs through spending. Even though large deficits make private investment less likely to occur, outlays do include long term investments and are not solely for consumption. To concur with Wolfson, investment into long-term assets like education and infrastructure would increase future revenues for the government. This is one solution to the Great Recession, to increase investment into education and infrastructure. This would increase total aggregate demand, as more resources could be employed and any debt incurred would be paid off in the future. To conclude, government spending and investment can be effective so long as they are employed efficiently.

Expansionary fiscal policy is the key to the Great Recession in that the government is re-employing idle resources. Classical economist theory doesn't apply during a recession because it argues that spending is equal to investment. This is the case during full employment, but that is not occurring during a recession. It is said that when the government increases spending that the funding has to come from somewhere," implying that the government has to borrow more or raise taxes. Classicists believe that changing interest rates on loanable funds will change how much is saved and therefore how much is invested, but this is not the case. People tend to save and spend more when they make more income, and the opposite is true as well. Because of this Keynesian thought, there is no automatic stabilizer. This is where the multiplier effect comes in. When government spending increases, the aggregate demand changes differently depending on the nature of the government spending. For example, when government spends on transfers (through SNAP, for example) the multiplier effect [how much additional may be gained by a transfer or investment] is near 1.6-1.8, and even when infrastructure receives investment, the multiplier is still a healthy 1.3-1.4 (Miller et al 2013: 137). Ruess argues that the multiplier is effective because the economy isn't operating on the conditions of full employment. If there were somehow full employment during a recession, then it would be impossible to escape because increased government spending couldn't increase output. Therefore, Keynesian theory proves that increased government involvement is necessary to expand aggregate demand and total output.

Supporting the states' finances is also important in removing the economy from the effects of the Great Recession. In Pollin and Thompson's article in *Real World Macro*, they reveal that 60% of government pension funds were invested in corporate stocks whose prices took a hit during the initial collapse (Miller et al 2013: 142). However, the states can still finance these pensions despite losses through taxes if the state governments introduce a more progressive tax rate and use some of that amount to fund pension plans. The remainder of the increased tax revenue can be spent on, as earlier mentioned, infrastructure and education, as the federal government's contribution to those investments is dwarfed by state and local funding. These investments, as maintained by Pollin and Thompson, are vital. The public workers who would be employed by the states because of these investments cannot be blamed as they are part of the solution. The states' finances need to be reorganized in a way that earns revenue from those who are most able to pay and spends that revenue on projects that will yield the greatest benefit.

To establish a progressive tax rate raises the counterargument that if the wealthy are taxed, that's income they cannot inject into the economy. This can easily be refuted by Freidman's articles. In "Who are the "47%'," he notes that the 47% of people who are not paying taxes include the elderly, disabled, and those with low income (Miller et al 2013: 146). The implication he is reaching is that any tax increase on these Americans would be insignificant in gaining revenue. This implication has merit, because raising taxes on the poor only makes them poorer, which discourages them from finding jobs. (Why find a job if your income tax will be so great?) And the amount of revenue generated by the poor would be insignificant in contributing to the recovery of the Great Recession. Therefore, to heavily tax those who already have so little to be taxed would do little in picking up the speed of recovery.

Finally, in regards to recovery of the Great Recession, it is important to note the structure behind the deficit. To summarize Friedman's point, the deficit is not from increasing spending but rather from decreased revenue (Miller et al 2013: 153). Although spending had increased in order to provide relief to banks, it is also important to see why revenues fell. The crisis caused millions of jobs to be lost, and no income means no tax revenue. To increase spending has the same effect on the deficit as falling revenue has, so it is easy to blame one or the other when discussing the deficit. And during a recession, it would be unwise to cut spending. The current goal should be to exit the recession; the government debt can wait. However, since a balanced budget is required, increasing taxes is required. And to impose them on the wealthy would yield the greatest benefit as the spending is aimed towards those with low income, and to tax those same people would cancel out the benefits introduced by spending.

Fixing the Great Recession is the first priority. Others are demanding that the government budget is balanced, but that would prevent the recovery from gaining any momentum. Miller and Sciacchitano contest the idea that the United States will end up like Greece, which is in economic ruins. The Greek government resorted to borrowing money with a 35% interest rate (Miller et al 2013: 162). The reason for Greece's out-of-control debt is due to the fact that it was almost entirely owned by foreign entities, and these entities saw the risk in Greek investment and called their debts, spiraling Greece into economic trouble. Secondly, the European Central Bank is forcing Greece to maintain a balanced budget, which will ensure that recovery is slow. The country needs to adapt expansionary policy in order to recover from depression, which would mean an imbalanced budget with heavier spending and lighter taxation. To compare to the United States, most of the U.S. debt is held domestically. Therefore, as long as Americans are willing to accept the American dollar (which they will), the government will not face a debt crisis. So it is okay to drive up deficit spending now, during the recession, in order to reach recovery. Increased debt will not push America into a crisis, and upon coming out of the recession, efforts can be directed towards the total government debt.

B. Paying Off the Government Debt

Once the economy emerges from the Great Recession, logically the next goal would to begin paying off debts incurred prior to and during the recession. Fiscal policies to accomplish this goal would not be unlike those employed to recover from the Great Recession; expansionary policy will be utilized. One component of this policy is to cut taxes; however, the tax cuts must affect the *right* people. Friedman illustrates this point by concluding that tax cuts on the wealthy leads to no noticeable difference on aggregate spending

(Miller et al 2013: 150). In comparison to other countries, the Americans pay, proportionally, the least amount of income taxes. The United States needs to increase taxes in order to produce a surplus with which to pay off the debt. As mentioned earlier, taxing the lower income American produces no significant revenue. It would be more beneficial to tax the wealthy because when they aren't taxed, that amount of money is moved into savings which doesn't contribute to the growth of the economy. Some of the wealthiest Americans choose to move their savings offshore to ensure it isn't taxed. Therefore, the government must increase tax revenue by taxing the people who are most able to pay, which would yield the greatest revenue with which to pay off accumulated debt.

Another solution to reduce the government debt would be to reduce the amount of government expenditures on programs like Social Security and Medicare. Although Frank contends that Social Security is almost entirely self-funded, these programs won't last forever. And even though the Social Security fund has mounted a large fund (to the tune of 2.5 trillion dollars), the amount being paid out is exceeding the amount collected through payroll taxes (Miller et al 2013: 158). This would require the budgets of states to divert some funds into the program to make it "self-sufficient." However, these funds would be better spent if funding investment projects like infrastructure. A quick fix to this would be to raise the retirement age, thereby reducing the number of people collecting social security. This would allow more of the state budgets to be spent on more efficient expenditures.

CONCLUSION

The Great Recession's effects were immediate and long-lasting; the unemployment rate and increasing debt are indicators of this economic downturn. However, in order to return to a more prosperous economic condition and eventually reduce the government debt, expansionary fiscal policy is required. This would reduce taxes and increase government spending in order to stimulate aggregate demand. This would be most efficient if an unbalanced budget was allowed and government spending went to projects which would have greater returns on investment in the future, like education. In sum, a few changes in the fiscal policy will be required if the recovery period is to be soon and short.

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