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Let’s Be Honest: We’re in a Depression, Not a Recession, And There’s No End In Sight

Richard A. Posner August 23, 2011 | 12:00 am

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If the notion that we are merely living through the aftereffects of a mere “recession” that ended in 2009 sounds somewhat ridiculous, that’s because it is. If we were being honest with ourselves, we would call this a depression. That would certainly better convey both the severity of our problems, and the fact that those problems have no evident solutions.

The American economy currently has both a short-term problem and a long-term problem. The short-term problem is that the economy is depressed; it is growing more slowly than the population, with the result that per capita income is declining. The high rate of un- and underemployment is a factor, but is itself the product of other factors, having mainly to do with the reluctance of over-indebted consumers (over-indebted in major part because of loss of equity in their houses, the major source of household wealth) to spend, the reluctance of the impaired banking industry to make risky loans, and the reluctance of businesses to invest and to hire, which is due in part to weak consumer spending and in part to profound uncertainty about the nation’s economic future.

The roots of this catastrophic situations lie primarily, I think, in the incompetent economic management of the Bush administration and the Federal Reserve. The persistence of the depression, however, is due in part at least to surprising failures of the Obama administration—poor leadership, poor management, the sponsorship of incomprehensibly complex health care and financial regulation laws that have created widespread uncertainty that has discouraged consumption and investment, and the inability to explain the nature of the economy’s problems to the general public. These failures caused the stimulus enacted in February 2009 to be botched in both in its design and its administration, resulting in the discrediting of deficit spending as a response to depression.

So what can be done now? Probably nothing. Anything that involves spending, such as a new stimulus program, would come too late to be effective. Measures that would not involve spending, such as devaluing the currency (which the Federal Reserve could do by buying a great many bonds, thus flooding the world with dollars), could stimulate our exports and hence production and hence employment and reduce imports (which would further help domestic production), but they are too risky given the interdependence of our economy and the economies of the rest of the world. Europe is staggering and would be hurt by our devaluing, and our banks and other financial institutions are heavily involved in those European economies.

The long-term problem should be easier to solve. The problem is not the federal budget deficit *per se*, huge as it is. The public debt of the United States, which is what the federal government owes to persons who have lent money to the government (mainly purchasers of Treasury securities), and thus excludes debt incurred to finance entitlements and discretionary spending, is currently $9.7 trillion, with 46 percent of it owned by foreign governments and other foreigners. Although $9.7 trillion is big even for the United States, we can roll it over more or less effortlessly and at very low interest rates, at least at present and in the immediate future.

The problem is not the level of the debt but its growth. In the seven years between 2000 and 2007 (the last year before the financial crisis that triggered the current depression), the public debt grew in real (that is, inflation-adjusted) terms by 56 percent, the consequence of reckless spending and tax cuts by the Bush administration. Between 2007 and 2012 (the debt in fiscal 2012, which ends September 30 of next year, is of course an estimated number), a shorter period, the nation's public debt will have grown by another 134 percent. The annual increase from 2009 to 2010 and the (estimated) annual increase from 2010 to 2011 are both 17 percent, and the estimated increase for 2012 is 18 percent. These annual rates of growth vastly exceed the rate of the nation's economic growth even in prosperous times, and if they continue will bankrupt the federal government.

Unfortunately, even when the economy recovers, and tax revenues increase, the federal deficit will continue to rise because of the rapid growth of entitlement expenditures—primarily Medicare and Social Security and, because of the health-reform law, Medicaid. Leaving politics to one side, the increase in Social Security costs can easily be controlled, by a combination of raising the age of eligibility, revising the formula for calculating cost of living adjustments, and means testing—limiting eligibility to persons who do not have substantial other income. Medicare costs are more difficult to control, but not impossible. Medicare too can be means-tested—there is no reason to subsidize the medical costs of affluent people. Copayments and deductibles can be increased to make people think harder about whether they want expensive treatments of marginal efficacy. Medicare can be transformed, as proposed by Congressman Paul Ryan, from a government- administered heath care program to a subsidy program to enable non-affluent persons to buy private health insurance. And medical research can be refocused on finding cures for medical conditions such as blindness and dementia, which require protracted, expensive care because they create severe disability in the elderly without killing quickly.

Efforts to curb increased entitlement spending can be complemented by closing tax loopholes, some of which are as enormous as they are unjustified, notably the deduction for mortgage interest. Half the adult population, moreover, pays no income tax. Everyone with an income should pay income tax equal to a modest percentage of his income.

So the deficit, politics aside, should be manageable. But it's worth pointing out that anything that takes money out of the economy, such as reducing federal spending or increasing federal taxes, will exacerbate the current depression. Consumers will have less money to spend, and this will discourage employers from hiring. So the reforms that I have been discussing should be phased in gradually over a period of years.

But it's not clear that we have enough years. Suppose that the economy recovers by the end of 2012, and in 2013 and subsequent years grows at a 4 percent annual rate. (The long-term growth rate is about 3 percent, but growth is usually more rapid when it starts from a low level.) The public debt won't continue to grow at 17 or 18 percent a year, but suppose it grows at 7 percent a year. Then the already very large federal deficit will continue to grow, and indeed, to compound: At a 7 percent annual growth rate, our public debt in 2012, estimated at $12.4 trillion, will grow by 40 percent in five years if none of the reforms designed to limit that growth are implemented before the end of that period. Yet if they are implemented while the economy is still struggling, the result may actually be to increase the deficit by driving tax revenues down (because incomes will be depressed) despite the elimination of loopholes, and by increasing transfer payments to the unemployed and others hard hit by the economic crisis.

The result is a quandary. I don't see a way out of it. I hope others do.

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