We are now in the final month of a long election season, and in spite of the fact that Nevadans will continue to be bombarded by political advertising, most of us have already made up our minds on which candidates we support. If we are to have any hope of crafting sensible policy solutions after the election, however, it is important for us to separate the wheat from the chaff in this political discussion. We need some sense of history and perspective regarding the current economic situation in order to know how to proceed.

If you haven’t figured it out yet, this was a very unusual recession. Severe depressions were regular events before WWII, but since then our recessions have been comparatively short and shallow, with most declines in economic activity lasting six months to a year, followed by faster growth that recovered lost ground.

But the buildup of mortgage debt prior to 2006 and the collapse of housing prices afterwards played a huge part in the financial crisis which turned this recession into a near-depression, and excessive private leveraging was not limited to housing. Since then, deleveraging by producers, tightened lending by banks, and reduced consumption by households who felt much poorer due to the collapse of their home equity all contributed to several years of dramatically-reduced private spending.

In the face of all this, the federal government’s record fiscal stimulus was not really as big as we think, particularly since state and local governments responded to declining tax revenue by cutting their spending to match. Most people are surprised to learn that the government now spends less on goods and services than when President Obama took office, if we include state and local governments. While some observers mistook federal hiring for the decennial census of 2010 as evidence of rapid growth, federal employment has increased by 12 thousand jobs during his entire term, a rise of only 0.4%, and a pittance compared to the 650 thousand jobs lost in state and local governments.

Pundits talk about how policy uncertainty has depressed private investment spending, but this is misleading. Certainly residential investment in new housing has fallen dramatically since 2006, but the rest of investment has almost recovered back to pre-recession levels, while industrial and commercial lending has now bounced back as well.

The economy could not recover to its former self, and should not be expected to. The pre-recession economy was largely built on rising private debt and excessive construction, while Americans were spending more than we produced by borrowing from abroad. Every dollar we borrowed from the savings of other countries was a dollar they did not spend on our exports. Our export sector did start growing faster after the recession, but this year the Euro-mess and the slowing Chinese economy have slowed that back down.

As private debt declined, government debt rose in response. Paying down debt through increased savings is good in the long run, but in the short run it makes a recession worse. It is not only sovereign public debt that matters.

Economists like to distinguish between structural and cyclical deficits. Tax revenues rise and fall with the business cycle, while some types of government spending rise during recessions automatically. Thus, recessions worsen government budget deficits, even if the government makes no effort to stimulate demand. If we followed a sensible policy, we would have taken advantage of the upper part of the business cycle to pay down our debt before the recession, so we didn’t have to do the wrong thing at the wrong time.

The structural part of the budget deficit is unsustainably high, but candidates and pundits who talk about the deficit sometimes reminds me of Captain Renault in the film Casablanca, as they are shocked – shocked! – to discover we are suddenly running budget deficits under President Obama. Yet we turned surpluses into deficits back in Fiscal Year 2002, and the peak deficit year was FY2009, which began a month before the election. That deficit was projected to be $1.2 trillion before President Obama even took office, although with the stimulus passed in
spring 2009 it rose to a bit over $1.4 trillion. Since President Obama took office, the budget deficit has only come down a little, helped along by more cuts to the payroll tax and federal support for state spending on Medicaid and unemployment benefits.

In a nutshell, the major source of the current structural deficit in the federal budget is the tax cuts we passed in 2001 and 2003, exacerbated by the rising cost of healthcare. Federal income tax receipts averaged 11.2% of personal income during President Clinton's second term, but averaged only 8.9% from 2003 to 2007, before the recession began. The lost revenue almost precisely equaled the average budget deficit under President Bush, even with increased military spending from two wars. By 2009, with the recession, federal taxes were down to 7% of personal income, the lowest share since 1950.

Including Medicare and Medicaid support, federal healthcare spending grew steadily from 3.6% of GDP in 2000 to 5.5% in 2009, due to both an aging population and rising healthcare costs. From 1990 to 2008, the Consumer Price Index grew 2% faster per year for medical care than everything else (that price difference has dropped to 1% since 2009).

The structural issue over Medicare costs is how they will affect future deficits if costs keep growing at this rate. But it is a mistake to focus only on the public sector. The U.S.A. currently spends about 18% of GDP on health care, twice as much as other developed economies. Shifting the cost from public to private without addressing the underlying problem does the public a disservice.

Under current law, the deficit is projected to come down dramatically next year, though few think we will actually go over this fiscal cliff. Most of the stimulus spending has already expired. The income tax cuts and the more recent payroll tax cuts will also expire on January 1, and together these are estimated to bring in over $400 billion more in annual tax revenue. In addition, Congress passed an automatic sequestration last year that will cut $1.2 trillion in spending over the next nine years, including a 9.4% cut to defense (excluding military pay and benefits), and an 8.2% cut to nondefense discretionary programs.

There are only three problems with this fiscal cliff. First, implementing these spending cuts and tax increases might work when the economy is near full employment, but under current conditions they might push the economy back into recession, which could backfire on the deficit. Second, tax increases are politically unpopular, and we should expect to see the government scramble to reduce the number of people affected by it. Third, the sequestration cuts are intentionally arbitrary, and we should expect to see a major effort to change how many of the cuts are made. Still, a gradual implementation of tax increases and spending cuts once the economy is a little stronger would help us get the budget to a more sustainable level.

Debates over the optimal size of government are too often ideological, and we need to take a deep breath. The U.S.A. remains one of the most market-driven economies in the world, and even though governments often become a larger portion of the economy during a recession, our government is still relatively smaller than in most other developed nations. Restoring Clinton-era tax rates does not lead to socialism, and efforts to reduce our healthcare spending are not fascism.

We need some sense of balance regarding the public/private mix. Free and private markets usually work better than government, but not at all times and not in all areas. Government does not always have to be in conflict with the private sector, and sometimes can support and promote market activities. While there are lots of things we can do better, neither candidate, nor the parties they represent, has a monopoly on either bad ideas or good ideas. But until we can get to the point where we can agree on an initial set of facts and quit demonizing those who disagree with our interpretations, we will remain stuck in our respective corners.

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