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Doug Bandow: Congress paves way to fiscal disaster

By Doug Bandow

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Washington

The new budget bill has passed, hiking spending and taxes. Capitol Hill is back to the bipartisan business of mulcting taxpayers.

Unfortunately, Washington can't afford to wait for fiscal reform. As the Congressional Budget Office noted, the debt-GDP ratio "is higher than at any point in U.S. history except a brief period around World War II, and it is twice the percent at the end of 2007."

The agency's most optimistic estimate, the so-called "baseline," is that Uncle Sam will add $6.3 trillion more in red ink over the next decade. Annual deficits are expected to fall through 2015, and then begin moving up again.

However, more realistic is CBO's "alternative" scenario, given how politicians usually behave like politicians. In this case Uncle Sam would run up $8.8 trillion more in red ink.

These estimates presume good economic times ahead and a minimum of new bailouts. Unfortunately, that seems over-optimistic. Fannie Mae and Freddie Mac are paying back their subsidies, but have not established adequate reserves against likely losses. The Federal Housing Administration faces rising losses and bad debts. Even the Postal Service continues to lose money.

Moreover, the entitlement tsunami — Social Security, Medicare, Medicaid and now health-insurance subsidies — will not have fully developed by 2023. As a result, warned CBO, without substantial policy changes, "debt will rise sharply relative to GDP after 2023." Put everything together and economist Laurence Kotlikoff figures that unfunded federal liabilities currently exceed $220 trillion.

There's more. Because federal debt crowds out private investment, CBO estimates that every additional dollar of government debt reduces national saving by 57 cents. As a result, the baseline scenario would see a GDP drop of 4 percent or more by 2038. Under the alternative scenario the reduction would be 7 percent or perhaps more.

Unfortunately, additional negative feedbacks would be many. Said CBO, "Lower output implies less income and, thus, less tax revenues." Higher interest rates would hike federal debt payments.

Uncle Sam would have to raise taxes or borrow ever more. Under the alternative scenario the official (exclusive of Social Security-Treasury transfers) debt to GDP ratio would run around 190 percent by 2038, greater than Greece at its worst. In a paper for the U.S. Monetary Policy Forum earlier this year, economists David Greenlaw, James D. Hamilton, Peter Hooper and Frederick S. Mishkin posited one scenario under which "the debt/GDP ratio would rise much more rapidly, hitting 304 percent of GDP by 2037."

Moreover, explained CBO, "Growing federal debt would increase the probability of a fiscal crisis, when investors would lose confidence in the government's ability to manage the budget, and the government would thereby lose its ability to borrow at affordable rates." Based on international experience, David Greenlaw and his colleagues warned that "countries with high debt loads are vulnerable to an adverse feedback loop in which doubts by lenders lead to higher sovereign interest rates which in turn make the debt problems more severe."

The economists concluded that "countries with debt above 80 percent of GDP and persistent current-account deficits are vulnerable to a rapid fiscal deterioration as a result of these tipping-point dynamics." In that case federal liabilities likely would explode, as they did in the 2008 financial crisis.

The feedback loop would continue to worsen. Noted Greenlaw, et al., "If U.S. government finances are not put on a sustainable path ... then the public might expect the Federal Reserve to be forced to monetize this debt. What would then unhinge inflation expectations would be the fear of fiscal dominance, which could then drive up inflation quickly."

Amazingly, observed David Greenlaw, et al., "As recently as the 1990s, the United States government was running budget surpluses and there was serious discussion of what would happen if the federal government was able to retire its debt." That world is long gone, probably forever.

Still, Washington is celebrating "good news." For the first time in five years, the annual federal deficit has dropped below $1 trillion.

Alas, the cheery interlude will be brief. Soon the red ink again will be growing, and the more government spends and taxes, the worse will be the economic impact. No wonder the CBO warned of "the unsustainable nature of the federal government's current tax and spending policies."

Washington only faces "difficult choices." America's political leaders should be choosing among them instead of passing another dishonest feel-good budget agreement.

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