Congress Fakes Fiscal Responsibility

Budget deal continues to bankrupt America.

By: Doug Bandow – December 19, 2013

There never was any doubt that the Senate would follow the House in voting to hike spending and taxes. The *New York Times* exulted: "A Break in the Inaction: The Bipartisan Budget Deal May Not Be A Washington Cure-all, but It Clears the Air." How grand! A majority of Capitol Hill Republicrats and Demoblicans have gotten back to the business of mulcting taxpayers.

House Budget Committee Chairman Paul Ryan (R-Wisc.) presented the legislation as a deficit-cutting measure. However, his mind apparently was elsewhere: after the negotiations he announced that he is pursuing the chairmanship of the far more important Ways and Means Committee when term limits force the latter's chairman, Dave Camp (R-Mich.) to step down in 2015. Rep. Ryan will need the leadership's support to grab the plumb job. And that requires him to represent GOP leaders rather than common taxpayers in any budget battles.

The most risible aspect of a risible bill is the claim that entitlement spending caps set to take effect a decade hence — after four congressional and two presidential elections — will save tens of billions of dollars. Yet as Congress approved this provision it was abandoning the discretionary spending caps approved just two years ago. Rep. Ryan and his Republican cohorts gave up $62 billion in real outlay increases for fake future cuts. It's the standard Washington game that is constantly replayed.

Unfortunately, Washington can't afford to wait for fiscal reform. Denizens of the city celebrated that in 2013 the federal government's deficit fell to "only" $680 billion. Alas, that was the fifth highest in history. The red ink exceeded $1 trillion each of the last four years. And without genuine budget reform, the annual deficit will be back up to around a trillion dollars by the end of the coming decade. But even these numbers understate Washington's budget problems.

The best case offered by the Congressional Budget Office remains a disaster. Noted CBO: "Between 2009 and 2012, the federal government recorded the largest budget deficits relative to the size of the economy since 1946, causing federal debt to soar." 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 national debt is $17.2 trillion, more than 100 percent of the GDP, which is higher than in Europe — and about $150,000 per taxpayer. CBO's most optimistic estimate, the so-called "baseline," is that the next decade will add just $6.3 trillion more in red ink. Annual deficits are expected to fall to about $378 billion in 2015, a massive sum which seems small only in comparison with recent trillion dollars plus

deficits. Then deficits will begin moving upward again. In 2016 the deficit will run $432 billion, roughly the previous record set in 2008. By 2023 federal ink will run $895 billion, poised to set new records in succeeding years. The official debt-GDP ratio used by CBO, which ignores Social Security-to-Treasury transfers, will have increased by a third.

However, even this scenario is far too optimistic. The agency offered an "alternative" scenario which presumes that presidents and legislators continue to act like politicians, breaking past commitments and avoiding hard decisions. Like, for instance, lifting discretionary spending caps to increase outlays by billions of dollars as part of the latest budget deal. Before that the administration and its congressional allies seized upon the deficit's drop from stratospheric to merely outrageous to proclaim the budget crisis over and propose new spending programs. Even House Speaker John Boehner announced: "We do not have an immediate debt crisis." In this case CBO expects the decade to add $8.8 trillion more in red ink.

These baseline estimates presume good economic times ahead and a minimum of new bail-outs. Unfortunately, that seems over-optimistic. Fannie Mae and Freddie Mac are paying back their subsidies, but analyst Chris Whalen warned that they appear to have established inadequate reserves against likely losses. If so, "payments made to Treasury might need to be reversed," perhaps to the tune of tens of billions of dollars. Moreover, the Federal Housing Administration has taken over from as the fount of cheap mortgages and has been called the "new subprime," with rising losses and bad debts. That agency now is heading toward a bailout. Who knows what federal entity will be next? Even the Postal Service, with a first class mail monopoly, lost $5 billion last year, after running a $16 billion deficit in 2012.

Moreover, the entitlement tsunami will not have fully developed by 2023. Explained CBO: "Under current law, the aging of the population, the rising costs of health care, and the scheduled expansion in federal subsidies for health insurance will substantially boost federal spending on Social Security and the government's major health care programs, relative to GDP, for the next 10 years and for decades thereafter." Without substantial policy changes, "debt will rise sharply relative to GDP after 2023."

Indeed, Medicare and Social Security alone will carry all before them as the Baby Boomers retire. Abundant benefits have been promised with no funding arranged. Total unfunded liability for these two programs alone exceeds $100 trillion. Add Medicaid, federal civil service pensions and health care benefits, and public health insurance subsidies — likely to explode given how Obamacare is both driving up premiums and creating incentives for companies to dump employees into federally subsidized exchanges — and more, and the red ink will climb ever further. Economist Laurence Kotlikoff figured total federal debts, unfunded liabilities, and other obligations to exceed $220 trillion.

But this is just a static analysis that does not take into effect the impact of harmful budget policies on the economy. Warned CBO: "The fiscal policies of the extended baseline tend to worsen the economic outlook" and the budget outlook in turn. Every debt increase threatens the future.

Explained the agency: "Increased borrowing by the federal government generally draws money away from (that is, crowds out) private investment in productive capital because the portion of people's savings used to buy government securities is not available to finance private investment. The result is a

smaller stock of capital and lower output in the long run than would otherwise be the case." Rising interest rates actually increase the incentive to save, but "the rise in private saving is generally a good deal smaller than the increase in federal borrowing, so greater borrowing leaders to less national saving." For every dollar increase in borrowing, CBO figured there is "a net decline of 57 cents in national saving."

The result is to make us all poorer. Explained the agency: Given current estimates, "the ratio of debt to output would rise significantly over the next 25 years, as would marginal tax rates; both of those changes would reduce future GDP relative to what it would otherwise be." Indeed, the agency projected that interest rates would be a half percent higher and "federal debt held by the public would rise" an extra 8 percent by 2038.

Indeed, figured CBO, "the higher debt and higher marginal taxes rates resulting from the policies in the extended baseline would, on balance, reduce real GNP by about 4 percent by 2038." The drop could be as great as 6 percent. Moreover, "the reduction in the capital stock makes workers less productive and decreases pretax wages relative to what they would otherwise be."

In short, borrowing more causes us to owe more and pay more in interest. At the same time, we will be saving, producing, and earning less. It's a prescription for economic and budget disaster.

Still, these big spending policies would have an ironic result. Generally advanced by advocates of income redistribution in the name of the poor, these initiatives would actually enrich the people who currently possess the most capital. Explained CBO: "the productivity of existing capital is greater because more workers make use of each unit or capital — for example, each computer, piece of machinery, or structure — and that greater productivity raises the return on capital. A higher return on capital boosts the return on equity shares in the ownership of capital and boosts the return on other investments (such as interest rates on federal debt) that are competing for people's savings."

So the big spenders actually enrich the wealthy while hurting the economy.

Moreover, this policy would cause additional negative feedbacks. Said CBO, under "the extended baseline, budgetary outcomes would be worse after accounting for the effects of the reduction in economic output and the increase in interest rates. Lower output implies less income and, thus, less tax revenues." Higher interest rates would hike federal debt payments. Indeed, under the optimistic extended baseline scenario, CBO figured interest rates would go to five percent, up from the two percent average over the last 40 years. As a result, "If policymakers wished to maintain the benefits and services that are embodied in current laws and not allow deficits to increase as interest payments grew, then tax revenues would have to increase as well."

This depressing analysis still is too optimistic. It is based on the "mere" $6.3 trillion deficit increase over the next decade. The "extended alternative fiscal scenario," based on an $8.8 trillion hike, would wreak worse economic havoc. Explained CBO: "On balance, the higher debt and lower marginal tax rates would reduce output and raise interest rates relative to what they would be under the extended baseline. Including economic feedback, CBO projects, real GNP would be about 7 percent lower in 2038 under the

extended alternative fiscal scenario than it would be under the extended baseline with economic feedback." The official (exclusive of Social Security-Treasury transfers) debt to GDP ratio would be 190 percent.

Other analyses are even more pessimistic. In a paper for the U.S. Monetary Policy Forum earlier this year, economists David Greenlaw, James D. Hamilton, Peter Hooper, and Frederic S. Mishkin posited one scenario under which "The debt/GDP ratio would rise much more rapidly, hitting 304 % of GDP by 2037."

Of course, things could end up even worse. Noted CBO: "If participants in financial markets came to believe that policymakers intended to allow debt to continue to rise on an ongoing basis relative to the size of the economy, interest rates would probably increase by more than their historical relationship between debt and interest rates would suggest." Greenlaw et al. offered one scenario under which "bond yields would skyrocket, eventually getting above 25%."

Moreover, "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," warned CBO. Greenlaw and his colleagues raised a similar alarm.

Making a broad international analysis, they reported: "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." Exploring the experience of advanced economies caused them to "conclude 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."

On the positive side, a fiscal crisis might force Washington to stop borrowing.

If not, however, federal liabilities would explode, as they did in the 2008 financial crisis. Such an event, noted the economists, "could make it much more difficult for the U.S. to maintain a sustainable budget course." CBO pointed to the inevitable increase in Washington's financial obligations through manifold credit and insurance programs: "Although CBO includes some losses from those credit and insurance programs in its baseline projections, a major disruption in the financial system, a deep slump in the economy, or other unexpected events could result in significantly greater losses relative to CBO's projections."

Again, as in 2008, implicit promises could be as expensive as explicit guarantees. "Moreover, the federal government may have significant implicit liabilities apart from the liabilities created by formal government programs. In the event of a financial crisis, for example, federal policymakers may decide to provide monetary support to the financial system, as they did during the recent financial crisis."

The feedback loop would continue to worsen. Noted Greenlaw & Co.: "If U.S. government finances are not put on a sustainable path, we could see the scenario outlined above, where markets lose confidence in U.S. government debt, so that bond prices fall and interest rates shoot up, and 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."

The ever-expanding deficit would result from excessive outlays, not inadequate revenues. For instance, under the optimistic extended baseline, by 2023 the deficit "would be 6.5 percent of GDP, larger than in any year between 1947 and 2008." But not because Washington is not taxing enough. In fact, revenues would have increased to 19.5 percent of GDP, well above the 17.5 percent average over the last four decades. Rather, "total federal noninterest spending would be larger relative to the size of the economy than it has been, on average, over the past 40 years."

It seems shocking today, but David Greenlaw et al. observed that "As recently as the 1990s, the United State 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. Indeed, despite Europe's Eurozone problems, that continent's long-term budget prospects may be better than America's. Noted Greenlaw and colleagues: despite significant risks, "the Euro area's overall fiscal path looks a good deal more benign than that of the U.S. (with a smaller debt ratio that is on a downward trajectory going forward)."

Good news! For the first time in five years, the annual federal deficit has dropped below $1 trillion. Bad news! Washington officials believe that Uncle Sam's budget problems are over.

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 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 need to start choosing among them instead of passing another dishonest feel-good budget agreement.