



## Digging Down on The 800 Pound Debt Gorilla

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For the first time in living memory, government spending has become a major issue. In the past, Republicans would run against taxes and Democrats against spending cuts, with neither party really running hard against spending. This had the predictable result of lowering taxes, raising spending, and inflating the public debt.

Now, thanks largely to the Tea Party movement, we have an actual honest-to-God public outcry against government spending. This is changing the political play book for both parties. I decided to speak with two think "number crunchers" to ask about whether Congress will change its spending ways. Here's what **Bill Beach**, director of The Heritage Foundation's Center for Data Analysis, and **Tad DeHaven**, budget analyst on federal and state budget issues for the Cato Institute, had to say.

BB: When we talk about the public finance problem today, there's only one problem. It's not next year's deficit, not how much tax money is coming in next year, those are trivial. Unless we solve the debt problem, the IMF will come in and take over our budget. But before that, Standard and Poor's will come in and downgrade our treasuries from Triple A to something else.

The chief problem of our budget is the long-funded, long-term unfunded liabilities and whether or not we can stay away from 90 percent debt to GDP ratio by 2020. Those are the issues Congress should be thinking about all night long, all day long.

We need to have massive cuts in spending now and a new tax code that would raise revenue without slowing the economy. The new tax code should have a progressive element to it, and not tax capital and labor as intensively as this one does. It needs to have a much more democratic tax base. Otherwise, you can't solve these problems.

This deficit centers around on young people. I call them the "debt paying generation". These are young people between the ages of five and thirty and makes up about 115 million people. This is an inter-generational problem.

The tsunami of debt from Social Security, Medicare and Medicaid will push the total debt to 320% of GDP in 2050 and 750% in 2083. If you begin from the current proposition that you are looking at seven and a half trillion dollars of public sector debt, how much will have be borrowed to pay for the immediate past and current services?

And if you look at the trend, and we're using CBO numbers here, we're looking at 15 trillion dollars by 2020. So, if you translate this into how large is the debt as a percentage of GDP — we're looking at a debt to GDP ratio of 90 percent in 2020.

According to some research institutions like Harvard, there's a fairly strong case that as most mature countries get closer and closer to 90 percent, you get closer to a statistical certainty where the economy of the debt burden country will really, really slow down.

You are talking about trillions of dollars that is standing in the way of policy change. A trillion dollars is one-thousand billion dollars. LeBron James made 42 million dollars last year. He's the highest paid sports person around. He would have to work for 23,809 years to make a trillion dollars. These numbers are shockingly big.

TD: I would like to see some folks elected to take on spending primarily in the Republican party. In the Democratic party and I'm not making an ideological statement here, but they want bigger government and they're content to increase taxes to pay for it.

The Republicans like to promote tax cuts but they like to spend as much and that's not going to get us out of this problem either. The problem is with the four trillion dollar federal budget and you have a lot of folks who are getting government goodies. And while Republicans, particularly the leadership, like to make largely vague claims to wanting to reduce government spending, when it comes to the specifics, they curl in the fetal position.

But there are some folks running for office who really understand this course is unsustainable and they are willing to have that discussion with the American people. Its a discussion that needs to be had because unfortunately right now there is a large portion of the electorate that thinks if you do away with waste, fraud and abuse that will solve our problem. That will not solve our problems.

So, I'm hoping again, we get some folks in there that will put some pressure on the Republican leadership to really get serious about not just cutting spending but to address the question, what's the proper role of government and until you do that, you can't do anything serious to fix this problem.

The 800 pound gorilla in terms of spending are the Medicaid and Social Security Programs. I would also add in national defense. According to some estimates, we spend about a trillion dollars a year being the world's global policemen.

I think we need to re-evaluate our role in the world whether can we afford to police the world. So entitlements and defense are in my views the two biggest issues that need to be address if we were to reign in spending and get our deficits and debt under control.

### **LL: When it comes to our ferocious spending, where does China factor in as well as other government debt holders?**

TD: The question that centers around that is when will they demand higher interest rates? Right now, the government has been getting away with low interest rates to finance their debt and the bond holders can certainly put pressure on the government to get things under control by pushing interest rates up.

But obviously if interest rates move higher, that will just increase borrowing costs by the government and it would really compound the situation. Right now, despite its weak economy, the US government is getting away with being a safe haven because the overall global economy is weak. But while the U.S. government is not having much of a problem issuing debt, that could change and that could change very quickly.

BB: There's a public letter that was released on May 14th by the IMF that contained warnings to a number of countries and for the first time in the history of the IMF, there was a warning to the United States.

This was after an April 30th publication by the IMF which laid out in detail what the United States needed to do in the next five years to avoid having its total government debt (that's the sum of federal plus state) exceed 100 percent of GDP by 2015. See, when you add in the state debt you get to a much worse

situation.

And the IMF said the structural deficit has to be reduced each year by 330 billion dollars. Now the structural deficit is the annual shortfall which is on automatic pilot. Programs that continue to spend because they are largely entitlement programs. The IMF has a somewhat consistent track record worldwide in telling countries who are in financial bad shape- reduce your spending and get your revenues in shape.

But the IMF isn't the only voice we hear on the need for the United States to cut spending. According to my contacts, China last summer took all of its long-term treasury positions that were in 20 year notes and completely changed their portfolio to three month notes. Then six or eight months ago we started hearing China say the United States has to change its ways on spending and debt accumulation.

Financial crises always happen quickly and suddenly. They never happen slowly. It will happen when bond holders lose faith that the U.S. Treasury will not perform as promised on these notes and as strange as it may seem, there is now some suspicion that this might be the case. When I hear the World Bank, the IMF, the Chinese National Bank, the Bank of England, saying pretty much the same thing about the U.S. its concerning.

**LL: Social Security is one of the programs mathematically easiest to tackle, but we often hear from officials as one of the ways to fixing the problem is to increase the retirement age.**

**If that continues, people will be working until their 75. Do policy makers have the will to change these entitlement policies?**

BB: The ball is in the court of the policy makers. It's not in the court of the wealth creators and the policy makers have to make a dramatic change in their behavior. They need to come back to Washington and make the first steps to reforming social security. That will keep the bond holders and credit agencies from withdrawing their support.

The burden on these policy makers is fixing Social Security. Job one for them is Social Security. It's not unemployment or to even repeal a program at this point. They have to get the ball rolling on this to send a message to our creditors.

The fact they are not doing it is what has the financial markets so terribly concerned. Its baked in the cake that we are going to get to these unsustainable debt levels if they don't make the moves in the next few months in the next Congress. There is no question as to what the mission is. It is just as clear as waking up in the morning and seeing the sun.

TD: This is my position, not CATO's but I personally would like to see the entitlement programs eventually phased out. You find a cut off age and the age above the cut off gets the benefits as prescribed under law. I will not say entitlement because the Supreme Court has already ruled that there is no entitlement.

Congress can make changes tomorrow morning if they wanted to. And those below a certain age, would be on their own and use their savings the way they want to. If you want to have some sort of safety net I think you need to have a discussion of who should provide it. I think weaning and phasing the systems out are the best way to go. I think it would make for a significantly more prosperous society.

There is a lot of criticism we hear from folks, well you can't just say you want to cut spending, you actually have to come up with the cuts. I couldn't agree more so we created this website ([Downsizinggovernment.org](http://Downsizinggovernment.org)) and are going cabinet by cabinet and coming up with list of cuts and explaining the cuts.

**LL: Do you have an overall number on the amount of cuts your group has made so far?**

TD: Right now I think we're up around 400 billion to 500 billion, and its still a work in progress. We have some of the big players up there now, health and human services, transportation, education and things like that.

**LL: Bill, what is looming out there that has you worried?**

BB: If you had a failure of one or two of our larger states or four or five of our mid-size states, that would cause a run on public sector debt. So I'm worried about the big states of course, California being the biggest one, but I'm worried about the Michigan's, the Ohio's — those states that are teetering on the edge of financial emergencies. They can't go bankrupt, but they can go into financial exigencies and its general obligation debt which are rated by the same agencies that rate treasuries, becomes vulnerable to re-ratings and you can see a run on state debt.

We've had period of time where state debt lead the economy down a bad path nationally. In the nineteenth century, we had several state debt crises — we had a big debt crisis in the twenties and thirties. We had another state debt crisis in the seventies. And every time if it got bad enough, it was felt by everybody in the entire economy.

So given the fact the federal government is teetering, if you have some of the state government's teeter and if you are a foreign bond holder who is not making a whole lot of distinction between the debt of California and the debt of the United States, this could be the trigger that if pulled, creates a financial crisis in this country of historic proportions.

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