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Obama has no Plan B

Budget fantasy won't help us cope with coming fiscal disaster

By Richard W. Rahn

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President [Obama](#) has just presented his new budget, which again ignores reality. It contains another trillion-dollar deficit, which assumes a large increase in revenue resulting from a tax-rate increase on “the wealthy” and corporations. He knows, and so does everyone else, that [Congress](#) is not going to pass the tax increase. Even if it did, the projected revenues would not be forthcoming because the “wealthy” people would change their behavior and find other ways to obtain income, and economic growth would decline, costing tax revenue. Corporate taxes are paid by consumers in higher prices and by workers in lower wages - so much for the promise not to increase taxes on those making less than \$250,000. Every good tax economist knows this, but the president chooses to ignore reality and demagogue the issue.

Even more disturbing is the lack of discussion about a contingency plan if his projected economic scenario does not work out - and the probabilities are that it will not work out. The reality is that the United States and most other governments, particularly the Europeans, have reached or are close to reaching the limits of their ability to tax and borrow. This situation means there is going to have to be either massive cutbacks in government spending or very high inflation.

Everyone knows that if an individual or a business takes on too much debt, the interest payments on the debt eventually will crowd out all other spending unless one radically cuts spending or declares bankruptcy. Governments differ. The ones that print their own money, such as the United States, usually resort to inflation as a way to reduce the real value of government payments and the real value of the debt, leaving bondholders holding the bag. Governments that do not print their own money, such as [Greece](#), California and Illinois, are forced to cut spending radically - whether they want to or not - or default on their debt, unless some other government or international agency chooses to bail them out.

The United States has been able to get away with greater-than-trillion-dollar deficits per year and a big increase in the ratio of gross domestic product to debt because the U.S., even though it's in great fiscal trouble, is not as bad off as many European countries and others, so money still comes into this country. Also, the United States has been able to keep its debt-service interest payments low because the [Federal Reserve](#) has been buying the debt and now is the single biggest holder of the [U.S. government](#) debt. The [Fed](#) injects cash into the economy to pay for the [government](#) bonds it buys, which normally would result in higher inflation rates. But the banks, financial institutions and others have been increasing their cash balances (absorbing the [Fed](#) cash), in part because the [government](#) increased reserve requirements and there are so few low-risk lending opportunities.

However, this game has limits. At some point - next month, in six months or next year - the private economic players will stop hoarding cash and inflation will break out, or there will be a massive cut in government spending to reduce government borrowing.

Think about the following scenario. A war erupts involving Iran, most Iranian oil shipments cease, and shipping in the Persian Gulf is disrupted. As a result, oil prices soar, driving up the cost of almost everything. With the spike in inflation, bondholders refuse to lend at close-to-zero interest rates. The cost of financing government debt then also soars, and the [government](#) is forced either to reduce spending greatly or to print dollars (greatly reducing their value and making everyone poorer).

One can construct many scenarios that would trigger the fiscal crisis. With the high probability of a crisis, a prudent person, business or government would have a contingency plan in place to deal with the disaster when it comes. The Obama administration apparently has no contingency plan, other than wishful thinking. At the moment, almost 40 percent of federal spending is financed with debt. When the crisis comes, new low-cost debt cannot be sold and, because of the hit to the economy, tax revenues will fall. The federal government may then be forced to cut spending in half in real terms (either through explicit budget cuts or through inflation).

Almost two-thirds of government spending (\$2.1 trillion) goes to Social Security, Medicare, Medicaid, food stamps, unemployment insurance and other income transfers. The other third of government spending (\$1.3 trillion) is considered discretionary (in fact, it is all discretionary) and more than half of this is for defense-related items.

Business executives often are faced with having to make drastic cuts in the size of their operations - because of changes in technologies or markets - in order to preserve and rebuild the company. Good executives have contingency plans that include keeping only the most vital parts of the business and getting rid of the stuff that is not contributing to profit. Politicians and government executives often attempt to avoid hard choices - the new [Obama](#) budget being Exhibit 1. A fiscal contingency plan is needed now to avoid additional pain from the coming economic disaster.

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