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Forget The Fiscal Cliff, But Fear The Looming Debt Crisis

By: Doug Bandow – December 3rd, 2012

The liberty of Americans is at risk when Congress is in session. Unfortunately, members have come back for a lame-duck session.

Top of the agenda is dealing with the "fiscal cliff," the impending expiration of tax cuts and imposition of automatic budget cuts. President Barack Obama wants to increase taxes as part of a deficit reduction package.

But the public is understandably skeptical. Half of Americans believe any additional tax revenue would go to new programs, not deficit reduction.

Government spending has continued relentlessly upwards for decades, irrespective of president, party, program, or promise. There's no reason to believe that this time would be different.

Uncle Sam is ever profligate and irresponsible. Washington wastes money with wild abandon. The federal government redistributes wealth to any group with a letterhead and lobbyist. Surely Washington should curb its expensive tastes before it seizes more of people's earnings.

Moreover, the spending crisis is too big to solve by taxing the "rich," whoever they are. Former congressmen Chris Cox and Bill Archer warn: "When the accrued expenses of the government's entitlement programs are counted, it becomes clear that to collect enough tax revenue just to avoid going deeper into debt would require over $8 trillion in tax collections annually. That is the total of the average annual accrued liabilities of just the two largest entitlement programs, plus the annual cash deficit." In contrast, the total adjusted gross income of those earning more than $66,000 a year was $5.1 trillion and net corporate income was $1.6 trillion. Confiscate it all and there still isn't enough to pay the annual increase. And you could only steal the money once, since people wouldn't keep working if government left them with nothing.

Unfortunately, the near-term budget problem pales compared to the longer-term challenge. The national debt is $16.3 trillion, more than the annual GDP. Toss in all current unfunded federal liabilities and the number is $222 trillion, according to economist Laurence Kotlikoff.

Uncle Sam just can't help himself. The only answer is to cut spending.

Republicans talk a lot about fiscal responsibility, but have been no less irresponsible than Democrats. For instance, George W. Bush raised spending in virtually every area. The Medicare drug benefit was the largest expansion of the welfare state in 40 years.

Nick Eberstadt of the American Enterprise Institute recently analyzed entitlement spending and concluded: "the administrations of Richard Nixon, Gerald Ford and George W. Bush presided over especially lavish expansions of the American entitlement state. Irrespective of the reputations and the rhetoric of the Democratic and Republican parties today, the empirical correspondence between Republican presidencies and turbocharged entitlement expenditures should underscore the unsettling truth that both political parties have, on the whole, been working together in an often unspoken consensus to fuel the explosion of entitlement spending."

Still, most Republicans now seem to recognize that something must be done about entitlements. Not so most Democrats and their special interest allies. For instance, Senate Majority Whip Richard Durbin (D-Ill.) said he doesn't want to consider entitlements as part of the "fiscal cliff" negotiations. They are too complex, he claimed. Moreover, Social Security "does not add a penny to our deficit."

Of course, that is nonsense: the program is running a deficit and the "trust fund" is an accounting fiction. The money has been spent. Anyway, if policymakers aren't willing to address Social Security, Medicare, and Medicaid, the three largest domestic programs, why bother doing anything? The so-called fiscal cliff is of little consequence compared to the coming spending tsunami powered by Social Security, Medicare, and Medicaid. Observed outgoing Senate Budget Committee Chairman Kent Conrad (D-ND), "If you're going to solve this problem, you're going to have to deal with where the spending is."

The Congressional Budget Office recently published "An Update to the Budget and Economic Outlook: Fiscal Years 2012 and 2022." The outlook is bleak. For the fourth straight year the annual deficit exceeded one trillion dollars. Accumulated red ink continues to climb: "Federal debt held by the public will reach 73 percent of GDP by the end of this fiscal year—the highest level since 1950 and about twice the 36 percent of GDP that it measured at the end of 2007."

Next year under CBO's most favorable estimate the budget deficit would fall to "only" $640 billion. Over the next decade Uncle Sam would pile up another $2.3 trillion worth of debt. The deficit would start climbing again in 2019—for years.

The near-term deficit slowdown does not reflect increased budget responsibility. CBO pointed out that in 2012 "Spending is projected to equal 22.9 percent of GDP—a drop from last year's 24.1 percent but still well above the annual average of 21 percent of GDP over the past 40 years." That level would dip to 21 percent by 2018 "before rising again to more than 22 percent in 2022."

Moreover, explained CBO: "Most of the projected decline in the deficit occurs because revenues are set to rise considerably in the coming years under current law—from 15.7 percent of GDP in 2012 to 19.6 percent in 2015 and 21.4 percent in 2022." Indeed,

revenues are "estimated to increase by one-third between 2012 and 2014" primarily because of expiration of the Bush tax cuts.

Even if Congress doesn't hike tax rates, "various features of the individual income tax would cause average tax rates to rise over time, increasing revenues as a share of GDP by an estimated 1.7 percentage points over the next decade." For instance, bracket creep would occur as income increases moved people into higher tax brackets. Social Security taxes also are likely to go up.

Unfortunately, there is little reason to believe that projected spending cuts will occur. For instance, Social Security and Medicare expenditures will be rising. So will health insurance subsidies under ObamaCare. The only question is how much.

At least last year's Budget Control Act theoretically targeted so-called discretionary spending. However, this is a relatively small category of federal outlays—governed by annual appropriations rather than statutory eligibility—and Congress capped future expenditures rather than cut specific outlays. A future Congress could undo the change by simply appropriating more money.

Which is likely. The promised cuts presume that "Discretionary spending will fall to 5.6 percent of GDP by 2022—the lowest level in at least 50 years." Even growth at the rate of inflation would mean "discretionary outlays would fall to 6.4 percent of GDP by 2022." Yet discretionary spending has been that low in only "four of the past 50 years." There's no evidence that Congress has grown the budget backbone necessary to enforce such limits.

The problem is not just discretionary spending. There's also the possibility of refusing to enforce Medicare cuts originally approved in 1997—which Congress has done every year since, including in 2010, when it was approving ObamaCare, which mandated other, equally unrealistic, Medicare reductions. CBO also worried about the deficit impact

Under the agency's "alternative fiscal scenario" the near-term budget looks frightening. Warned CBO: "deficits over the 2014-2022 period would be much higher than those projected in CBO's baseline, averaging about five percent of GDP rather than one percent." The 2013 deficit would run another trillion dollars. The added ten year total would be nearly $10 trillion. With higher deficits would come a bigger national debt: "Debt held by the public would climb to 90 percent of GDP by 2022—higher than at any time since shortly after World War II."

Even this estimate is unduly positive. There could be one or more recessions. Oil prices could surge, cutting demand for other goods and services. CBO also warned that a worsening Euro crisis "could lead to further turmoil in international financial markets that could spill over to U.S. financial markets," triggering "a self-reinforcing downward spiral, weakening the growth of households' income and diminishing consumers' and businesses' spending and therefore reducing the need to hire new workers."

Moreover, both higher tax rates and higher deficits would threaten the economy. The former would cut incentives to work and save. As for the latter, explained CBO: "larger budget deficits and growing federal debt would hamper national saving and investment and thus reduce output and income." That is, government spending would crowd out productive private activity; as a result, we would earn less while having to pay more. The

agency projected that real GDP would be 1.7 percent lower under the alternative fiscal scenario.

Overall, warned CBO, "the policies assumed in the alternative fiscal scenario would lead to federal debt that would be unsustainable both from an economic and from a budgetary perspective." Indeed, the financial horror facing America is evident in another recent CBO study, "The 2012 Long-Term Budget Outlook."

Bailouts are continuing with the Postal Service, Federal Housing Administration, Pension Benefit Guaranty Corporation, and more. America's wars are acting as unfunded liabilities, with Americans facing trillions of dollars in future spending to care for injured veterans. The federal government owes several trillion dollars in unfunded pension payments for its own workers.

Worse is the expected explosion of entitlement spending. Explained CBO: "The aging of the baby-boom generation portends a significant and sustained increase in the share of the population receiving benefits from Social Security and Medicare, as well as long-term care services financed by Medicaid." Per capita health care outlays will continue to race ahead faster than expenditures on other goods and services.

Overall, disaster looms. Said CBO: "Without significant changes in government policy, those factors will boost federal outlays relative to GDP well above their average of the past several decades—a conclusion that holds under any plausible assumptions about future trends in demographics, economic conditions, and health care costs."

All federal programs, minus net interest payments, have averaged 18.5 percent of GDP over the last 40 years. But now, warned the agency: "spending on the major health programs and Social Security [will] grow from more than 10 percent of the GDP today to almost 16 percent of GDP 25 years from now." The rest of the government would be in addition.

Over the long-term the differences between baseline and alternative scenarios grows ever larger. The baseline is not good: while CBO foresaw noninterest outlays falling below 20 percent of GDP by 2017, because of increasing entitlements "such spending would reach 23 percent of GDP in 2037." Still, assuming rising revenues and economic growth, the agency presumed a slow decline in debt per GDP ratios, from 73 percent this year to 53 percent in 2037. The latter would remain above the historic average, but not catastrophically so.

In contrast, the alternative threatens a dramatic rise: "the growing imbalance between revenues and spending, combined with spiraling interest payments, would swiftly push debt to higher and higher levels. Debt as a share of GDP would exceed its historical peak of 109 percent by 2026, and it would approach 200 percent in 2037." In contrast, the ratio for Greece peaked at 143 percent.

The longer one waits to act, the bigger the problem will grow. Explained CBO: "if lawmakers wanted to close the fiscal gap through 2037 but did not begin until 2015, they would have to reduce noninterest spending or increase revenues over that period by 5.2 percent of GDP—rather than 4.8 percent, the percentage reduction or increased needed in 2013. If they waited until 2020 to close the fiscal gap through 2037, they would have to cut noninterest outlays or raise revenues over the remaining period by 6.8 percent of GDP." Put another way, a ten-year delay in action would allow the debt-to-GDP ratio to

climb 40 more points, which "would cause real output to be lower by between 21/2 percent and seven percent in the long run."

Moreover, the foregoing estimates don't account for the impact, or "economic damage," as the agency puts it, likely from Uncle Sam's spendthrift policies. Explained CBO, the skyrocketing debt "would reduce national saving, leading to higher interests rates, more borrowing from abroad, and less domestic investment—which in turn would lower the growth of income." With government crowding out private investment "the reduction in the capital stock makes workers less productive and decreases pretax wages," which in turn reduces "people's incentive to work." The agency figured that total GDP would be four percent lower in 2027 and around *13 percent lower* in 2037. Alas, "Beyond 2037, as projected debt relative to GDP grew even more, the estimated negative effects on the nation's output and income would increase."

Higher debt also would inflate interest payments, raising federal outlays even more. Under the baseline scenario net interest payments would hit about three percent of GDP in the 2020s and then drop. Not so under the alternative scenario, when interest costs would steadily rise, hitting almost ten percent of GDP by 2037. At that point they would account for *27 percent of federal outlays*. They would "rise to even higher levels in later years because of ballooning debt."

Interest charges likely would rise even higher because rising government borrowing would tend "to raise interest rates by leading people to allocate a larger portion of their savings to the purchase of government securities, such as Treasury bonds, and thereby 'crowding out' investment in productive capital goods, such as factories and computers." Concluded CBO, "the sustained surge in federal debt that is projected under the extended alternative fiscal scenario would probably increase interest rates more quickly and by a larger amount than is reflected in the estimates in this chapter." Without corresponding spending cuts, the debt would increase even faster and end up even higher as a result.

As if all this wasn't bad enough, "Growing debt also would increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget and the government would thereby lose its ability to borrow at affordable rates." The result could be new bail-outs, higher interest payments, and even more debt. The only hope: the inability to borrow easily might finally force previously unattainable reforms.

Washington's nightmare budget future is driven by excessive spending, not inadequate taxing. Over the last four decades noninterest federal outlays have averaged 18.7 percent of GDP. They now run 22 percent. As costs tied to the financial crisis and recession fall that number will drop to 19 percent or 20 percent (baseline versus alternative scenarios) in 2018. The spending share similarly will jump to 23 percent or 26 percent in 2037. Alas, "In both cases, noninterest outlays would continue to grow steadily in later years."

Toss in interest payments and the numbers are worse, far worse in the case of the alternative scenario. In 2037 "total spending would be 36 percent of GDP," about ten percent higher than under the baseline scenario and 14 percent higher than the average over the last 40 years.

As for taxes, the alternative scenario presumes revenues at their past 40-year-average. The exploding deficit is caused by rising expenditures, not falling taxes. In contrast, the baseline scenario presumes much higher levies, 24 percent of GDP by 2037: "All told, average tax rates (taxes as a share of income) would rise considerably, and people at various places in the income distribution would pay a larger percent of their income in taxes than people in the same places do today. In addition, the effective marginal tax rate on labor income would rise from about 28 percent now to about 36 percent in 2037."

Federal spending must come down. Uncle Sam must live within his means.

Americans can't afford foreign aid—the government is borrowing money to give to other governments. Americans can't afford pork and earmarks—largely political gifts by legislators used to win reelection. Americans can't afford the endless grants, loans, and loan guarantees for every interest group that passes through Washington—homeowners, landlords, big and small businesses, doctors, farmers, students, banks, property developers, activist groups, and just about everyone else.

Americans can't afford the Pentagon—which has turned "defense" into a costly mix of foreign aid and social engineering, subsidizing rich allies and engaging in nation-building. Americans can't afford entitlements—which are middle class welfare rather than social insurance, funded by the young. All of these programs need to be cut. There can be no sacred cows.

Politicians don't need more money. They need to spend less and more wisely. That is the only answer to the "fiscal cliff." And it is the only answer to the longer-term debt crisis.