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Stealing from future to continue borrowing

Risks of raising debt limit without fiscal discipline.

By Jagadeesh Gokhale

The talks on a deal to resolve the federal debt limit problem recently ground to a halt, with neither side budging from its position. The negotiations must now be completed by those in the highest pay grades, including President Obama. But he has pledged not to increase taxes on 95 percent of Americans. That makes the withdrawal by Republican lawmakers from Vice President Biden's group a master stroke: Will the president now follow rank-and-file Democrats by insisting on tax increases? Or will he lead them to a different destination by caving to Republican demands?

The president will need to cut spending or raise taxes to bring the deficit under control. Neither option is painless. But doing nothing risks an even deeper economic depression.

It is not possible to cut government spending significantly - as the Republicans are insisting - without hurting the economy in the short term. As Keynesian economists claim, a reduction in deficit-financed government spending will mean fewer government purchases of goods and services and smaller transfers to those with the largest consumption propensities. And those reductions will diminish aggregate demand, leading immediately to slower employment and output growth.

The alternative, as many liberal analysts point out, is to increase government revenues - by eliminating targeted corporate tax exclusions and requiring high earners to pay more taxes. But tax increases will burden consumers and businesses, reducing their spending and causing a similar reduction in aggregate demand.

The two alternative policies - spending cuts and tax increases - are intended to reduce projected federal deficits and the national debt. So those dollars cannot be used to replace lost aggregate demand. Under each policy, a $1 reduction in the national debt will reduce aggregate demand by $1 - relative to financing debt service through additional borrowing. Thus both policies would yield similar amounts of economic pain.

How did we get here? Consider that the first comprehensive evaluation of the nation's fiscal condition in 1991 showed U.S. total debt at $26 trillion, of which explicit debt held by the public was only about $2.7 trillion. Here, implicit debt is simply prospective shortfalls of government revenues over expenditures. Continuing those economic policies would result in our generation simply taking $26 trillion more of future generations' wealth, by converting implicit debt to explicit debt.

We're now in that future, having added trillions more to the nation's implicit plus explicit debt in the meanwhile.

The simple implication of Keynesian economics is that shifting aggregate demand from tomorrow to today means that employment and output will be higher today but must be commensurately lower tomorrow. Keynes suggested that governments could counter negative business cycle shocks by spending money borrowed from the future to "stimulate" the economy today. But he did not advocate the abandonment of fiscal discipline: Governments could and should repay the stimulus by amassing budget surpluses during good economic times - something we have failed to do.

The consequence of having continually borrowed from the future to buoy output and employment is an eventual economic slowdown and relative poverty manifested by higher debt-service costs and limited policy options - unless we decide to usurp yet more wealth from the future. The debt limit is only at $14.3 trillion today. That means the entire implicit debt accumulated in the past has not yet been converted into explicit debt on the government's books.

Should we simply increase the federal debt limit without requiring changes in the projected trajectory of government spending or revenues? Could the aphorism "tomorrow never comes" apply to Uncle Sam? No, because embellishing the Keynesian perspective is the rationality of market actors and the idea that continued fiscal profligacy eventually leads to the loss of market confidence. As we recently witnessed, multiple Keynesian stimulus efforts have failed to perk up the U.S. economy.

Yogi Berra once observed: "The future isn't as good as it used to be." We must face the consequences of past borrowing from today's economy - including the loss in effectiveness of traditional Keynesian policies to restore the economy to health. Increasing the debt limit without simultaneously guaranteeing fiscal discipline will mean that "we" (the generations alive then) must eventually cut public spending or hike taxes by even more to balance the government's books and - Keynesians would have to admit - risk creating the mother of all economic depressions. Just look at Greece today.

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