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A Path to Fiscal Sanity

Cut the deficit by spending less? Sounds crazy, but it just might work.

By Jagadeesh Gokhale

It has been known since the early 1980s that the U.S. federal budget embodies a large structural imbalance — one that persists through the economy's ups and downs. In 1980, Ted Kennedy referred to this during his campaign for the presidency; Bush I, Clinton, Bush II, and Obama commented on it during theirs.

Estimates of how large this imbalance is, and of what it would take to solve it, have been available for two decades. These analyses consistently show two things: It would be costly to put off dealing with the problem, and federal debt will surge once the baby-boomers begin to retire during the late 2000s.

They are retiring now.

When questioned on entitlement reforms, legislators dutifully genuflect to the need for policy adjustments. But until now, that budget fix was one for the future. Immediately after being elected, lawmakers adopted a "business as usual" attitude, seeking more benefits for today's voters by appropriating vast sums for their pet projects.

And again, in the aftermath of the 2008 financial meltdown, policymakers on both sides of the aisle scrambled to bail out banks, automakers, insurance companies, traders, consumers, and so on, and the Fed injected huge amounts of cash into the financial markets. The cherry on top of this spending binge is the Obama administration's proposed health-care "reform" — which entails additional trillions of dollars.

The recent announcement that U.S. deficits will total $9 trillion over the next ten years suggests that "business as usual" will rapidly come to an end. That's the problem with long-term budget constraints — they inexorably draw closer, eventually forcing hasty and ill-conceived policies via a budget crisis.

What to do?

Estimates from the Social Security and Medicare trustees and the Congressional Budget Office, academic studies, and other reports suggest that the total federal fiscal imbalance amounts to 8 percent of future U.S. productive capacity. Since only about one-half of the nation's total income is subject to taxes, Americans would have to immediately and permanently devote another 16 percent of their taxable incomes toward resolving it.

Is this a feasible solution? Probably not. It's unlikely that Americans are willing to bear the additional tax burden. Also, tax increases tend not to increase government savings; Congress quickly dissipated post–Cold War budget savings through tax cuts and rapid growth in government spending. And higher taxes would significantly erode individuals' incentives to work and save, start and expand businesses, hire workers, and so on.

If tax increases aren't the answer, reduced government spending has to be. Of course, this will impose direct costs on the primary beneficiaries of government transfers and other public programs, which is politically unpopular.

I've heard many a policy analyst around D.C. say that budget reform will become politically feasible only when a cash crisis becomes imminent. For example, the last major reform of Social Security was enacted in 1983, when the program's trust fund was on the brink of exhaustion. But lurching from crisis to crisis is not a desirable or fair way to exercise stewardship over the nation's fiscal affairs.

Others suggest that the economic implications of fiscal adjustments won't necessarily be bad — that excess federal obligations can be simply "inflated away." True, if the federal debt grows too large, the Fed can print money to pay it, and ignite higher inflation in the process. But this is not an effective way to balance the budget as a whole, because large parts of the budget can't be inflated away in this manner: Social Security benefits are indexed against inflation, and federal health-care benefits are provided in-kind. The inflation rate required to compensate for this problem would be huge.

Further, when used this way, inflation is just another tax — instead of taking citizens' money away to pay the government's debt, it makes citizens' money worth less to shrink the value of the government's debt — and it can discourage productive activity just as much as other taxes can.

Just as preventing obesity by avoiding fatty food makes more sense than losing weight after the fact, it would be better for our economic health to proactively slow debt accumulation — preferably by gradually reducing future federal spending commitments — rather than risk the debilitating consequences of sky-high taxes, runaway inflation, or even federal defaults.

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