

Fiscal Shock and Awe in the United States

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EXECUTIVE SUMMARY

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The US federal budget deficit was \$US1.4 trillion (10% of GDP) in the fiscal year that ended on 30 September. Remarkably, 40 cents of every dollar spent by the government had to be borrowed.

There is nothing new about the US budget being in deficit, but the stakes have been raised dramatically in the past year by the impact of the global financial crisis and public policy responses to it. Although this impact will dissipate over the next few years, its fiscal legacy will be an addition to the level of government debt equivalent to 30% of GDP.

Ten-year projections suggest that the deficit will not be eliminated under current policies. To the contrary, it will begin to widen again and federal debt will approach 100% of GDP by 2019. Projections beyond 10 years, although less reliable, point clearly to the deficit and debt rising dramatically under the weight of demographic trends, rising health care costs, and a burgeoning interest bill. Within 25 years, the deficit could reach 15% and debt 180% of GDP.

These trends raise the prospect of government insolvency, capital flight, an exchange rate crisis, and hyperinflation in the world's largest economy. In this sense, current US fiscal policies contain the seeds of the next global financial crisis. The consequences would be so catastrophic that before they occur, US political institutions will be forced to change fiscal policies so as to reduce the deficit. But the nature of the change in policies will be critical to future US economic performance and its place in the world.

The choice that American policymakers face is whether to preserve their country's federal government sector at its relatively small size by winding back the prospective expansion of federal outlays or to lift taxes substantially to finance the growth of government and become more like a European size public sector. Increasing the tax burden to the extent necessary to restore fiscal balance would stifle incentive and innovation and drag down the long-term performance of the US economy. Cutting back on spending would be the most benign route back to fiscal health.

The current administration and Congress are more likely to favour higher taxes than spending restraint. But there will be strong political resistance to new and increased taxes, and future congressional and presidential elections could hinge on this issue. For this reason, some of the fiscal policy adjustment may also be achieved through spending restraint. But however the adjustment is made, history suggests that it will be gradual, sporadic and incomplete. A chronic deficit of some size is likely to remain, although the disaster scenarios are likely to be averted.

It may well be inevitable that the relative economic standing of the United States, and therefore its place in the world, will decline as other less mature economies advance. But the US fiscal problem has the potential to hasten the decline and nudge the global balance of power away from the United States. Much hinges on how the fiscal problem is dealt with.

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Introduction

The United States has just recorded by far its largest federal budget deficit since World War II. Although the deficit will shrink from this extreme level, the outlook is for continuing large deficits and escalating public debt, particularly in the medium to long term. This paper will analyse the post-crisis prospects for the federal budget, likely policy responses, and the implications for the US economy, the global economy, and therefore Australia.

Although there is nothing new about the US federal budget being in deficit, the stakes have been raised dramatically in the past year. The deficit in the fiscal year just ended was \$US1.4 trillion. Government spending and debt have long been measured in the trillions, but this is the first time that the deficit has joined them in the same stratosphere.

The 2009 deficit was 10% of GDP, and 40 cents of every dollar spent by the federal government had to be borrowed. An equivalent Commonwealth budget deficit in Australia would be above \$A120 billion, or twice its projected level.

The US federal debt held by the public jumped to almost \$US8 trillion or about 55% of GDP at 30 September, a level last seen in the 1950s when it was still on its way down from the Everest-like peak of World War II. In the two years of the financial crisis to date, debt has risen by almost 20% of GDP, which is more than it rose in the 20 years of its last major ascent ending in 1993.

In Australia, by comparison, the post-War peak Commonwealth debt was 19% of GDP in 1996 and the projected peak debt resulting from the current series of deficits is 14% of GDP in 2014. To match America's 55% of GDP, the Commonwealth of Australia's net debt would need to be \$A650 billion.

The situation is potentially much worse in both countries because their governments have taken on all sorts of contingent liabilities in the cause of propping up the financial system and, in America's case, the automobile industry. A more complete picture would also take in the growing debts of state governments. But there is enough shock and awe in the basic federal budget deficit without needing to embellish the picture further.

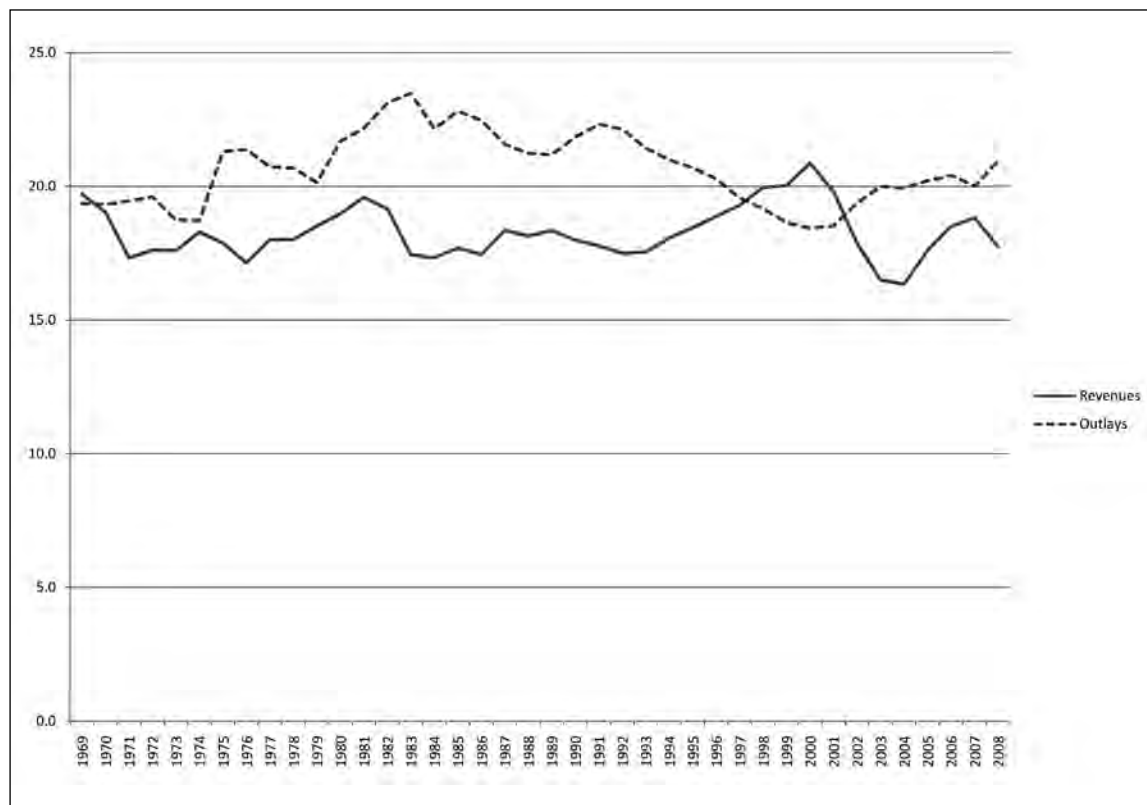
Chronic budget deficits: four decades and counting

Over the four decades since 1969, the outstanding feature of the US federal budget has been the persistence of the deficit. Only four years out of 40 have shown a surplus, and these were all associated with the bubble in the technology and telecoms sector in the late 1990s. The average deficit over 40 years to 2008 was 2.4% of GDP, but even this benefitted from a surplus in the social security fund, which was never going to continue forever. Excluding the social security surplus, the deficit averaged 3% of GDP.

Contrary to popular dogma on both sides of politics, the deficit was not due to rising government spending or falling taxes, both of which fluctuated around their long-term averages (20.7% of GDP for spending and 18.3% of GDP for revenue). The deficit was a carryover from the Vietnam War and the new social programs introduced under Lyndon Johnson's 'Great Society' banner in the 1960s. In subsequent decades, the deficit persisted but fluctuated through recessions, booms, tax cuts, tax increases, and changes in the security climate affecting defence spending.

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Diagram 1: Four decades of US budget spending and revenue



Following the fall of the Berlin Wall and the demise of the Soviet Union, for example, defence spending halved from 6% to 3% of GDP until 9/11 changed the world. Halving the defence expenditure in the 1990s—the so-called ‘peace dividend’—enabled the Clinton administration to achieve surpluses in its last few years. In general, defence spending has been a much more significant component of government spending in the United States than in most democracies, and whether it rises or falls in the future will be an important determinant of future deficits.

Political institutions have rightly been criticised for their failure over many years to correct the structural deficit. The fluctuating pattern of the deficit reveals, however, that the problem was contained one way or another until the financial crisis struck in 2008. George W Bush is blamed for many things, including a lax fiscal policy, but the peak deficit on his watch was in fact lower than under the administrations of George H Bush, Ronald Reagan, and Jimmy Carter. There is a glimmer of hope, therefore, that America’s political institutions do have what it takes to address the budget problem if they are under enough pressure to do so.

One reason that the deficit has persisted for so long is that the political class came to believe that the economy, the financial system, and the world would accommodate it. It always helped that the dollar was (and remains) the major reserve currency, and surplus countries such as oil exporters, Asian tigers, Japan, and China were happy to amass dollar-denominated sovereign debt. Given such conditions, it was a tempting and viable option for politicians to avoid the pain of cutting spending or raising taxes to the extent needed to balance the budget. Perhaps the current crisis and the daunting projections of the US deficit will help shake the political class out of its entrenched complacency.

The budget in the short-, medium- and long-term future

The daunting projections referred to above are most usefully examined in their short-term (two years), medium-term (10 years), and long-term (beyond 10 years) perspectives.

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(a) The short-term (to 2011)

The best news about the fiscal outlook is that much of the explosion in the deficit in fiscal year (FY) 2009 was due to temporary factors—the costs of the financial system and auto industry rescue operations; the discretionary fiscal stimulus packages; and the automatic budgetary effects of the recession (mainly revenue losses). The budget will suffer further from these three sources in FY2010 and FY2011, but the damage will begin to dissipate after FY2009 provided the financial crisis does not take a turn for the worse and the economy begins to recover. The Congressional Budget Office (CBO) projects that under current policies, the deficit will shrink to a still massive 9.6% of GDP in 2010 and 6% in 2011, and debt held by the public will reach 65% of GDP in 2011.¹ The independent projections of the International Monetary Fund (IMF) are qualitatively similar but quantitatively more pessimistic, with the deficit still at 7% of GDP in 2011 and debt held by the public reaching 75% of GDP in that year.²

Even if the CBO's somewhat hopeful base case scenario is realised, and the budget reaches a more even keel after 2011, the legacy of four consecutive years of inflated deficits will be a level of debt more than 50% higher, as a proportion of GDP, than before the crisis, and nominal debt of almost \$US10 trillion. The famous debt clock in Time Square, New York, will struggle to record an additional \$US5 trillion of debt over just four years. Whether 65% or 75% of GDP, the debt burden will be higher than at any time since the early post-World War II years. The difference then was that debt was in steep decline; in the current episode, it is soaring to a new plateau from which there is no prospect of a steep decline.

(b) The medium-term (2012–19)

The CBO has also published projections up to 2019 that indicate medium-term post-crisis trends. According to the baseline projection, the deficit will shrink to 3% of GDP in 2013 and remain close to that level until 2019, with both outlays and revenue inching up as proportions of GDP. This is based on the assumption that the economy will emerge from the crisis at a real growth rate of more than 4% and then ease back to a trend growth rate of about 2.2% towards the end of the decade. In this scenario, the debt/GDP ratio would level out below 70%.

The CBO's baseline, however, assumes current law continues. The CBO also constructs an alternative scenario: '... by incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.'³ In other words, it is a more realistic scenario under which the deficit, after initially narrowing from its current extreme level, would start to rise again and reach over 7% of GDP by 2019. Debt, instead of reaching a plateau, would rise to 87% of GDP on its way towards 100% and more. The projections show that two-thirds of the deterioration relative to the baseline comes from higher spending and only one-third from lower revenue.

The IMF's independent projections are very similar to the CBO's more realistic scenario, with the IMF projecting a level of publicly held debt approaching 100% of GDP in 2019. This will occur because the interest bill keeps expanding and the budget excluding interest (the 'primary' balance) remains in deficit.

The more realistic scenarios show that a business-as-usual attitude from policymakers—complacency and a passive approach of waiting for the current storm to pass—is not consistent with fiscal sustainability. Indications are that policymakers are itching to be active but in the other direction: they are changing policies in ways that will inflate the deficit. The current proposals for health care reform are a case in point, but even before that, the CBO's analysis of the President's proposed 2010 Budget revealed that it would actually add to the deficit by amounts ranging up to 3.5% of GDP in 2019. Again, two-thirds of this increment would come from higher spending.

Far from adding 3.5% of GDP to the deficit, the IMF has estimated that an adjustment of that magnitude in the opposite direction is needed just to stabilise debt at

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its post-crisis level—which is the IMF’s definition of fiscal sustainability. Cutting non-interest outlays by 3.5% of GDP would represent a cut of 16% from their projected 2012 level, while adding that much to revenue would call for a 19% across-the-board hike in taxes and other revenues. The longer the adjustment is postponed the bigger it becomes, because the deficits will cause the interest component of outlays to snowball.

Table 1: Projections of the Budget Deficit (as per cent of GDP)

Fiscal Year	Congressional Budget Office		IMF
	Baseline Scenario	Alternative Scenario	
2007	1.2	1.2	1.2
2009	10	10	14.2
2011	6.1	N/A	7.3
2019	3.4	7.4	8.0
2035	5.6	14.6	N/A
2050	8.3	22.2	N/A
2080	17.8	42.8	N/A

Sources: Congressional Budget Office; International Monetary Fund

(c) The long-term (10 years and beyond)

The CBO’s long-term projections extend all the way to 2080.⁴ While such a long forecasting horizon may appear impossibly ambitious, it points to long-term trends, even if the precise figures must be taken with a grain of salt. The CBO’s projections are of a similar kind to the Australian Treasury’s intergenerational reports, which to date have looked ahead to 2046.

The US projections show that after 2020, the budget gap will be further widened by a combination of demographic trends, rising health care costs, and a burgeoning interest bill. Three social programs will account for all the increase in spending: social security (the contributory public pension scheme); Medicare (free or subsidised health care for the over-65s); and Medicaid (for the very poor). These programs will account for a little over 50% of all federal non-interest spending in 2020, and their share is set to rise further to 60% by 2035 and 65% by 2050.

The growth in these programs and the snowballing interest bill would push the deficit up to 15% of GDP and debt to 180% of GDP 25 years from now. Interest would account for 22 cents of every dollar spent by the federal government. The figures become even more dramatic in later years. To close the deficit in 2035, revenue would have to rise by 75% or non-interest spending would have to shrink by half.

The economic and financial system would snap before any of these scenarios was realised and policymakers would be forced to act, but the projections indicate what needs to be done and that it would be easier to do it sooner rather than later. The so-called ‘entitlement’ programs of social security, Medicare and Medicaid require early surgery, even if it only involves a gradual curtailment of benefits over a long period. The fiscal outlook would also benefit greatly from any action to curb health care costs, although this is a problem that plagues the entire health system, not just Medicare and Medicaid. For example, if the growth in annual health care cost were to slow by just one percentage point, the prospective federal budget deficit in 2040 would be lower by over 4% of GDP.⁵

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Table 2: Projections of debt held by the public (as per cent of GDP)

Fiscal Year	Congressional Budget Office		IMF
	Baseline Scenario	Alternative Scenario	
2007	37	37	37
2009	55	55	58
2011	65	N/A	76
2019	68	87	100
2035	79	181	N/A
2050	128	321	N/A
2080	283	716	N/A

Sources: Congressional Budget Office; International Monetary Fund

Economic implications

So much for the arithmetic, but what does it all mean for the US economy, the global economy, and therefore for Australia?

As explained below, there are major economic and social implications. The size of the US economy and the pivotal, global role of its financial and capital markets ensure that the implications are important not only for the 300 million Americans but also for the world and Australia.

There is a view that the United States can muddle through with a more or less permanent budget deficit. After all, it has done so for the last four decades, despite the alarm bells sounding at times along the way. Japan and Italy are sometimes cited as developed countries that have managed even bigger deficits and much higher public debt burdens. Whether or not such a relaxed attitude to the deficit was justified in the past, there is no justification for complacency now. Japan and Italy are hardly poster children for fiscal laxity. Their economies have survived but not prospered. In the United States, complacency may have been rewarded in the past, but the deficits of today and the projected debt levels are well beyond previous peacetime numbers.

The economic implications have short- and long-term dimensions. In the short term, huge deficits can be funded without much difficulty because private sector (business and housing) investment has slumped and private saving has increased as households seek to reduce their debt burdens. In these circumstances, the public sector faces little competition for loanable funds.

Whether the deficits are stimulating the economy in the short-term is another matter. While much of the deficit in 2009 and 2010 results from automatic fiscal responses to the recession and the fiscal cost of bail-out packages, the Bush and Obama administrations have also indulged heavily in Keynesian discretionary fiscal stimulus policies. These are adding about 5% of GDP to the deficit over 2009 and 2010, making it one of the larger fiscal stimulus efforts in the world.

Debate rages among Keynesian, supply-side, and rational expectations schools about the efficacy of this stimulus. I and others at The Centre for Independent Studies have joined in this debate elsewhere, so I will not go over the same ground here other than to comment that the supply-side and rational expectations schools are on stronger grounds than the Keynesians and that discretionary stimulus is not likely to be effective.⁶ This is particularly the case in the United States, where it is so widely accepted that fiscal policy is on an unsustainable path that fears of future tax increases overshadow any short-term economic boost from fiscal stimulus. The stimulus is doing more to undermine

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confidence than to boost it. If the US economy is showing signs of stabilising and starting to recover, it is because of expansionary monetary policy and actions to rescue the banking system, not because of fiscal stimulus.⁷

While there is vigorous debate about the short-term effects, the arrival of trillion-dollar deficits and frightening projections of the debt burden have concentrated minds more than ever on the medium- and long-term fiscal problem. The Obama administration has scored points at least for being more open about the problem, even though its actions have only made it worse. The medium- and long-term implications can be considered on the basis of what will happen if nothing is done to narrow the deficit, what will happen if it is narrowed, and what will happen under the most likely policy response.

Consequences of a failure to act

The CBO's long-term analysis is remarkably candid for an official document and leaves little doubt that current fiscal policies contain the seeds of the next global financial crisis with its epicentre this time in Washington, D.C., rather than New York. Perhaps this is not surprising if one considers that over-gearing (excessive indebtedness) in the private sector is at the heart of the current crisis, and the problem of excessive indebtedness is in the process of being transferred to the public sector. It is not clear how simply passing the problem between sectors can be a solution to anything. The CBO's analysis contains chilling references to the risks of government insolvency, capital flight, a dollar crisis, and hyperinflation.

Government indebtedness will be on such a scale that the growth of the interest bill itself becomes a major driving force towards larger deficits and debt in a vicious cycle. The CBO's projections show the interest bill becoming the largest single expense item in the budget by 2035—larger even than social security or Medicare, both of which will also expand substantially by then. The projected deficits would drain capital from the private sector, crowd out private investment and, therefore, retard potential economic growth. The safety valve provided by foreign saving, which has worked in the past, will eventually fail as the appetite for US government securities cannot keep up with the supply; this will push up interest rates and push down the exchange value of the dollar.

These trends would have the makings of a financial earthquake, but there is no foretelling how long it would take for the earthquake to happen. History suggests that the responses would not be smooth and orderly but would build up over time and break in a sharp and disruptive fashion just as the financial crisis did in September 2008. In the meantime, the apparent absence of adverse consequences may lull policymakers into a false sense of security.

One possibility is that inflation will be the new safety valve by working as a tax that erodes the real value of the debt. Even assuming, however, that the Federal Reserve's independence and focus on low inflation could be sufficiently compromised to bring about this result, a policy of inflation would hardly provide a workable solution. It might conceivably work to offset a one-off increase in debt, but as a response to a persistent and rising debt it would become fully anticipated by bondholders and degenerate into hyperinflation.

The consequences of a failure to act would be so catastrophic that they won't come to pass. Political institutions will act. So we should focus on the consequences of action to narrow, if not close, the budget gap. These depend on the nature of the action taken—whether to curb spending or raise taxes.

Consequences of action to narrow the deficit

Whenever events cause America's public policymakers to decide that enough is enough and the deficit must be tackled, they will face a fundamental choice critical to the nation's future. America is sometimes portrayed as a land of the rugged individualist, suspicious of government and resistant to its expansion. This is a caricature—even if it was once accurate—but there is still a grain of truth to it, particularly when the United States is compared with Europe.

Although there is a strong case that government is too large even in the United States, among all developed countries it still has one of the smallest government sectors and one of the least centralised. Federal government outlays, as noted above, have averaged just over 20% of GDP. Sub-national governments are larger and more financially independent than in the Australian federation, but even when they are added the total public sector is 32% of GDP, slightly smaller than Australia's and the smallest among OECD countries except Japan and Korea. This also means that the US tax burden is among the lowest of the OECD countries.

The choice policymakers face is whether to preserve America's status as a *relatively* smaller government/lower tax country by winding back the prospective expansion of federal outlays or to lift taxes substantially in order to finance the growth of government and become more like a European size public sector. According to the CBO's long-term projections, federal outlays could grow from their historical average of just over 20% of GDP to 26% in 2020, 34% in 2035, and 42% in 2050. Adding in the state and local sectors, this trend would make the US public sector bigger than most European countries' public sectors are now.

Notwithstanding the recent spectacular failures of its financial system and the demise of its auto industry, historically the United States has always had a more flexible, dynamic, innovative, and entrepreneurial economy than most other mature economies. This has underpinned productivity growth and high living standards for Americans, but it has also been positive for the global economy.

The relatively low US tax burden has been an important ingredient in the American economic success story. Increasing the tax burden to the extent necessary to restore fiscal balance would stifle incentive and innovation and drag down the long-term performance of the US economy. This is why cutting back government spending would be the most benign route back to fiscal health. America's economic prospects would be much brighter if the government could lay out a credible plan to restore fiscal balance through spending restraint and to remove the risk of large tax increases that now hangs over the private sector.

The IMF has estimated that a fiscal adjustment (spending reduction or tax increase) of 3.5% of GDP is needed over the next few years just to stabilise the debt burden at the level it will reach as a result of the current recession and policy actions. The longer the adjustment is delayed, the bigger it becomes. Adding 3.5% of GDP to the tax burden would represent an increase of 20% on prospective tax levels after the effects of the recession have passed. Reducing non-interest outlays by the same amount would represent a reduction of a little over 15%. These are large adjustments, but such a reduction in outlays is attainable if the political will is there. Outlays as a percentage of GDP did fall by that much over the 10 years to 2001, albeit in a favourable economic climate.

What is actually likely to happen?

There is now a strong focus on the risks to fiscal sustainability, but history suggests that action to address the deficit is likely to be gradual, sporadic and incomplete. A chronic deficit of some size is likely to remain, although the disaster scenarios are likely to be averted.

The current administration and Congress are more likely to reach for the tax increase levers than for spending restraint, but they will meet stiff resistance when they realise that the current soak-the-rich approach will not be enough and they will have to soak the majority if they want to lift tax revenue by 20%. Obama has, as promised in his campaign for the presidency, already increased income tax on high earners. Administration officials are hinting at more tax increases ahead. Informed observers are predicting that there will eventually be a federal value added tax (or GST). The United States is one of the few remaining countries without one. Even Alan Greenspan has recently endorsed the idea.

The IMF has identified as revenue raising options higher marginal tax rates for most income groups, base broadening (limiting deductions for household mortgage

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and corporate debt), higher energy taxes, measures to ensure better compliance, and a federal consumption tax. Some of these might be sensible reforms, but some would also undermine incentive. There will certainly be strong political resistance, and future congressional and presidential elections could hinge on this issue.

The likely direction of taxes will take the United States towards the European public finance model. But the political resistance to tax increases ensures there will also be some attention to spending restraint. We can expect the government to screw down defence outlays as much as the global security situation permits. Ambitious new spending proposals, such as that for health care reform, are likely to be stillborn or curbed. Social security and Medicare benefits may be cut for future beneficiaries.

Conclusion

The fiscal deficit and debt problem is one of the biggest public policy issues facing US policymakers, and by its nature is linked to many other public policy issues. It will remain long after the current financial and economic crisis has receded into history. The fiscal problem contains the seeds of another crisis, but one that can be prevented by policy action that is strong and timely enough. The world, and not only the United States, has an interest in avoiding such a crisis. The ways in which the fiscal problem is addressed will have a major bearing on the structure, efficiency and dynamism of the US economy in the decades ahead. It may well be inevitable that the relative economic standing of the United States, and therefore its place in the world, will decline as other less mature economies rise. But the fiscal problem has the potential to hasten the decline and nudge the global balance of power away from the United States.

Endnotes

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