Washington's Crisis of Government

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Something must be wrong if America's fiscal problems can make almost as much news in Australia's mainstream media as our own federal budget. People are talking loosely about a 'debt crisis,' but I argue that there is no debt crisis yet. Rather, there is a crisis of government reflected in a huge budget gap between expenditure and revenue, which if not corrected, will create a debt crisis in the future.

US federal government debt: Past, present and future

The US gross federal debt is approaching $15 trillion, or 100% of gross domestic product (GDP). Excluding debt that the government owes to itself (intragovernmental debt), the figure for 'debt held by the public' is around $10.5 trillion (or 70% of GDP). There are also state government debts and non-debt liabilities and contingent liabilities, which dwarf the debt liabilities, at both the federal and state levels.

Historically, this level of debt was seen post World War II, after which it declined over many years to acceptable levels (Figure 1). Should we expect the same escape from high debt levels this time? I think not, because coming out of a world war and going into a long period of strong economic growth was a much more favourable set of circumstances than what prevails now. Instead of shedding the burdens of a world war, the United States is living with a financial crisis that is going to weigh heavily on its economic growth for years.

Deficits drive debt levels, and the US federal budget is in deficit this year to the tune of $1.5 trillion (or almost 10% of GDP). It has hardly improved from its highest level in the financial crisis. The Congressional Budget Office (CBO) and the International Monetary Fund (IMF) foresee some moderation in deficits over the next several years, even if economic expansion is only modest, but deficits will still be large enough to further increase debt as a percentage of GDP. Debt held by the public could reach 100% of GDP within 10 years.[*]

Beyond 2020, projected debt levels spiral upwards for two reasons: the cost of the public pension and health care schemes will increase rapidly as population ageing intensifies; the public debt interest bill will rise exponentially as ballooning deficits, debt and interest payments feed off one another. The interest bill will eventually become the government's biggest expenditure program.

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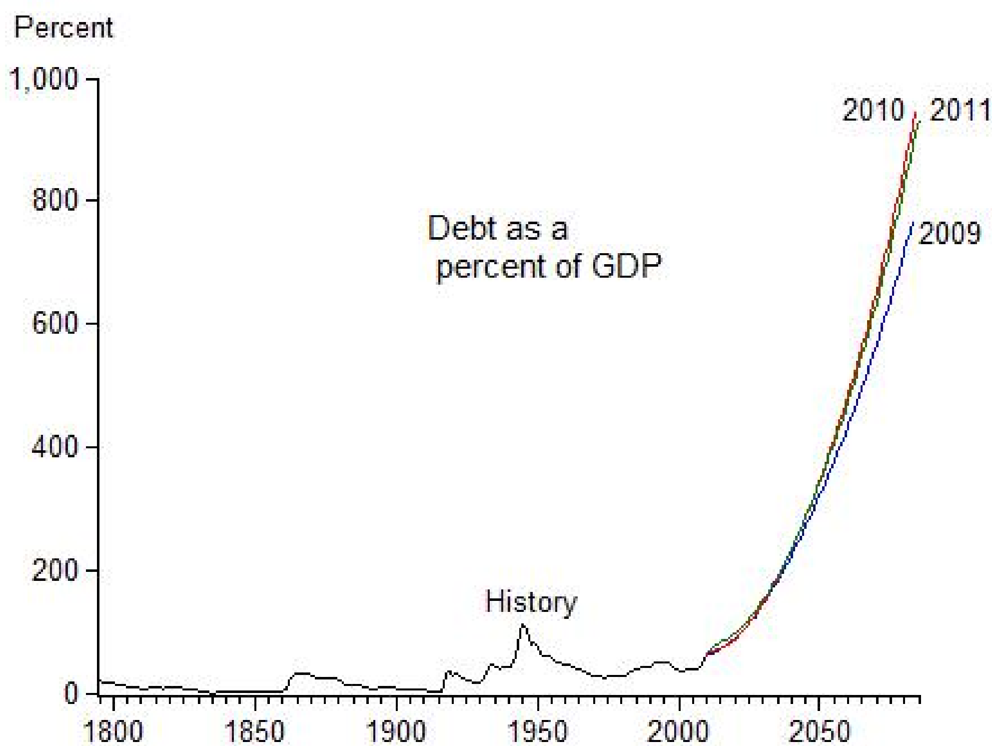
[*] The CBO has a 'baseline' set of projections and an alternative fiscal scenario. Under the baseline projections the debt burden would stabilise over the next few years, while under the alternative scenario it would continue to rise. Here I draw on the projections under the alternative scenario because the assumptions are more realistic.

Underlying these long-term projections is a massive expansion in the size of the federal government from around one-quarter of GDP now (a peacetime record) to one-third by 2035 and over 40% by 2050. Thus, in a quarter of a century, the government/private mix in the US economy would resemble the 50/50 split that now prevails in many European economies, placing great upward pressure on the tax burden.

Figure 1: US federal debt since 1800 (% of GDP)



Source: John Taylor's blog, *Economics One*

How much is too much?

Public debt is often expressed as a percentage of GDP, but this is done to facilitate comparisons over time and between countries. The sustainable level of debt depends on each country's circumstances; nobody can say with precision what percentage of GDP is sustainable for any particular country. There is no identifiable tipping point. There is nothing magical about 100% of GDP. Ultimately, the bond markets decide when enough is enough and they can do so seemingly out of the blue. Crises tend to unfold rapidly and unpredictably, not gradually or in a linear fashion. The United States has more wriggle room by virtue of its reserve currency status, but ultimately that will not be enough to save it.

All we can say at this point is that US public debt has entered a danger zone; if it remains on its current path, a crisis will occur at some time, whether that is next month, next year, or next decade. There is less concern about the current level of debt than about its projected path and the failure of the political process to respond. The more it appears that politicians are failing to grapple with the problem and that the projections will become reality, the more probable a crisis becomes. That is what Standard & Poor's recent credit rating downgrade of US Treasury debt says.

Apart from the increasing risk of a sudden and debilitating crisis, a high and rising debt burden creates headwinds for economic growth by putting upward pressure on interest rates and undermining private sector confidence—the so-called 'crowding out' effects. The painstaking economic history research by Reinhart and Rogoff identifies 90% of GDP as a critical level beyond which public debt slows economic growth by an average of 1% per year, but the critical level will vary from country to country.

Another cost of a high and rising debt burden is that it narrows the government's room for manoeuvre in responding to domestic and international problems such as recessions, financial crises and wars. As interest costs absorb an increasing share of available tax dollars, government does not have much scope to do anything other than pay interest to bond holders. As the CBO says, '… the reduced financial flexibility and increased dependence on foreign investors that would accompany rising debt could weaken the United States' international leadership,' which is surely an understatement.

Size of the deleveraging task

In business language, the US government needs to deleverage. The financial crisis was a consequence of excessive financial leverage. The private sector is already deleveraging. The public sector in the United States was too highly leveraged going into the financial crisis for it to comfortably take on the additional public debt resulting from the crisis. As a result, it has entered the danger zone of indebtedness. The only question is when does it needs to reduce its indebtedness and by how much. Economic growth will help but there is universal agreement that economic growth on any realistic scale will not be enough on its own to cut the debt burden. Action is needed to cut spending and/or raise taxes. Let us call this the fiscal adjustment task.

The size of the adjustment depends on the target level of debt and when the adjustment is made. The CBO calculates that to keep the debt/GDP ratio in 2035 at the same level as it was at the end of 2010 (62% for debt held by the public), an immediate fiscal adjustment of about 5% of GDP would be needed. That is, federal non-interest spending would need to be cut by 5% of GDP or federal taxes increased by 5% of GDP or some combination adding up to 5%. On a 50-year view**,** the immediate adjustment goes up to 6.6% of GDP.

The longer the adjustment is postponed, the bigger it becomes. Under the 2035 horizon, if action is delayed until 2015 the adjustment becomes 6% of GDP, and by 2020 it becomes 8% of GDP.

The IMF has also done these calculations but with the more ambitious target of getting the gross debt/GDP ratio (currently over 90%) back to 60% by 2030. To achieve that, an adjustment of about 7% of GDP is needed, spread up to 2020.[†]

These adjustments are large, but other countries have made fiscal adjustments of this magnitude or larger in modern history. The US deleveraging task is therefore achievable provided there is political will.

Assessing the deleveraging effort so far

The above estimates of the size of the adjustment task were made before the recent budget cuts announced as part of the political compromise to lift the legislated debt ceiling. It is therefore instructive to compare those budget cuts with the adjustment task described above. The answer is that it represents only a small start.

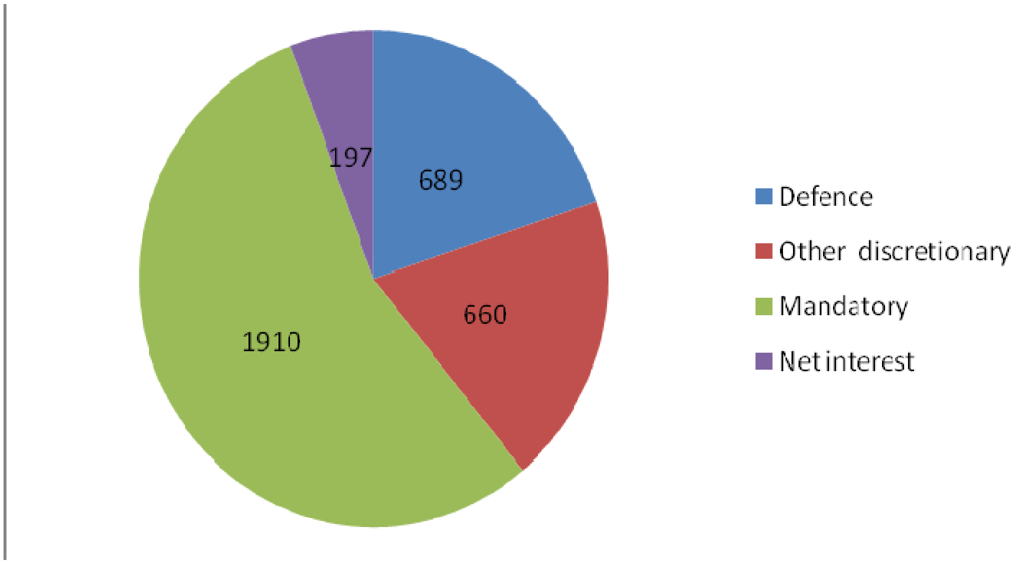
The compromise involves a first instalment of $917 billion in spending cuts and creates a joint committee of Congress to come up with another $1,500 billion by 23 November. If that commission fails, or if it succeeds but the Congress fails to pass the package by 23 December, cuts of $1,200 billion will take effect automatically in 2013. Thus, the total of the first and second round cuts will be either $2,400 billion or $2,100 billion.

The numbers may sound impressive, but there is less to them than meets the eye. For one, they are sums of annual savings over 10 years, and for another, they include interest savings as well as the savings in non-interest spending. In fact, the reduction in non-interest spending in the first year is only $22 billion out of total non-interest spending of $3,400 billion. In the tenth year, the annual savings would increase to $116 billion. These amounts will expand in the second round, but by the tenth year the savings will at best be perhaps $300 billion, which by then would represent a 6% cut on that year's non-interest outlays. This would be 1.3% of GDP. Including interest savings, this becomes 1.7% of GDP. This is a start, but it's not nearly enough.

The other point about the deleveraging effort so far is that it is narrow and leaves untouched the most politically sensitive expenditure savings options as well as tax increases. US budget outlays are classified into discretionary (defence and non-defence), mandatory (dominated by three social programs, Medicare, Medicaid and Social Security), and interest (Figure 2). So far, savings have been concentrated on discretionary outlays, which comprise only 40% of the total. This approach is imposing an unsustainable squeeze on a narrow slice of the budget while leaving the social programs, which are the fastest growing components of the budget, untouched because of their political sensitivity. The social programs account for all of the projected long-term growth in non-interest outlays as a share of GDP. One test of the credibility of budget cuts still to come is that they are more broadly based and include savings in the social programs.

[†] The IMF calculates the required fiscal adjustment for the United States to be 11.3% of GDP, but says that about 4% will already occur under current projections to 2016, leaving a residual of about 7% of GDP.

Figure 2: US Federal Government Spending ($ billion)



Source: US Congressional Budget Office

The deficit can also be cut by raising taxes (either by increasing tax rates or closing loopholes), but to date, this option has been vetoed by the Republicans. They are right to lean against tax increases, but given the magnitude of the deleveraging task, it is difficult to envisage accomplishing it without any tax increases at all.

Consequences of deleveraging for economic recovery

There is a view, widely held among commentators, that public sector austerity programs should not be attempted now because they would tip fragile economies into recession. Some in the US, such as Paul Krugman and Joseph Stiglitz, go even further and argue that there should be another dose of fiscal stimulus. These assertions are hotly contested by the likes of John Taylor, who sees credible deficit cuts as giving a boost to the private sector through positive confidence and expectations effect.

This is a re-run of the arguments about the effectiveness of Keynesian fiscal stimulus that raged a couple of years ago, but this time the argument is about the other side of the coin. Adherents of Keynes believe that fiscal stimulus provided a worthwhile boost to aggregate demand, activity and employment, and that fiscal retrenchment will damage demand, activity and employment, which is the last thing the US economy needs now. The opposing camp—'supply-siders' for want of a better term—do not accept these propositions. They see unsustainable debt levels as creating uncertainty and fear in the private sector that swamps any stimulatory effects of deficit spending.

My own view is closest to the supply-siders. Keynesian fiscal policy prescriptions, if they ever work, do not work in a balance sheet recession and its aftermath, which is where we are now. I accept that fiscal restraint could have short-term dampening effects on the economy, but these are a price that has to be paid for deleveraging, and they will not be fatal to economic expansion. It is difficult to imagine a more powerful antidote to the current reluctance of the US private sector to invest and add to payrolls than a credible plan of action to halt and reverse the growth of public debt over the next few years.

There are those who say the US can have both—more fiscal stimulus in the short term and plans for deleveraging in the longer term. One finds such ideas in the editorials of *The Economist* and the speeches of the new Managing Director of the IMF. In an ideal world of lower debt burdens and fiscal managers with pristine credibility, this combination of jam today and austerity tomorrow might just work, but in the actual world US policy makers have no credibility. Any promise of fiscal stimulus today combined with restraint tomorrow would be dismissed as just another political fix to put off any action to control deficits and debt and would provide no assurances about the future.

Conclusion

There is no public debt crisis in the US at the moment. If there were, the Treasury would not be able to borrow for 10 years at 2%. Investors are flocking to US Treasuries, not fleeing them. There was a manufactured political crisis over the debt ceiling a month ago, which has further damaged policymakers' credibility, but that is something different from an immediate debt crisis.

Although there is no debt crisis, there is a huge budget gap that contains the seeds of a crisis. This can still be averted by strong, credible and timely policy action. The political obstacles to such action are well known, and the question is whether those obstacles will be overcome. One source of hope is that in the space of 12 months, the political consensus has gone from denial to recognition that there is a problem to action to address it, but there needs to be a lot more action.

While there is now a consensus that the deficit is the enemy, the generals are deeply divided about how to fight it. Overlaying the battle of the deficit is a battle of ideologies about the size of government, and therefore about the mix of expenditure cuts and tax increases needed to reduce the deficit. Although the deficit should be priority one, the outcome of this battle of ideologies is not a matter of indifference to Americans or the rest of the world, for it will help determine America's long-term economic future.

Do not expect any 'big bang' solutions to the deficit problem. This will be a war of attrition—a war that can still be won as long as the political system stays the course and keeps taking meaningful steps towards deleveraging over the next few years. To be credible, these steps will need to include action to curb the projected costs of social programs.

The next installment in this saga will come in November and December, and we should expect more brinkmanship in the run-up to critical dates. Something will come out of it, even if it is only the unsatisfactory fall-back option. Then the fight will be taken to next year's election, which may be the most important for a long time in setting America's fundamental direction.

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