ECONOMIC ANALYSIS

Fiscal Crisis, Part 1: The Slow Descent to Second-Class Status

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It is undeniable that we are on the path to fiscal collapse. This decline will occur in two stages. First there is the decay as the swelling national debt wears away the economy's foundations and commits more and more future income to foreign creditors. We are already in stage one.

In stage two a lethal combination of phenomena arises in quick succession: greater default risk, looming inflation, higher interest rates, declining growth, financial market instability, and an acceleration of government borrowing. They feed on each other. The economy heads on a downward spiral. Between stage one and stage two there is a tipping point. Experts know it will come, but nobody wants to predict when. (See the box on p. 502.) This article is about the slow economic decline of stage one. Next week part 2 will describe the hell of a full-blown fiscal collapse.

There is no question economics has failed us. The old paradigms have been made obsolete by the hard reality of the 2007-2009 financial crisis and soaring government debt. But some ideas can be salvaged from the wreckage. And one that will be particularly useful in coming years is the standard supply-side analysis of the impact of government debt on long-term economic growth. When government issues debt, it uses private savings that otherwise could be used for productive new capital and technology. This results in reduced capital formation (both tangible and intangible), which in turn reduces productivity, wages, competitiveness, and economic growth.

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This crowding out of capital by government borrowing is mitigated by two factors. First, an increase in government debt (which is negative public saving) is usually accompanied by an increase in private saving. (One way of thinking about this intuitively is that future retirees recognize that a larger government debt will ultimately result in higher taxes, and they save more in order to pay those taxes.) But most economists agree that the offset from private saving is only partial.

Second, some increases in government borrowing do not rob from the pool of funds for domestic capital formation but come from foreign investors. This effect is now widely recognized. Hardly a news story about the public debt fails to point out that an increasing share of newly issued U.S. debt is purchased by foreigners. Economists believe that perhaps one-quarter or one-half of U.S. government debt is absorbed by external borrowing. This investment from abroad is a mixed bag. It is good because, to the extent it occurs, government debt will not crowd out domestic capital formation. (Think of new factories opening.) But there's a downside: The profits from those investments flow overseas. (The factories are owned by foreigners.) So, in the face of larger deficits, funds from foreigners can keep interest rates low and capital formation strong, but national income available to U.S. citizens declines. In terms of official economic statistics, if foreign lending offsets increases in the national debt, gross *domestic* product (measuring output irrespective of ownership) will remain steady but gross *national* product (measuring income of residents) will decline.

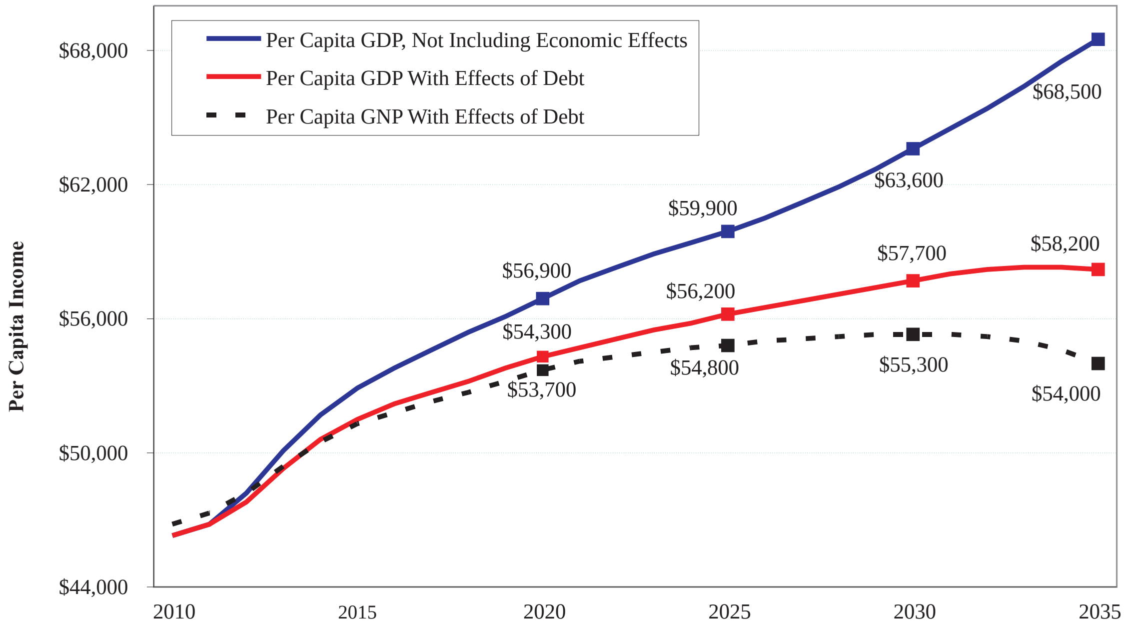
So one way or the other — through reduced domestic capital formation or through reduced ownership of domestic capital — the future well-being of Americans is hobbled by debt.

This crowding-out effect is what people mean when they talk about government debt reducing our standard of living. It is implicit in almost every discussion about the effects of rising government debt.

At least three studies have quantified the impact of government debt on long-term growth:

- In 2003 the Joint Committee on Taxation used a variety of macroeconomic models and found that despite the positive effects of tax cuts on long-term economic growth, the negative effects of deficits were stronger and the net effect of "pro-growth" tax cuts financed with debt was negative (*Doc 2003-11771*, *2003 TNT 91-83*). The $550 billion tax cut studied by the JCT was found to reduce the size of the economy by 0.1 percent. Without the positive-growth

Figure 1. The Effect of Government Debt on the U.S. Standard of Living



Source: CBO, "The Long-Term Budget Outlook," June 2010, *Doc 2010-14510, 2010 TNT 126-19*.

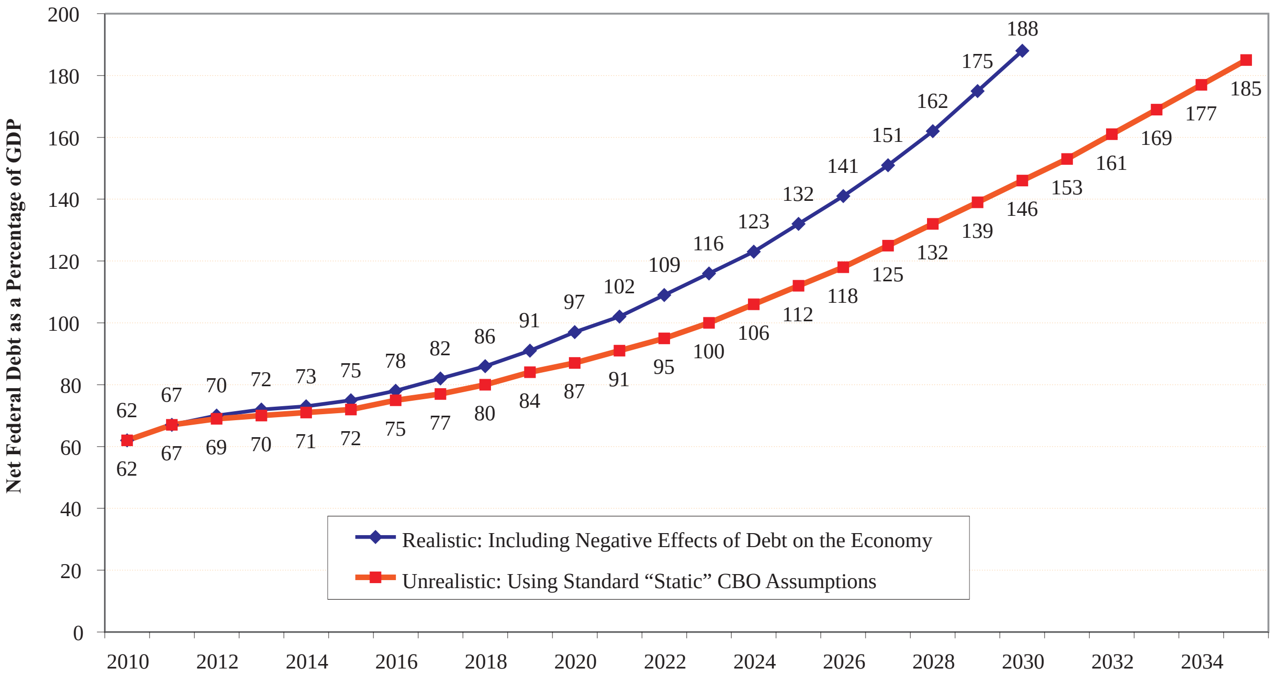
effects of the tax cuts, the negative effects of the deficit on long-term growth would have been larger. An earlier study by William Gale and Samara Potter arrived at similar results and, because the increased debt was partially financed by foreign investors, the decline in GNP was more than twice the GDP decline ("An Economic Evaluation of the Economic Growth and Tax Reconciliation Act of 2001," *National Tax Journal*, March 2002, pp. 133-186).

- In May 2010 economists at the IMF estimated that a 10 percentage point increase in the debt-to-GDP ratio is associated with a 0.15 percentage point slowdown in the annual real GDP growth rate ("Fiscal Monitor: Navigating the Fiscal Challenges Ahead," May 14, 2010). That means that the rise in debt from the recession (estimated by another IMF study to be equal to 27 percent of GDP) has resulted in a decline in the rate of economic growth of 0.4 percentage points (Carlo Cottarelli and Andrea Schaechter, "Long-Term Trends in Public Finances in the G-7 Economies," IMF staff position note, Sept. 1, 2010). Over the next decade, the U.S. debt-to-GDP ratio is projected to grow by a similar amount, so we can expect another 0.4 percentage point decline in the growth rate because of rising government debt.

- In June 2010 the Congressional Budget Office, consistent with its findings from prior years, reported that projected increases in government debt have significant negative effects on the growth of GDP and even larger negative effects on the growth of GNP. This is illustrated in Figure 1. By 2020 growing government debt will reduce per capita GDP by $2,600 and GNP by $3,200. Figure 1 is remarkable because it shows that under current policies, official U.S. government estimates show national income actually declining. Between 2030 and 2035, per capita GDP declines from $55,300 to $54,000.

The negative economic effects of debt — higher interest rates and lower growth — increase the numerator and decrease the denominator of the debt-to-GDP ratio. These effects are illustrated in Figure 2. The bottom line in the chart is what the CBO typically reports. It assumes that rising government debt does not raise interest rates or adversely affect growth. As bad as the bottom line looks, the top line — showing what the CBO actually thinks will happen — is considerably worse. By 2020 the projected debt-to-GDP ratio is 97 percent, taking into account higher interest rates and lower growth instead of the 87 percent in the standard CBO projection. Figure 2 is remarkable because it shows matters are worse than usually advertised.

Figure 2. From Bad to Worse: Adjusting Standard CBO Debt-to-GDP Projection to Include Economic Effects of Higher Debt



Source: CBO, "The Long-Term Budget Outlook," June 2010, *Doc 2010-14510*, *2010 TNT 126-19*.

More Problems Here and Now

Besides these supply-side effects, the rising debt presents other immediate problems. The first is tax uncertainty. Republicans on national television are constantly complaining that the Obama administration is stifling economic growth with uncertainty about what future taxes will be. But think about it for a minute. As long as projected deficits endlessly grow, future taxes will be highly uncertain no matter which party controls Washington. Suppose Republicans take the House in 2010, win a 60-seat Senate majority and the White House in 2012, and extend the Bush tax cuts permanently in 2013. Whatever benefits those tax cuts may have will have a diminished effect because any thinking person knows that future taxes must rise (perhaps by larger amounts than before the tax cut). With the economic and political situation becoming increasingly volatile, taxpayers not only don't know how large future tax increases will be, they don't know what form they will take. This mounting uncertainty is a drag on the economy.

Yet another problem with large deficits is the ability *and willingness* of the U.S. government to address future economic crises. It is abundantly clear that concerns, whether justified or not, about the expanded government debt have made the nation reluctant to enact any significant additional stimulus. This is a stunning development in macroeconomic policy when there is 9.6 percent unemployment and every politician clamoring that joblessness is the nation's number one problem. Debt levels make us reluctant to fight unemployment. Fears about government debt are hurting the economy now.

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Looking into the future, investors will be less willing to invest in the United States if politicians are afraid to vigorously respond to financial panics and major recessions. Fears of less macroeconomic stability in the future dampen business confidence now.

More Research on Current Problems

Besides the standard supply-side analyses cited above, there are new empirical studies suggesting

Uncertainty About the Tipping Point

"How likely is an economic shock from U.S. growing debt and what might it look like? No one knows for sure."

— Peterson-Pew Commission on Budget Reform
"Red Ink Rising — A Call to Action to Stem the Mounting Federal Debt"
December 2009

"No one can estimate with any accuracy the risk of any crisis in the financing of the federal government, nor when any such crisis might occur."

— Committee on the Fiscal Future of the United States
"Choosing the Nation's Fiscal Future"
January 2010

"Neither experience nor economic theory clearly indicates the threshold at which government debt begins to endanger prosperity and economic stability."

— Fed Chair Ben Bernanke
April 27, 2010

"Unfortunately, there is no way to predict with any confidence whether and when such a crisis might occur in the United States; in particular, there is no identifiable tipping point or debt relative to GDP indicating that a crisis is likely or imminent."

— Congressional Budget Office
"Federal Debt and the Risk of a Fiscal Crisis"
July 27, 2010

"No one knows at what point we would hit the tipping point. . . . There [is] nothing close to a consensus about what would kick off a crisis."

— Maya MacGuineas
Committee for a Responsible Federal Budget

the United States is already suffering declines in growth because of heightened debt levels. This research looks at the historical record of government debt levels in both developed and emerging economies. Its central theme is that when government debt exceeds a certain level, it begins to have large effects on economic growth.

The research along this line that has gotten the most attention is that of Carmen Reinhart and Kenneth Rogoff, who have compiled their findings in a book (*This Time Is Different: Eight Centuries of Financial Folly*: Princeton University Press, 2009). Reinhart and Rogoff assert that when gross public debt exceeds 90 percent of GDP, an economy's rate of growth declines considerably — perhaps by as much as 1 percentage point. Separate research by Mehmet Caner, Thomas Grennes, and Fritzi Koehler-Geib says that slower growth kicks in when gross debt exceeds 77 percent of GDP ("Finding the Tipping Point — When Sovereign Debt Turns Bad," revised paper for March 11 World Bank conference on debt management, May 20, 2010). Figure 2 shows U.S. net debt. (Net debt is gross outstanding U.S. government debt less debt held by U.S. entities like the Social Security Trust Fund.) Our gross debt is about 92 percent of GDP, exceeding the threshold for slower growth identified in both studies.

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Welcome to phase one of the U.S. fiscal crisis. It doesn't get its share of coverage in the event-driven media because there is no event. Without blanket media coverage to mobilize public opinion, politicians will not act. Any hope that the president's deficit reduction commission will come to the rescue is false. The extraordinary political polarization guarantees inaction and gridlock for at least the next two years.

Things will go from bad to worse. At some point — the tipping point — this slow descent accelerates, and the economy goes into a tailspin. That's the subject of next week's article. ■