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Tempting the Tipping Point

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Can the U.S. escape a fiscal death spiral?

If governments continue to pile on more and more debt, when will they reach the tipping point? The Greeks appear to be close to the tipping point, and it is only a matter of time before other European countries, and eventually even the United States, begin their fiscal death spiral.

The Greek government's unwillingness to make the hard choices necessary to put its fiscal house in order in the past few weeks has caused investors to demand a 2.5 percent premium on its government-issued Eurobonds over those issued by the German government.

First, a little background. Eurozone governments have a contractual obligation not to incur annual deficits of more than 3 percent, yet the deficit forecast for 2010 for all major Eurozone economies is far in excess of that number. Greece (12.2 percent), Ireland (14.7 percent) and the U.K. (at 12.9 percent) are even in double digits. As can be seen in the accompanying table, the average Eurozone deficit is projected to be 6.9 percent, more than double the agreed-upon limit.

Greece has reached a crisis stage and, as noted, its debt is now selling at a deep discount compared to other EU countries. Ireland has a bigger deficit, but its total net government debt is only 38 percent, as contrasted with Greece's 95 percent. But the Irish, unlike the Greeks, are instituting a credible plan to cut government spending and get their economy back on the growth track.

Country Debt and Deficit Forecasts

Country	2010 Budget Deficit Forecast (as % of GDP)	2010 Government Net Debt Forecast (as % of GDP)
France	8.2	60.7
Germany	5.0	54.7
Greece	12.2	94.6
Ireland	14.7	38.0
Italy	5.3	100.8
U.K.	12.9	59.0

Eurozone	6.9	57.9
U.S.	9.6	65.2
Japan	8.2	104.6

Sources: OECD, European Commission, CBO

The fundamental problem with most of the world's largest economies is that they have allowed government spending to grow faster than economic growth, which can only lead to long-run economic disaster.

Many governments are proposing tax increases, but they cannot tax their way out of this problem because most of their tax rates are already above their long-run revenue-maximizing rate.

Further tax increases will only result in even slower economic growth and an increase in the underground economy, making the fiscal situation worse rather than better. The responsible choice is a radical cut in government spending growth, with the alternative being economic stagnation or worse, likely coupled with a high rate of inflation.

Japan has tried to spend itself into prosperity by issuing more and more debt. Up until now, it has avoided inflation but has suffered a decade of economic stagnation, with a falling share of world gross domestic product, and the situation can only get worse.

The Obama administration and the Congress are in a headlong rush to push the country over the fiscal tipping point. The fiscal tipping point is the point where the interest that premium bond buyers are demanding to compensate them for the risk of default and/or accelerating inflation causes the total interest cost to be so high that the government is borrowing just to pay the interest. This is equivalent to a family being so far in debt that it is borrowing just to pay the interest on its mortgage, credit cards, etc.

The proposed health care plan and the environmental cap-and-trade scheme will add trillions of dollars to the U.S. debt over the next few years and, in all likelihood, soon will drive the total debt burden to well over 100 percent of GDP. Even if the administration were to tax the "rich" at 100 percent of their incomes, there would still not be enough money to pay for all of these spending schemes.

The following should be known to most members of Congress. The size of the U.S. government is already well over the welfare and economic growth-maximizing rate. Taxes on upper-income Americans are well above the revenue-maximizing rate. Thus, for those in the political class to further increase the size of government and government debt as a percentage of GDP is grossly irresponsible. It is almost as if they had a death wish for the country.

Humans are quite good at adapting to climate change. Our species has already lived through hundreds of climate cycles. What they are not good at is adapting to the fiscal and monetary falsehoods of politicians. Yet, the politicians would prefer to fly around the world talking about climate change rather than putting their fiscal house in order.

Bond buyers are not stupid. They can see what is happening. If the administration and Congress do not soon reverse course, the cost of servicing the debt will quickly drive the U.S. to the fiscal tipping point.

Once the tipping point is reached, government will shrink one way or another, because there will be no way to fund the previous bloated state. Who will be most hurt? Those most dependent on government.

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