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Shrinking Government Debt Doomsday

By Richard W. Rahn
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White House not serious on budget

The White House just revised the deficit forecast to $1.65 trillion for this year, up from $1.3 trillion last year. This is a $300 billion increase in the deficit in this year of claimed “economic recovery.” The House Republicans are trying to come up with a proposal to “cut” $100 billion from this year’s budget, and the White House says it is too much. To restate: The White House just increased its estimate of the budget deficit for this year by an amount much larger than the House Republicans are trying to save.

This week, the White House also released its budget proposal for next year. The proposal claims it will reduce the deficit by $1.1 trillion over 10 years. It also says it will reduce the deficit to 3 percent of gross domestic product (GDP) by 2017, but last year administration officials told us their budget would reduce the deficit to 3 percent of GDP by 2015. President Obama‘s deficit reduction commission said the U.S. needed $4 trillion in deficit reductions over the next 10 years, but the president is proposing to reduce the deficit by only $1.1 trillion over the same period. If you feel the administration is not serious and the fiscal situation in the United States is continuing to get worse, you are in touch with reality.

The president is proposing that the government spend more than $3.7 trillion (his budget “cuts” also contain many spending increases). The terms reckless, irresponsible and mad are inadequate descriptions of what he is proposing. There is evidence that once a government lets its debt/GDP ratio rise more than 90 percent, the economy begins to seriously weaken and government spending starts to spiral out of control as the interest payments on the debt grow faster than the economy. The United States will probably hit the 90 percent threshold within a year (the current level is 68 percent, up from 37 percent in 2008).

Up to now, foreigners have been willing to buy U.S. debt, but as inflation heats up (which it is now doing globally), domestic and foreign lenders will insist on higher interest to compensate for the expected inflation. The United States has been able to finance its debt with very low interest rates over the past few years, with the Federal Reserve’s “quantitative easing” programs - that is, they have been buying debt with money they just print. We are probably close to the endgame with this particular racket, which cannot go on forever.

Greece has already shown the world what happens when the debt/GDP ratio reaches critical levels. Government services, employment and transfer payments are drastically cut because there is no other choice and the economy goes into the tank. The rest of the world will be in no position to help the United States. Britain and a number of other European countries will also likely breach the 90 percent threshold this year, while Japan will be at 200 percent. Japan has been able to get away with a higher debt/GDP ratio because almost all of the debt is held by the Japanese and Japanese institutions. But this has led to economic stagnation and now the endgame is upon them (China just replaced Japan as the world's second largest economy). What will the United States do as the Japanese begin to sell their trillion dollars in U.S. government securities to meet their own liabilities?

Mr. Obama has also proposed a number of tax increases in his budget. These tax increases will only slow economic growth, particularly given the high level of debt service that will be required to finance not only the federal debt but also the growing state and local government debts. Economic growth depends on having sufficient saving, which is put into productive investment to create jobs and technologies. If government is grabbing most of the savings of private individuals and businesses through debt issuance, inflation and taxes, the result is economic stagnation and increasing unemployment.

Is there a way out of this bleak scenario? Yes. Real - not phony - reductions in government spending, particularly on transfer payments (commonly known as entitlements). Mr. Obama, most irresponsibly, has not even addressed the entitlement problem in his proposed budget. However, Rep. Paul D. Ryan, Wisconsin Republican and House Budget Committee chairman, has put forward a "road map" to fiscal sanity.Will the Republicans have the courage to take Mr. Ryan's lead? If so, will the Democrat-controlled Senate have the courage to back up the House Republicans? And finally, will Mr. Obama eventually decide to be responsible and accept real budget reform? Too many "buts" for Washington, which is too bad for the rest of us.

Put on your seat belts because the situation will get worse before the political class will act. In the meantime, I suggest you read "Downsizing the Federal Government" (Cato.org) by my Cato colleague Chris Edwards on how to reform and cut government spending, so at least you will be able to speak sensibly with elected officials and be viewed as prescient and wise when the fan is hit.

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