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How the Debt Crisis will End

by Richard W. Rahn

WHEN BORROWING REACHES LIMIT, COLLAPSE AND NEW ECONOMIC ORDER TO RESULT

It became increasingly clear last week how the debt crisis will end - and it is not going to be comfortable. The latest phony solution is for the large, “responsible” countries to demand more fiscal responsibility from the smaller and purportedly “less responsible” countries. In Europe, Germany’s Angela Merkel and France’s Nicolas Sarkozy are demanding that other European states give up some of their sovereignty and agree to strict limits on their deficit spending. President Obama and Treasury Secretary Timothy F. Geithner, as well as British Prime Minister David Cameron, have been lecturing the European Union about being more fiscally responsible. How odd and hypocritical, based on their own behavior.

DEBT CONTROL

Years in compliance with the 3% deficit target, 1999-2011:

	Deficit as Percent of GDP	
Country	Years in compliance	Years not in Compliance
Euro Zone:		
Germany	6	7
France	6	7
Italy	4	9
Non-Euro Zone:		
U.S.	7	6
Britain	5	8
Japan	3	10

Sources: CBO, OECD

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Given normal growth of roughly 3 percent, annual deficits of 3 percent or less tend not to be a problem. Small deficits tend not to increase the ratio of debt to gross domestic product (GDP) and debt service as a percent of GDP. That is why the annual deficit limit under the European Union Maastricht Treaty was set at 3 percent. The accompanying table shows the dismal record of the major countries when it comes to hitting the annual deficit target during the 13 years that the euro has been in existence.

Of the 17 eurozone countries, only Finland and Luxembourg have been in compliance all 13 years. The three biggest eurozone countries, Germany, France and Italy, have been out of compliance more years than they have been in compliance. The three big, democratic, non-eurozone countries, the United States, the United Kingdom and Japan, also have had dismal records in keeping their own deficits under the prudent 3 percent rule.

The simple fact is that most democracies are unable to police their own fiscal behavior, let alone the behavior of other countries. Europe not only is sitting on a fiscal time bomb, which already is starting to explode, but also has a demographic time bomb with a rapidly aging population. Despite the fiscal crisis of the past few years, which is accelerating, most of Europe has done next to nothing to cut back entitlements to a manageable level, which is equally true of the United States. Looking at the actions of the European leaders, rather than listening to their words, it is obvious that they increasingly are using the European Central Bank to buy the sovereign debt of their members after repeatedly saying they would not.

People buy government bonds because they think the government will use its coercive taxing powers to take real assets from the citizens to pay the bondholders. But, as with everything else, there is a limit. Many knowledgeable observers already have recognized that Greece is tapped out in terms of the ability of the government to obtain more tax revenue. The Greeks simply will not pay. They will quit work or go into the shadow economy.

As economist Art Laffer explained very well decades ago, there is a limit to how much government can tax income and expect to receive more revenue. There also are limits to how much a government can tax property. It can raise the rate but may destroy the value of the property in doing so - thus no more revenue. The government can raise taxes on businesses until they no longer exist (at least legally). The government can raise the tax rate on consumption - a value-added tax or sales taxes, but at some point, goods and services move to the untaxed, shadow economy.

The politicians have promised more benefits to the people than can be financed, even if the state had unlimited coercive tax power, which it doesn’t. The point has been reached in some countries where the taxing power is beginning to collapse, and with it, the whole house of cards. When governments can no longer sell their bonds (at least at rates that do not merely speed up fiscal ruin) the game is over.

What we are likely to see is an ever-increasing rate of inflation coupled with more and more bankruptcies among both government and private entities. A government-entity bankruptcy occurs when the bills that must be paid each month are not covered by tax revenues and fees, regardless of whether or not the courts recognize the bankruptcy. The continuing fiscal chaos will take its toll in slower or negative economic growth. The real value of debt will be eroded at an accelerating rate. Hence, few will lend at any rate, forcing an even greater rate of economic contraction.

The existing political class will be thrown out - peacefully or violently. Governments will then start over and explicitly disavow all of the previous promises for entitlements. New monies will be created by both private parties and governments, and things will begin anew without the yoke of unpayable debt. The transition will be dreadful. But with luck, the new political orders and economies that will emerge can get mankind back on a rapid economic and individual-liberty growth track.

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