Washington Times Op-Ed: Catastrophic Budget Failure

Leonard E. Burman

Abstract

The latest CBO budget outlook predicts a bleak scenario if we don't change our current policies. In a Washington Times op-ed, Len Burman explains why even this gloom-and-doom outlook is "wildly over-optimistic."

Document date: July 14, 2009
Released online: July 14, 2009

Catastrophic Budget Failure

Washington Times, July 14, 2009

By Len Burman

Last month, the Congressional Budget Office (CBO) published the latest version of what has become a very scary document called "The Long-Term Budget Outlook." CBO Director Doug Elmendorf is scheduled to walk the Senate Budget Committee through it on Thursday.

CBO, famous for understatement, concludes that "current policies are unsustainable." This is true whether it looks at the Obama administration's official budget or a future in which all of the Bush tax cuts expire and the middle class gets swallowed by the alternative minimum tax. What CBO means is, either way, we are doomed.

Here's what CBO predicts will happen if we continue current policies:

Next year, our debt will exceed 60 percent of our total economic output, or gross domestic product (GDP). We would not meet the standards Poland and Estonia needed to qualify for admission into the European Union.

In 2023, our debt will exceed 100 percent of GDP — the highest level since World War II ended.

By 2076, debt will be more than 6.5 times GDP. Put differently, with current policies, there's no chance that children born today will get much of their promised Social Security and Medicare benefits.

The really bad news? This bleak scenario is wildly over-optimistic. It assumes that the economy keeps growing at historical rates, and interest rates on government bonds stay low.

But neither is likely to happen. As CBO says, parenthetically, "Starting in the 2060s, projected deficits become so large and unsustainable that CBO's textbook growth model cannot calculate their effects."

Translation: We're heading over a cliff!

CBO's projections assume that interest rates will stay low. But with these massive deficits, rates will eventually rise to reflect the growing riskiness of government bonds. Berkeley economist David Romer has shown that investors may, overnight, go from being willing to lend to the government at low rates to being afraid to hold T-bills at any price. If this happens, the rise in rates could be extreme — not just a percentage point or two.

Can't happen? It was just a few months ago when exactly the same fate befell highly rated corporate bonds. Suppose the Treasury held an auction and nobody came?

Ideally, this dismal situation will be averted. Investors should look at the CBO report and demand higher interest rates right now, and progressively steeper rates in the future if our fiscal house is not put in order. This would put pressure on policymakers to cut deficits.

Unfortunately, there are two problems with this self-correcting scenario. First, it might choke off a nascent recovery. Second, it assumes financial markets are rational and foresighted. Yeah, right. And remember much of our debt is held by foreigners whose cash fuels our purchases of their oil and consumer goods. They'll keep lending — at least for a while — to prop up their own economies.

When the bubble bursts, two things could happen, both bad. One is that the U.S. defaults on its bonds. This would cripple financial institutions that are legally required to hold government securities and create a foreign policy fiasco since other governments hold so much of our debt.

Or, we could print money to pay back the bonds coming due. This creates inflation - a lot of inflation. Think

Weimar Republic or Argentina. (CBO helpfully points out that hyperinflation is economically inefficient since it drives people to barter.)

At the same time, the government would have no choice but to slash spending and raise taxes. This, plus very high interest rates, would drive the U.S. and world economies into a depression that could span decades — dwarfing today's painful downturn.

Taxes would rise to levels that would make a Scandinavian revolt. And the government would not be able to provide anything but the most basic public services. We would no longer be a great power (or even a mediocre one), and the social safety net would evaporate.

We can still avoid this disaster, but we need to act quickly. The sooner we move to reduce our deficits, the smaller the required tax increases and/or spending cuts will be. The reason is straightforward: The less debt we accumulate, the smaller our interest payments. On our current trajectory, CBO projects that by 2031, interest on the debt will cost more than Social Security. And, again, that assumes implausibly low interest rates.

So, after Mr. Elmendorf finishes explaining why our current policies are disastrous, I'd like all of the Senate Budget Committee members to say what they plan to do about it. If they answer "cut wasteful government spending" or "tax people making over $250,000," Mr. Elmendorf should remind them that we'd have to cut government spending or increase taxes by an average of 8.2 percent of GDP over the next 75 years to prevent the debt from increasing — and more if we continue to defer action. That sum equals all discretionary spending, including national defense, or all income tax collections in 2008. Cutting waste or taxing rich people alone isn't enough.

It's time to make some hard choices. Or we're doomed.

Len Burman is an Urban Institute senior fellow and co-director of the Urban-Brookings Tax Policy Center.

Other Publications by the Authors

- Leonard E. Burman