

Sunday Forum: The Debt Bomb

Rudolph G. Penner

Abstract

The current financial crisis poses a severe threat to the economy, but it also creates a tremendous opportunity, writes Rudolph Penner in the Pittsburgh Post-Gazette. It gives politicians cover for undertaking painful actions to get the long-run deficit under control—actions that should have been taken long ago.

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Even before the mother of all bailouts, we were living well beyond our means, says the Urban Institute's Rudolph Penner.

The financial market bailout is going to be very, very ugly. That's for certain. Treasury Secretary Henry Paulson says he didn't want to propose it, but he had to. Whether or not the bailout was really necessary will be debated for years.

The catalyst for our financial woes was the fall in housing prices. The problems were multiplied by careless lending and financial engineering that was too clever by half. No one understands the full implications of the complex securities and derivatives that were invented, but they spell much trouble.

While the White House, Congress, the Federal Reserve and others try to stabilize markets, other indirect sources of the economic onslaught should not be ignored. Our households are profligate. Our government is profligate. The result is a national saving rate that is so low that it cannot finance the investment necessary for satisfactory improvements in our standard of living.

Luckily, foreigners have stepped in and invested their savings in the American economy. As a result, we have continued to grow at a steady pace interrupted only by an occasional recession.

But our heavy dependence on foreign investment has limited our freedom of choice. Would we have bailed out Fannie Mae had we not been pressured by its Chinese investors? Would we now be engaged in this extraordinary bailout were it not for the threat of foreign investors leaving our shores and tanking our economy? Maybe, but foreign pressures have been extremely important in shaping recent events.

Unfortunately, our dependence on foreign savers is sure to grow. The federal government is headed for many years of huge deficits, even before the extravagant promises of our presidential candidates are taken into account. Those deficits will have to be financed and domestic savers do not seem up to the task.

The underlying and ongoing deficit dilemma is due to three programs—Social Security, Medicare and Medicaid. They now constitute almost one-half of federal spending minus interest payments, and they are growing faster than tax revenues and the economy because of soaring health costs and the aging of the population. In all, roughly half of federal spending outside of defense and interest goes to people 65 and over, and the baby boomers have only started to retire.

So far, our national entanglement with entitlements has been largely ignored by Sens. John McCain and Barack Obama, except for some brief allusions. Even before the need for a massive bailout of the financial industry was declared—a bailout whose costs could completely paralyze government—it was likely that looming budget deficits would severely limit a new president's ability to fulfill his promises, whether they involved expanding health-insurance coverage, extending and adding to the Bush tax cuts or anything else.

If we continue to implement what are considered to be "routine" policies, such as protecting taxpayers from the growing reach of the alternative minimum tax and extending "temporary" tax breaks that have been renewed many times before, it is easy to foresee the government debt held by the public growing by considerably more than 25 percent over just the next two years. Even though the bailout's portion of the national debt will be backed by private securities, it is not clear that foreigners will be eager to buy so many bonds.

The current financial crisis poses a severe threat to the economy, but it also creates a tremendous opportunity. It gives politicians cover for undertaking painful actions to get the long-run deficit under control—actions that should have been taken long ago.

The word "painful" should not be overemphasized, however. Our fiscal problems do not stem from paying for Social Security benefits as they exist today or for current health costs. They come from having promised ever-increasing benefits and from providing a blank check for whatever new medical technology comes along, no matter how expensive or ineffective.

In other democracies, politicians have used economic and fiscal crises as excuses for implementing long-needed reforms in Social Security. The most dramatic case occurred in Sweden in the early 1990s. After seeing their gross domestic product drop and their budget deficit soar, the Swedes implemented a far-reaching and ingenious Social Security reform that has now been emulated in other countries and could be a good model for the United States. Among other features, the Swedish system automatically slows benefit growth if it encounters financial difficulties and provides for individual accounts in approved mutual funds.

How might we make much-needed progress here? As a first step, the new president will have to announce soon after the election that fiscal conditions are much worse than he anticipated and that we cannot afford all that he promised. President Clinton did that in 1993.

Options worth considering include a bipartisan budget commission that would submit proposals to Congress for a single up or down vote. Given past commissions' lack of success, however, a more productive route might be to convene a bipartisan budget summit like the one that brought us a massive deficit-reduction package in 1990.

It wasn't easy then and it will be even harder now, given the poison partisanship that afflicts Congress, but expending the political capital that generally accompanies a new president into office might be the most responsible spending spree in our history.

Whether we face a financial abyss today is debatable. It is, however, certain that we shall face one eventually unless we get our fiscal house in order. Even if a calamity does not occur for a number of years, steadily growing fiscal pressures will make us impotent to do other good things. One would think that politicians would want to escape that bind. Who knows, they might even resort to putting the nation's interests above that of their parties.

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