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THE REAL CLIFF

Christopher DeMuth
on the looming debt calamity

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The Real Cliff

The staggering debt from decades of continuous government borrowing is about to come due

BY CHRISTOPHER DEMUTH

It is important to understand that the fiscal cliff is a charade. There are, to be sure, many conscientious debt reformers working to avert our proclaimed year-end epic fall—along with many cynics who are using the occasion to advance pet projects that will make the debt problem worse. But all concerned are working within a fiscal system that has become seriously pathological. The cliff is the latest expression of that pathology.

Just last year, the president and Congress agreed by statute to (a) increase the federal government's public debt by more than $2 trillion (up to $16.4 trillion) and (b) begin reducing annual federal spending by less than one-tenth that amount starting in 2013. A variety of temporary tax reductions, aimed at spurring recovery from the Great Recession, were also scheduled to expire in 2013. Now that the new debt has been borrowed and spent, the prospect of actually reducing our annual $1 trillion deficits by a significant amount is regarded by all sensible people as a catastrophe that must be avoided at all costs.

And what is to be done to stop the spending cuts and tax increases? This month's partisan positioning over raising taxes on the wealthy masks a consensus, embraced by the leadership of both parties, on two essential principles of cliff-avoidance. First, the vast majority of Americans who are middle class must be spared any clear-and-present impositions: Their direct income taxes must not be increased, and their Social Security and Medicare benefits must not be reduced any time soon—meaning that any reductions will be as contingent, and possibly ephemeral, as last year's debt-reduction accord. Second, the federal debt must be immediately increased by yet another $2-3 trillion, with further increases of equal magnitude certain to follow.

These principles embody America's de facto fiscal policy since the early 1960s: continuous government borrowing to pay for current consumption. That policy was, in the first instance, an unintended consequence of Keynesianism, which proposed that government shore up aggregate demand by spending more than it taxed during economic downturns.

Previously, government borrowing had been mainly for investments to secure or improve the future—expenditures appropriately shared with future generations. These included not only physical infrastructure such as roads and water systems but also wars (almost always debt-financed) and national expansion (Jefferson purchased the Louisiana territory mainly with Treasury bonds, which Napoleon promptly sold at a discount).

Keynes introduced the idea that government could legitimately borrow not only for production but also for consumption. Just as a creditworthy individual may take out a mortgage to purchase a home with future earnings, so government could borrow a share of tomorrow's wealth to meet urgent current needs. There had always been cases, such as natural disasters, in which governments had spent liberally, and if necessary by borrowing, to sustain incomes in the face of widespread emergency losses. Writing in the 1930s, Keynes in effect generalized the proposition to encompass economic emergencies of the magnitude of the Great Depression. His postwar apostles made refinements—such as "countercyclical stabilization" and "the full-employment balanced budget"—to moderate more routine fluctuations in the business cycle.

These were important intellectual advances. Although subject to many objections and qualifications, they were admirable efforts to respond to hardship and harness the modern economy more tightly to individual well-being. But, like many such advances, they emerged from a particular milieu and then reshaped that milieu in surprising ways.

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The Keynesian nostrums were conceived in an era when the balanced budget was the universally accepted norm: They assumed that debts incurred during depressions and downturns would be balanced by surpluses during booms and upturns. And the prospect of balance over the course of business cycles seemed unproblematic during the Depression, when the economy had been roaring in the recent past, and during the three postwar decades (through 1974) of bracing growth marred by only moderate recessions.

What was not foreseen was the effect of the Keynesian proposition in the context of practical politics. For it taught that government officials, in weighing current revenues and expenditures, should weigh the needs of the known present against the resources of an imagined future. But the present is always cluttered with problems and difficulties, while the future is an abstraction. The future is also, in the progressive American mind, a more prosperous and untroubled place—especially if we can just get ourselves through today's pressing exigencies. This manner of thinking tended to dissolve the distinction between investing for the future and borrowing from the future.

Even more insidiously, Keynesian borrowing raised the prospect of providing the electorate as a whole with higher current benefits than taxes to fund those benefits. Whatever the future may hold, it will certainly be populated by many people who are not voters today—the younger generation and the yet unborn. Today's debts will be repaid by some or all of them, in one way or another—through higher taxes or lower benefits to accommodate payments on the loans, or through loan defaults, or through the partial default of inflation. When clever economists assure politicians that more government debt is unworrisome because "we owe it to ourselves," they are using the soothing collective "we" to gloss over all the contentious tasks of allocating burdens and benefits among competing interests and constituencies that are the stuff of practical politics. ("What do you mean 'we,' Kemosabe?") At any point in time, politicians will be happy to relax the resource constraints on their own choices and leave greater constraints for their successors to deal with.

These political dynamics quickly left formal Keynesianism in the dust. In the 52 years since 1960, the federal budget has been in balance or surplus only five times (although the deficits before 1975 were mostly small); the cumulative deficits have far exceeded the surpluses, and there has been no correlation of fiscal balances to economic cycles. Each new year has brought its own unique and compelling reasons for borrowing just a little bit more for a little while longer—with the effect of shifting consumption further ahead of production from every new baseline. Even the economic expansions of the mid-1960s and mid-1980s were treated not as opportunities for budget surpluses but instead as evidence that deficit stimulus was working. The exceptional surplus years of 1998-2001 may be chalked up to the steely discipline of President Clinton or Republican Congresses (or to the virtues of divided government and the dot-com bubble), but it should be noted that they began as a surprise—Clinton's 1998 budget proposed a deficit and projected deficits through 2002.

Now there is more to the story, and a twist in the plot. Following the stagflation of the 1970s, liberal Keynesianism was joined by conservative, anti-Keynesian "supply-side economics" as a new force for debt expansion. Supply-side theory rejected aggregate demand management and emphasized microeconomic incentives, especially the tendency of high marginal tax rates to suppress economic growth and, to a degree, government revenues. Once again, an important intellectual advance acquired a life of its own. In the journals and newspaper op-eds, tax cutting was advocated to promote economic production, but in the hands of politicians it acquired additional purposes—including, eventually, promoting debt-financed consumption.

Ronald Reagan and Jack Kemp were authentic supply-siders, but they and other Republicans understood that tax cutting could serve an electoral purpose as well: In response to the big-spending Democrats, the GOP could turn the tables and offer lower taxes rather than purse-lipped fiscal restraint. Then, a few years into Reagan's first term, another purpose appeared. The administration had been much more successful in cutting taxes than cutting spending; while the economy was recovering smartly, deficits and debt were growing steeply. What were limited-government conservatives to do?

I was working at the White House and OMB in those years, and was party to many a late-night argument over two divergent strategies. "Starve the Beast" held that the public would tolerate only so much deficit spending—so cutting taxes would at some point restrain spending as well. "Serve the Check" held that the only way to limit spending was to charge its full price at retail: Set taxes at an average of 20 percent of individual incomes and we would discover whether the public really wanted federal spending of 20 percent of national income.

Reagan went with "Starve the Beast." As a loyalist, I will note that, after inflation was tamed and the economy rebounded, he was still engaged in a huge defense buildup that he regarded as an investment—to abolish the Soviet Union. That turned out rather well, but it also turned out that the public's tolerance for high debt and deficits was much larger than anyone had supposed. Today, one would have to say that tolerance is unlimited so long as the public is faced with abstract numbers in newspaper headlines rather than tangible consequences.

Nevertheless, tax cutting and "no new taxes" became increasingly embedded in Republican electoral strategy. As they did, they took leave of supply-side economics just as completely as demand stimulus had taken leave of its Keynesian origins. Indeed, tax reductions for the masses (but not for the wealthy and corporations) became a matter of bipartisan consensus and competition. Through the tax legislation of the 1980s, 1990s, and 2000s, progressively greater numbers of Americans had their income taxes reduced or were removed from the rolls altogether, and many credits and deductions were added for a variety of favored activities, from children to childcare to energy-efficient appliances.

The transformation of fiscal policy was accompanied by—and, no doubt, was in some significant degree caused by—a larger transformation of American politics and government. Beginning in the 1970s, the old establishment hierarchies of the political parties and Congress were displaced by more decentralized, populist, freewheeling forms of decision-making. Critically, the congressional finance, ways and means, and appropriations committees—previously imperious gatekeepers for federal taxing and spending—were among the unhorsed. Into the vacuum came legions of well-organized interest groups with newfound abilities to secure targeted transfer payments and tax preferences. Above all, American society was becoming more affluent, more educated, and older—and more concerned with issues of health, amenity, and income insurance. Nicholas Eberstadt of the American Enterprise Institute and others have documented the remarkable shift in the composition of federal spending from the 1970s to today—from traditional public goods such as national defense and physical infrastructure to social insurance (especially Social Security, Medicare, and unemployment insurance), welfare programs, and many other kinds of transfer payments.

Projected Social Security and Medicare shortfalls put the federal debt at more than five times annual GDP. Generational accounting suggests that future generations will be paying nearly all of their lifetime incomes in taxes, which obviously cannot happen.

These profound changes might have been manageable if they had been accompanied by old-fashioned budget balancing that obliged government officials to make hard choices among competing interests. Instead, the concurrent discovery of the political magic of continuous public borrowing produced something not only new but financially addicting: government as an engine for debt-financed consumption. In retrospect, a key turning point came in the expansion of Medicare to cover prescription drugs. A drug benefit was added during Reagan's last year in office—but it was, at his insistence, "budget neutral," funded entirely by program taxes and premiums, and it proved wildly unpopular. Following a senior riot in the streets of Chicago, aimed at Ways and Means Committee chairman Dan Rostenkowski, the program was repealed a year later. George W. Bush and the Republicans learned the lesson well. Their 2003 Medicare drug benefit, costing more than $60 billion annually, was funded mainly (more than 75 percent) by new government borrowing. That proved very popular.

The era of prolonged and growing government debt since the mid-1970s has corresponded with slower and more volatile economic growth as measured by per capita GDP, median and average incomes, and total-factor productivity. This will present an interesting chicken-and-egg question for economic historians: Did the debt-for-consumption project eventually slow rather than stimulate economic growth, or did slowing growth have other causes, and inspire government to increase borrowing in an effort to sustain accustomed levels of income growth? But for now—following the Bush and Obama economic stimulus and financial bailout programs of 2007-2010, the stupendous annual deficits of President Obama's first term, and the continuing neglect of the huge financial imbalances of our Social Security and Medicare programs, and with the prospect of trillion-dollar deficits for the foreseeable future—we can say with assurance that our national debt has become an impediment to growth and is going to crush the economic expectations of many Americans.

The federal government's public debt is now about 75 percent of annual GDP and growing rapidly, and already more than 100 percent if one includes the Treasury Department's intra-government debts to Social Security and other programs. These amounts put us in the range where, historically, government debt has seriously depressed economic growth and risked sovereign defaults and wrenching fiscal contractions, even when interest rates were low. But our true indebtedness is much higher than that, much higher than our peak debt during World War II, and not far behind that of the crisis-wracked EU. Accounting for the chasm between projected Social Security and Medicare payments and revenues (which the government's official debt figures unfortunately ignore) puts the federal debt at more than five times GDP. Generational accounting suggests that future generations will be paying nearly all of their lifetime incomes in taxes, which obviously cannot happen.

Calculations such as these point to the real harm of financing current consumption with ever-increasing public debt. Substantial segments of the population become accustomed to levels of government benefits that cannot be sustained. With time, an inheritance of continuous stimulus can be withdrawn slowly, permitting private adjustments and, with luck, resumed economic growth. But the longer the stimulus continues, the greater the likelihood that personal expectations will be shattered by an emergency that an insolvent government is no longer in a position to respond to. That will certainly mean widespread losses and hardship, and perhaps political instability as well, and, worst-case scenario, temptations for Kirchner-style confiscations.

It is remarkable that, in our current straits, and with the demographic clock running out on the graduated reforms to our entitlement programs that nonpartisan think tanks have been propounding for decades, the government has shifted its stimulus machinery into overdrive. With the economy still shaky, we are warned, now is not the time to begin consolidating our debts! With interest rates so low, we would be fools not to borrow trillions more while the getting is good! With the states $7 trillion in debt and maxed out on private borrowing, Washington needs to be doing more not less! This is what a pathological fiscal system sounds like when debt stimulus no longer stimulates and its options are running out.

The fiscal cliff will be avoided, or not. We face two other challenges that are much more serious and nearly as immediate. The first is to begin contingency planning for the coming debt crisis—which may arrive as early as next year, when California is the first of our bankrupt states to apply for a massive uploading of debt to the federal government. The second is to establish institutions of public finance with a fair chance of disciplining rather than placating the populist pressures of contemporary politics, and of right-sizing our middle-class welfare state to acceptable levels of middle-class taxation.

These institutional tasks can hope to succeed only after we have developed a new public rhetoric of fairness. It should be a matter of acute national embarrassment that our leaders can pretend to be redistributing from wealthy to average citizens when, in fact, they are redistributing in far greater measure from the young and unborn. Our rhetoric must teach that, although government borrowing is appropriate for certain purposes, the routine redistribution of wealth from future generations to ourselves is undemocratic, corrupting, and ultimately impoverishing. We don't need to wait for a deadline or a crisis to take this intellectual leap. ♦