THE DEBT CRISIS IN THE U.S.: CAUSES, CONSEQUENCES, AND SOLUTIONS

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The debt crisis is real, but it is merely a symptom of the more fundamental crisis which is one of undisciplined federal spending growth. The great tragedy of democracy, as has been known since the time of the ancient Greeks, is that those in the democratic majority increasingly resort to voting themselves benefits that they expect others to pay for -- through taxes on the most productive or by debt[1]. This 2,500-year old Greek tragedy is now being played out in the United States. Government spending has been increasing faster than GDP, which will eventually destroy the private economy. The solution is to increase the growth rate of GDP and/or greatly reduce the growth in government spending.

Consider your own family. If year after year, you spend 40 percent more than you earn, bankruptcy will likely be your fate. If you own or manage a business, and again, if year after year you spend 40 percent more than your revenues, the business is bound to go bankrupt. Governments that do not print their own money, such as California, Illinois, and Greece, and spend far more than they receive in tax revenue year after year, can also face bankruptcy – as we have already seen with several California cities this year.

For the last four years, the U.S. federal government has been spending almost 40 percent more than it has received in revenues; but because the federal government prints its own money,

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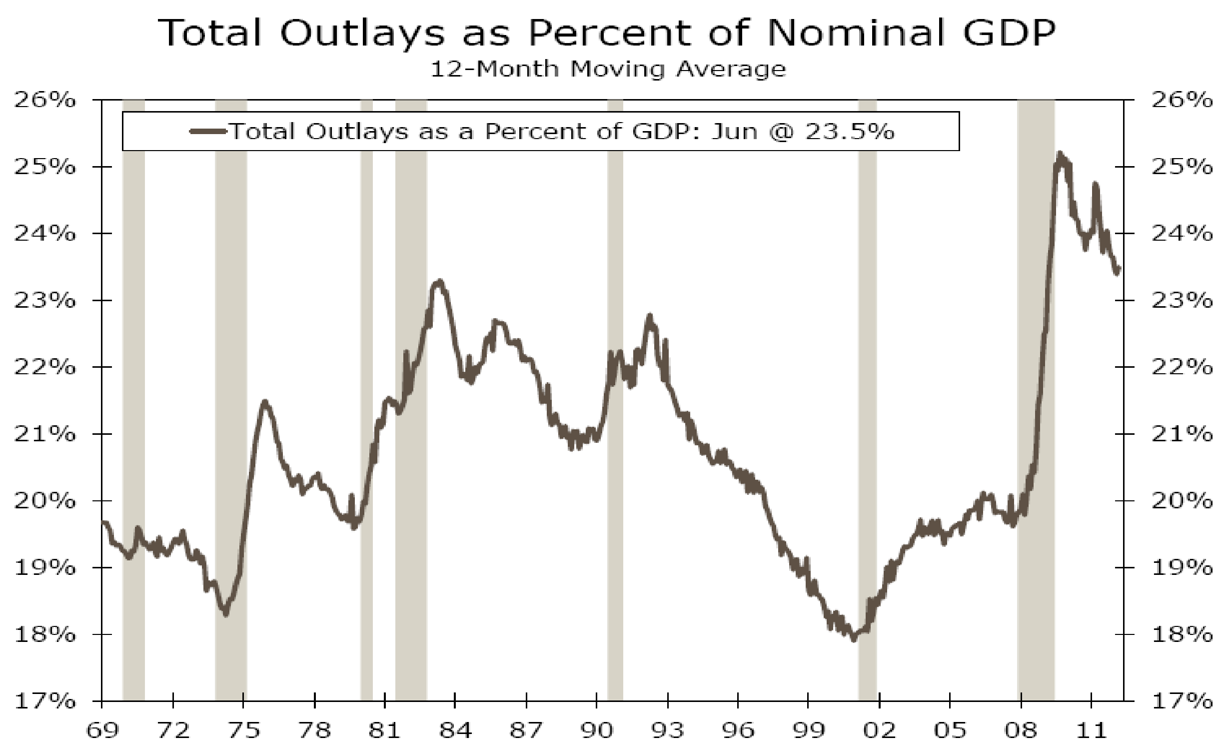
[1] The following quotes, which may be apocryphal, have been attributed to Lord Woodhouselee, Alexander Fraser Tytler, a Scottish historian and professor who wrote several books in the late 1700s and early 1800s. Nevertheless, it illustrates the point: "A democracy is always temporary in nature; it simply cannot exist as a permanent form of government. A democracy will continue to exist up until the time that voters discover that they can vote themselves generous gifts from the public treasury. From that moment on, the majority always votes for the candidates who promise the most benefits from the public treasury, with the result that every democracy will finally collapse over loose fiscal policy, (which is) always followed by a dictatorship."

"The average age of the world's greatest civilizations from the beginning of history, has been about 200 years. During those 200 years, these nations always progressed through the following sequence:

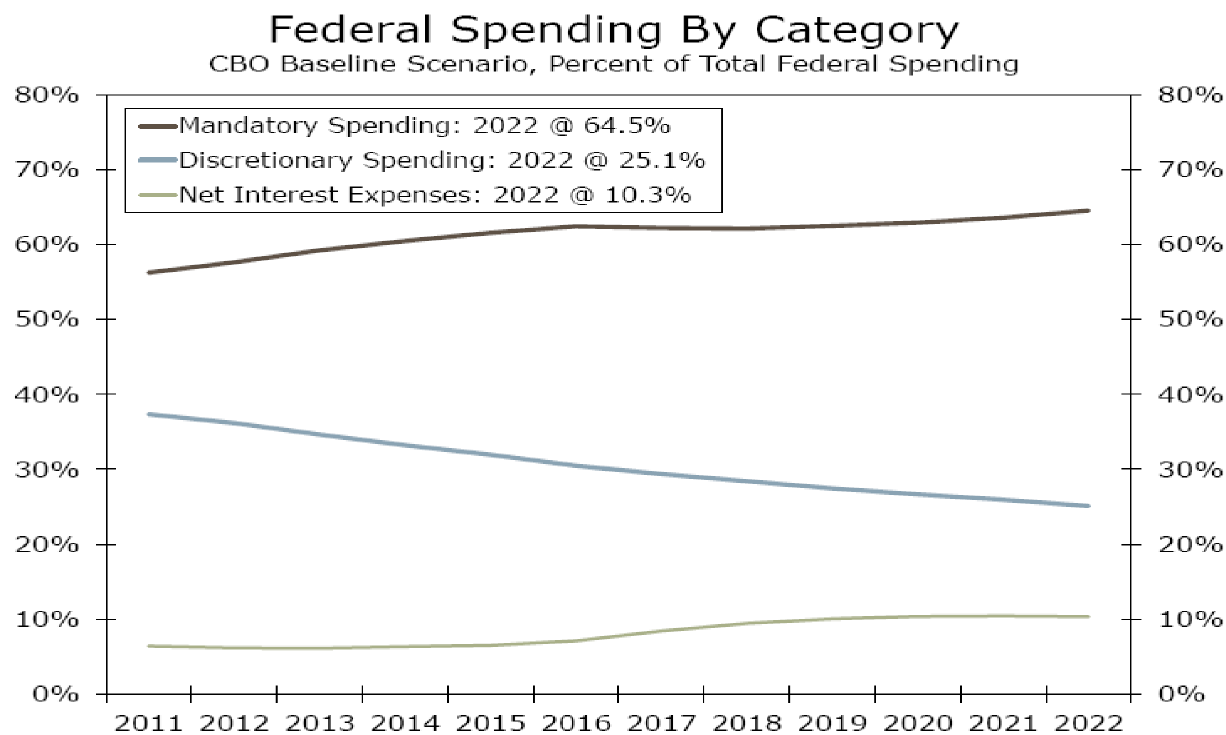
From bondage to spiritual faith;
From spiritual faith to great courage;
From courage to liberty;
From liberty to abundance;
From abundance to complacency;
From complacency to apathy;
From apathy to dependence;
From dependence back into bondage."

it will not go bankrupt in the traditional sense of the word. Those who supply goods and services to the government will still be paid in dollars no matter how big the debt – even though the dollars may be worth a lot less in real terms than at the time the contracts were made. The same is true for those who receive government "entitlements," such as Social Security, Medicare, or federal pensions. Under conditions of very high inflation, the inflation indexing is likely to lag behind the real drop in the value of the dollar by a year or more, so the real incomes of the "entitlement" recipients will fall.

For the past 50 years, federal government spending has averaged about 20 percent of GDP. However, for the last four years, it has been averaging about 24 percent. (By way of historical reference, federal government spending averaged between two and three percent of GDP up to WWI when it jumped up, but it went back down in the 1920s to under four percent. In 1945, at the height of spending for WWII, federal spending reached 45 percent of GDP, but at war's end it was quickly brought down to about 16 percent.)

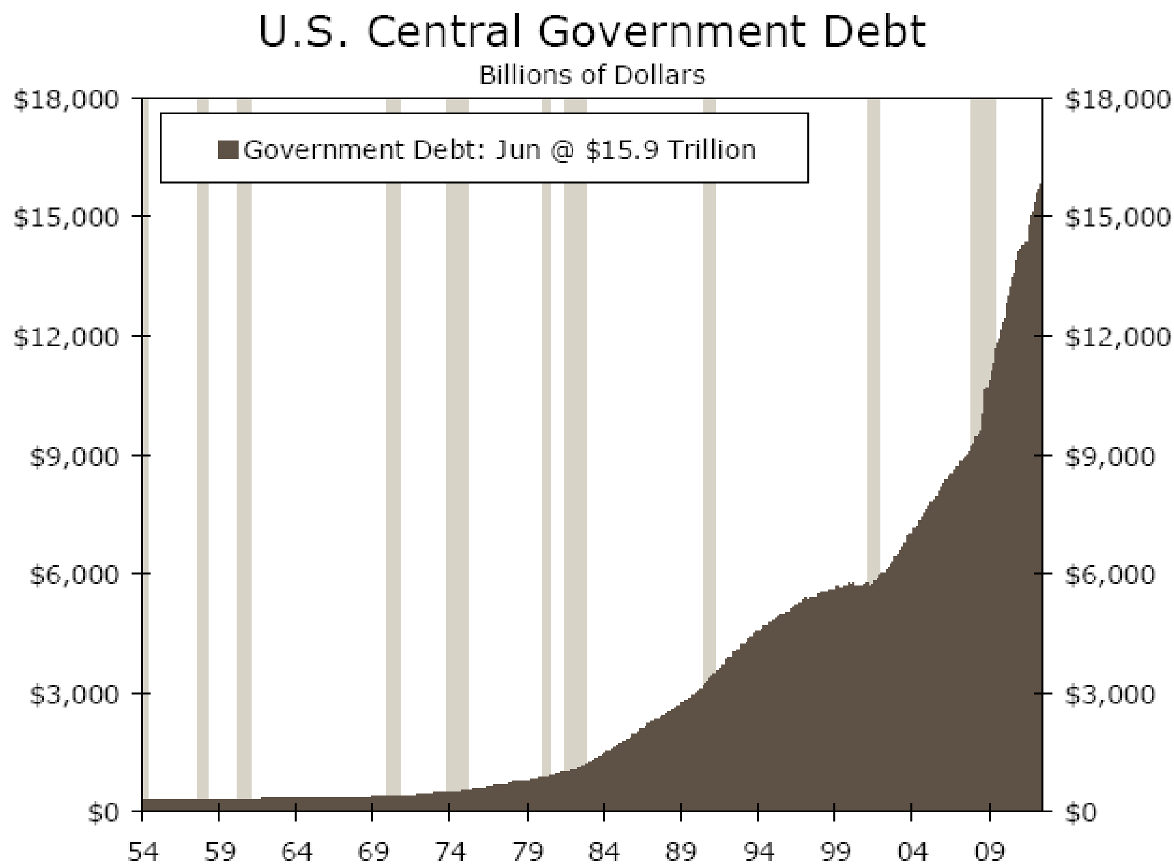


Source: U.S. Department of the Treasury, Congressional Budget Office, Wells Fargo Securities, LLC



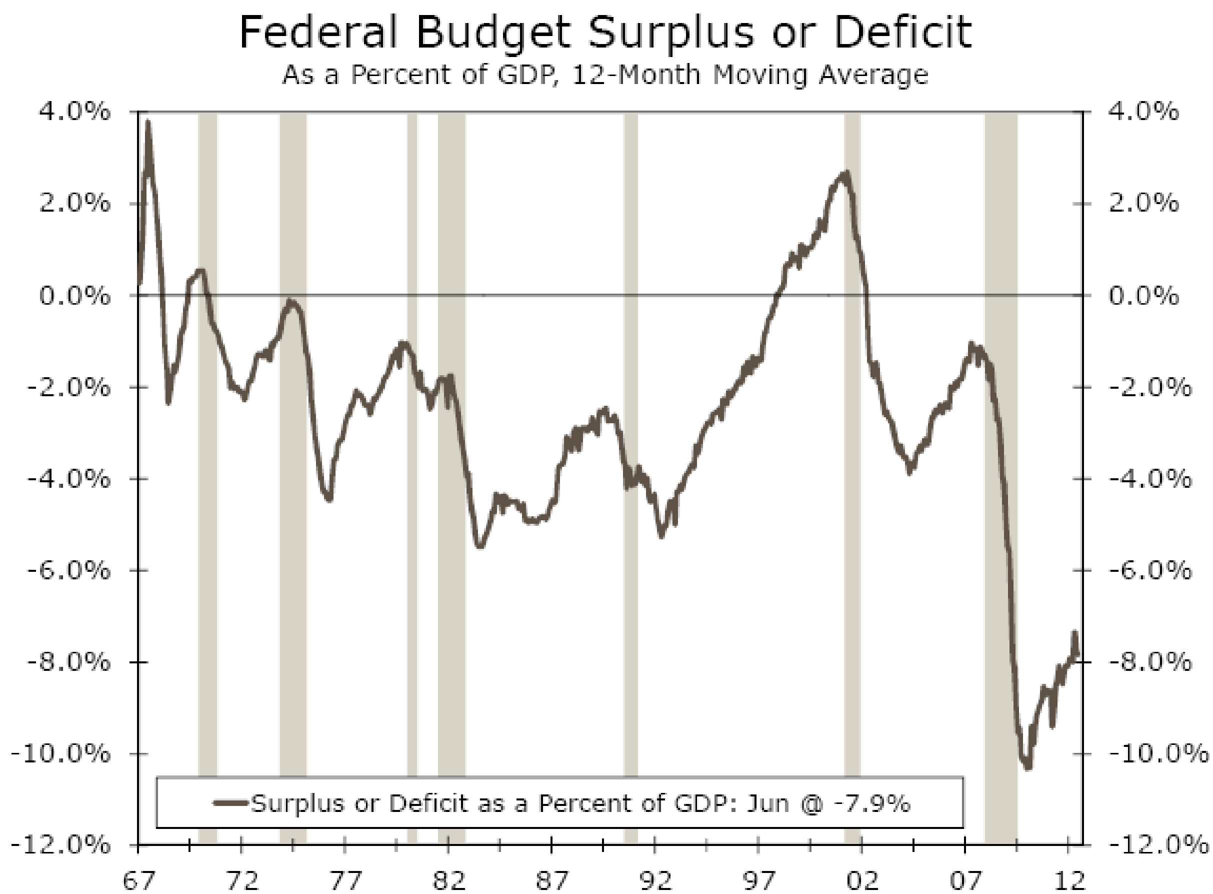
Source: U.S. Department of the Treasury, Congressional Budget Office, Wells Fargo Securities, LLC

And again, during the past 50 years, federal tax revenues averaged about 18 percent of GDP, leaving an average deficit of about two percent per year. Economic growth averaged closer to three percent during this same period of time, and since economic growth was on average higher than the average deficit, the U.S. debt-to-GDP ratio fell over that time. In other words, the *explicit* balance sheet became sounder. However, the *implicit* balance sheet, which includes all of the unfunded liabilities for Social Security, medical entitlements and federal pensions, grew rapidly. These unfunded liabilities are now estimated (by various economists) to be some place between eight and fourteen times the current U.S. GDP of about 16 trillion dollars. Even the numbers at the low end of the estimates for unfunded liabilities are well over 100 trillion dollars and are so vast that, by necessity, they will force major changes in the programs.



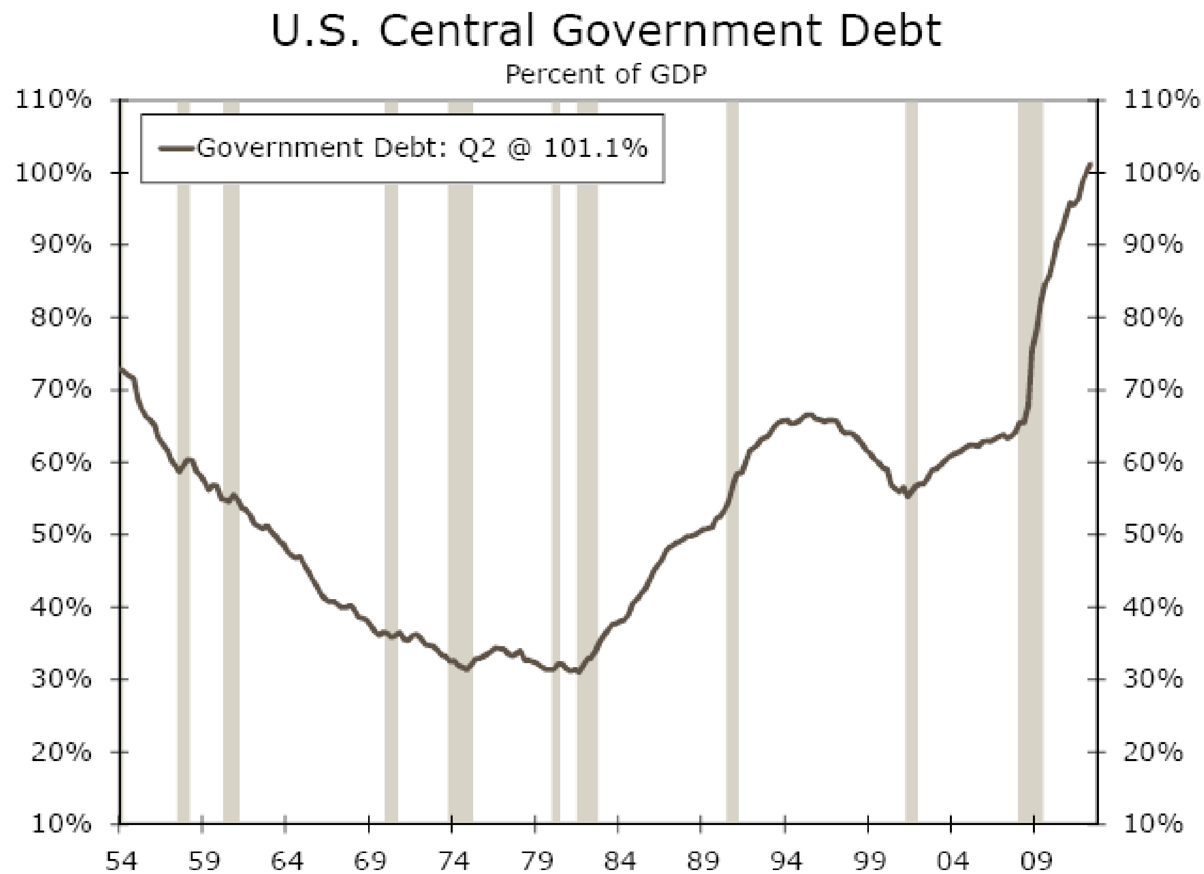
Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

For the last four years, federal tax revenues have fallen to a little more than 15 percent of GDP as a result of the recession and persistent high unemployment. It is worth remembering that the current tax rate structure, with only minor changes, produced tax revenues of 18.5 percent of GDP as recently as 2007 when the U.S. was close to full employment. Because of the progressive nature of the U.S. tax system, revenues are very sensitive to changes in the rate of economic growth. Economic slowdowns result in an even greater drop in revenue as a percentage of GDP, and economic growth of greater than three percent results in a rapidly increasing tax take as a percentage of GDP.



Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

The gap between tax revenues and government expenditures has exploded from the historic and very manageable average of two percent to an average of nine percent for the last four years. As debt rises as a percentage of GDP, the amount of interest of the ever increasing debt rises, and eventually the Federal Reserve (Fed) will not be able to keep the rate of interest down. If inflation really picks up, as it did during the Carter administration, the interest payment required on the federal debt will explode, eating up a very high percentage of federal revenues. There have been countless examples of countries getting into this debt death spiral.



Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

Individuals get into similar situations. If they take on more debt than they can afford, they will find themselves increasingly borrowing to pay the interest of the previous debt. Their creditors then view them as less credit worthy and increase their interest rates in order to compensate for the risk. At some point, the interest owed each month exceeds the debtor's income. The scenario with a county is a bit different. As the debt burden rises, the pressures increase to resort to just "printing money," which eventually causes inflation, which, in turn, causes those who buy the government debt to demand higher and higher interest rates until the money becomes increasingly worthless and the economy becomes dysfunctional.

Professor Steve Hanke and Nicholas Krus of Johns Hopkins University have just published the most complete list to date of the "World Hyperinflations[2]." They have documented 56 cases where inflation had been at rates of 50 percent per month or more. The world's worst inflation was in Hungary in 1945-46, where the daily rate was 207 percent and where prices doubled every 15 hours. The Zimbabwe inflation of 2007-08 ranks number two with a daily

[2] Hanke, Steve H. and Krus, Nicholas, "World Hyperinflations," *Cato Working Paper No. 8*, August 15, 2012, http://www.cato.org/publications/working-paper/world-hyperinflations

inflation rate of 98 percent and where prices doubled every 24.7 hours. In 1993, I served as an advisor to the head of the central bank of Ukraine when the country was experiencing a 285 percent monthly inflation rate – prices doubled every 15.6 days. It that case, many government departments were issuing their own credits, so the central bank had no control over the money supply – and, as a result, the central bank was powerless to stop the inflation. Faced with hyper-inflations or even high inflations, people resort to the use of foreign currencies, gold, or other commodities for money - and even various forms of barter.

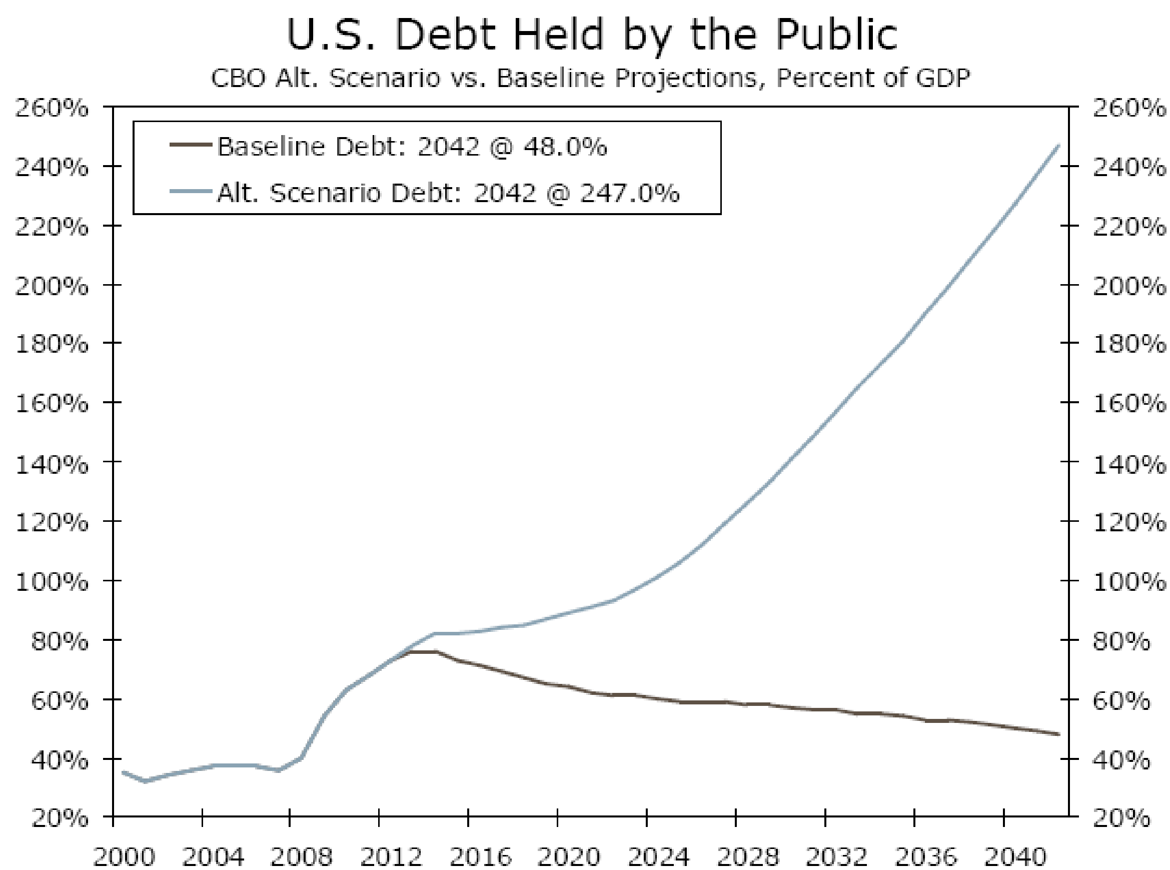
Central banks like the Fed create money by buying the bonds that governments issue to pay their bills when they spend more than they take in from taxes. These bonds are bought by individuals, businesses and other institutions, and by central banks. When private parties buy government bonds, they do so from money they have saved. But when a central bank buys a bond, normally from a bank, it can do so from money it just creates – in either paper or electronic form. The new money is a liability on the balance sheet of the central bank which is collateralized by the bond it bought. If a central bank creates money at a faster rate than the economy is producing new goods and services, this causes the value of the money to fall, which we call inflation.

As previously noted, when countries add more and more debt in relation to their GDP, bond buyers demand higher interest rates to compensate for the risk that governments might default or inflate away the value of the currency. Higher interest rates make it more difficult for governments to service their debt and they get into a death spiral of both ever increasing debt and higher and higher interest costs. To keep interest rates down, central banks have been buying government debt, but this can only work up to the point where the money supply can be increased without causing a big inflation.

In the U.S., the Fed has not only been buying large quantities of government bonds but also mortgaged-backed securities "guaranteed" by the U.S. government. There are a number of problems with this. Some U.S. government agencies and departments are guaranteeing the debt of other government agencies. The Fed, after all, is a U.S. government agency. So the only real "guarantee" is that of the IRS using its coercive police powers to pay for all of these debts by extracting taxes from what may be an unwilling public. Another problem is that the Fed lists the value of the mortgage-backed securities it holds at their acquisition cost rather than their current market value as any private company would be required to do, for good reason. The problem with the Fed accounting is that at least some of these securities will never be paid in full, leaving the taxpayers with the responsibility for the loss. The Fed does turn over its profits from the interest on the bonds to the Treasury, so the bad loans will result in less profit to the Treasury - again leaving the taxpayers on the hook for the difference.

When the government borrows money by selling notes and bonds to pay its bills, it is taking away part of the savings from individuals and businesses. Saving and its productive investment is the seed corn of a modern economy. It is only from savings that the funds for research and development, new and improved technology, and more capital equipment for workers become available. When government takes some of this saving, it is reducing productivity growth unless it is able to invest more wisely than the private sector, which is rarely the case. This is one of the reasons why economic growth tends to be slower in countries with larger government sectors.

Apologists for ever more government spending often argue that, as the population ages, healthcare and pension costs naturally rise, and that a civil society needs to do more to take care of the less fortunate. It is indeed true that, as the average age of a population increases, there is a greater demand for pension benefits and medical spending. However, it is not true that the government needs to directly pay for these, at least not in the majority of cases. More than thirty countries have adopted a version of the Chilean pension system developed by Dr. Jose Pinera when he was labor minister. Such a system allows workers to invest in productive securities (not just in government bonds) which have been shown to provide much higher rates of return over the long run, enabling people to have more discretion as to when they retire and how much they receive. As far as providing medical insurance to the elderly and others, several think tanks, including the Cato Institute, have developed practical and realistic plans that protect individuals and whose cost to the taxpayers does not rise more rapidly than GDP.



Source: Congressional Budget Office and Wells Fargo Securities, LLC

Without changes to the “entitlement programs,” particularly Medicare and Medicaid, those programs will undeniably continue to grow faster than GDP, and deficits will continue to be so large that the debt-to-GDP ratio will continue to explode. The accompanying Congressional Budget Office (CBO) chart of debt held by the public “alternative scenario” basically assumes that no change is made to the entitlements, which CBO projects would result in a debt-to-GDP ratio of 247 percent in the year 2042 – merely thirty years from now.

This will not happen because it cannot happen. The alternatives are:

1. Congress makes the necessary changes in entitlements so they no longer grow faster than GDP and do not continue to take up an ever increasing share of the budget. The Cato Institute and other think tanks have put forward realistic budget proposals, as has House Budget Committee Chairman Paul Ryan, to show that this is entirely possible without causing individual hardship.

2. Congress does nothing or very little to change the entitlement programs and they continue to grow, eating away at productive capital formation, until economic growth stops or turns negative. Once that happens, the country will be faced with a full scale economic crisis, requiring massive real cuts in government spending (either through an explicit inflationary policy or direct and large budget cuts).

3. Congress tries to cure the problem with tax increases, but the tax increases slow economic growth, even further resulting in less than the projected revenue, again, eventually resulting in a full economic crisis as in alternative number 2.

4. An implicit policy of higher inflation (which the Fed seems to be trying to induce at this time with its announcement of open-ended purchases of government debt). Higher inflation can buy time temporarily, but history shows that it is almost impossible to have a steady state of inflation, such as five percent per year. Increased inflation normally results in accelerating and variable inflation until the inflation pain becomes so great that the politicians and central banks are forced to bring it to a halt, which causes an economic turndown while the readjustment takes place, after which time normal growth begins again. The 1980-82 recession was an example of a turndown necessitated by the need to stop the inflation.

It is obvious that alternative number 1 is the responsible course of action.

However, as of this writing, there is not a majority in the Senate to make the necessary changes, and President Obama has so far expressed an unwillingness to recognize and make the essential changes in government spending and particularly with the entitlements. In fact, the president’s budget, according to CBO, will increase the deficit by $3.5 trillion over the CBO baseline projected over the next decade, or a total additional deficit of $6.4 trillion between now and 2022.

The above numbers are probably unrealistically optimistic because of economic growth assumptions that are unlikely to be achieved. The CBO has forecast a recession beginning in the first quarter of 2013 (as have many private forecasters) unless something is done to prevent the tax increases slated to take place as of January 1, 2013. Even though the U.S. House of Representatives has passed legislation to keep in place the current tax rates, the Senate has not acted and is most unlikely to do so before the new Congress. So the U.S. is now left with the almost certainty of another recession, causing millions of additional Americans to lose their jobs, which will cause another surge in the debt-to-GDP ratio, bringing the U.S. more quickly to the day of reckoning.

President Obama and many others argue that the solution to the deficit problem is to increase taxes on the rich (i.e., those making $250,000 per year). But to close the deficit hole by taxing them would require they pay a tax rate of almost 100 percent, and in year two and thereafter most of them would be gone – so almost no tax would be collected. Other alternatives would be to triple the tax on every household making more than $100,000, or double the tax on all of those making more than $75,000. Such proposals are obviously political non starters, and, even if implemented, would be economically disastrous.

The fundamental problem with increasing marginal tax rates on upper-income people is that most of the tax increase would come from their savings. Recall from the earlier discussion that savings and its productive investment is the seed corn of the economy which economists call capital formation. The result of such tax increases over time will be slower economic growth, higher unemployment, and ultimately less tax revenue. Economists endlessly debate what income tax rate maximizes revenue over the long run (the Laffer Curve). In the very short run, sudden tax rate increases on upper-income people can result in more revenue; but over time, they find legal and perhaps illegal ways of avoiding the tax. The higher the tax rate, the more sensitive people are to any changes in it. Most studies show that the long-run revenue maximizing income tax rate is between 20 percent and 35 percent (and for the capital gains tax rate, well under 15 percent). Current proposals to increase tax rates for high-income groups would put many of them in the 50 percent or more marginal tax rate bracket when state tax income taxes are correctly included. Such rates are well above the revenue maximizing rates and will only serve to slow growth and job creation, and would actually reduce tax revenues in the long run.

Some modest increase in consumption taxes would be likely to increase government revenues –even as a percentage of GDP, but such taxes hit all income groups and thus meet with considerable political resistance.

A number of studies have shown that high state income tax rates drive many of the high earners to lower income tax rate states. For example, California, with its high tax rates, has been running big deficits and has a faltering economy, while Texas, with no state income tax, has been booming. The bottom line is there are virtually no examples of countries overcoming big deficit and slow growth problems with major tax increases on income and capital. The only solution is to cut the growth in spending. *Again, there is no mathematical tax increase solution to a problem where government spending persistently grows faster than the GDP.*

What then is the solution to the problem? From an economist's standpoint, the solution is rather obvious – increase GDP growth and cut spending. GDP growth will increase when:

- The multiple tax rates on capital are reduced or eliminated;
- Taxes on labor are reduced to less than their long-run revenue maximizing rate;
- Regulations that do not meet a cost-benefit test are eliminated and the complexity of those remaining regulations is reduced;
- Trade barriers are reduced;
- Legal uncertainty is clarified and the rule of law is strictly enforced;

- And stable money exists.

Government spending should be sharply reduced. The U.S. government has grown far beyond what was outlined in the Constitution and now engages in countless activities that would be far better left to the private sector or, at least, state or local governments. Few government expenditures meet a cost-benefit test, and those that do not should be stopped. Some Keynesian economists and economic know-nothings in the political and media classes argue that more government spending will create jobs through a mythical multiplier that has never been observed in the real world. Those who believe that more government is better ignore the fact that all government spending must be funded from the productive activities of the people, and this funding must first be the result of coercive taxation or borrowing that reduces productive capital formation. Despite all the empirical evidence to the contrary, those who advocate more government spending also must believe that government can spend money more wisely and efficiently than the private sector.

Despite the massive unfunded liabilities, it is possible to make a course correction before economic collapse. So-called discretionary government spending has been reduced in the past (as a percentage of GDP) – during the Reagan and Clinton administrations – and, given modest political will, can be reduced again as House Budget Committee Chairman Paul Ryan has proposed in his budget. Every reasonably knowledgeable observer knows that the entitlement programs must be reformed, and, as previously noted, many of the think tanks and Chairman Ryan have developed proposals that could work. The open questions are – do the American people now have the political wisdom and maturity to elect members of Congress and a president who will make the necessary changes, or will the U.S. continue on the denial road? The November 2012 elections will be a good indication.

But what if the political leaders choose the irresponsible route, ultimately leading to high inflation and a rapid fall in the standard of living? The poor, the elderly and many others will suffer, but the U.S., unlike many other countries, still has one ace in the hole. The U.S. government owns tens of trillions of dollars of assets, many of which could be sold to cover a limited-term financial crisis. The government owns a third of the land in the U.S. – only a small percentage of which is in parks (and even those could be sold to private operators). The government has trillions of dollars in oil, gas, and mineral reserves on its properties that it has unnecessarily locked up and which could be leased or sold. The list goes on and on.

Selling assets can only provide short-term breathing room, but is there anything that can be done about the fundamental problem that all democracies have, whereby those in the majority eventually vote themselves benefits at the expense of a productive minority? Fortunately, the United States is a Constitutional Republic, unlike most European and other parliamentary democracies; thus it is harder for the politicos to do bad things – which is probably why the U.S. has existed longer than most democratic countries. Once the current spending and deficit problems are dealt with one way or another, I suggest two modest Constitutional amendments to reduce the recurrence of the present problems.

First, abolish the 16th amendment which provided for a federal income tax. An income tax is fatally flawed on a number of accounts, including the fact that “income” can never be properly defined, and that it lends itself to increasing complexity and discrimination. And the income tax has served as a huge source of revenues for the government, which allowed much of the non-productive and destructive growth in the size of government.

Two, require super majority votes for all tax increases and spending (perhaps two-thirds), and not allow any automatic spending – that is, each year actual spending for pension, medical, and all other programs would need to be approved or limited. And the amendment should have a provision that all spending and regulation be subject to a cost-benefit test (even though the definitions would likely be abused), and must contain a clear statement as to what part of the Constitution permits such spending or regulation.

The fatal flaw in the Constitution as it now operates (unlike the intention of the founders) is that the political classes have found ways to allow those with a vested interest (the concentration of benefits) to too often overcome the general interest (because of the dispersion of costs). The modest Constitutional amendments I have proposed would do much to rectify the needed balance. Remember a Constitution is a non-democratic construct, designed to protect both the minority and general interest against the majoritarian passions of the moment and destructive self-shortsightedness.

In conclusion, the debt crisis is merely a symptom of the underlying lack of spending control, which is a result of the breakdown in historical Constitutional constraints and traditions. The problem can be and will be solved either by rational political actors being responsible or by a financial breakdown with dire and uncertain consequences for all.