Opinion

The Risk of Short-Term Fiscal Fixes

BY JOHN A. WEINBERG

As I write this column in early January, Congress has just enacted legislation to head off a looming fiscal crisis known as the "fiscal cliff." Without an agreement by congressional leaders and the president, taxes would have increased markedly on January 1, with, among other things, the expiration of the 2001 and 2003 tax cuts, the end of the Social Security payroll tax reduction, and a sharp rise in the number of taxpayers subject to the Alternative Minimum Tax. At the same time, automatic spending cuts of more than $100 billion annually would have kicked in. The cumulative effect of these changes would likely have been damaging to the economy in the short run.

Many of the elements of the fiscal cliff were the result of earlier attempts by Congress to impose discipline on itself: The temporary nature of the Bush-era tax cuts and the Obama-era payroll tax cut ensured that Congress would have to consider explicitly whether to extend them in light of the country's fiscal situation. The automatic spending cuts were the result of a legislative fight in the summer of 2011 over the debt ceiling, a mechanism that effectively requires Congress to enact legislation before federal debt can grow beyond a preset point.

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Among its provisions, the fiscal-cliff legislation, titled the American Taxpayer Relief Act of 2012, increases some income tax and estate tax rates, limits tax exemptions and deductions for higher-income earners, and delays the automatic spending cuts for two months. Reasonable people can differ on the wisdom of these changes — but the Congressional Budget Office (CBO) has determined that the legislation will increase, rather than decrease, the federal deficit. What remains to be done is for policymakers to take meaningful steps to deal with the very real challenges created by the country's growing debt.

The larger picture of our fiscal situation is not an attractive one. The CBO, using realistic assumptions about the current path of fiscal policy, estimated in August that federal debt held by the public will reach $22 trillion in a decade, amounting to 90 percent of GDP, and will continue escalating from there. Already, federal debt exceeds 70 percent of GDP — the highest level since 1950, when the federal government was still paying down its borrowing for World War II, and a share about twice the level of just five years ago.

There is a broad consensus that the deficit must be addressed eventually. The controversial question is how long the difficult choices can be postponed. At stake is a possible loss of confidence in U.S. government debt; we can keep borrowing at reasonable rates only as long as financial markets believe that the debt will be repaid from future surpluses and future borrowing capacity. If investors lose that belief — if they conclude that the government's only realistic options are to default or to have the central bank inflate away the debt under political pressure — the game is over; their willingness to hold federal debt would decline, increasing the cost of debt service, and making fiscal reforms all the more difficult.

How many years do U.S. policymakers have before such a day of fiscal reckoning? We are in largely uncharted territory. History provides little guidance on the conditions under which investors would begin to view federal debt as unsound. In 1946, federal debt held by the public reached 109 percent of GDP — but the wartime needs that had brought about the debt were known to be temporary, so the federal government was able to maintain the confidence of bond buyers. Overseas, Japan's gross debt has recently been more than 200 percent of GDP without panicking investors, yet Greece is dealing with crisis conditions on account of a gross debt around 170 percent of GDP.

Some take comfort in the fact that interest rates on Treasury securities remain low. They believe rising interest rates will give us a flashing yellow light in sufficient time for us to take action. That assumption could be correct. It is certainly an attractive and comforting one, particularly at a time when spending cuts or tax increases would hurt an already tepid recovery.

The severity of the fiscal situation of an indebted government is a matter of expectations, however, and expectations can shift suddenly. Because the federal debt is sustainable only as long as investors believe it is, a sudden loss of confidence would have dire consequences.

Consequently, the responsible assumption for policymakers is that low interest rates do not necessarily foretell a prolonged period in which standstill agreements between branches of government and short-term fixes will continue to be enough. Indeed, continued delay of a more lasting resolution may itself be harmful to confidence. Making adjustments after expectations have already turned would almost certainly be costlier and far more painful. **RF**

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