Politics spooks market more than US debt
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Is the United States budget really in such a parlous state? The deficit is historically large and some official projections suggest an unsustainable debt profile. But the essential problem is political, not economic.

Among the many fatuous arguments in this debate, the comparison of the government's budget with a household budget may be the most disingenuous. When times are tough, households tighten their belts to make ends meet. In uncertain times, households save more and reduce debt.

Governments shouldn't do this, and don't. Rather than belt-tighten, they allow the automatic stabilisers to operate: expenditures on unemployment benefits rise and tax revenues fall. As well, additional stimulus is often provided to regain full employment as quickly as possible.

Households may respond to hard times by seeking more income. But when budget tax revenue falls in a recession, it would be foolish to raise tax rates to compensate.

When households incur too much debt, they risk bankruptcy. When governments issue debt in their own currency, they can always honour their debt.

In short, households are inevitably pro-cyclical, spending up big in good times and making a downturn worse by skimping. Governments are meant to do the opposite: that's what macro-policy is about.

Why, then, the vehement criticism of the US budget and debt?

At 10 per cent of GDP the deficit is the largest since 1945. In part this reflects the slide into recession and the automatic stabilisers. But it also reflects a failure to achieve surpluses during the boom times. "Exhibit A' is the Bush tax cuts for those with taxable income over $250,000.

The deficit is not an intrinsic or intractable structural problem. After all, the budget was in surplus as recently as the last years of the Clinton presidency. If Clinton could do it, why not Obama?

The economics is simple: action is needed on both the revenue and expenditure sides. The time profile is, in principle, equally straightforward: don't implement the restructure while unemployment is at 9 per cent. But make a credible detailed commitment, now, to bring the budget back into balance over the medium term as the economy recovers.

The Tea Party's mantra of no tax increases would make this impossible. Federal tax revenue is historical 18-19 per cent of GDP. It is currently 14 per cent, reflecting the recession, the Bush tax cuts and payroll tax cuts. The Congressional Budget Office (CBO) projects that if all tax cuts were restored to their full legislated levels, tax revenue would rise quickly, reaching 23 per cent of GDP by 2035. The budget would be close to balance within a few years and the debt ratio would plateau.

On the expenditure side, the problem is a 'sleeper': the aging population and increasing healthcare costs will raise related expenditures from 10 per cent of GDP to 15 per cent. To put this in perspective, the long-run ratio of Federal expenditure to GDP (excluding interest payments) has been 18.5 per cent.

This COB projection seems eminently achievable. On the tax side, it will be some time before payroll tax can be restored. But the Bush tax cuts have been the culmination of a long progression of tax reductions which have taken the top marginal rate down from 75 per cent to 35 per cent. In 1992 the top 400 taxpayers paid an average tax rate of over 29 per cent but now, with incomes increased five-fold, they pay 21.5 per cent. As Warren Buffet noted recently, he and his billionaire friends have been 'coddled long enough by a billionaire-friendly Congress'.

This is symptomatic of a wider point: America is a lightly-taxed country. Among the OECD countries, even in normal times the total tax (Federal and state) is the fourth lowest, beaten only by Turkey, Korea and Mexico. There is clearly considerable scope for other taxes. The US is one of only two OECD countries with no Federal VAT (the other is Saudi Arabia). The tax system is full of loopholes inserted by Congress for favoured constituents. Petrol is still cheap, so there is room to tax energy more heavily.

That said, there is work to be done on the expenditure side as well. America is still struggling to keep healthcare costs contained. And of course it's not hard for the 'small-government' advocates to find examples of egregious waste.

This CBO projection would take the debt-to-GDP ratio from 69 per cent this year to flatten out just over 80 per cent. Of course the CBO also has a less sanguine projection. If taxes are not quickly returned to normal and if healthcare expenditures are not constrained, debt climbs to its historical peak of 109 per cent by 2023, and to 190 per cent in 2035.

This is an unsubtle message. The budget is fixable, but it will take some hard work. The Clinton surpluses required Herculean efforts by bi-partisan committees restraining expenditures and promoting tax increases. A similar outcome was within reach as recently as the Bowles/Simpson proposals late last year (which envisaged that debt could be stabilized at 65 per cent of GDP). A Congressional 'super committee' has been given the task of cutting expenditure, but its mandate and composition suggest that it is not up to the task.

There is no need to dramatically cut the deficit right now. Financial markets are ready to fund the deficit at rates which are lower than they were before the S&P downgrade. What is needed now is a credible commitment to get onto a path resembling the CBO's sanguine projection. Financial markets have been spooked not by the intrinsic problem of the deficit or the debt, but by the apparent political impasse. Will the Tea Party really stick to its resolve to 'starve the beast', even if this means imitating Japan's lost decades?

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