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Zandi: Economic optimist

It is easy to be gloomy about our nation's fiscal problems. The federal government narrowly averted a shutdown over the 2011 budget and it looks like lawmakers plan to play chicken over the fast-approaching national debt ceiling. These same lawmakers must soon reach agreement on long-term government spending and tax policy, or the nation will suffer fiscal and economic ruin. Yet I'm optimistic.

Lifting the debt ceiling by July 4 is absolutely vital; otherwise the Treasury will be unable to borrow and be forced to slash spending. As it happens, the gap between federal revenues and expenses reaches its deepest point of the year in mid-July, nearly $6 billion per day. The Treasury will pay its bills until nothing is left, then simply stop.

No government function will be spared. Never mind keeping national parks open or funding Planned Parenthood; in question will be payment for our soldiers, Social Security and Medicare checks, food stamps and unemployment insurance. There is even debate about whether the government will miss interest and principal payments on its debt. Such a default would send global financial markets into turmoil, drive interest rates skyward and cause stock and house prices to crash.

The scenario is so scary as to be unimaginable, and thus is not possible, in my view. More likely, something positive will emerge from all the brinksmanship. In late 1995 and early 1996, when the government last shut down, policymakers averted calamity by making significant reforms to Social Security.

This time, policymakers could agree to change the budget process. President Obama last week called for automatic spending cuts and tax increases if the federal deficit hasn't narrowed sufficiently by the middle of this decade. Even Republicans might find this appealing.
But changing only the budget process won't come close to adequately addressing our long-term fiscal problems. That requires fundamental changes to spending and tax policy.

The good news is that a political consensus is forming between the rational right and rational left. Two bipartisan commissions have now concluded that both spending cuts and tax increases are necessary, and that the biggest part of deficit reduction should come from less spending. Historical experience suggests that countries that tackle their fiscal problems by spending less see their economies perform better in the long run.

In addition to freezing discretionary spending, Congress must put entitlement programs on solid financial ground, permanently. Indexing the Social Security retirement age to longevity, means-testing benefits and tying them more accurately to inflation are all ways to do this. The changes should not affect those nearing retirement, who counted on the current system in their planning. But younger workers have decades to make the necessary adjustments.

Tax reform, meanwhile, should focus on reducing tax expenditures — those exclusions, exemptions, deductions, and credits that currently cost the federal government close to $1.2 trillion per year. The mortgage-interest deduction is among the largest of these, but hundreds of other loopholes indirectly pay for tuition, health insurance, child care, local property taxes, and so on. From an economic perspective, there is no difference between eliminating tax loopholes and cutting government spending; the result is the same.

Limiting tax expenditures could raise enough revenue to allow lower marginal tax rates for individuals and corporations. This might help end the decade-old political war over tax rates for those making over $250,000 a year. It would also make U.S. firms more global competitive and likely to invest and hire at home.

I'm not saying any of this will be easy; policymakers will almost surely need a push from markets. Interest rates are still low, suggesting the global investors who buy U.S. government debt don't mind our fiscal mess. But their patience stems largely from the lack of alternatives. Europe and Japan have fiscal problems worse than ours and emerging economies are too small to absorb all the available global cash. This won't last. Indeed it may take higher interest rates to convince Americans and their representatives that there is no alternative to solving the nation's fiscal problems.

Even then, it will take political courage to get the job done. Whoever is in charge after the next election will need to show a clear willingness to both raise taxes on the middle class and impose cuts on the future growth of Social Security and Medicare. Supporters will rebel, as did supporters of the first President Bush when he backtracked on his "read my lips" pledge. Bush didn't get a second term, but his brave move led to a federal budget surplus a decade later.

No leader can really change anything without being willing to give up everything. Our nation has overcome many daunting challenges, mostly because we had leaders who put the nation's future ahead of their own. It is time for our current leaders to do the same, and I'm optimistic they will.

Mark Zandi is chief economist of Moody's Analytics Inc. He can be reached via help@economy.com.

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