The Washington Post
POSTOPINIONS

Moody's economist Mark Zandi: How to cut the deficit — and the trouble if we don't

By Mark Zandi, Friday, July 15, 10:34 AM

The Obama administration and Congress must raise the federal debt ceiling by Aug 2. That is all there is to it. In a post-default world, financial markets would unravel and the U.S. and global economy would enter another severe recession. The nation's already daunting fiscal problems would spiral out of control as tax revenue plunged and demand surged for unemployment insurance, food stamps, Medicaid and other programs supporting vulnerable Americans.

Yes, it would be wonderful if politicians could agree to rein in future budget deficits as part of a debt-limit deal. But that isn't necessary right now. Simply raising the debt ceiling enough to last through next year's elections would appease global investors and sustain the economic recovery. The 2012 vote will be a referendum on how to address our fiscal problems: The winner sets the agenda, and tough decisions can be made after the next president and Congress take office.

It is laudable that lawmakers have attempted to do more now, hoping that the pressure surrounding the debt ceiling would force big changes in fiscal policy. And it is encouraging that they are coalescing around the same budget math: President Obama has called for about $4 trillion in deficit reduction over the next decade; so did Republican Rep. Paul Ryan (Wis.), chairman of the House Budget Committee, in his budget proposal; and so did the Simpson-Bowles fiscal commission. About $4 trillion over 10 years is the amount of deficit reduction needed to make the government's fiscal situation sustainable, keep interest rates low and strengthen our economy in the long run.

There are significant disagreements over the composition of the deficit reduction, but these can be overcome, if we agree to achieve the entire $4 trillion reduction through cuts in government spending — and that includes tax expenditures.

Here's how that can work. Approximately $2 trillion in cuts would affect discretionary non-defense spending, defense outlays and entitlement programs. (After all, there is no way to address our budget problems without meaningfully changing Social Security, Medicare and Medicaid.) Another $1 trillion would come through cuts in tax expenditures — the exclusions, exemptions, deductions and credits that riddle the tax code, costing the government more than $1 trillion each year. The mortgage interest deduction alone is worth some $1.4 trillion over the next decade. But there are hundreds more, indirectly funding student expenses, health insurance, child-care costs, local property taxes and on and on.

Tax expenditures are more properly thought of as government spending than as tax cuts. A deduction for local property taxes, for example, is equivalent to the federal government sending checks to homeowners. Cutting tax expenditures is thus cutting government spending. Indeed, removing tax expenditures — tax breaks targeted for specific purposes — is analogous to eliminating congressional earmarks.

Most tax expenditures are also inefficient and regressive. The mortgage interest deduction, for example, does nothing to improve housing affordability, its ostensible goal. Any tax benefit is simply capitalized into house prices, which rise as the deduction fuels demand. And the benefits go to owners of bigger homes with larger mortgages and higher incomes, who can itemize and thus claim the deduction.

These spending cuts and tax-code changes should not begin today or even next year; the recovery is too fragile right now. There already is a substantial level of restraint in our fiscal policy: The current payroll tax holiday will expire at the start of next year, for instance, as will the emergency unemployment insurance program. But by 2013, the odds are that the economy will be strong enough to gracefully digest more spending cuts, as long as they are phased in over the decade.

The remaining $1 trillion in spending cuts needed to reach the $4 trillion deficit-reduction target would result from lower interest payments on a smaller federal debt load as the other cuts are realized. This highlights the benefits of acting quickly and definitively — as well as the cost of not acting: Interest payments would continue to mount and ultimately overwhelm the budget.

Even if a comprehensive agreement to achieve fiscal sustainability is out of reach right now, lawmakers must not go over the debt-ceiling cliff. Without an increase in the ability to borrow, the federal cash flow might be sufficient to make timely debt payments, but what of the government’s countless other obligations? And credit-rating agencies are nervous that Treasury wouldn’t even be able to make debt payments a priority; Moody’s, my employer, just put U.S. debt on review for a possible downgrade.

Defaulting on the nation’s debt would be cataclysmic. The U.S. Treasury’s Aaa rating is the one constant in the world’s financial system. When times are bad anywhere on the planet, global investors flock to Treasury bonds because they know they will get their money back. This “flight to quality” has pushed U.S. interest rates to near-record lows and has been vital to keeping our economy afloat. Yet this benefit was earned over more than two centuries by adhering to the bedrock principle that the United States always pays its bills on time. One misstep, and the government would have to pay higher interest rates for years, perhaps for generations.

Even if Treasury was able to put debt payments at the top of its priority list, the government would come up well short on its other obligations. The shortfall in August alone would approach $150 billion. Government employees could be furloughed, unemployed workers might not receive full benefits, and even Social Security recipients and veterans could come up short.

Though in this scenario there would be no U.S. debt default, stock and bond markets would still react harshly. Cracks are already developing in the market for credit-default swaps on Treasury bonds, where investors buy insurance in case of a bond default. If there is no progress on the debt ceiling in the coming week, more rating agencies will act, and these cracks will turn into fissures.

If spending cuts began in early August, global investors would question the security of their bonds as they saw even Social Security recipients going unpaid. We may have a rerun of the TARP moment in September 2008, when the House initially voted down the bank bailout fund and stock prices plunged. At the very least, stock markets and the value of the dollar would fall sharply and interest rates would spike if the deadline for raising the debt ceiling was missed.

Turmoil in the financial markets, along with draconian cuts in government spending, would sink the fragile economic recovery overnight. There is no way the private sector could fill the gap created by such a sharp pullback in federal outlays. With such a diminished economy, tax revenue would suffer and demands on government support programs would increase, worsening the nation's fiscal situation. Instead of needing $4 trillion in deficit reduction over 10 years to achieve fiscal sustainability, we would require something closer to $5 trillion. And unemployment would again reach double digits and remain stuck there for at least a couple of years.

It is hard to imagine that political leaders and policymakers would dare go down this dark road. So I expect that they will find a way to increase the debt ceiling on time. If they also figure out how to even partially address our long-term fiscal problems during their negotiations over the next couple of weeks, that would be a big plus. But it is not necessary right now. That's what the 2012 campaign will be all about.

Mark Zandi is the chief economist at Moody's Analytics and the author of "Financial Shock: Global Panic and Government Bailouts — How We Got Here and What Must Be Done to Fix It."

Read more from Outlook, friend us on Facebook, and follow us on Twitter.