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On a debt high wire

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These are scary times for the U.S. economy. And nothing is scarier than Washington's war over the federal debt ceiling.

The Obama administration and Congress have two weeks to act; otherwise, financial markets will be thrown into turmoil and the economy will fall back into recession. I believe policymakers will act in time, but my conviction wanes with each passing day.

Because the issues are so complex, let's try to explain the current mess through questions and answers:

What is the debt ceiling? This is a legal cap on the amount of debt the federal government can issue. The law was first passed almost 100 years ago as a condition on federal borrowing for World War I. It has been raised many times since then without a problem

The limit is currently $14.29 trillion. According to the Treasury Department, the government will reach that limit Aug. 2. After that, the Treasury says it will pay bills as they come in, until it runs out of cash. It is unclear whether the Treasury will have enough cash to make a $23 billion Social Security payment that is due in full Aug. 3.

Some have suggested that Aug. 2 isn't a firm date and that the Treasury could figure out a creative way to pay its bills. This is incorrect. There literally isn't enough to meet all the government's obligations.

Will the nation default on its debt if the ceiling is not raised in time? It's hard to see how the Treasury could avoid a default - a failure to make interest and principal payments on its bonds on time - if the debt ceiling isn't raised this month. The Treasury's projected cash shortfall for August alone is close to $150 billion.

That's a very large hole to fill; it would require cutting a huge amount of government spending to make the debt payments on time. This may be impossible anyway, since the Treasury says it doesn't have the legal authority to prioritize debt payments over the government's other obligations.

What would be the economic impact? All Americans would suffer. Stock and house prices would fall, interest rates would rise, and the economy would slide into a severe recession. The unemployment rate would quickly rise back into double digits, and would stay there for at least a couple of years.

The nation's fiscal problems would also deteriorate; a new recession would shrink tax revenues and put more pressure on government to spend on unemployment insurance, food stamps, Medicaid, and other income supports. We all would face much higher interest rates for years, and perhaps decades, as investors demanded compensation for an increased risk that the United States would default again in the future.

Will lawmakers resolve their differences and raise the debt ceiling? The prospects that they will are high. It is hard to imagine elected officials being so reckless with our economy. If you don't buy that, it is hard to imagine them being so reckless with their own political futures.

Financial markets are betting they won't be. At least so far, stock and bond markets have reacted little to the rancor in Washington. Investors have witnessed numerous political close calls - the most recent being the government's near shutdown this spring over the budget - and know we always get it together in time.

What will policymakers agree to in order to get a deal? The most likely deal will involve as much as $2 trillion in government spending cuts over the next decade. This isn't enough to solve our fiscal problems, but it is a reasonably good start. The cuts would mostly involve spending caps on discretionary programs, including defense, but would also include some Medicare savings. The deal is not likely to include substantive increases in tax revenues.

What is needed to solve our fiscal problems? Even if they make this deal, policymakers have much more work to do. To restore stability to the nation's finances, deficits must shrink by $4 trillion over the next decade. Given the dollars involved, this will require cuts to Social Security, Medicare, and Medicaid spending and also require more tax revenue.

The revenue doesn't have to come from higher tax rates. Indeed, it would be better if it came from decreasing the many deductions, credits, and other loopholes in our tax code. These tax expenditures are just another form of government spending: There is no difference between the taxes saved from a home-mortgage deduction and the government sending you a check of equal value.

But these will be very difficult changes to make and thus will have to wait until after the 2012 election. That election will be a referendum on these issues; whoever takes office in 2013 will decide how to address them. Since I was 18 years old, I've been told that each election was the most important of my lifetime. This one really is.

It is not hyperbole to say that the nation's economic fate depends on whether the Obama administration and Congress raise the federal debt ceiling by Aug. 2. I believe they will do the right thing. They had better.

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