Paydown problems

America As federal debt nears the ceiling mandated by Congress, the need to tackle the budget deficit is ever more evident – but neither the economic nor the political climate is right, writes **James Politi**

It was the most startling of warnings. If the US does not get its finances in order "we will have a European situation on our hands, and possibly worse", claimed Paul Ryan, the new Republican chairman of the House of Representatives budget committee.

The consequences of not tackling the country's mounting debt burden would be dire, he last week told an audience of leading budget experts and economists at a gathering in Washington. "We will have the riots in the streets, we will have the defaults, we will have all of those ugliness problems," he said, referring to "French kids lobbing Molotov cocktails at cars, burning down schools because the retirement age will be moved from 60 to 62".

As it stands today, the US borrows about 40 cents of every dollar it spends. Curbing the budget deficit has been the stated mission of Mr Ryan, a rising Republican star, for several years. But such calls for action have multiplied in Washington in recent months, igniting what some say is the fiercest debate over fiscal and budgetary policy in decades.

The risks are big. If the government rushes into austerity, cutting too much and too quickly, it could stunt economic recovery. But if the political system cannot forge some kind of consensus on steps to restore US deficits to sustainable levels, the danger is potentially even greater: a sovereign debt crisis in the world's largest economy.

"It's a weak period for the economy, so I don't think you want to do serious deficit reduction anyway, but we are playing a dangerous game and we will start to pay a price for fiscal irresponsibility," says Ethan Harris at Bank of America Merrill Lynch.

The big fear is that if no action is taken, investors might eventually punish the US for its fiscal laxity. That would raise borrowing costs for businesses and consumers, force severe austerity measures and risk social unrest. Not only America's triple-A credit rating could be threatened; some point to consequences in foreign affairs and defence as well. Mike Mullen, chairman of the joint chiefs of staff, last year warned that the debt pile could limit the flexibility of the US in funding its military – in his eyes the "most significant threat to our national security".

So far, capital markets have not reacted much to the dismal long-term outlook. The 10-year Treasury yield, for instance, has been trading this week well below 3.4 per cent, close to historical lows although it has risen in recent months. Still, a growing number of voices are calling for a deal to address America's strained public finances, even if it means tackling programmes such as retirement benefits and healthcare for the elderly that have long been protected.

Gene Sperling, a fiscal hawk who returns as head of the National Economic Council

Jack Lew, new White House budget director: 'continuing to invest' amid cuts

Yet whether this anti-deficit rhetoric translates into a meaningful turn towards austerity in the coming months – and leading into the 2012 presidential election – is much in doubt, for two main reasons: severe political divisions and the continuing fragility of the economic recovery.

"It's not urgent but at some point it's going to become more urgent," says Phillip Swagel, who was a senior economic official in the George W. Bush administration. "Clearly the markets don't think we're Argentina, but we should send them a signal that they are right, that we will address the issue."

A deal extending Bush-era tax cuts and unemployment benefits in December failed to send that message, adding $858bn to long-term deficits without any commitment to reductions in the future, even though supporters argue that if the measures boost growth, America's budgetary position will improve too.

But more big tests of America's commitment to fiscal discipline are looming. On January 25, President Barack Obama will lay out his legislative priorities for 2011 in his State of the Union address to Congress, and measures to reduce long-term deficits are expected to be on the agenda.

Some policies have already been flagged. In December, the president announced a two-year freeze on pay for civilian government workers, a nod to the need for budget cutting to begin at some point. The Pentagon has also been trying to get ahead of the game: last week it announced that it would trim its annual budgets of more than $500bn by a combined $78bn over the next five years compared with earlier projections.

Along with possible additional steps to cut discretionary spending across government agencies, start tackling social security reform and set a framework for tax reform, these measures will be incorporated into the White House's proposed annual budget, to be presented in mid-February. Much attention will be paid to both the scope of these proposals and how specific they are, and to signs of the seriousness of the administration's commitment to deficit reduction.

'Using the need to raise the debt limit as a way to force a crisis could undermine the US severely'

Jack Lew
Budget director

Mr Obama's new economic team certainly bodes well for fiscal hawks, including as it does Jack Lew as budget director and Gene Sperling as head of the National Economic Council. The two are back in the same roles they held under Bill Clinton in the 1990s, when the US reduced its deficit through negotiations between a Democratic White House and a Republican Congress. Mr Clinton left office with a budget surplus.

Few expect the administration to take the aggressive approach sought by some prominent Democrats such as John Podesta of the Center for American Progress, a think-tank with close ties to the Obama White House. This would involve cuts to large programmes such as Social Security and Medicare, followed swiftly by a move towards tax reform. But it is unlikely to happen, because it could expose the administration to a barrage of attacks from both its Democratic base and from Republicans.

Nevertheless, Mr Lew maintains that the administration's resolve on deficit reduction is clear. "We need to have a bipartisan effort, which will address the serious fiscal challenges before us while at the same time promoting an agenda that will build the foundation of the American economy in the future, which to us means continuing to invest in education and innovation even while we make reductions in other places," he says.

But Republicans, who gained control of the House of Representatives in elections last November, partly on a message of fiscal rectitude and opposition to government spending, have other things in mind. They envisage spending cuts on a much larger scale than what is palatable to the White House or many congressional Democrats – and could resist any attempt by the administration to press ahead with new stimulus measures.

Many Republicans have shown little willingness to consider tax increases as part of any deficit reduction package – which many economists believe to be an essential component of a deal. The result could easily be gridlock, with both parties and the White House trading accusations, and investors and businesses growing increasingly nervous about America's ability to deal with the debt problem.

Meanwhile, a deadline that will force the two parties to engage – and probably battle – on fiscal issues is close. Any time between March 31 and May 16, the Treasury estimates, US debt will hit its congressionally mandated limit of nearly $14,300bn. If the administration and Capitol Hill cannot agree on a deal to raise that threshold, the US would have to shut down the government and default on its international debt obligations – potentially triggering the debt crisis that for the moment seems so distant.

Many Republicans have insisted that a higher debt ceiling should be tied to their aggressive spending cut targets, setting the stage for a big political showdown as the date approaches.

The administration does not believe the debt limit should be used as a bargaining chip to extract concessions. "Our view is a clean debt bill is the only responsible thing to advocate – and we're clearly going to have to engage in Congress on this," says Mr Lew. "We have no alternative but to raise the debt ceiling and it would be irresponsible to use the need to raise the debt limit as a way to force a crisis that could undermine the US economy and its standing in the world very severely."

Lawmakers as well as analysts expect in general that over the next few months a limited agreement – possibly on its own, and possibly involving the enactment of some deficit reduction measures proposed by the administration plus some new ones – will be reached. But while such an accord could placate investors in US debt for some time, it will probably only delay America's reckoning with its unsustainable public finances rather than correct the course.

America's budget deficit in the year to last September amounted to about $1,300bn – the second highest on record. Over the next several years, as the economic recovery advances and the impact of emergency spending measures taken during the recession start to wane, the country's deficits are expected to shrink naturally.

But the relief will be temporary: because of the retirement of the baby-boomer generation, which starts in earnest this year, the cost of government healthcare and pension programmes is projected to soar. According to a report issued last month by an 18-member bipartisan commission on fiscal responsibility, by 2025 tax revenues will be sufficient to finance only interest payments – which are projected to soar from their current $200bn a year to more than $1,000bn – and entitlement programmes, with no room for anything else.

"Every other federal government activity – from national defence and homeland security to transportation and energy – will have to be paid for with borrowed money," it warns. By 2035, rising debt could reduce gross domestic product per capita by as much as 15 per cent. That would imply a harsh reduction in Americans' standard of living.

Paul Ryan, Republican chair of House budget committee: warns of 'riots in streets'

Kent Conrad: Democratic chairman of Senate budget committee

This gloomy picture is what could eventually cause a crisis in international capital markets. It is also what drove the commission, led by Erskine Bowles, former White House chief of staff under Mr Clinton, and Alan Simpson, former Republican senator from Wyoming, to attempt what had rarely been tried before in Washington: to craft a detailed template to solve the country's budget woes, offering Americans and their lawmakers a concrete glimpse of what it would take to correct the problem.

The plan recommended a total of $3,900bn in deficit reduction by 2020, with a three-to-one ratio of spending cuts to tax increases. The commission proposed raising the state pension age, curbing government healthcare and limiting popular tax breaks such as the ability to deduct interest paid on mortgages.

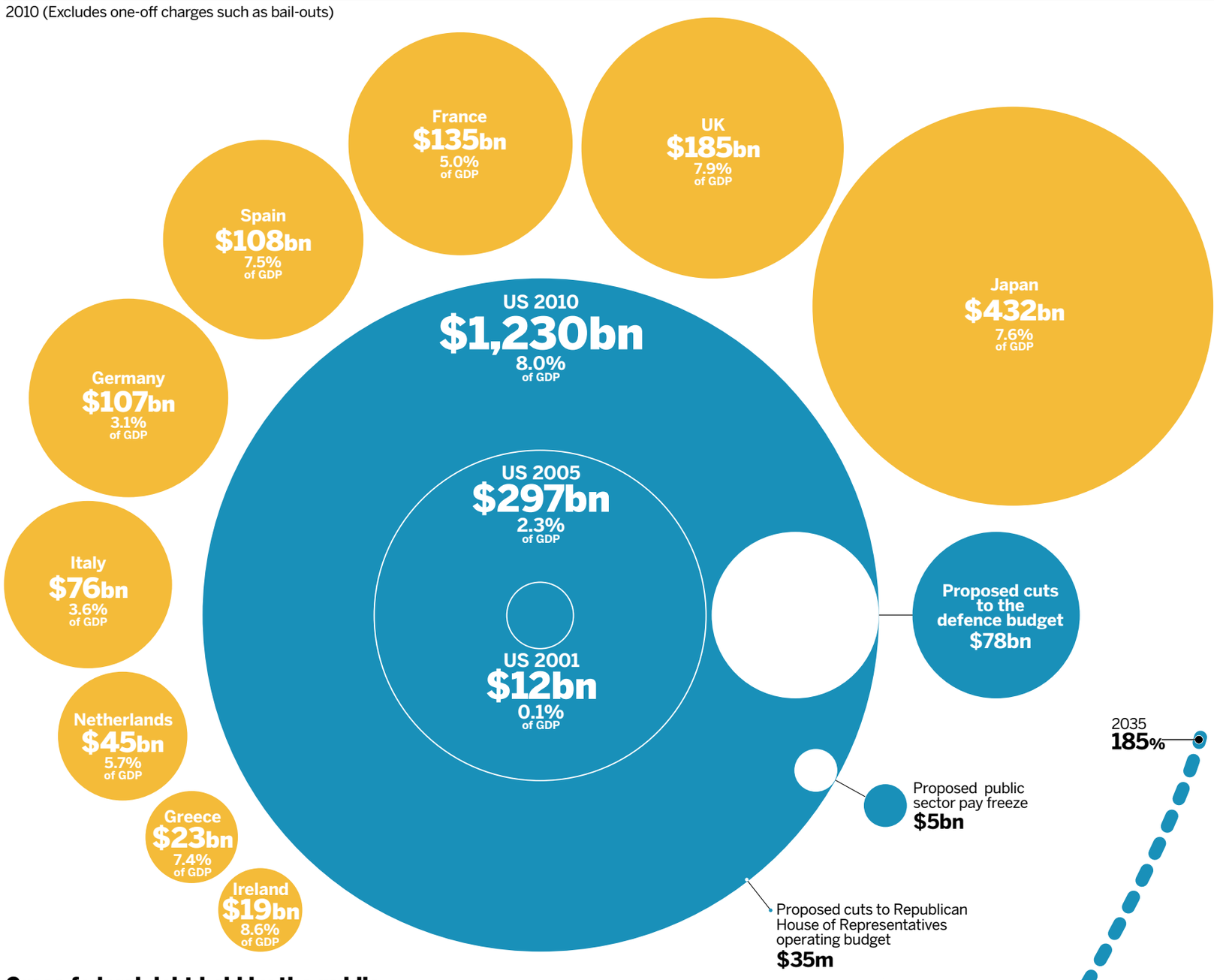
Some potential options to cut the deficit – such as a consumption or value added tax, or a tax on carbon – were sidelined as politically infeasible. That contributed to a surprising level of agreement on the recommendations, with 11 panellists voting in favour of the package, including six sitting lawmakers. Still, this was not enough to force a vote in Congress on the measures, which would have required a 14-member majority.

The failure of the Simpson-Bowles commission to reach the required threshold is what left America's fiscal fate in the hands of the ordinary political process, from the White House to congressional leaders such as Kent Conrad, chairman of the Senate budget committee, as well as Mr Ryan. Turning back to Europe's debt woes, Mr Ryan declares: "This is not who we are, and this is not the fate that we want to have."

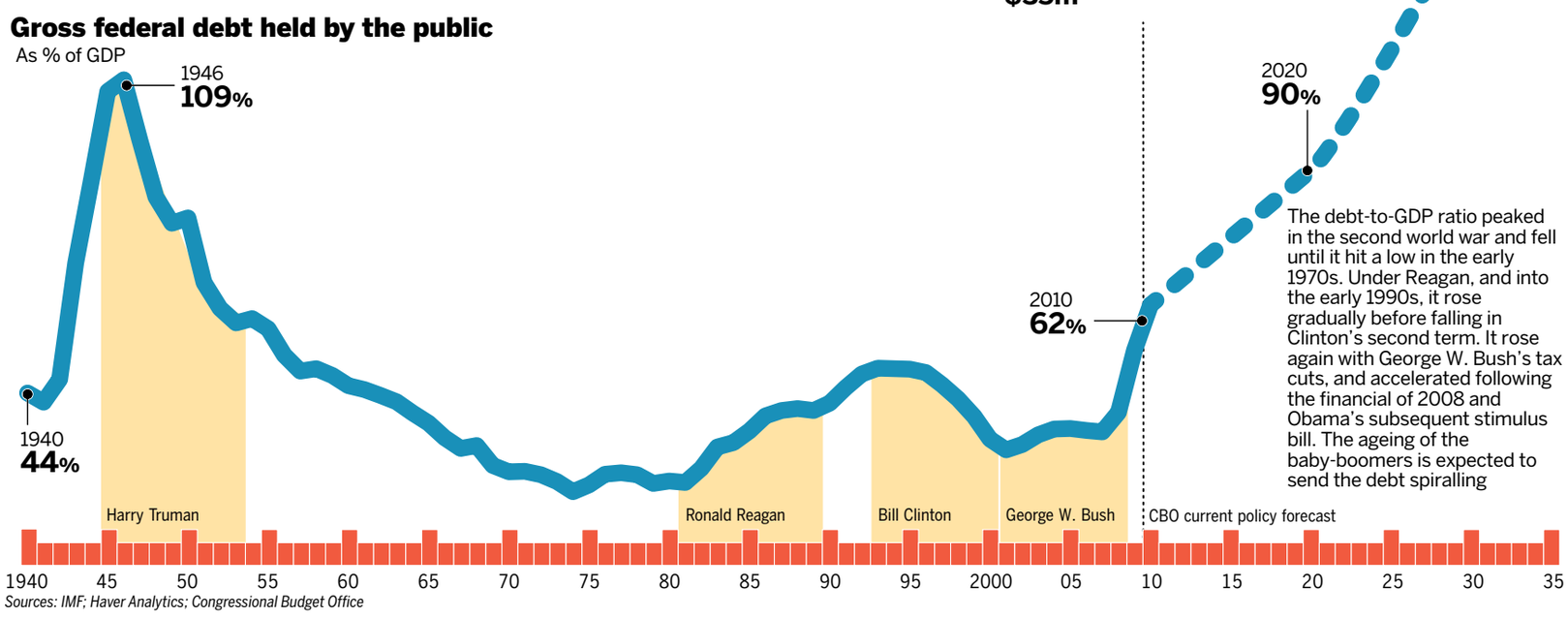
However avoiding that fate – and ushering in a new era of US fiscal responsibility – will require a level of political harmony that, in spite of a growing awareness of the problem, still seems elusive.

Structural deficit

2010 (Excludes one-off charges such as bail-outs)



Gross federal debt held by the public



Sources: IMF; Haver Analytics; Congressional Budget Office

IN DEPTH

States of emergency: news, analysis and commentary on a state-level fiscal crisis facing the US
www.ft.com/usstates

Austerity America

Cuts start to hurt as states seek to balance the books

While the US may take steps this year to curb its deficit, large-scale fiscal retrenchment on a federal level is not widely expected until after 2012. Many Americans, however, already have a sense of what austerity feels like.

State and local governments, run by both Republicans and Democrats, have been busy slashing public programmes – and in some cases raising taxes – to plug huge budget shortfalls brought on by the recession.

Some measures have been extremely painful: states have narrowed the eligibility of low earners to government healthcare programmes; public university tuition rates have increased as financial aid for students has been cut at state level; and an estimated 400,000 state and local workers – including teachers and firefighters – have been fired since August.

Others are happening this year. On Tuesday, the Illinois state legislature raised its income tax from 3 per cent to 5 per cent, and the corporate tax rate from 4.8 per cent to 7 per cent. The budget proposal unveiled by Jerry Brown, California's new governor, includes $12.5bn in cuts. Among them are a 10 per cent pay reduction for state employees; $1.5bn less funding for CalWorks, an employment programme for the poorest residents; and $1bn in cuts for higher education, including the University of California system.

"What states face is their worst budget year ever because revenues are still down and the need for services is up and federal aid is running out," says Nicholas Johnson of the Center on Budget and Policy Priorities in Washington. Paul Krugman, economist and commentator for The New York Times, has said the US is suffering from the actions of "50 Herbert Hoovers – state governors who are slashing spending in a time of recession", in a comparison with the US president in office during the Great Depression.

The reason these tough measures are being taken on a state level is that every state – except Vermont – is required by law to balance its budget every year, a fiscal straitjacket that does not bind the federal government.

If some states and local governments fail to meet this requirement, jeopardising their ability to pay creditors, it could seriously damage municipal bond markets, a cornerstone of US capital markets, potentially precipitating a new financial crisis.

For this reason, there has even been talk of possible federal bail-outs of the largest and worst-off states, though that seems unlikely at present. Republicans in control of the House of Representatives are resistant; and Ben Bernanke, Federal Reserve chairman, has said states should not expect loans from the central bank.

Fonte: Financial Times, London, January 14 2011, Primeiro Caderno, p. 7.