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PIIGS "Я" US?

THE COMING U.S. DEBT CRISIS AND WHAT CAN BE DONE ABOUT IT

Stephen R. Richardson*

SUMMARY

The U.S. is beset by weak economic growth, ballooning debt and stubbornly high unemployment but the collapse of the housing bubble that spurred the 2008-2009 global financial crisis was more a consequence than a cause of what is wrong. The real culprit was and remains poor policymaking in the areas of taxation, finance and economics, which helped bring on the crisis by encouraging Americans to engage in counterproductive behaviour. This paper warns that without meaningful fiscal reform, the U.S. risks joining the PIIGS — Portugal, Ireland, Italy, Greece and Spain — on the road to ruin through unsustainable debt, high spending and chronically low growth. The author acknowledges the heated partisan debate over whether the answer is higher taxes or lower spending and explains that neither course alone offers a practical way out. A balanced approach incorporating aspects of both, combined with detailed policy reform as set forth in this paper, is the best solution. U.S. politicians must put aside their differences and replace bad policies with sound ones or the American economy will face disaster.

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The United States of America has the largest, most innovative and most flexible economy in the world. But two years after the global financial crisis of 2008-2009, the U.S. economy is struggling badly to recover:

- Economic growth is anaemic: at 1.9 percent real GDP growth in the first quarter of this year;[1]
- Unemployment and underemployment is high and chronic: at 9.2 percent, with only a little more than one million of the over eight million jobs lost in the recession having been recovered;[2]
- U.S. consumers, savers and investors are weighed down by a staggering 32 percent decline in the value of residential housing[3] — a percentage decline similar to that during the Great Depression;
- Serious commodity inflation is dragging down consumption and production; the CRB commodities index has increased about 30 percent in the last year.[4]

Perhaps this picture simply reflects a slow but reliable recovery toward a strong economy following a cyclical economic downturn? It does not.

Perhaps, left to its own devices, the U.S. economy will over time mend itself and return to the high levels of economic growth and prosperity Americans have become used to? It will not.

The global financial crisis of 2008-2009 was not a normal cyclical economic downturn. It resulted from the implosion of a huge asset bubble in the U.S. housing market. The reasons for the lack of a meaningful economic recovery can be traced to serious structural problems in American economic, fiscal and tax policy, which helped cause the crisis, and to the U.S. government's response to the crisis.

While the U.S. housing bubble was exacerbated by some important regulatory and financial market failures, these were not its fundamental cause. In the context of large-scale securitization of U.S. residential mortgage debt, these failures served to add to the magnitude and severity of the crisis.

At the root of the global financial crisis was bad public policy on the part of the U.S. Government, and some other countries. These bad policies took the form of aggressive government borrowing, massive over-subsidization of private housing and an extended period of cheap money.

Thus, it is important to bear in mind that the economic actors in this drama — from the families who borrowed too much money for a home, to the developers who went on a building spree to supply them, to banks and investors who provided too much risky capital to fund them — were not acting from a lack of reason; they were doing what government policies were encouraging them to do.

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[1] U.S. Department of Commerce, Bureau of Economic Analysis.

[2] U.S. Department of Labor, Bureau of Labor Statistics.

[3] S&P/Case-Shiller Composite 20 Index.

[4] See the Thomson Reuters/Jefferies CRB Index.

Examples of key U.S. government and central bank policy structures that helped cause the housing bubble include:

- The activities of the two giant government sponsored mortgage financiers, Fannie Mae (FNMA) and Freddie Mac (FHLMC);
- Mortgage interest deductibility for income tax purposes;
- Highly leveraged financial institutions;
- Minimal restraints on sub-prime lending;
- An extended period of cheap money spurred by low policy interest rates.

These policies led to an enormous, debt-financed over-investment by Americans in residential real estate, which represented a misallocation of economic resources in the economy on a grand scale. This resulted in unsustainable and ultimately unproductive economic activity in residential construction and many other derivative areas, which in turn fuelled unrealistic housing price increases that could not be maintained.

When housing prices fell and the housing bubble finally burst in 2008-2009, homeowners, developers, lenders and investors sustained enormous financial losses.

Similar price declines occurred in the U.K. and some other European markets at about the same time for similar reasons.

Financial institutions and investors in the U.S. and around the world were heavily exposed to the U.S. and other housing markets through the residential mortgage market, not only as mortgage originators, but also through widespread securitization of mortgage debt and the use of credit default swaps. In this way, the housing crash in the U.S. quickly became a worldwide financial crisis as institutions and investors saw the value of their assets fall or were called on their own financial commitments. This widespread loss of value froze credit markets and many of these institutions then failed or had to be bailed out by governments. One contemporary estimate put the total financial system losses at $4 trillion.

The combination of massive losses in the housing market and in the financial system quickly led to a severe contraction of consumption, industrial production and business investment, which brought on serious recessions throughout the developed world.

This extraordinary financial crisis demanded extraordinary measures from governments. Fiscal spending and monetary loosening measures by governments and central banks around the world — particularly as co-ordinated by the G-20 — prevented a complete financial meltdown, but only at the cost of transferring large amounts of private loss and private debt into public debt. Some countries like Canada went into the global financial crisis in a strong fiscal and structural position (Canada's net government debt was 23 percent of GDP[5]) and suffered less of an economic shock, managing the added costs of fiscal stimulus comparatively easily.

Other countries struggled more. The U.S. and some European countries, in reacting to the global financial crisis, greatly increased their already large public debt loads by borrowing more money to fund financial losses, bailouts and fiscal stimulus.

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[5] OECD Economic Outlook No. 89, 2011.

U.S. borrowing, in particular, has occurred on a huge scale. The U.S. government continues to run an annual deficit of about $1.4 trillion (about 9.5 percent of GDP).[6] Even at current extremely low interest rates, Secretary of the Treasury Timothy Geithner recently noted that this results in the government having to borrow close to 40 cents for every $1 it spends.[7] These massive annual deficits have, in only a few years, swollen U.S. federal gross debt to about $14.3 trillion—the current legal borrowing limit.

U.S. federal debt, when added to state and local government debt, results in total net government debt of about 75 percent of the country's GDP[8] — a percentage that is increasing rapidly with annual deficits. As bad as this picture is, it worsens if future unfunded liabilities, particularly for entitlement programs such as Social Security and Medicare, are taken into account. Some estimates of these unfunded government liabilities amount to well over $50 trillion.[9]

Even though current political negotiations to raise the legal debt ceiling to avoid a U.S. government default at the beginning of August 2011 may result in some spending reductions going forward, they are unlikely to do much to halt rapidly increasing government debt. A spending cut in the range of $2 trillion over 10 years would be only a $200 billion reduction per year, or less than five percent of the federal government's annual gross operating costs of $4.47 trillion.[10] If other key factors such as the U.S. government's presently low borrowing costs were to remain constant and if there is zero incremental growth in federal spending (both unlikely circumstances), such a spending reduction would only reduce the current annual U.S. federal deficit from 9.5 percent of GDP to around eight percent. At even optimistically robust rates of economic growth, this would not prevent a rapidly increasing debt-to-GDP ratio.

Such a large and increasing amount of public debt represents a massive burden on the U.S. government, on taxpayers and on the economy. It means that large and increasing portions of annual revenue need to be devoted to paying interest on the debt. It also increases inflationary pressures and suppresses financial activity and economic growth.

This increasing debt trajectory is unsustainable. If nothing is done soon about the growth in U.S. public debt, the situation will end badly. At some point, holders of U.S. government debt, particularly foreign holders, will see heightened risk and require higher interest rates. That will mean a downward spiral of increasing interest costs and greater borrowing. Even at current rates and using optimistic assumptions, the Congressional Budget Office has estimated that interest payments on federal debt will increase over the next 10 years from 1.4 percent of GDP to 3.4 percent.[11] Increasing interest rates from normalization and credit downgrades would make this worse. As debt continues to build, holders will eventually lose confidence altogether in the country's ability to maintain the value of its debt or repay its obligations. A financial and economic crisis, worse than the last one, will unfold.

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[6] See *2010 Financial Report of the United States government*, issued by the U.S. Department of the Treasury; also U.S. Department of Commerce, Bureau of Economic Analysis.

[7] Reported on CNBC Website: http://www.cnbc.com/

[8] Supra Note 5.

[9] These include information provided by the U.S. Government Accountability Office.

[10] Supra Note 6.

[11] *Federal Debt and Interest Costs* issued by the U.S. Congressional Budget Office.

An extreme example of what can happen when government borrowing gets totally out of hand may be seen in those unfortunate European countries known by their collective acronym as the "PIIGS." What these countries have in common is too much government debt, too little economic growth, too high a rate of unemployment and the need for financial help from the outside to avoid insolvency. The following data offer a clear picture:

	Net Government Debt 2011 (% of GDP)	Real GDP Growth 2011	Unemployment Rate 2011	EU/IMF Assistance
Portugal	75.5	-2.1	11.7	Yes
Ireland	70.0	0.0	14.7	Yes
Italy	100.6	1.1	8.4	Not yet
Greece	124.8	-2.9	16.0	Yes
Spain	45.7	0.9	20.3	Not yet

SOURCE: OECD Economic Outlook No.89, 2011

For these countries the policy choices are grim: (1) continued and severe fiscal consolidation — that is, "austerity" — in the form of increased taxes and reduced government spending; (2) default and/or debt restructuring or (3) some combination of both. All of these choices encompass, at best, a bleak national economic future in the near term and perhaps worse.

While the U.S. is not yet in the same position as the PIIGS, it appears to be heading in the same direction. And if the U.S. does not stop trying to spend and borrow its way to economic growth instead of making hard choices in favour of good structural policy changes, it may well get there. Fortunately for the U.S., there are a number of important advantages it has compared to the PIIGS, should it choose to implement a sound economic, fiscal and tax policy structure for the country.

One advantage is that the U.S. controls its own currency, which currently serves as the world's favourite reserve and safety currency. This means that the U.S. can probably retain lower real interest rates for a longer period of time than would otherwise be the case. However, easy monetary policy is not a solution to real economic problems as the last several years — which saw both historically low policy rates and massive quantitative easing — demonstrated. In the long run, the U.S. needs to return to realistic real interest rates for savings. But in the shorter term, low borrowing costs may offer some benefits in terms of flexibility, cost savings and extra time to implement other policy actions.

The U.S. government urgently needs to make a key structural policy change by effecting a substantial fiscal consolidation. This means reducing and eliminating its annual budget deficit and reducing its debt (at least in relative terms as compared to annual GDP).

Obviously, the problem of a government spending much more than it collects in revenue allows for a solution that involves reducing expenditure, raising taxes or some combination of both. It is up to each sovereign country to choose the level of public goods and services it wishes to provide, and to establish a tax revenue system that will yield funds sufficient to finance these expenditures.

Sound public policy requires governments to choose between higher spending with higher taxes and lower spending with lower taxes, and accept the policy consequences. The former will do more to optimize relative equality through a higher level of social spending at the cost of overall economic growth, while the latter will do more to optimize overall economic growth with less social spending to affect relative equality.

The U.S., however, has not made a choice between the two approaches. As deficit and debt figures amply demonstrate, U.S. governments are spending at a comparatively high rate (total annual government outlays are equal to 41.3 percent of GDP), while generating revenue at a comparatively low rate (total annual government revenue is equal to 31.2 percent of GDP). In comparison, the PIIGS generally maintain high taxes and even higher spending:

	Government Outlays 2011 (% of GDP)	Government Revenue 2011 (% of GDP)
United States	41.3	31.2
Portugal	47.5	41.6
Ireland	45.5	35.4
Italy	50.5	46.6
Greece	49.4	41.8
Spain	42.4	36.2

SOURCE: OECD Economic Outlook No.89, 2011

While the U.S. could theoretically close its large fiscal deficit gap by only reducing spending, the size of the problem would make this extremely difficult and the massive reduction in social, defence and other spending required seems unlikely. For example, just to balance its federal budget on a current basis, at current low interest rates and not taking into account any increases in costs, the U.S. government would need to cut its spending across the board by over 30 percent! There are few if any examples of a nation successfully implementing this level of expenditure reduction.

So while the debate about whether fiscal consolidation should be carried out by reducing expenditures or raising taxes continues to rage in the U.S., analysis strongly suggests that the U.S. will have to do both.

Regarding expenditures, the structure of U.S. federal government spending, together with experience in other countries, indicates that it would be impossible to make meaningful progress toward balanced budgets without tackling the biggest and most costly entitlement programs such as Social Security and Medicare.

Social Security, as a defined benefit retirement arrangement, will continue to be costly to fund, particularly if realistic assumptions about investment returns are utilized to determine ongoing funding levels. Nevertheless, it is clear what needs to be done to move the system to a sound financial position and reduce its drag on current federal finances. Some combination of reductions and deferrals of benefits and increases in contribution levels need to be implemented to move Social Security from a pay-as-you-go system to one that is partially and increasingly funded. In light of the long transitions needed, these types of changes will take time to have a fiscal impact. But in the medium and longer term, they will help the U.S. realize significant fiscal savings and build a more sustainable public pension system.

At the same time, the structure of the Medicare program will also need to be altered to reduce costs to assist in federal fiscal consolidation. However, even substantial reductions in the net costs of these large entitlement programs should not be the only government cost reductions sought for this purpose. Across-the-board percentage reductions in all federal government discretionary spending, including defence costs, will need to be considered as part of the solution as well.

As noted above, on the tax side the U.S. has the advantage of having more room than many other countries to use increased tax revenue as part of a large fiscal consolidation. Because all taxes distort economic activity, it is never possible to raise taxes without making some trade-off against economic growth. However, careful choice of the taxes used can minimize negative economic consequences, particularly on the business investment needed for growth.

While an increase in corporate or personal income taxes will impose additional burdens on savings and investment, an increase in consumption tax would not do this.

A U.S. federal value-added tax levied at the rate of 10 percent, which would not tax savings or businesses, and which would include protection for low-income earners and other features similar to the Canadian Goods and Services Tax, would raise about $500 billion per year. This is sound tax policy that the U.S. needs to consider carefully.

The U.S. also needs to consider changing some of the failed public policies that contributed to its current problems or are hampering economic growth and recovery. This category includes a number of sound policy approaches that would contribute to positive economic outcomes such as:

1. Stopping new mortgage finance activity by Fannie Mae and Freddie Mac and eventually running off their current loan inventory while shifting to a pure insurance-based model for government support for mortgage finance. This would not involve the relevant government agency borrowing, lending, investing or dealing in mortgages. Rather, it would insure privately provided mortgages, subject to prudent criteria relating to credit, term, down payments and related matters. This not only avoids unwarranted government financial exposure to the activities of a quasi-private business venture, it also provides a mechanism for monitoring and exerting some influence on the mortgage market through control of insurance criteria.
2. Phasing out or restricting mortgage interest deductibility for income tax purposes for owner-occupied housing. This deduction is simply a subsidy for debt-financed home ownership, which works as a perverse incentive for continuous leveraging and against the build up of home equity. This deduction has no sound basis in tax policy as it allows cost recognition for borrowing for personal use without any imputation of rental income, yet it causes a large drain on income tax revenues.
3. Reforming taxation of corporations and their shareholders by reducing corporate tax rates while integrating the taxation of corporate distributions in the form of dividends. The current U.S. corporate tax system is an odd version of a classical system that treats the corporation as a totally separate entity for tax purposes, but which burdens the corporation with a relatively high tax rate while providing preferential lower tax rates on dividends and capital gains to individual shareholders. This inhibits investment by applying a higher tax burden at the level where marginal investment decisions are made while failing to effectively relieve from double taxation of corporate income. Moreover, this relatively high corporate tax rate is not competitive with rates in other developed countries with which the U.S. competes for investment.

The U.S. corporate income tax system could also greatly benefit from a change in taxation of foreign-source business income by abandoning the foreign tax credit approach that discourages repatriation of foreign earnings to the home country. A better approach would generally exempt repatriation dividends from foreign corporations from U.S. tax.

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Having set out the above prescription for improvements to U.S. fiscal, tax and economic policy, there is no doubt that each of these carries great political difficulties and risks. Nevertheless, the message is clear: **Bad public policy got the U.S. into this mess and only good public policy will get it out.**

We can only hope that U.S. policymakers will realize as much and work together to make the difficult choices necessary to establish these sound policies. This is the way to avert a further crisis and provide for their country's ongoing prosperity.

About the Author

Stephen R. Richardson recently retired as Associate Deputy Minister, Department of Finance, Government of Canada, following a long career in public service and private practice.

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Prior to his appointment as Associate Deputy Minister in 2007, Mr. Richardson was Director and Chief Executive Officer of the Canadian Tax Foundation, an independent tax research organization that provides the public and the Government of Canada with expert impartial tax research on current issues of taxation and government finance.

From 2001 to 2003, Mr. Richardson served as Senior Assistant Deputy Minister, Tax Policy, at the Department of Finance, Canada.

From 1975 to 2001, Mr. Richardson was engaged in the practice of tax and corporate law with Torys LLP (from 1981 as a partner) in Toronto, where he focused on the taxation aspects of corporate finance, mergers and acquisitions and other corporate transactions, with emphasis on international transactions.

On leave from law practice, from 1983 to 1985, he served as Director of Tax Policy — Legislation, at the Department of Finance, Canada. From 1993 to 1994, he also took time off from his law practice to act as Visiting Professor at the University of Toronto, Faculty of Law and Professor of Policy at the Institute for Policy Analysis.

He has written extensively on taxation and finance and has been a lecturer on taxation and related issues at the University of Toronto, Faculty of Law; the Harvard International Tax Program; and at the Tax Programme at the University of Waterloo, School of Accountancy.

Mr. Richardson received a B.A. (with High Distinction) from Wayne State University in 1968, and an M.A. from the University of Michigan in 1970. In 1973, Mr. Richardson earned an LL.B (with Honours) from the University of Toronto, Faculty of Law. He has been a member of the Ontario Bar since 1975.

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