Bankruptcy—Gradually, Then Suddenly?

BY ROMINA BOCCIA

U.S. government spending is on a collision course with economic disaster. Legislators need not lift another finger to increase spending any further. The U.S. federal budget is on a Titanic-esque voyage that could result in a fatal crash with a massive iceberg of unfunded entitlement obligations. This ship also has no captain.

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It is racing full steam ahead on autopilot. Failure to grab the helm and change course undermines living standards, technological progress, and the very foundations of liberal democracy. It will take greater constituent or economic pressure to get members of Congress to finally act.

In just five years, publicly held debt—the portion of debt the government has borrowed in credit markets and from the Federal Reserve—will exceed the highest level of debt recorded in U.S. history: 106 percent of gross domestic product (GDP). And in just 10 years, even if one assumes no major wars, recessions, or public health crises occur, publicly held debt will grow to between 120 and 140 percent of GDP. Within 30 years, public debt would exceed 180 percent of GDP.

Projections differ depending on whether modelers assume that the 2017 tax cuts will expire or that Congress will extend some or most of them and depending on the degree of optimism modelers apply to economic

assumptions for growth and interest rate estimates. And none of those estimates account for unexpected new spending, despite ongoing discussions in Congress to increase spending for everything from fighting climate change to boosting American fertility to subsidizing domestic industries deemed critical for competing with China. Despite historically high deficits, the answer in Washington to any problem, real or perceived, continues to be more spending.

Even if the current federal government spending trajectory was affordable in the sense that Congress would simply need to raise the taxes to pay for it, the fact that most of the growth in federal spending will go toward subsidizing consumption, rather than toward productive investments, is problematic. This directs resources away from growth-enhancing activities and directs them toward political rent seeking, thereby undermining current and future prosperity. Even when the government makes the case for subsidies to build defense-relevant industrial capacity, political bargaining leads to a misallocation of resources toward politically favored outcomes and undermines the stated goals. As my Cato colleague, Scott Lincicome, points out in his commentary "Social Policy with a Side of Chips" in *The Dispatch*: "Even the most well-intentioned and theoretically sound plan . . . can fall victim to legislative sausage-making, KStreet meddling, bureaucratic capture, and other facets of public choice economics."

HIGH SPENDING AND DEBT COME AT A HIGH COST

Excessive public debt with damaging consequences is here now. High government debt that grows faster than the economic product of a country has costs. And those costs, whether they are seen or unseen, are significant.

From the obvious seen costs of interest rates consuming an ever-larger share of the U.S. federal budget, there are also the too often neglected unseen costs of reduced economic growth. As Jack Salmon highlighted in the fall 2021 *Cato Journal*, after reviewing 40 studies published from 2010 to 2020 on the relationship between public debt levels and economic growth, the research unequivocally demonstrates that high debt hurts growth. In looking at studies exploring the existence of a particular threshold where government debt negatively affects growth, Salmon identified that government debt drags down growth when it exceeds 80 percent of GDP in industrialized nations.

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As government borrowing rises, it crowds out private investment and reallocates resources from productive endeavors, with the potential for pushing out the technological frontier, toward politically driven spending that all too often has negative growth effects. Higher interest rates on federal government borrowing spills over into higher interest rates in the private sector, making it more difficult for businesses to launch and expand and for individuals to buy homes and cars and to make other major purchases. The results of excessive government spending and debt are lower economic growth, lower living standards, and an enhanced risk of a fiscal crisis.

As the government borrows more, interest costs will rise. The Congressional Budget Office (CBO), Washington's nonpartisan government agency that projects budgetary outcomes and scores congressional legislative proposals, projects net interest costs will total $640 billion this year. That total cost is equivalent to 13 percent of all federal revenues. By 2033, the CBO projects net interest costs will reach $1.4 trillion, or 20 percent of federal revenues. On that trajectory, interest costs will exceed U.S. defense spending as soon as 2028. If interest rates were 1 percentage point higher than CBO currently projects over the next 10 years, interest costs would rise to nearly $2 trillion a year by 2033.

A FISCAL CRISIS COULD OCCUR WITHOUT WARNING

The interest cost scenarios discussed above all assume a gradual increase in debt and interest costs. Often discounted is the significant tail risk of a sudden fiscal crisis: the chance of huge economic losses in the event rising public debt triggered a loss of confidence that would send interest rates skyrocketing. Such a crisis could be triggered if investors change their expectations about the U.S. government's ability or willingness to pay its debts at the agreed-upon value.

As Ernest Hemingway wrote in his 1926 novel, *The Sun Also Rises*:

> "How did you go bankrupt?" Bill asked.
> "Two ways," Mike said. "Gradually and then suddenly."

The U.S. dollar is the world's preeminent reserve currency, and it is the preferred method for global exchange. Treasury bonds are as close to cash as it gets, likely trading at interest rates that are below what is sensible given the U.S. government's precarious fiscal imbalance. These features of the U.S. currency regime are also bugs when it comes to giving off warning signals to legislators that it's time to tighten the fiscal belts before investors turn away from the U.S. Treasury bond market. There is no canary in this coal mine.

Two aspects of U.S. public debt markets deserve particular attention: its winner-take-all nature and investor herd mentality.

In a winner-take-all market, the asset considered safest, currently U.S. Treasury bonds, would attract most of the available capital at cheap prices, while the nearest competitors' bonds would trade at a substantial risk premium. A surge in volatility in global markets, as was apparent during the financial crisis of 2008 and during the COVID-19 public

health emergency, would send investors scouring for safe havens to park their money in until market movements smoothed. In such cases, investors will flock to U.S. Treasury bonds, even if the source of the volatility, such as during the financial crisis of 2008, originates in the United States. As Leonard Burman and others wrote in the 2010 *National Tax Journal* article "Catastrophic Budget Failure," the U.S. government bond market operating like a winner-take-all market "would explain why Treasury yields plummeted even as the U.S. financial sector was teetering on the brink of collapse and the economy was heading into a deep recession, and it would be consistent with the further decline in U.S. interest rates when Greece and other Eurozone countries experienced debt crises."

If the U.S. Treasury market indeed represents such a winner-take-all market, we may not experience gradually increasing interest rates to warn legislators that the tide is about to turn. Rather, U.S. government interest rates may stay low for far too long, lulling legislators into a false sense of security as they continue deficit spending without serious concern. Yet, when the tide turns, it could quickly swallow up any opportunity for sensible policy changes. Instead, it could force legislators to make sudden, steep spending cuts and attempt to rapidly raise more revenue, just as the economy crashes under the weight of rapidly rising interest rates.

This situation is also where investor herd mentality plays against us. Herd models suggest that a fiscal crisis can arise suddenly because investors' behavior is driven more by the actions of other investors in the market rather than guided by the underlying economic fundamentals. When investor sentiment toward the safety of U.S. Treasury bonds turns, the first investors to sell off their holdings can reap significant rewards, while those who hold onto their investments could face steep losses. This creates a powerful incentive for investors to act quickly and follow one another in a panic, potentially leading up to a self-reinforcing cycle of bond sales and increasing interest rates.

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As U.S. publicly held debt continues to grow, the volume of outstanding U.S. treasuries makes the federal government's ability to borrow vulnerable to sudden shifts in investor sentiment and changing market conditions. Should a financial panic ensue, the government has little chance of stopping the flood wave of declining bond market sales, rising interest rates, and pressure to monetize the debt via the Federal Reserve. In the worst-case scenario, the United States might even lose its standing as the world's preeminent reserve currency, with implications for America's economy and national security.

Although rational market actors can see the unsustainability of the U.S. fiscal trajectory from miles away, they continue to buy U.S. Treasury bonds—until they don't. As emphasized by Carmen Reinhart and Kenneth Rogoff in their book *This Time Is Different: Eight Centuries of Financial Follies*, which surveys more than 800 years of financial crises data, debt crises tend to be triggered suddenly by a crisis of confidence in debt-laden countries. Meanwhile, Washington politicians have garnered a well-earned reputation for being procrastinators when it comes to dealing with inevitable issues—that is, until they are forced by a hard deadline with damaging consequences, a crisis that demands action, or constituent pressures leading up to a tight election race to address those issues.

A BRAC-LIKE COMMISSION TO REFORM ENTITLEMENTS

The debt limit has presented such a legislative deadline; yet thus far, it has failed in forcing reforms to the very programs driving the United States toward fiscal ruin. The culprits are clear: Medicare and Social Security make up 95 percent of long-term unfunded obligations. Other attempts at reducing deficits are mainly tinkering along the periphery.

Substantive reforms to old-age entitlement programs will inevitably be implemented over many years. Consider that the two-year gradual increase in the Social Security eligibility age was agreed upon in 1983. Fast-forward 40 years, and that age increase is still being phased in. For political and fairness reasons—namely, allowing Americans to adjust for how much to work, save, and invest when old-age benefit policies change—major changes to Medicare and Social Security will only begin to be phased in after an adjustment period. This will likely mean a delay of 10 or more years before big changes will take effect.

Entitlement spending represents an $85 trillion iceberg. To illustrate the magnitude of that figure, unfunded obligations for Medicare and Social Security are equivalent to $650,000 for every U.S. household. Given such massive long-term funding shortfalls, the U.S. federal budget is heading full steam toward an inevitable crash with economic reality. The long-term planning required to change this fiscal course is woefully lacking in the current Congress. And with presidents from both parties—President Biden now and President Trump before him—discouraging members of Congress from even discussing the need for entitlement reform, the solution to America's entitlement crisis most likely lies outside the legislature.

A commission like the Base Realignment and Closure (BRAC) commission carries the greatest promise for elevating the entitlement reform discourse past short-term election politics and toward addressing America's

long-term unfunded obligations. Such a commission should be composed of independent experts and guided by clear criteria—such as returning public debt as a share of GDP to below 80 percent in less than 30 years and achieving 75-year trust fund solvency for Medicare and Social Security. Commission recommendations should be self-executing unless Congress intervenes. This ship may sink if we wait until a majority in Congress is willing to go on the record in support of entitlement reforms.

Congress only knows how to limit discretionary spending, or so it seems. Most fiscal agreements impose spending caps on less than 30 percent of the budget, the discretionary portion that Congress determines annually. A more favorable view would suggest that a prudent Congress should limit that spending, which it directly controls. And even on that front, legislators have repeatedly fallen short of sticking to agreed-upon spending limits. There are gaping holes in "hard" spending caps, leaving room for so-called emergencies that rarely meet that mark. And can one blame Congress for renegotiating spending limits in future years, when most Washington insiders know that even holding tight to discretionary spending agreements won't make a big difference in slowing the growth of the debt?

FISCAL ILLUSION HIDES INEVITABLE TRADEOFFS

Regrettably, constituents aren't putting enough pressure on their legislators to tackle rising spending and debt. And why would they? Thanks to seemingly unlimited borrowing as taxes stay low, Americans are under a fiscal illusion. Washington passes on a large share of the cost of government spending to future generations. To no one's surprise, when something is discounted, people buy more of it. And so it is with government spending. Americans put up with a larger government and demand more benefits for themselves than they would if taxpayers were internalizing the full cost of government spending today.

This isn't just theorizing. As Cato's Emily Ekins found in a recent poll on Americans' attitudes toward student loan debt cancellation, although most Americans support debt cancellation in principle, their support plummets when tradeoffs are introduced. Support for student debt cancellation drops from 64 percent to below 25 percent when respondents are confronted with the prospect that colleges will raise prices following loan cancellations, and support drops to about 36 percent if the policy comes at the cost of higher taxes.

Even with the threat of higher taxes, most Americans aren't so sure they'd be affected. The top 10 percent of income earners pay about 60 percent of all revenues at an average tax rate of 27 percent. Meanwhile the bottom 20 percent of American income earners pay zero dollars in taxes, due to refundable tax credits offsetting any tax liability they incur. Popular discourse seems to suggest that closing America's fiscal gap merely requires asking the "rich to pay their fair share." In truth, a European-style welfare state will require European-style taxation, which falls far more heavily on lower- and middle-income workers. As my Cato colleague Adam Michel has calculated, workers making about $40,000 in the United States would pay $6,000 more in taxes if they moved to the average European country. Sure, European citizens receive several additional government benefits in exchange, but they do so at a loss of choice and control and at a high opportunity cost.

It's no coincidence that Americans are much more innovative globally than Europeans. While there are several factors affecting a nation's propensity to innovate, the returns to work and risk-taking play a significant role. If a European-style high tax system were to become the future for the United States, American entrepreneurship and innovation would most certainly take a hit. Less innovation translates to lower living standards and slower economic growth, which reduce opportunity and increase the likelihood of internal strife. Economic stagnation is one of the key driving forces behind violent conflicts.

AVOIDING DISASTER

America, a nation still standing strong, is on a course toward decline. With peacetime public debt levels quickly growing toward post–World War II highs as old-age entitlement programs rack up tens of trillions in unfunded obligations, legislators do not have an enviable task. To steer this ship away from disaster would require the heroic feat of untangling unfunded benefit promises made by legislatures of the past, while current legislators would have to face the inevitable political costs. The easiest way out for American politicians is to ignore the problem until it can't be ignored anymore. By that time, sensible policy changes that protect the most vulnerable Americans from harm and avoid economy-crushing tax hikes on innovators and job creators will have likely expired. Unfortunately, it wouldn't be the first time that a major superpower undermined its own long-term prosperity to avoid short-term political pain.

It will likely take much greater constituent or economic pressures before politicians will act to avoid further economic decline. Heeding the words of Milton Friedman, "we have to make it politically profitable for the wrong people to do the right thing." When those pressures take hold, a BRAC-like fiscal commission offers the most promising way to overcome the political gridlock that is driving America toward a fiscal crisis. Today's politicians do not feel responsible for entitlement promises made by their predecessors, and they're unwilling to personally sacrifice to course correct. Giving politicians a way—a lever they can pull—to set entitlement reform in motion, without legislators having to personally take the helm, may very well be the only way to steer America out from the rough seas ahead. ■