

A2
S1

Report II

YA-HSIN CHEN

In this research, we should focus on the real fiscal risks that we face. The writer concluded in three issues: the scheduled tax increases and spending cuts, the value of money the predominant reserve currency indefinitely, and social insurance.

I think the fiscal problem is inevitable, but I'm not sure there is enough cognition there to experience much dissonance. Government should try to avoid the bad that will happen that will occur with the fiscal cliff, no matter how quickly it could be addressed. In this article, the writer only suggested that revenue and spending changes made now will be too small to make up for the damage done by the Bush tax cuts. To undo the effects of 4 trillion dollars of revenue lost, we'd have to make that up somehow. And until the economy recovers, such sized spending cuts throw us back into recession. And after a financial recession, recovery takes ten years. In my opinion, it should provide more solutions to prevent his prediction of economic cliff for the US. I don't agree the policy. If government is taxing the wealthy people and redistribute the money into spending programs that actually generate jobs then yes it can lead to a better economy. Not only can this immediately benefit growth but it can also increase social mobility which will be incentive the working and middle class to work harder. And with the current deflationary environment and choked credit markets many rich are just hoarding money unwilling to invest it waiting for better times. It is at times like this that the government can step in and invest it for them. And then, the cuts will not affect the economy. Effectively stealing it from the population's savings accounts, therefore if the cuts are allowed to occur then the money will be spent elsewhere. Of course, government contractors will have to lay-off. But the demand will be passed to a different sector of the economy and the unemployment due to the cuts will be temporary. I think the flexible and challenged policy is good, but government should think twice before they practice it, special for the time, economic crisis.

A



December 6, 2012, 5:00 am [13 Comments](#)

The Real Fiscal Risks in the United States

By SIMON JOHNSON

Simon Johnson is the Ronald A. Kurtz Professor of Entrepreneurship at the M.I.T. Sloan School of Management.

A great deal of attention is currently focused on the notion that a “fiscal cliff” of higher taxes and spending cuts awaits at the end of this year. The good news is that politicians are finally talking about the budget – and working hard to communicate their competing messages regarding what should be done to put public finance on a more sustainable footing.

The bad news is that almost the entire national conversation on deficits and debts misses the real fiscal risks that we face.

There are three major issues.

First, the main risk is that in the near future the government will do too little by way of fiscal adjustment.

The drama of the word “cliff” and the image of falling off it makes things seem more worse than they are. To be sure, if all the scheduled tax increases and spending cuts go into effect, 2013 would be a difficult year – although there is no sign that this kind of fiscal adjustment would lead to the problems of the financial crisis of 2008.

The politicians will do a deal. Probably not now, when the Republicans are pressed to raise tax rates – this goes too deeply against what has become an ideology over the last 30 years.

It will be much easier to reach an agreement in January or February, when tax rates have gone up — which they will do automatically, if there is no agreement by Dec. 31 — and the Republicans are being asked to vote for what would presumably include cutting tax rates for middle-class Americans relative to those new levels.

But the deal to be struck between the White House and the Republican House will probably be too small to adequately address our fiscal issues.

If we want to start putting federal government debt on a more sustainable path, we should find a path to fiscal adjustment that undoes the net effect on the budget of the George W. Bush-era tax cuts, which represent about \$4 trillion over the next 10 years. You can do that through revenue or through spending reductions, but that is the right goal to aim for — putting our federal finances back closer to where they were in the late 1990s. (For a primer, I recommend this piece by my colleague James Kwak.)

Such a change would put government debt on track to stabilize around 40 to 50 percent of gross domestic product by 2030 — an entirely reasonable and responsible goal. (In “White House Burning: The Founding Fathers, Our National Debt, and Why It Matters to You,” James and I run through alternative scenarios and discuss the policy options. You can tweak the numbers up or down somewhat, but the most important goal is to take debt off its current explosive path.)

President Obama has suggested a headline number for fiscal adjustment of \$1.6 trillion, while the recent Republican counterbid was \$800 billion — both over 10 years (a standard accounting convention for this kind of discussion.)

Irrespective of how you feel about the policy combination each side is proposing, the “big numbers” are too small.

The United States doesn’t need to do more immediately. In contrast to many parts of Europe, we have some time to make our fiscal adjustments — particularly while interest rates remain low. The country should phase in a big part of its needed fiscal adjustment as the economy recovers. For example, part of any budget adjustment should be linked to employment relative to G.D.P. — any tax cuts in the new year could be phased out as the economy recovers.

Second, the working assumption of all American politicians is that the dollar will remain the predominant reserve currency indefinitely — the United States is the safe haven for investors and governments around the world. They particularly regard United States government debt as a safe asset in troubled times — and this is what allows us to borrow

so much at low interest rates. (For a brief history of public debt in the United States – including how it has been useful in the past and how overreliance on foreign borrowing now makes us vulnerable, see the PBS NewsHour [profile](#) of “White House Burning.”)

About half of all federal government debt outstanding is held by foreigners. Sooner or later, foreigners will want to buy less United States debt. Either they will want to hold other assets – the fashion in currencies comes and goes over time, just like everything else – or they will save less (in which case they may hold onto their existing United States government debt but not want to buy so much of new issues).

Many countries hold their foreign reserves in dollars and have built these up over time. China, for example, holds over \$1 trillion (the exact number is not public information; some people say the true number is significantly higher). This is far more than China needs, and it is no surprise that its interest in buying more United States Treasury debt is waning (see the [latest official data](#)).

No American politician wants to talk in public about what the implications of shifts in China’s savings and investments would be on our ability to finance federal government debt at reasonable interest rates. The middle class will pay more tax or receive fewer benefits, or both, over the coming decades – that’s the inconvenient math of the Congressional Budget Office. Which politician wants to level with voters on the scale of this issue?

The third risk is that our process of fiscal adjustment will undermine social insurance, primarily Social Security and Medicare.

We insure each other against outliving our assets and encountering an expensive version of ill health in old age. This insurance is mostly run through the federal government, for one simple reason. There was no private insurance market for older Americans before Medicare was created – and there will be none if Medicare is phased out or withers.

The most likely situation is this. After much shouting, a fiscal deal is reached in the new year – with a headline adjustment of around \$1 trillion over 10 years, and perhaps with a 50-50 split between tax increases and spending cuts. Public attention recedes. Commentators proclaim that the budget problem has been fixed.

But then we hit a real fiscal crisis, with foreigners declining to buy newly issued Treasury paper and interest rates on that debt – and interest rates more broadly throughout the economy – rising sharply. The Federal Reserve fights to keep interest rates down, but its

monetary policy in that instance is regarded as inflationary, further destabilizing the situation.

That crisis – date unknown but intense for sure – forces much more damaging fiscal cuts, including cuts in Medicare but also across the board (and bringing higher taxes). This is exactly the kind of disruptive fiscal austerity that damages an economy. One such dramatic, even humiliating, potential scenario is described in gripping detail in the opening pages of “Eclipse” by Arvind Subramanian (my colleague at the Peterson Institute for International Economics).

We end up poorer, more unequal and struggling to remember how we ever cared for one another in old age.