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The next great crisis: America's debt

At this rate, your share of the load will be $155,000 in a decade. How chronic deficits are putting the country on a path to fiscal collapse.

By Shawn Tully, senior editor at large
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(Fortune Magazine) -- Normally Paul Krugman, the liberal pundit and Nobel laureate in economics, and Paul Ryan, a conservative Republican congressman from Wisconsin, share little in common except their first names and a scorching passion for views they champion from opposite political poles. So when the two combatants agree on a fundamental threat to the U.S. economy, Americans should heed this alarm as the real thing. What's worrying both Krugman and Ryan is the rapid increase in the federal debt - not so much the stimulus-driven rise to mountainous levels in the next few years, but the huge structural deficits that, under all projections, keep building the burden far into the future to unsustainable, ruinous heights. "The long-term outlook remains worrying," warned Krugman in his New York Times column. Krugman strongly supports President Obama's spending plans but bemoans the shortfall in taxes to pay for them.

Ryan flays the administration for piling new spending on top of already enormous deficits. "This isn't a temporary stimulus but a ramp-up in debt followed by a greater explosion in spending and debt," he told Fortune, predicting a day when America's creditors will start viewing the U.S. Treasury as a risky bet. "The bond markets will come after us with a vengeance. We're playing with fire." Krugman favors far higher taxes, while Ryan wants to curb spending, but for now what's so big and so dangerous that it distresses such diverse types as Krugman and Ryan - and should scare all Americans - is the Great Debt Threat.

The bill is far too big for only the rich to pick up. There aren't enough of them. America will have to lean on citizens far below the $250,000 income threshold: nurses, electricians, secretaries, and factory workers. Within a decade the average household that pays income tax will owe the equivalent of $155,000 in federal debt, about $90,000 more than last year. What the Obama administration isn't telling Americans is that the only practical

solution is a giant tax increase aimed squarely at the middle class. The alternative, big cuts in spending, aren't part of the President's agenda. To keep the debt from wrecking the economy, the U.S. would need to raise annual federal income taxes an average of $11,000 in 2019 for all families that pay them, an increase of about 55%. "The revenues needed are far too big to raise from high earners," says Alan Auerbach, an economist at the University of California at Berkeley. "The government will have to go where the money is, to the middle class." The most likely levy: a European-style value-added tax (VAT) that would substantially raise the price of everything from autos to restaurant meals.

The growing debt will burden Americans not just with heavier taxes but also with higher interest rates and slower economic growth. On June 3, Fed chairman Ben Bernanke warned Congress that heavy borrowing is one of the factors driving up rates. The trend is just beginning, according to Allan Meltzer, the distinguished monetarist at Carnegie Mellon. "Rates can only stay low if foreign investors keep buying our debt," he warns. "I predict far higher rates over the next few years." The risk that the U.S. will follow Britain, which was warned recently that it could lose its triple-A bond rating, has risen from virtually nil to a real possibility, judging by the sevenfold jump in the cost of insuring Treasury debt in the past year. The big borrowing is already spooking the bond markets. This year rates on 10-year Treasuries have jumped from 2.2% to 3.7%. A further increase in rates would aggravate the situation, raising the interest costs on the debt and increasing its size even more.

As Krugman and Ryan point out, the problem isn't so much the big budget gaps for this year and next, though their scale is shocking. It's the policies that will allow the trend to become far worse in the future. After the stimulus spending winds down and the economy recovers, our spending will still far exceed our revenues. In 2009 the U.S. will post a deficit of $1.8 trillion, or 13.1% of GDP, according to the nonpartisan Congressional Budget Office, twice the post-World War II record of 6% in 1983 under Ronald Reagan. Now let's look forward to 2019, the final year for the budget projections for the administration and the CBO. Even in a scenario that assumes healthy economic growth, the CBO puts the 2019 deficit at $1.2 trillion, or 5.7% of GDP. "That wouldn't be a huge number for an economic downturn, but it's extremely high in a full-employment period," says William Gale, an economist at the centrist Brookings Institution. It gets worse from there. Around 2020 the cost of the big entitlements, Social Security and Medicare, soar as the peak wave of baby boomers retire.

It can't go on forever, and it won't. What will shock America into action is the prospect of fiscal collapse, which will grow more vivid each year. In 2008 federal borrowing accounted for 41% of GDP, about the postwar average. By 2019 the burden will double to 82% by the CBO's reckoning, reaching $17.3 trillion, nearly triple last year's level. By that point $1 of every six the U.S. spends will go to interest, compared with one in 12 last year. The U.S. trajectory points to the area that medieval maps labeled "Here Lie Dragons." After 2019 the debt rises with no ceiling in sight, according to all major forecasts, driven by the growth of interest and entitlements. The Government Accountability Office estimates that if current policies continue, interest will absorb 30% of all revenues by 2040 and entitlements will consume the rest, leaving nothing for defense, education, or veterans' benefits.

To understand why a massive tax increase, probably a VAT, is the mostly likely outcome, it's crucial to look at what's driving the long-term, widening gap between revenues and spending. Put simply, spending is following a steep upward curve, while revenues are basically fixed as a portion of GDP. Why? Because future spending is driven mostly by entitlements, which are programmed to rise far faster than national income, while revenues depend heavily on the personal income tax, which yields receipts that typically rise or fall with GDP. Under George W. Bush, the U.S. experienced a prelude to the crisis before us: Spending rose rapidly, while revenues remained reasonably flat. Bush created an expensive new entitlement, the Medicare drug benefit (cost this year: $63 billion), and let spending on domestic programs from education to veterans' benefits run wild. Over seven years the wars in Afghanistan and Iraq added a total of some $900 billion to the budget. All told, Bush raised

spending from 18.5% to 21% of GDP, setting in motion a chronic budget gap by piling on new spending without paying for it.

Under Obama the Bush trend keeps going, but this time on steroids. It's important to see the Obama budget projections as two phases, the crisis period of astronomical spending in 2009 and 2010, and the normal phase, from 2011 to 2019. Most of his stimulus and other big programs are designed to give the economy a jolt in 2009 and 2010 and then largely disappear or be offset by tax increases - at least that's the plan. Then the surge in outlays comes from two forces that would wreak budget havoc for any President: the relentless rise in entitlements and the surge in debt interest.

Making the challenge far greater: Obama's budget is packed with a wish list of expensive new programs, led by a giant health-care-reform plan. He promises to pay for them mainly with higher taxes. But if extra revenues don't materialize - and most that he's proposed now look unlikely - will he abandon many of his cherished priorities or push them through without full funding, substantially deepening the debt crisis? The answer could determine how fast America reaches the hour of reckoning that could usher in a VAT.

Let's divide Obama's budget projections into the plausible, the impossible, and the questionable. First, the plausible: It's optimistic but highly possible that spending on Fannie Mae, Freddie Mac, and the Troubled Assets Relief Program (TARP) will fall from more than $500 billion this year to around $20 billion in 2010, and keep declining from there. It's also plausible that the costs of the wars in Afghanistan and Iraq will fall to around $50 billion a year.

Now the practically impossible: Obama is using a timeworn gimmick by pledging that nonmilitary discretionary spending, outlays that require annual approval, will rise just 2.1% a year from 2012 to 2019. It won't happen. Obama is raising spending in this category, which includes education, health research, and homeland security, a generous 9% in 2009 and 10% in 2010, excluding the stimulus outlays. "It's far more likely the category will match its historical growth rate of around 6.5% a year," says Brian Riedl, an economist with the conservative Heritage Foundation. The GAO says it will rise with GDP, at well over 5%.

Let's examine one of the questionables. Obama's prize initiative - and by far his biggest - is his health-care plan. In his 2010 budget request the President proposes a $635 billion "down payment" or "reserve fund" toward universal health coverage over ten years. As the administration acknowledges, the $635 billion doesn't come close to covering the full expense of the program. Leonard Burman, chief of the nonpartisan Tax Policy Center, estimates the total cost at $1.5 trillion. Obama plans to offset the down payment from two sources: from limiting deductions for high earners - still another hit to the over-$250,000 crowd - and from squeezing the balance from Medicare through curbing unnecessary hospital stays and ending a plan offering HMO services. Once again, Obama will most likely lose a big part of the revenue he counted on. The limitation on deductions is encountering what looks like fatal opposition in Congress. Obama and his budget director, Peter Orszag, swear that the health-care plan will not worsen the deficit. "We are committed to making sure that health-care reform is deficit neutral," Orszag told Fortune.

The administration's attachment to reform goes far beyond the campaign to provide universal care. Orszag adds, correctly, that unbridled health-care costs, chiefly for Medicare, "are the most important driver of our long-term entitlement problem." Obama is also counting on massive investment in infrastructure to reduce medical costs by spreading electronic record keeping, promoting prevention and wellness, and conducting research to determine the most effective therapies. It's impossible to predict how much money those initiatives would actually save. The administration isn't making a forecast.

Although a VAT seems inevitable, the administration isn't ready to get behind it. "While we are open to ideas to finance health-care reform in a deficit-neutral way," says Orszag, "the VAT is an idea popular with academics, but not one seriously considered by policymakers." The problem, however, is that the income tax simply won't do the job. Closing the budget deficit in 2019 by taxing only people earning more than $250,000 would require lifting their federal marginal tax rates to around 60%. The budget already calls for them to pay, on average, $30,000 more a year than in 2008, with the biggest hit falling on households with income above $500,000. Raising income taxes on all the Americans who pay them wouldn't work either. It would require a 55% increase per household, a political impossibility. The one other major new revenue raiser on the table is a tax on employer-provided health care, but that would merely help pay for a new program to cover the uninsured, rather than closing the deficit.

A VAT, on the other hand, would tax such a giant pool of purchases that a relatively low rate of 10% to 15% could generate the revenues needed to pay for Obama's agenda and balance the budget. The VAT, which would be imposed like a federal sales tax, is paid along the chain of production by wholesalers and retailers. The cost is passed to consumers in the form of higher prices. For the Democrats, the problem with the VAT is that it falls heavily on the middle class and low earners, who use a far higher portion of their incomes to buy things than the rich do. Some of the sting can be removed by exempting food and clothing from the VAT or sending rebates to lower-income households. But the middle class would be a big target in any event. "A lot more people will pay," says Gale. "We cannot get there from here without a VAT."

That brings us back to Krugman and Ryan. Wonder of wonders, they agree again - this time that a VAT is coming. Krugman likes the idea, though he says the middle class will pay more. "There's probably a value-added tax in our future," he writes. Ryan despises the VAT as the beginning of the end of the American empire. "The VAT is definitely the trajectory Obama is putting us on," he laments. Ryan believes that the big growth in government in Europe came from the easy money it provided. He makes a good point. It's not a destiny to be desired. And when the two Pauls agree, you can bet it's where things are headed.

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