The coming crises of governments

By ROBERT J. BARRO

The global crises of financial and housing markets are now being superseded by new crises of governments. The fiscal challenges for the weaker members of the eurozone are early warnings, as are analogous problems in American state governments weighed down by unfunded pension and healthcare liabilities. Without action, this new crisis of state competence could soon become just as damaging as its recent financial predecessor.

This week's US debt deal, along with the prospect of debate on fiscal solutions in the run-up to the 2012 elections, provides some room for optimism. But America's fiscal problems have deep roots. The recession of 2007-09 stemmed from the unprecedented bust in the housing market, driven by reduced lending standards and propelled by congressional pressures on private lenders and the reckless expansions of Fannie Mae and Freddie Mac. It is, however, important to recognise that this mistake is now understood and will not be repeated.

In the aftermath of the debt ceiling agreement there will be calls for further stimulus for America's economy. This would be a grave mistake. In the financial turmoil of 2008, bail-outs by the US and other governments were unfortunate, but necessary. However, the subsequent $800bn American stimulus package was largely a waste of money that sharply enlarged the fiscal hole now facing our economy.

President Barack Obama's administration has consistently overestimated the benefits of stimulus, by using an unrealistically high spending multiplier. According to this Keynesian logic, government expenditure is more than a free lunch. This idea, if correct, would be more brilliant than the creation of triple A paper out of garbage. In any event, the elimination of the temporary spending is now contractionary and, more importantly, the resulting expansion of public debt eventually requires higher taxes, retarding growth.

I agree that budget deficits were appropriate during the great recession and, for that reason, the kind of balanced-budget rule currently proposed by some Republicans should be avoided. However, since government spending is warranted only if it passes the usual hurdles of social rates of return, the fiscal deficit should have concentrated on tax reductions, especially those that emphasised falls in marginal tax rates, which encourage investment and growth.

Despite relief at the debt-ceiling agreement, America's fiscal situation remains deeply problematic. Any attempt to head off a crisis of government competence must begin with serious long-term reform. Reductions in the long-term path of entitlement outlays have to be put on the table, with increases in ages of eligibility a part of any solution.

We also need sharp reductions in spending programmes initiated or expanded by Mr Obama and his extravagant predecessor, George W. Bush. Given the inevitable growth of the main entitlement programmes, especially healthcare, increases in long-term federal revenue must be part of an overall reform.

So what, specifically, can be done? An effective future tax package would begin by setting US corporate and estate tax rates permanently to zero, given these taxes are inefficient and generate little revenue. Next, it would gradually phase out major "tax-expenditure" items, such as tax preferences for home-mortgage interest, state and local income taxes, and employee fringe benefits.

The structure of marginal income-tax rates should then be lowered. Marginal rates should particularly not increase where they are already high, such as at upper incomes. The bulk of any extra revenue needed to make up the difference should then be raised via a broad-based, flat-rate expenditure tax, such as a value added tax. A rate of 10 per cent, with few exemptions, would raise about 5 per cent of gross domestic product.

Of course, such a new tax would be a two-edged sword: a highly efficient tax, but politically dangerous. To paraphrase Larry Summers from long ago, we don't have VAT in the US because Democrats think it is regressive, and Republicans think it is a money machine. We will get VAT when Democrats realise it is a money machine, and Republicans realise it is regressive. Obviously, I worry about the money machine property, but I see no serious alternative for raising the revenue needed for an overall next-stage reform package.

The raucous debt-ceiling debate represents a good start in forging a serious long-term fiscal plan. Substantial additional progress will be needed, sadly much of which will probably have to await the outcome of the next US election. Yet progress must be made - or the impending crises of governments, signalled by possible downgrades of US debt, will make the 2008-09 recession look mild.

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