August 8, 2011

The Downgrading of a Debtor Nation

By MENZIE D. CHINN and JEFFRY A. FRIEDEN

THE Treasury can cry foul all it wants, but the decision by Standard & Poor's to downgrade America's credit rating by one notch last Friday, and the subsequent plunge in the stock market, are serious symptoms of a loss of confidence — an assessment that is fundamentally political, not economic.

There is little question about the technical ability of America to make good on its debts — but there are grave questions about the political system's ability to resolve our nation's financial problems.

The debt-ceiling deal between President Obama and Congressional Republicans merely staved off a crisis of confidence for the moment. It does not address our immediate need to avoid falling back into recession, or our longer-term need to raise enough revenue to pay for the social spending Americans want.

Moreover, the deal sidesteps the fundamental challenge the country now faces: who will pay to fix what was broken during the past decade by irresponsible tax cuts, ruinously expensive wars, failures of regulation and the resulting housing and financial booms and busts?

In the short term, the plan cuts a bit of discretionary nondefense spending, a category that in fact has not grown particularly rapidly. This is a mistake. With unemployment at 9.1 percent, and long-term joblessness at record levels, we need more spending, not less. But the agreement all but rules out new spending to boost the economy, at a dangerous time. The chances of a double-dip recession are growing — and a further slowdown will increase, not reduce, the budget deficit.

The longer-term spending and revenue commitments are no better. Certainly spending, in particular on Medicare and Medicaid, needs to be restrained. But the deficits cannot be reined in without tax increases, and the "framework" does little or nothing in this regard. The S. & P. decision to downgrade reflects, in large part, the expectation that Republicans will not allow the Bush tax cuts to expire.

The recent skirmishes all dance around the central issue: the United States is in the midst of the world's largest debt crisis. The Treasury now owes the public almost $10 trillion, including $4.5 trillion to foreigners — and that doesn't include what households and companies owe. For decades to come, Americans will face the core problem of every heavily indebted nation: who will bear the burden of adjustment?

Countries borrow for many purposes: canals and railroads in the 19th century, factories and highways in the 20th, and in the last decade, a housing and financial boom in Europe and America. When the projects don't pan out and the debtor country falls into crisis, what happens to the accumulated debts? Who pays? Creditors or debtors? Workers or investors? Rich or poor? The European Union is tearing itself apart over this question, which divides creditor nations from debtor nations and which divides groups within nations. The American variant of this conflict is just beginning.

Perhaps, some Americans believe, we can shunt the adjustment costs onto foreigners. Indeed, our creditors worry that the United States will reduce its debt burden the old-fashioned way, by inflating it away. A few years of moderate inflation, and a weaker dollar, would significantly lessen the real cost of servicing the country's debts — at our creditors' expense.

But adjusting to the reality of America's accumulated debts will inevitably require sacrifices at home. The battle over who will be sacrificing has already begun, albeit under veils of rhetoric. The Republicans seem unconcerned about stimulating recovery, and primarily concerned that none of the long-term costs of balancing our budget be paid by upper-income taxpayers. No surprise: unemployment among the one-third of Americans with the highest incomes is barely 4 percent, while for the lowest third it is more than four times that level.

The Democrats, for their part, seem content to insist that the adjustment burden not fall on beneficiaries of government spending, whether public employees or recipients of social spending. This reflects their base in the labor movement, the public sector and the poor.

We lost the first decade of the 21st century by squandering our wealth and borrowing as if there was no tomorrow. We risk losing this decade to an incomplete recovery and economic stagnation.

An economically responsible, politically feasible distribution of the costs of working our way out of the crisis will require higher taxes, a more efficient tax code, and restrained growth of social spending, particularly Medicare. To ignore these realities, and the contentious choices they entail, is merely to postpone the inevitable day of reckoning — and probably to make it worse.

Menzie D. Chinn, a professor of public affairs and economics at the University of Wisconsin, Madison, and Jeffry A. Frieden, a professor of government at Harvard, are the authors of the forthcoming "Lost Decades: The Making of America's Debt Crisis and the Long Recovery."