Debt Ceiling Lifted but Something's Gotta Give

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Obama might have negotiated a way out of the debt ceiling stand-off but the larger problems of the US economy aren't going to disappear, writes Ian McAuley.

The standoffs in the US Congress over the last few days have shifted the world's focus away from the fiscal troubles of the Mediterranean countries and on to those of the USA.

For now, there is a resolution, of sorts. Republicans in Congress, urged on by their Tea Party faction, have used their numbers to tie Obama's hands. Deficit reduction is to be achieved through spending cuts rather than tax increases or any reversal of the Bush Government's tax cuts.

This resolution has avoided a US Government default, which would indeed have had immediate global consequences — specifically a rise in global interest rates resulting from a downgraded US Government credit rating and severe contraction in the working capital required to finance global trade and investment. That working capital is still dominated by the US dollar: 84 per cent of foreign exchange transactions involve US dollars. The last crisis in confidence in the US dollar was in 1973, when the de facto gold standard unravelled, precipitating a prolonged period of economic difficulty.

While such an immediate crisis has been avoided, the cobbled-together resolution will nonetheless have consequences.

The first is that it places the US clearly on the path of fiscal contraction. This will have effects on domestic economic activity — in an already sluggish economy. And because the US is still such a large economy, global growth will slow. Even China will feel the effects because the USA is a major market for Chinese goods.

The second consequence is longer term, for even if in time the US Government budget is brought back into balance, the way this will have been achieved will have done nothing to fix the nation's deep-seated structural problems, and indeed may have worsened them.

To deal with the first consequence — the nation's fiscal contraction — it is useful to consider the state of American public finances. The Republicans are right in pointing out that these are in poor shape — what they don't point out, however, is that the fiscal rot set in under their watch when the Bush administration expanded government outlays without expanding public revenue. When Bush was elected in 2001 US federal government outlays were 18 per cent of GDP; eight years later, at the end of Bush's term, they were 25 per cent of GDP. Over the same period federal revenue fell from 20 per cent of GDP to 15 per cent of GDP, resulting from big falls in corporate and individual income taxes, the latter favouring particularly the well off.

Admittedly the US needed a fiscal stimulus at the end of this period, because of the global financial crisis, but that crisis was aggravated by poor economic management, which involved a combination of accumulating deficits and reckless monetary policy on the Republicans' watch; from 2001 to 2004 US official interest rates were near rock bottom, leading to the boom and bust of the GFC. Official interest rates are once again at rock bottom (0.125 per cent); the accumulated federal debt stands at around 100 per cent of GDP, and the annual budget deficit is 9 per cent of GDP — a figure matched only by Greece and the UK among OECD countries. All the country's fiscal and monetary ammunition has been spent, and unemployment is still above 9 per cent.

In summary, US government outlays — federal, state and local — are now around 40 per cent of GDP, which isn't far below the OECD average. The image of America as a country of "small government" is belied by these figures. It remains, however, a country of small taxation. Something has to give.

Worse, and this relates to the longer term consequences, there is nothing to show for America's accumulation of government debt. Many northern European countries, most notably Germany, have reasonably high government debt, but this has been used to finance economic infrastructure. In fact it is sound business practice to use debt to fund public assets, a point which seems lost to many Australian politicians and journalists.

By contrast, US debt has been used to finance two wars, farm subsidies, higher jail populations, tax cuts for the rich, and more outlays for the Medicare and Medicaid programs where the government has to meet the prices set by private insurers (which themselves are publicly subsidised). Even the Greeks have done better than the Americans, for as they went into debt at least they enjoyed themselves in the process!

An economically responsible approach to the US difficulties would be to raise taxes, particularly on corporations and on the rich, and to introduce a carbon tax, while re-directing public expenditure rather than reducing it drastically. Raising corporate taxes would not be painful domestically, because a large amount of the income of US corporations is earned overseas. And taxing the well-off would restore a sense of fairness and would raise revenue.

On the expenditure side there is an urgent need to invest in productive assets including education, transport infrastructure, public health, and environmental repair. And that's all before doing anything about chronic poverty, with its related problems of crime and urban decay. Unless the US economy can be re-structured to provide well-paid jobs, poverty will go on sapping public revenue, because even parsimonious welfare programs are overwhelmed by high rates of poverty.

Another result of policies to shift the economic mix from current consumption to carefully directed public expenditure would be an improvement in the overseas balance on the current account, because public expenditure is more likely to be spent domestically.

The opportunity for such re-structuring has been lost, however. The Republicans don't seem to be interested in economic responsibility; their congressional stances have been driven by their lunatic right wing fringe and a desire to embarrass President Obama, even if this means damaging the nation's economy — a large scale replication of Australian politics if you like.

In so doing, they have brought world attention to their nation's institutional weaknesses, just as Hurricane Katrina in 2005 displayed to the world the ugly images of American poverty. Some may gloat over seeing the US humiliated, but those who understand history know that national humiliation can have ghastly consequences, and that many people will interpret US failure as a failure in democracy, rather than as a manifestation of economic ignorance and short-sighted greed.