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Last Chance, America

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"A point that gets lost in the current debate over whether and how to change the tax system is that the real level of taxation is not a function of the transfers called 'taxes.' Real taxation occurs when public claims are asserted against resources. The private claims of those who have financed our submarines and bombers, while supplying us with VCRs and BMWs, will not disappear. The debate over what we call 'taxation' is ultimately about who will bear those claims and when. Assuming that the claims are to be paid—and neither default nor its cousin, runaway inflation, is a serious option—someone out there will have to be taxed explicitly. How much tax will be paid overall is by now largely determined. What is at stake in the unfolding political contest over taxation is how consumers and suppliers of capital will fare vis-à-vis each other as the United States lurches toward the Millennium. It is not yet 1789 (when one of the world's great economic powers came apart after losing its hold on its fiscal destiny), but it is later than you think."

I wrote those words in 1989 (the 200th anniversary of the French Revolution) to bring home the looming cost of American profligacy, both public and private. Then, as now, I was not alone in these dire views. The twin deficits, in the federal budget and in international trade, weighed on many minds. Our fiscal distress was immediate, and apparently intractable.

As we all know, the calamity widely feared (or perhaps even secretly craved by scolding Cassandras like me) did not come about. Instead, our fiscal condition righted itself admirably in the 1990s, leaving us a strong economy and a reassuringly sound national balance sheet at the dawn of this century.

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Events did not take that salutary turn initially, however. The early 1990s unfolded eerily like the past few years, albeit somewhat shy of today's extremes. Recovery from the 1991-92 recession was halting and jobless as months molted into years. Budget and trade deficits continued to mount, triggering a populist anger that found a voice in Perot's 1992 run at the presidency. But then, almost imperceptibly at first, our fiscal condition righted itself. In the mid to late 1990s, we experienced a thriving economy and restored fiscal health.

In light of that outcome, my ominous words of 1989 may seem overwrought. We had, however, a closer brush with ruin than many realize. Few today appreciate how implausible was our escape, brought on by an astonishing confluence of good fortune and virtuous policy.

As we relive similar fiscal travails today—with the heat turned up even higher—it is worth considering how we made it through in that earlier time. Many readers still remember, but I can't resist basking a little in better days. First, the collapse of the Soviet Union and the ensuing end of the Cold War brought a large peace dividend. Second, the populist anger of the time, although stoked by mounting deficits just as today's, was less hostile to any and all tax increases. Third, stunning breakthroughs in information technology fostered mighty increases in private investment and labor productivity. Fourth, much of the world shook off statist economic practices in the 1990s, embracing instead market freedom, which had lain dormant for centuries before.

To grasp how powerful was this confluence of events, consider the following: in 1991 federal spending was 22.3 percent of GDP; by 2000 it had fallen to 18.4 percent of GDP (the lowest it had been since 1966). That (and not the surplus—which is simply an arithmetic incident of lower spending and higher tax revenues) is the number we should extoll from the 1990s. [In 2011, by comparison, federal spending is estimated to be 25.5 percent of GDP.]

So we were lucky. But the lucky, as they say, make their own breaks. The 1990s unfolded as a virtuous circle of fortunate events in which bountiful luck was reinforced by good policy. Fiscal policy in the 1990s, although in some respects almost accidental, was as close to perfect as we'll ever see.

The fiscal story of the 1990s unfolded against the background of gridlock on the political front, a condition that today is widely credited with having damped down profligate tendencies at the time—on both ends of the ideological spectrum—through legislative inertia. But the salutary effect of gridlock is misunderstood to a considerable extent. Gridlock works well only if the condition it maintains is not harmful. In retrospect, the first two years of Clinton's presidency turned out fortunate on the fiscal front. The administration pushed through tax increases, but failed on health care. As a result, the gridlock that followed the 1994 mid-term elections actually preserved a relatively wholesome fiscal condition, in which public revenues had already risen while big spending increases had been forestalled.

Today's situation is the reverse. The Obama administration pushed through health care reform, but did not (and could not) raise taxes. If, in the wake of the 2010 mid-term elections, gridlock keeps things they way they are, it will drive us deeper into the fiscal abyss.

We readily take the measure of calamities like the Great Depression or September 11, but not of good fortune or wise action that staves off the worst. That is why today we undervalue the policies of the 1990s, and why the heroic and successful efforts of Ben Bernanke, Henry Paulson, and others in keeping the U.S. economy from collapse in 2008 and 2009 are slighted or even maligned in many quarters.

Those stalwarts did not see us safely to port, however. They only (and crucially) kept us from foundering. We still have to regain a hold on our fiscal destiny. I have advanced some ideas—good ones, fit to enrage both supply-siders and social democrats alike—that could move us in a healthier direction.[1] My immediate purpose here, though, is simply to assert that there is no fix for our situation, despite the win-win siren song crooned by self-described supply-side economists, without higher taxes. Taxes far lower than public expenditure may anesthetize us a bit longer, but the hangover will be fierce.

The most urgent step is to raise taxes. This is so, by the way, even if social democrats like Paul Krugman are right that the economy needs immediate massive stimulus. If taxes are raised, Congress can offset the near-term effect with spending. I can hear readers objecting: What difference does it make? Isn't that just a zero-sum game in which fiscal drag from increased taxes and stimulus from additional spending cancel each other out? No. Stimulus spending can be temporary. Tax cuts are forever. If today's tax rates are extended across the board—even one year beyond their scheduled expiration—the scorched-earth supply-siders, having tasted blood, will never let them go. The Obama administration's surrender to them late last year did not make them more tractable, but more rabid. The looming debt ceiling crisis has accorded the administration, through no merit of its own, one more chance to show some spine. Let this one slip away, and we are on the road to Greece.

In the 1990s we were accorded a lucky, even undeserved, reprieve from the consequences of our profligacy. It won't happen again. As the title says, last chance.

[1] Some of these ideas can be found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1536725.

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