An Economic Reckoning?

By Mano Mahadeva, CPA, MBA | Column Editor

Nobody runs a balanced budget all the time. There are times when our incomes exceed our expenditures – when this happens, our net worth improves. When our expenditures exceed our income, the converse happens and our net worth worsens. It is no different for the government. When tax revenue is higher than its expenditures, a surplus is created, which reduces its accumulated liability; when tax revenue is lower than its expenditures, a deficit occurs. To maintain equilibrium, it must borrow funds to finance this deficit and this borrowing is added to its accumulated liability – the federal debt.

Very few topics generate as much public frustration, confusion and controversy as the budget deficit and national debt. The recently achieved budget agreement, hailed as ambitious and bipartisan, further heightens these conversations and concerns, as the new budget and the recent tax cut plan projects an increase in our national debt by $1.2 trillion over the next two years.

Historically, debt helped to expand businesses, improve returns and enhance lifestyles. Social attitudes continued to change as we moved past the Great Depression and toward savings in the 1930s, to the advent of plastics in the 60s and to metals in the 90s, with a "buy now, pay later" mentality. The 1980s and 1990s produced steady growth with low unemployment and inflation, which helped mask the steady rise in debt levels. By early 2000, we were paying for imports with deficits financed by the same countries selling us services, oil and other commodities.

Low interest rates in the early 2000s fueled more borrowing. Hedge funds and private equity operators used debt aggressively around the globe. Homeowners consolidated debt via home equity lines of credit, further mortgaging their futures. Highly leveraged investment banks had record low levels of equity on their balance sheets. Bankruptcy was easy and a socially acceptable norm.

Then came the Lehman Brothers failure. This set in motion the dismantling of an overheated economic engine. The spigot of credit closed. Global growth became snail paced. Unemployment grew and as a result, there was more borrowing to finance basic needs. Private debt reshaped itself to public debt, leading to major bailouts.

The federal debt stood at $10 trillion in 2008; today, it is double that amount. Most blame this increase on the 2008 crisis. We had the economic stimulus package of $787 billion and an ongoing recession, which led to lower revenue and taxes, the funding of two wars in Iraq and Afghanistan that increased military spending to just nearly a trillion dollars, and rising mandatory spending for health care and pensions, costing more than half the intake in revenues.

Concern about the budget deficits and the national debt has fluctuated over time, with the ebb and flow of surpluses and deficits. As our debt tripled from what it was to today, the topic has once again taken center stage. Economists are split on their views of future capital formation – the traditionalists suggest that budget deficits will retard the growth rate of capital formation, reduce national income and our future living standards. The classical theorists suggest no impacts to either capital formation or the welfare of future generations. Past data tends to support the views of the traditionalists in that budget deficit size increases were accompanied by net positive inflows of foreign investment.

These foreign inflows account for a third of our national debt. They pay relatively lower rates as compared to historical levels. Most are our trading partners. They could influence what our policymakers do. Projected federal spending for health care costs and retirement costs continue to rise, chewing up more of our total spending, saddling us with commitment for years. If our ratings get affected, would investors stop buying our debt, when we have traditionally been the haven of safety in times of uncertainty?

Such is the quandary. We have never had a debt as large relative to the economy as it is now and is projected to be over the coming decades. This is an area of unchartered waters and no one seems to offer what might happen. Financial booms and busts have occurred throughout our history because of policy mistakes, irrational human behavior, greed and a lack of sacrifice to name a few. And it seems to be politically easier to "kick the can" down the road and argue claims of improper methodology, smoke and mirror accounting and flawed data.

The basic economic problem is that our economy's finite resources are insufficient to satisfy the needs and wants of our citizenry. As such, our economy needs a drastic makeover in policy. Policy makers will have to make crucial decisions quickly to restore order to public finances. The capital market gyrations recently suggest that awareness of this inevitable reckoning is beginning to dawn. Let us hope that the crater already dug by some is not too deep.

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