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The coming debt debacle: Top economist says President Obama must slash spending, now

By John B. Taylor

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New federal budget numbers released last week by the Congressional Budget Office (CBO) ought to be a game-changer for Congress and the Obama administration. Even before the new estimates, opinion polls revealed serious concerns of most Americans about large deficits and exploding federal debt. Those concerns will only intensify now, because the new estimates show that the budget problem has worsened considerably: The federal deficit will be $2 trillion higher than earlier estimates over the next decade, bringing the debt increase under the administration's budget policy to $10 trillion.

Adding to the worry is that this large $2 trillion upward revision took place over the very short span of five months since the CBO's previous estimate in March. The revision is mainly due to higher estimated interest payments on the debt and new spending.

The President's proposed health care plan will pile on more debt, according to the CBO. And all this lies on top of the debt-increasing stimulus package passed in February.

These large deficits represent a systemic risk to the economy, worse, in my view, than the threat of a crisis in the commercial real estate mortgage market, which many think is the next shoe to drop. Under the new estimates, the ratio of debt to Gross Domestic Product (GDP), a measure of our ability to service the debt, will rise from 40% at the end of last year to over 80% in 2019 with the administration's budget. It will then continue to rise at an accelerating rate. By way of comparison, the debt to GDP ratio was 40% at the end of the 1980s - a decade remembered for high deficits - less than half that projected at the end of the coming decade.

Without spending discipline, damaging tax increases are required to close such deficits, and that is why rumors of new value-added tax are circulating. The deficits would also bring a long painful period of high inflation like the late 1960s and 1970s, a period of frequent recessions and persistently high unemployment when people began to lose confidence in the dollar.

And the growing deficits will require that the administration beg China and other countries to buy our debt, adversely affecting our foreign policy.

How much might taxes have to rise? To close the deficit in 2019 when it is projected to be running at a pace of $1.5 trillion per year, a 70% tax increase would be needed, clearly damaging to the economy and both politically and economically foolish.

But the calculations show that the problem is way too big to solve by tax increases alone.

So what game-change is called for? We must start scaling back the growth of spending now. Lay out a plan to balance the budget in five years. We must also end the bailouts - another government action hated by most Americans - by making it clear that institutions that are too big to fail are too big.

We should postpone a new health care program that requires increased government spending, and in the meantime focus on good ones that don't. In the current emergency situation we should be reforming existing entitlement programs before adding new ones.

And, since the budget problem is too big to solve by increasing taxes, we should not increase taxes. We can hear the objections: Pulling off some of the stimulus too soon will cause another downturn. But a growing debt, permanent tax increases and threats of inflation are far more likely to cause another downturn.

In my view the government stimulus program is not working. Virtually all the improved performance in the second quarter came from private investment, and making one-time payments to people is not jump-starting consumption.

But even if you thought the stimulus was working, this is no excuse for trillion-dollar-plus deficits as far as the eye can see. New facts are telling Washington to change course now.

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