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American Profligacy and American Power

The Consequences of Fiscal Irresponsibility

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The U.S. government is incurring debt at a historically unprecedented and ultimately unsustainable rate. The Congressional Budget Office projects that within ten years, federal debt could reach 90 percent of GDP, and even this estimate is probably too optimistic given the low rates of economic growth that the United States is experiencing and likely to see for years to come. The latest International Monetary Fund (IMF) staff paper comes closer to the mark by projecting that federal debt could equal total GDP as soon as 2015. These levels approximate the relative indebtedness of Greece and Italy today. Leaving aside the period during and immediately after World War II, the United States has not been so indebted since recordkeeping began, in 1792.

Right now, with dollar interest rates low and the currency more or less steady, this fiscal slide is more a matter of conversation than concern. But this calm will not last. As the world's biggest borrower and the issuer of the world's reserve currency, the United States will not be allowed to spend ten years leveraging itself to these unprecedented levels. If U.S. leaders do not act to curb this debt addiction, then the global capital markets will do so for them, forcing a sharp and punitive adjustment in fiscal policy.

The result will be an age of American austerity. No category of federal spending will be spared, including entitlements and defense. Taxes on individuals and businesses will be raised. Economic growth, both in the United States and around the world, will suffer. There will be profound consequences, not just for Americans' standard of living but also for U.S. foreign policy and the coming era of international relations.

THE ROAD TO RUIN

It was only relatively recently that the United States became so indebted. Just 12 years ago, its national debt (defined as federal debt held by the public) was in line with the long-term historical average, around 35 percent of GDP. The U.S. government's budget was in surplus, meaning that the total amount of debt was shrinking. Federal Reserve officials even publicly discussed the possibility that all of the debt might be paid off.

At that time, the United States had no history of excessive federal debt. This was not surprising since, on fiscal matters, it has always been a conservative nation. The one exception was the special and sudden borrowing program to finance U.S. participation in World War II, which caused debt to briefly exceed 100 percent of GDP in the mid-1940s, before beginning a steady return to traditional levels.

But over the first ten years of this century, a fundamental shift in fiscal policy occurred. When the George W. Bush administration took office, it initiated, and Congress approved, three steps that turned those budget surpluses into large deficits. The 2001 and 2003 tax cuts, which will reduce federal revenue by more than \$2 trillion over ten years, had the biggest impact. But adding the prescription-drug benefit to Medicare also carried a huge cost, as did the war in Afghanistan and, even more so, the war in Iraq.

These steps were also accompanied by the outbreak of an especially partisan period in American politics. In Congress, the Democratic center of gravity moved left, and the Republican one moved right. This caused the historically bipartisan support for fiscal restraint to vanish. In particular, both the individuals and groups working to lower taxes and those working to expand entitlements were strengthened.

These anti-tax and pro-spending forces joined with President George W. Bush to terminate the strict budget rules of the 1990s. The result was a swelled deficit. Because there was no longer a requirement that any spending increase or tax cut be paid for by a corresponding and deficit-neutralizing budget action, the giant tax cuts were not offset. The "hard cap" on nondefense domestic discretionary spending (which limited increases in such spending to the rate of inflation) also disappeared.

The consequences were predictable. Federal spending grew at two and a half times the rate it did during the 1990s. Two large rounds of tax cuts substantially reduced the ratio of federal revenue to GDP. The overall budget shifted dramatically, from a surplus representing one percent of GDP in 1998 to a deficit equal to 3.2 percent of GDP in 2008. Public debt per capita rose by 50 percent, from \$13,000 to more than \$19,000 over this period. The eight years of the Bush administration saw the largest fiscal erosion in American history.

Then, on top of this, the financial and economic crisis struck in 2008, and the United States confronted the possibility of a 1930s-style depression. Washington correctly chose to enact a large stimulus program and rescue tottering financial institutions. So far, such efforts have worked, at least to the degree that a depression was averted. A recovery (albeit one that is halting and weak by historical standards) is under way. But the gap between spending and revenues has widened much further.

Revenues, which had averaged 20 percent of GDP during the 1990s, fell to nearly 15 percent, while spending reached 25 percent in 2009. The deficit for fiscal year 2009 hit a staggering \$1.6 trillion, or nearly 12 percent of a GDP of just over \$14 trillion. In nominal terms, it was by far the largest in U.S. history. The deficit for 2010, at \$1.3 trillion and nine percent, was nearly as huge.

The medium-term outlook is poor. The Congressional Budget Office forecasts \$9.5 trillion of cumulative deficits through 2020 -- in other words, roughly \$1 trillion per year. The deficit-to-GDP ratio should decrease briefly during the middle of this period, as modest economic growth boosts revenues. But as 2020 approaches, it will rise again, back to nearly six percent, the consequence of sharply higher entitlement costs and slow GDP growth. President Barack Obama's own budget shows this same trend -- the first time a U.S. president has ever projected deficits that go back up.

Federal debt is the dollar-for-dollar result of deficits, and it has essentially tripled over this past decade, from \$3.5 trillion in 2000 (35 percent of GDP) to \$9 trillion in 2010 (62 percent of GDP). The Congressional Budget Office now sees it reaching 90 percent by 2020.

THE BIGGEST BORROWER

It is important to understand the impact of all this debt. As it grows, interest rates inevitably rise. As they do, the U.S. government's annual interest expense -- the cost of borrowing money -- will rise from one percent of GDP to four percent or more. At that point, interest expense would rival defense expenditures. And it would exceed all domestic discretionary spending, a category that includes spending on infrastructure, education, energy, and agriculture -- in effect, anything other than entitlements and national security. The U.S. Treasury would need to borrow a staggering \$5 trillion every single year, both to finance deficits and to refinance maturing debt.

Yet the real outlook for deficits and debt is much worse than these forecasts. For one thing, the debt that the United States effectively guarantees but that is not included in official totals is almost equal to the Treasury Department's stated \$9 trillion total. In particular, the debt of government-sponsored enterprises is another \$8 trillion. The biggest of these are the essentially bankrupt housing finance agencies, Fannie Mae and Freddie Mac. They have been placed into federal conservatorship, and for all practical purposes, their debt is equivalent to U.S. Treasury debt. The American taxpayer stands fully behind it.

State and local governments also owe huge amounts, on the order of \$3 trillion. And again, Washington indirectly stands behind much or all of it. This sector is deeply distressed, with the largest state, California, recently issuing IOUs. Moreover, many state and municipal pension systems use an antiquated pay-as-you-go funding approach, which has left them underfunded by another \$1 trillion.

The post-2020 fiscal outlook is downright apocalyptic, for two reasons. First, the aging of the U.S. population will drive sharp increases in health care costs (and at the same time, more Americans will be retired). Second, federal interest expense will rise exponentially, as the Treasury's borrowing costs grow with the debt. The Congressional Budget Office projects that official federal debt (excluding government-sponsored enterprises) could hit 110 percent of GDP by 2025 and 180 percent by 2035.

Adjusting these forecasts for the inevitably slower growth that would accompany such quickly rising debt levels means hitting those stratospheric ratios sooner.

Why is this scenario so dangerous? One reason is that a large amount of federal borrowing would eat up the stock of private capital that is available to finance investment. A higher and higher percentage of personal savings would be diverted to purchasing government debt and away from productivity-enhancing investments in equipment and technology. This would shrink the base of productive capital and flatten GDP and family incomes. As more and more debt piled up, growth would slow and Americans' standard of living would fall.

In addition, interest expense would become so large as to crowd out whole categories of federal spending. Budgets for research, education, and infrastructure, to name but three examples, would inevitably decline in inflation-adjusted terms. Washington's capacity to respond to domestic crises, such as the recent recession, would also fade. All of this would further undermine families' incomes.

Another problem is the inherent instability associated with the world's largest economy being the world's biggest borrower. This has turned the global dynamic of savings and borrowing on its head. For decades, most developed nations generated current account surpluses, or near surpluses, consistent with their export and investment strength. The poorer nations, for their part, ran deficits, as they imported capital to finance development.

But today, the United States is the biggest borrower, and developing nations are its biggest lenders. The data are imperfect but suggest that the central banks of emerging countries have been adding between \$700 billion and \$900 billion to their dollar portfolios in each of the past three years. Most of these additions have taken the form of U.S. Treasury securities. In other words, these central banks are lending to the United States. The biggest lender by far has been China.

Some argue that the United States' ability to borrow such vast amounts is a strength, but that view is misguided. China and the other lenders have no strategic reason to continue holding U.S. dollars. And even though they would suffer losses if, for example, the dollar fell sharply, the consequences of a much weaker dollar would be far worse for the United States. The longer Washington borrows from these countries, the greater the likelihood that they will purchase fewer U.S. Treasuries or even stop adding to their holdings of them altogether. At that point, presumably, the terms of U.S. borrowing would become increasingly onerous, causing a rise in interest rates and thus further slowing down the U.S. economy.

But it is precisely because this fiscal outlook is so frightening that the very prospect of it could trigger actions that would interrupt what is in train. Two scenarios are the most likely. The desirable one would involve proactive intervention by U.S. politicians. Realizing the dangers, Obama and leaders in Congress would negotiate a deficit-reduction package that pulls the country out of its fiscal slide. Such an intervention happened in 1990 and again in 1993 but on a much smaller scale and in a less partisan age.

This time, politicians could take the initiative on their own, or more likely, be pressed to do so by an

unhappy electorate. Recent polls indicate that public discontent over deficits and debt is sharply rising, but it is not clear that this translates into support for specific tax and spending changes. Indeed, the magnitude of the tax increases and spending cuts required makes such a voluntary deal unlikely. This judgment is only underscored by the fact that a sufficient number of Democrats and Republicans in Congress could not agree on the structure of the National Commission on Fiscal Responsibility and Reform -- a body created to identify fiscally sustainable policies. In the end, it had to be created by executive order. (The commission is due to report December 1, 2010.)

The more likely path, however, is a solution imposed on the United States by global capital markets. Such market forces have descended on Washington before, during the 1979 energy crisis, and have repeatedly rejected the financial policies of other countries over the ensuing 30 years, including those of the United Kingdom, Russia, Mexico, and, most recently, much of southern Europe.

There is no evidence of such an advancing storm today. Dollar interest rates are near record lows, and the currency itself is trading relatively calmly. Futures markets are not sending any disconcerting signals either. The weak outlook for growth and inflation, the euro's own troubles, the reserve status of the dollar, and the safe-haven character of Treasury bonds all may conspire to maintain this calm for some time, possibly for two or three years. But history strongly suggests that today's calm will not last in the face of the United States' disastrous fiscal outlook.

The events of 1979 are instructive. That was the time of President Jimmy Carter, stagflation, and the Iranian oil embargo. The value of the dollar had been slowly weakening over several months. Amid all that, Carter introduced his new budget, which contained a larger deficit than markets expected (although tiny by today's standards). That was the last straw. The dollar plunged, triggering an international financial crisis. Within one week, markets had forced the Federal Reserve to raise interest rates sharply and Carter to retract his budget, generating a U-turn in U.S. economic policy.

Despite the size of its economy and the reserve status of its currency, the United States was not immune from global financial rejection then. And it is not immune now. One way or the other, by action or reaction, there will be a profound shift in U.S. fiscal policy if the U.S. government continues to overspend. Deficits will be cut sharply through a combination of big spending cuts, tax increases, and, quite possibly, re-imposed budget rules. No category of spending or taxpayers will be spared.

DEBT AND CONSEQUENCES

It makes a big difference whether the new fiscal rectitude in the United States arises from domestic leaders making difficult decisions themselves or from international pressures imposing these decisions. The proactive approach would allow the United States to manage its transition into austerity, avoiding both severe disruption at home and a sudden reduction in its position abroad.

The forced result would be ugly and punitive. Collapsing confidence in Washington's ability to control its debt could trigger a dollar crisis among global financial markets, as there was in 1979, with the Federal Reserve compelled to raise interest rates way beyond what domestic needs alone would require. And the spending and tax adjustments might be sudden and indiscriminate, with little warning to the

countless injured parties.

Furthermore, the absence of a proactive solution would expose the United States to exploitation by the foreign governments lending to it. Approximately 50 percent of U.S. Treasury debt is now held abroad -- 22 percent of it by China alone. In normal times, China would have a stake in U.S. economic success, both to prop up a large market for Chinese exports (central to avoiding the potentially destabilizing political effects of rising Chinese unemployment that would result from a decline in exports) and to maintain the value of its vast dollar holdings.

But what if times were not normal? During a crisis over Taiwan, for example, Chinese central bankers could prove more dangerous than Chinese admirals. A simple announcement that China was cutting back its dollar holdings could put huge pressure on the U.S. dollar and/or interest rates. This would be similar to the way the United States used economic pressure against the United Kingdom during the 1956 Suez crisis, when Washington refused to support an IMF loan to the British government unless it agreed to withdraw its military forces from Egypt. That threat worked, as an overextended United Kingdom could not sustain its currency against foreign pressure. What goes around could easily come around.

But the impact of the United States' skyrocketing debt will not be limited to the behavior of markets or central bankers. Federal spending will decrease once the inevitable fiscal adjustment occurs, and defense spending will go down with it. Long insulated from economic considerations, defense spending now stands at \$550 billion a year. (It comes to \$700 billion when the costs of the wars in Iraq and Afghanistan are included.) This total represents some 15 percent of all federal spending and approximately five percent of GDP. The latter ratio is not high by historical standards; at the height of the Cold War, for example, defense spending amounted to a considerably higher percentage of GDP. But the defense budget will be cut because every category of spending (other than interest expense) will be cut. Politics will dictate that the pain be shared. In other words, cuts in entitlements and domestic discretionary spending will only be achievable if they are coupled with reductions in defense expenditures.

The good news is that total defense spending could be reduced by five percent or even ten percent without materially weakening the United States' security if (and admittedly it is a big if) the cuts are done intelligently and are applied to current operations as well as the procurement of weapons. The United States continues to develop and procure expensive advanced conventional combat arms beyond what is justified by its commitments, likely scenarios, and the gap in defense capabilities between it and potential adversaries. The United States spends more on defense than China, Russia, Japan, India, and the rest of NATO combined. The question is whether congressional politics (often distorted by the dispersing of weapons factories across different congressional districts) will allow the reductions to be done correctly.

Military operations need to be subject to cuts, too, if defense spending is to come down significantly without reducing the number of people in uniform. Together, the wars in Iraq and Afghanistan cost more than \$150 billion a year. The combat role of U.S. forces in Iraq has ended, and only 50,000 troops remain there. Additional savings can be found as the U.S. military withdraws from Iraq. But there is a

strategic argument for maintaining some U.S. forces in Iraq beyond December 2011, the date the two countries agreed would mark the end of any armed U.S. presence there. Such a presence would lessen the odds that Iraq's internal security situation would dramatically erode, and it would deter foreign intervention -- namely, by Iran. Nevertheless, the new fiscal order in Washington could require Iraq to pay for all or at least part of that presence, or go without it.

Shrinking budgets are likely to have an even greater impact on the future of the U.S. role in Afghanistan. The war there is now more than twice as expensive as the war in Iraq, and the U.S. commitment to Afghanistan has been increasing. Obama has pledged to begin drawing down U.S. forces there this coming July, but the signs are growing that any initial drawdown in U.S. force levels may be a token one.

Unknown are the pace of any subsequent reductions and the scale of any residual force. But a U.S. military presence in Afghanistan at or close to 100,000 soldiers will cost around \$100 billion a year. The coming fiscal austerity and the need to find cost savings in the defense sphere argue against maintaining that expense. Indeed, economic and strategic arguments both call into question the counterinsurgency approach of fighting the Taliban and the nation-building approach of investing heavily in the development of the Afghan government's capabilities and institutions. They suggest a more modest counterterrorism approach: going after the terrorists directly with drones, cruise missiles, and special forces, much as the United States is doing in Yemen and Somalia.

The new budgetary reality will also alter U.S. defense policy beyond these two conflicts. There will be fewer resources available to undertake wars of choice along the lines of Iraq and what has become a war of choice in Afghanistan. Nation building is a time-consuming, labor-intensive, and expensive exercise, and for these and other reasons, it is unlikely to be repeated on a scale approximating that of Iraq or Afghanistan for the foreseeable future. This does not mean that there will not be wars of choice -- a conflict with Iran is a possibility given its nuclear ambitions -- but rather that such wars will be both less common and more limited in their aims. Rarer still will be large-scale humanitarian interventions similar to those the United States conducted in Somalia and the Balkans in the 1990s.

The coming budgetary pressures will also affect spending on foreign aid, intelligence, and homeland security. The \$30 billion foreign assistance account will be one target for cuts, as will the \$15 billion State Department budget. Intelligence (estimated to cost more than \$40 billion annually) and homeland security (above \$50 billion annually) will also face increased scrutiny. The consequences of any reductions will vary. As with defense, when it comes to intelligence and homeland security capabilities, it matters less how much is cut than what is cut.

More than just financial resources will be affected. The United States' global influence, in all of its facets, will suffer. Washington's ability to lead on global economic matters, such as its recent urgings in the G-20 for more stimulus spending, will be compromised by the coming plunge into austerity. Similarly, the United States' voice within the IMF and other multilateral financial institutions will be weakened. Nor will Washington have the capacity to engineer direct financial interventions, as it did with the 1994 rescue of Mexico.

A related cost of the United States' debt has even greater consequences: the diminished appeal of the American model of market-based capitalism. Foreign policy is carried out as much by a country's image as it is by its deeds. And the example of a thriving economy and high living standards based on such capitalism was a powerful instrument of American power, especially during the Cold War, when the American model was competing with Soviet-style communism around the world.

Now, however, the competition comes from Chinese-style authoritarianism: a top-heavy political system married to a directed and hybrid form of capitalism. The recent stellar performance of China's economy in the midst of Western economic troubles has enhanced the appeal of its system. Reinforcing this trend is the reality that the U.S. approach (one associated with a system of little oversight and regulation) is widely seen as risk-prone and discredited after the recent financial crisis. If the United States is unable to address its own debt crisis and a solution is forced on it, then the appeal of democracy and market-based capitalism will take a further blow.

This shift in power from the United States, Europe, and Japan will accelerate the emergence of a nonpolar world, in which power is widely diffused among numerous states and nonstate actors. In particular, it will raise the global clout of the major emerging nations, including China, Brazil, India, and others. The relative position of the United States will inevitably decline, as will its ability to lead and shape international relations. No one else appears willing and able to assume this role. The result of reduced U.S. power will be a world that is messier and, in the end, less safe and less prosperous.

THE WAY AHEAD

How can the United States avoid a type of rejection by global financial markets that would cause a truly sharp decline in its global role? The answer is conceptually simple but, in domestic political terms, acutely difficult to implement.

The only way to stabilize the U.S. debt-to-GDP ratio is to move the budget into primary balance -- in other words, a position where revenues match spending, except for interest expense. Since the prospect of debt's reaching 90 percent of GDP by 2020 or sooner is far too risky, primary balance should be achieved well before that date, say, by 2015. This would mean that debt would likely peak at around 70 percent of GDP and gradually come down as deficits were cut and growth (ideally at more robust levels) was compounded.

That, however, will require reducing Washington's budget deficits by approximately \$300 billion a year -- a large amount by any standard. What makes this plan even more challenging is the reality that it must occur in a time of high unemployment. Economics and politics may come together to argue for a comprehensive package: any stimulus, including tax cuts, provided for near-term economic growth must be paired with medium- and long-term reductions in the deficit. There should also be a place for policies -- such as expanding trade -- with the potential to augment growth and, as a result, increase revenues and employment without raising taxes or increasing the deficit. But the politics are difficult. And even if they could be overcome, the budgetary effect, while helpful, would not be enough to reduce the deficit substantially.

Realistically, a responsible budgetary trajectory cannot be achieved through spending cuts alone. Since interest expense cannot be reduced, and since entitlements for the truly needy should not be, a spending-only strategy would have a brutal effect on all other categories of spending. Both defense spending and all aspects of domestic discretionary spending would need to be reduced dramatically.

The only sound approach, then, is a mix of spending reductions and tax increases. It would be wise to rely on spending adjustments, including entitlement reform, for a substantial part of the total. The new British government, to provide one guideline, is aiming for a three- or four-to-one ratio of spending cuts to tax increases. Some would argue that such ratios rely too much on reducing spending, but whatever the ratio, raising taxes is unavoidable.

Unfortunately, the politics of tax policy have become deeply partisan in the United States, where tax increases are now debated in theological terms. In historical terms, this is odd, since federal income-tax rates were consistently higher throughout the twentieth century than they are now. During the 1960s, for example, the top bracket was nearly twice today's level. That said, there is no reason that tax increases should come about through income taxes alone; there are many other options, including introducing a value-added tax, adjusting business and investment-related taxes, restoring an estate tax, and reducing certain exemptions.

The bottom line is that it will be extraordinarily difficult to pass a deficit-reduction program of the required magnitude. Obama and congressional leaders appointed the Bipartisan Budget Commission several months ago to recommend a program for achieving primary balance in the federal budget. Whether its conclusions are well received will say much about the prospects for a proactive solution, as will the extent to which Obama makes deficit and debt reduction a priority in the run-up to the 2012 election.

AT HOME AND ABROAD

The United States is fast approaching a historic turning point: either it will act to get its fiscal house in order, thereby restoring the prerequisites of its primacy in the world, or it will fail to do so and suffer both the domestic and the international consequences. It is not completely surprising that the United States is at such a juncture; other great powers throughout history have seen their circumstances reduced. But the reasons for this situation are different from what many anticipated.

Just over two decades ago, the historian Paul Kennedy published his influential study of the rise and fall of great powers. His thesis of "imperial overstretch" was simple but important: the costs of carrying out an ambitious and expensive overseas policy can undermine the economic foundations of a state. His warning bears some relevance to the position of the United States today, in that the wars in Afghanistan and Iraq have contributed to the economic pressures it faces.

But imperial overstretch is not the real issue here. The combined cost of the two wars accounts for only 10-15 percent of the country's annual deficit and much less than that of its cumulative debt, and the principal reasons for questioning the Iraq war several years ago and for questioning the war in Afghanistan today are more strategic than economic. It is fiscal, economic, and political failures at

home that are threatening the ability of the United States to exert the global influence that it could and should. In other words, it is not reckless American activity in the world that jeopardizes American solvency but American profligacy at home that threatens American power and security. The American people and their elected representatives postpone solving the country's debt addiction at their great peril.

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