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THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER

The Increasing Dysfunction of Government in the United States

Introduction

Permeating from the highest levels of the U.S. Congress, the Obama administration and federal agencies, through state legislatures and local municipalities, American governments of all forms and composition seem increasingly plagued by the viruses of division and gridlock. In the federal coliseum, the leaders of the Republican-controlled House of Representatives and the Democratic-controlled Senate have assumed polarized positions on many important issues of the day. Debate and compromise, so vital and fundamental to the ideals of the founding fathers at the Constitutional Convention 226 years ago in Philadelphia, are viewed almost as blasphemies in Washington today. What is in the best interest of America as a whole is taking a back seat to the special interests of lobbyists and political agendas. There is a clear and present danger of the neglect of the country's infrastructure—the maintenance of roads, bridges and dams—as well as funding for research and development. Clearly, most of the above-mentioned paralyses are either caused by, or affected by the inexorable rise in America's national debt, now approaching $17 trillion (U.S.).

The Unsteady States of America

In a partially excerpted article from July 27th: *The Economist* notes: 'Detroit is a flashing warning light on America's fiscal dashboard. Although some of its woes are unique, a critical one is not. Many other state and city governments—such as Chicago—across America have made impossible-to-keep promises for pensions and health care. Detroit shows what can happen when leaders delay reforming the public sector for too long. Nearly half of Detroit's liabilities stem from promises of pensions and health care to its workers when they retire. Typically, American states and cities offer their employees defined benefit pensions based upon years of service and final salary. These are supposed to be covered by funds set aside for the purpose. By the states' own estimates, their pension funds are only 73% funded. While that is bad enough, nearly all states apply an optimistic discount rate to their obligations, making the liabilities seem smaller than they are. If a more sober discount rate is applied, the true ratio is a terrifying 48%. Many individual states are much worse. The black hole in Illinois' pension fund is equivalent to 241% of its annual tax revenues; for Connecticut the figure is 190%; for Kentucky 141% and for New Jersey 137%.

By one recent estimate, the total pension gap for the states is $2.7 trillion (U.S.), or 17% of gross domestic product (GDP). That understates the mess because it omits both the unfunded pension figure for cities and the health care promises made to retired government workers of all sorts. In Detroit's case, the bill for their medical benefits ($5.7 billion U.S.) was even larger than its pension hole ($3.5 billion U.S.).

Some of this is the unfortunate side effect of a happy trend: Americans are living longer, even in Detroit, so promises to pensioners are more costly to keep. However, the problem is also political. Governors and mayors have long offered fat pension schemes to public servants, thus buying votes today and sending the bill to future taxpayers. They have also allowed some startling abuses. Some bureaucrats are promoted just prior to retirement, or allowed to accumulate lots of overtime, raising their final salary pension for the rest of their lives. Sometimes, their unions win annual cost-of-living adjustments far above the inflation rate. For example, a watchdog in Rhode Island calculated that a retired local fire chief would be paid $800,000 (U.S.) a year if he lived to be 100. More than 20,000 retired public servants in California receive pensions of over $100,000 a year.

Public employees should retire later. States should accelerate the shift to defined contribution pension schemes where what one receives depends upon what one contributes. These are the norm in the private sector ... Moreover, sooner or later some of these problems will surface in Washington, D.C. In Detroit, a judge recently ruled that federal bankruptcy law trumps a state law that makes it impossible to reduce pensions. However, the issue will rise again and will not truly be settled until it reaches the Supreme Court. Many places like Detroit will surely have to break some past promises and rightly so. Also, given the size of many of the black holes, the state or federal government may have to provide some assistance ... Uncle Sam offers an array of entitlements for which there is no real plan to fund. U.S. President Obama is on his way to joining George W. Bush as a president who did nothing about that, while Republicans in the House of Representatives imagine they can balance the books without raising taxes. The federal government spends more on health care than many rich countries and still does not cover everyone. America's dynamic private sector is carrying on its back an unreformed Leviathan. Detroit is merely a symptom of that.'

How Money Corrupts Congress

In the introduction of his book, *Republic, Lost* (published by the Hachette Book Group in New York City in 2011), author Lawrence Lessig writes: 'The single most salient feature of the government that we have evolved is not that it discriminates in favour of one side and against the other. Rather, the single most salient feature is that it discriminates against all sides to favour itself ... We have created an engine of influence that simply seeks to make those most connected rich ... I don't mean to rally anyone against the rich. However, I do mean to rally Republicans and Democrats alike, against a certain kind of rich that no theorist on the Right or the Left has ever sought seriously to defend: The rich whose power comes not from hard work, creativity, innovation, or the creation of wealth. It is the rich who instead secure their wealth through the manipulation of government and politicians. As Americans, the great evil that we face is the banal evil of second-rate minds who can't make it in the private sector and who therefore, turn to the massive wealth directed by our government, as a means to securing wealth for themselves. The enemy is not evil. The enemy is well dressed.

Americans harbour an enormous frustration with their Congress. All sides attempt to identify the source of their frustration with this institution in the evil or stupid acts of evil or stupid people—senators, or worse congressmen. Americans believe that money buys results in Congress, almost literally. Some even believe that congressmen take bags of cash in exchange for changing their votes. They speak as if they believe that members of Congress entered public life because they thought public life was a swifter path to quick cash. They wouldn't have their son or daughter marry a member of Congress, at least the member of Congress who lives in their abstract thoughts. Yet, when they actually meet their congressman, they confront an obvious dissonance. For that person is not the evil soul they imagined behind their government. He is not lazy and she is not sleazy. Indeed, practically every single member of Congress is not just someone who seems decent. These are people who entered public life for the best possible reasons and they believe in their work. They make enormous sacrifices in the process. They give people confidence, despite the fact they work in an institution which has lost the public's confidence.

Of course, there are exceptions. Obviously, some are more and some are less decent; some are more and some are less publically minded. Undoubtedly, why politicians make the sacrifices they make is difficult to understand, psychologically. The truth remains miles from the kind of machine of evil that most people presume occupies Washington. Any account of the failure of America's democracy that places idiots or felons in the middle, fundamentally misses what is actually transpiring. Instead, the story of the U.S. Congress highlights two characteristics which have become embedded in the American mindset: Firstly, there exists a gaggle of good souls who have become dependent in a way that weakens the democracy. Secondly, there exists a nation of good souls who recognize that dependency and assume the worst. The first flaw bends public policy and the second weakens public trust. Together, the two condemn the republic.'

In his publication *Throw Them All Out* (Houghton Mifflin Harcourt, 2011) author Peter Schweizer asserts: 'This is a book about how a permanent political class, composed of politicians and their friends, engages in honest graft. Let's call it crony capitalism. Here the invisible hand is often attached to the long arm of Washington and business is very good ...For many, serving as members of Congress is the best job they will ever get. Besides the income, they are rewarded with power and responsibility. Increasingly, members are leveraging that power and responsibility to create wealth as well. Crony capitalism unites these politicians with a certain class of businessmen who act as political entrepreneurs. They make their money from government subsidies, guaranteed loans, grants and set-asides. They seek to steer the ship of state into profitable seas. Twenty-first century privateers, they pursue wealth through political influence, rather than by producing new products or services. In addition to these political entrepreneurs, big investors turn to lobbying and insider information from their sponsored politicians to make their investment decisions. Political contacts, inside information, financial connections and influence are increasingly replacing open competition. Hard work and innovation should be driving the American economy, but in Washington, crony connections have thrown these stable economic helmsmen overboard.'

America's Debt to Society

In a recent *New York Times* op-ed, *Planet Money* blog co-founder Adam Davidson narrated: 'The Daily Treasury Statement, a public accounting of what the U.S. government spends and receives each day, shows how money really works in Washington. On August 27th. the government gleaned $29 million (U.S.) in repaid agricultural loans; $75 million (U.S.) in customs and duties; $38 million (U.S.) in the repayment of TARP loans; some $310 million (U.S.) in taxes and so forth. That same day, the government also had bills to pay: $247 million (U.S.) in veterans' affairs programs; $2.5 billion (U.S.) to Medicare and Medicaid and $1.5 billion (U.S.) each to the Departments of Education and Defense. By the close of that Tuesday, when all the spending and taxing had been completed, the government paid out nearly $6 billion (U.S.) more than it took in. This is the definition of a deficit and it illustrates why the government needs to borrow money almost every day to pay its bills. Of course, all that daily borrowing adds up and America is rapidly approaching what is called the X-Date—the day somewhere within the next four weeks—when the government, by law, cannot borrow another penny. Congress has imposed a strict cap on how much debt the federal government can accumulate, but for almost 90 years, it has raised the statutory debt limit well before it was reached. However, since a large number of Tea Party-aligned Republicans entered the House of Representatives in 2011, raising the debt ceiling has become a matter of fierce debate. This summer, House Republicans have promised—in House Speaker John Boehner's words—"a whale of a fight" before they raise the debt limit, if they even raise it at all.

If the statutory debt limit isn't raised again this fall, some serious financial decisions will have to be made. Perhaps, the government can skimp on its foreign aid or furlough all of NASA, but eventually the big-ticket items, like Social Security and Medicare, must be cut. At some point, the government won't be able to pay interest on its outstanding bond issues (U.S. Treasurys) and will enter what's termed a sovereign default; the ultimate national financial disaster achieved by countries like Zimbabwe, Ecuador and Argentina. In the case of the United States, however, it won't be an isolated national crisis. If the American government can't stand behind the dollar—the world's reserve currency—then the global financial system will very likely enter a new era in which there is much less trade and much less economic growth. By most accounts, it would be the largest self-imposed financial disaster in history. Nearly everyone involved predicts that someone will blink before this disaster occurs. Yet a small number of House Republicans (one political analyst suggested is no more than twenty) appear willing to see what happens if the debt limit isn't raised, at least for a short time. This could be used as leverage to force Democrats to drastically cut government spending and eliminate President Obama's signature health-care-reform plan. In fact, Representative Tom Price (R-Ga.) has stated that the whole problem could be avoided if the President agreed to drastically cut spending and lower taxes. Still, it is difficult to put this strategy into historical context. Plenty of countries—and some cities like Detroit—have defaulted on their financial obligations, but only because their governments ran out of money to pay their bills. No wealthy country has ever voluntarily decided—in the middle of an economic recovery, no less—to default. Certainly, there's no record of that happening to the country which controls the global reserve currency.

Like many, I assumed a self-imposed U.S. debt crisis might unfold like most involuntary ones. If the debt limit isn't raised by X-Day, I figured, the world's investors would begin to see America as an unstable investment and rush to sell their U.S. Treasurys. The American government, desperate to retain investment, would then raise administered rates far higher, forcing up rates on credit cards, student loans, mortgages and corporate loans; which effectively, would put a clamp on all trade and spending. The U.S. economy would collapse far worse than anything we've seen over the past several years ... On the other hand, rather than resulting in a sudden crisis, failure to raise the debt ceiling could lead to a slow bleed. Scott Mather, manager of the global portfolio at Pimco—the world's largest private bond fund—explained that while governments and institutions might go on a U.S. Treasury buying frenzy in the wake of a debt ceiling panic, they would eventually recognize that the U.S. government was not experiencing an odd, temporary bit of insanity. Ultimately, they would conclude that America had permanently become less reliable. Mather imagines institutional investors and governments turning to a basket of currencies, putting their savings in a mix of U.S., European, Canadian, Australian and Japanese bonds. Finally, America would lose its reserve currency status in the global economy.

America benefits enormously from its status as global reserve currency and safe haven. U.S. interest rates and mortgage rates are lower and corporations are able to borrow money to finance their new products more cheaply. As a result, there is much more economic activity and more wealth in America than there would be otherwise. If that status erodes, the U.S economy's peaks will be lower and recessions deeper; future generations will have fewer job opportunities and suffer more when the economy falters. Moreover, Mather points out, no other country would benefit from America's diminished status. When the base risk-free asset becomes more risky, the entire global economy becomes more risky and more costly. A political economist once reflected that it's a puzzle why the House ever passes any responsible economic policy. After all, the representatives are inherently focused on being elected every two years, while many responsible economic decisions involve trading a bit of present-day comfort for long-term gains. They're also encouraged to act foolishly. For instance, a vast majority of Americans wants Congress to pass costly programs—Social Security, Medicare, Defense—while simultaneously reducing taxes and the size of government. Yet as the Daily Treasury Statement indicates, this combination is impossible. If you watch the money flow in and out of government on a daily basis, request's like Price's soon seem gravely unrealistic. A vast majority of the money which the government spends each day is on those wildly popular programs like Medicare, Social Security and Defense. The fiscal reality is that the government doesn't tax enough to cover them. (Whatever you think of Obamacare, eliminating it would not solve America's debt problems.) Unfortunately, there simply aren't enough other easily reduced line items ... If it weren't so dangerous, the debt limit could be admired as a politically genius tool: it allows members of Congress to spend, cut taxes and then say they're tough on debt. In reality, however, the economy doesn't work that way.

This isn't the first time that Congress has tried to hold the economy hostage. In the 1890s, many representatives dithered over a now-obscure law governing the relative price of silver and gold. Global investors reacted in panic and the ensuing recession ensured that Congress never did anything like that again. However, it may turn out that the lingering debt ceiling debate is actually far worse than such a one-time disaster. Waging this argument for a few months won't lead to a sudden financial panic. However, if the debate becomes an annual affair, the world's largest investors will probably one day move toward a mix of other financial reserves. Decades from now, the world would probably be poorer on account of about only 20 people.'

Pensioners Are Pushing Many U.S. Cities and States Towards Financial Crisis

While Detroit may be an extreme case of fiscal incontinence, its bankruptcy highlights a long-term problem faced by many American cities and states; how to fund generous pension and health-care promises that are no longer affordable. *The Economist* notes: 'This problem has been decades in the making. It has always been easier for politicians to promise generous retirement benefits to public servants than to raise their wages. The bill for today falls due immediately; the bill for tomorrow can be delayed for decades. The same mindset once caused Detroit's big three carmakers to strike deals with workers, whereby they could retire as young as 48 with gold-plated pension and health-care packages. In the short-term, this brought industrial peace, but in the long-term it bankrupted GM and Chrysler; resulting in the 2009 government bailout. Like other cities, Detroit has made promises to creditors and retirees that it cannot meet in full. These issues will eventually be settled in court and the outcome will send shockwaves far and wide; affecting municipal bondholders, the insurers who guaranty such bonds, state and municipal public sector workers and taxpayers throughout America. Detroit's unfunded health-care burden is actually larger than its pension deficit. However, it is the pension problem which stands out. Firstly, unlike health care, the city has put aside specific funds to meet very specific pension promises. Secondly, the courts have made such pension promises legally very difficult to break. The issue also illustrates an emerging divide in American society. Most public sector workers can expect a pension linked to their salary. Only 20% of private sector workers benefit from such a promise. Almost entirely, companies have stopped offering such benefits because they have proven too expensive. However, in the public sector, the full cost of final-salary pensions has been disguised by questionable accounting. Pension accounting is naturally complicated. What is the cost today of a promise to pay a benefit in 2020 or 2030? The states have been allowed to discount that future liability at an annual rate of 7.5% – 8% on the assumption that they can earn such returns on their investment portfolios. The higher the discount rate, the lower the liability appears to be and the less the states have to contribute up front. Even when this dubious approach is used, the Centre for Retirement Research (CRR) at Boston College determines that states' pensions are 27% underfunded, which totals a shortfall of $1 trillion (U.S.). Moreover, they are paying only about four-fifths of their required annual contribution.

On a more realistic discount rate of 5%, the CRR determines the shortfall may be $2.7 trillion (U.S.). A similar calculation by Moody's Investors Service determines that pension schemes are 52% underfunded. The underlying economics of pension funds have deteriorated over the past 43 years. Americans are living longer. A 65-year old woman can expect to live three years longer than her counterpart could in 1970 and a 65 year-old man, four years longer. As the baby-boom generation retires, fewer workers must support more pensioners. New York City now has more retired policemen than working ones and spends more on police pensions than wages. Even worse, states and cities have used their pension funds as a way of offering supersized payments to senior managers and favoured workers. More than 20,000 former state or local employees in California have retirement incomes in excess of $100,000 (U.S.) per annum; a few enjoy more than $250,000 (U.S.) a year.

The Congressional Budget Office Predicts Unsustainable Debt

In its annual long-term outlook published this week and reported in the New York Times, the nonpartisan Congressional Budget Office (CBO) warned that President Obama and lawmakers have been reducing the wrong kind of federal spending, as they attempt to avoid unsustainable levels of debt in the coming decades. As a result of government spending cuts and rising tax revenues from the recovering economy, the CBO projects annual deficits will decline over the short term to 2.1% of the economy's output by the 2015 fiscal year, or about one-fifth of the peak shortfall at the height of the recession in 2009. However, beginning in 2016, the CBO projects annual deficits will increase again, as more aging baby-boomers begin drawing from Medicare, Social Security and Medicaid's long-term care benefits. By 2023, the annual federal deficit would increase to an estimated 3.5% of the gross domestic product (GDP), which is just beyond the level that many economists consider sustainable in a growing economy. By 2038, it would reach 6.5%. The accumulated federal debt held by the public, which had averaged 38% of GDP for the 40 years preceding the financial crisis that began five years ago this week, would reach100% of GDP in 2038. However, that probably understates the potential crisis, the CBO stated: 'because it does not account for the harmful effects that growing debt would have on the economy.' Since at least the Reagan era, budget experts have been warning that an aging population in the early 21st. century would drive spending for entitlement programs—chiefly Medicare and Medicaid and to a lesser degree Social Security—to levels which would crowd out military and domestic spending. Interest on the debt would also be a major and growing expense. What is different now is that the Republican-controlled House and the White House have been on a two-year budget cutting trend that has resulted in reductions in areas that are not driving the projections of future debt. Those discretionary spending programs include items as varied as Pentagon weapons purchases, air traffic control, science and research, education and national parks. Since 2011, discretionary spending had already been a target for annual cuts over nine years. However, the across-the-board sequestration reductions—which took effect last March when Republicans and President Obama could not agree on alternative deficit reduction measures—has pared the domestic and military programs further; resulting in increasing layoffs, furloughs and service cutbacks.

Republicans have supported keeping the sequestration cuts in place, rather than accepting President Obama's proposal for a mix of higher taxes on wealthy people and some corporations, plus cuts in future entitlement spending. Not surprisingly, the President will not accept their alternative for deeper reductions in Medicare and Medicaid without new taxes. By 2038, spending for discretionary programs and others unrelated to health care, Social Security and interest on the federal debt would—according to the CBO's report—'decline to 7% of GDP, well below the 11% average of the past 40 years and a smaller share of the economy than at any time since the late 1930s.' Discretionary spending alone, for domestic and military programs, would decline to 5.3% of GDP from today's 7.3%, which is already below the average of the last 40 years. In contrast, federal spending for the major health programs and Social Security would equal 14% of GDP in 25 years, double the level of the last four decades. While federal revenues are projected to grow—to 19.5% of GDP compared to the 40-year average of 17.5%—that is not enough to offset the rising spending for federal benefit programs.

The CBO report stated: 'Unless substantial changes are made to the major health programs and Social Security, those programs will absorb a much larger share of the economy's total output in the future than they have in the past.' Budgets proposed by House Republicans would replace Medicare with federal subsidies to buy private insurance—although at limited amounts—and would transform Medicaid into much reduced block grants to states. President Obama refuses to consider those far-reaching changes and has proposed savings for the existing Medicare, Medicaid and Social Security programs. However, Republicans refuse to accept the higher taxes which the President also demands. In the current budget debate, Republicans propose to repeal or delay President Obama's health insurance program. Representative Paul Ryan (R-Wis.), who chairs the House Budget Committee, responded to the CBO's report with a statement suggesting that: 'eliminating or delaying the program—named the Affordable Care Act—would address the nation's fiscal woes.' However, the Congressional Budget Office has reported that the Affordable Care Act would reduce deficits and that repealing it would increase deficits, largely because the program's costs would be offset by taxes and savings from care providers who would benefit from an increase in insured patients.

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Summary: U.S. President Obama to Face New Test of Resolve over Budget Talks

As documented this week in the *Financial Times*, Washington faces two fiscal crises over the next four weeks pitting the White House against Republicans in Congress, both of which are littered with partisan mines to make passage difficult within such a short period of time. Firstly, Congress must approve a new budget by the end of the month or face a government shutdown. Secondly, Congress must also raise the nation's statutory debt limit by mid-October to fund public spending, under the threat of triggering a sovereign default. President Obama approaches the budget negotiations buffeted by his struggle to control foreign policy on Syria and controversy over his handling of the choice of a new Federal Reserve Board Chairman.

However, the Republican leadership in Congress is even weaker. Tea Party-backed Republicans are demanding that approval for spending measures be linked directly to the withdrawal of funding for President Obama's signature legislative achievement on health reform; namely the Affordable Care Act. In a speech this week in Washington, U.S. Treasury Secretary Jack Lew reiterated the White House's position on 'Obamacare,' which was passed by Congress in 2010, upheld by the Supreme Court in 2012 and begins in earnest within weeks: 'The President will not negotiate over the debt ceiling. He will not accept measures that would tie a debt limit increase to defunding, or delaying Obamacare.' John Lawrence, a former chief of staff to Nancy Pelos—the Democratic House Minority Leader—observed: 'There are about 50 to 60 Republicans in the House who are willing to drive the car over the cliff and call it a victory.'

Addressing a mid-week session of the Business Roundtable in Washington—which represents the CEOs of large U.S. corporations—President Obama stated: 'A sovereign default would be disastrous for our economy and for businesses across the country. Many reasonable Republicans have said it would be reckless and irresponsible to use the threat of default as a bargaining chip, but some of the extreme members of the Republican Party continue to threaten the full faith and credit of the United States government.'

Maya MacGuineas, President of the Committee for a Responsible Federal Budget—which has been pushing for a big fiscal agreement—declared: 'It is time for lawmakers to look at the tough choices that are before them and work towards a bipartisan agreement. Jumping from crisis to crisis, with one short-term solution after another is not going to change the skyrocketing trajectory of our (national) debt.'

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"Those who cannot remember the past are condemned to repeat it." Santayana