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Special Commentary

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Fiscal Cliff and True Reform: Short-Term Band-Aids and Long-Term Constructive Surgery[1]

Saddled with enormous debt after the domestic and military spending of Louis XIV, the French government was on the brink of its third bankruptcy in less than a century. Into this 18th century environment steps John Law with the idea of a Banque Générale, which could issue paper money as a means to revive French economic power. To finance the government and the Mississippi Company, the French monetary system would transition from silver and gold coinage to paper money with the expansion of the money supply providing a much needed stimulus. But Law had no clear idea of where to stop. More shares were issued to finance the Mississippi Company, backed by printing more paper money. As Voltaire later would say, "It is a chaos I cannot fathom." Inflation skyrocketed and the ownership of silver and gold was limited by the government. In the end, Louis XVI made good on the French debt with his head.[2]

From the viewpoint of our favorite decision maker—ourselves—the present fiscal policy debates represent a set of tensions and conflicts among alternative outcomes and their economic implications that increase the risk premium of any decision we make. How is a decision maker to navigate the political decisions that carry economic consequences?

The present fiscal policy debates represent a set of tensions and conflicts.

Planning for the future requires the development of long-term expectations; yet, the past four years have witnessed a sequence of short-run policy decisions (stimulus—temporary and targeted, cash for clunkers and payroll tax cuts) that have culminated in the fiscal cliff challenge of today. Beyond the temporary fiscal cliff lies the ongoing outsized fiscal deficits and spending commitments and the follow-on implications for monetary policy. In this vein, the discussion on the fiscal cliff and the Bowles-Simpson program that obviates entitlements provide only a resolution to current ills but no real solution to long-term budget imbalances. To be sustainable, any budget agreement must deal with entitlements and the adjustments to entitlements that policymakers continue to avoid. Revenue improvements consistent with the current 2.1 percent trend of economic growth over the past three years, and likely another such year in 2013, will not generate the revenue to meet the promises of a prior generation of policymakers. To balance the budget would require, as indicated by David Romer, possible adjustments as spending reductions, tax increases and the implicit or explicit reneging on government debt through hyperinflation or default.[3]

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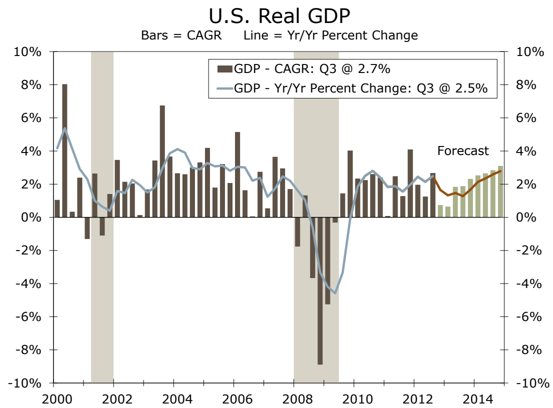
[1] This paper is based on discussions at the Global Interdependence Center's Conference: The Global Financial Crisis: Lessons from Japan, Session II: "How to Manage the Government Debt Hangover" in Tokyo, Japan on Dec. 3, 2012.
[2] Ferguson, Niall. (2008). *The Ascent of Money*. The Penguin Press. Pp. 138-157.
[3] Romer, David. (2006). *Advanced Macroeconomics* (3rd ed.). McGraw-Hill. P. 566.

The Limits of Growth—and Government

The pace of GDP growth sets the limit on any society's ability to fund public spending.

As illustrated in Figure 1, the pace of GDP growth sets the limit on any society's ability to fund public spending—even for the United States. This is the essence of economics—making choices with scarce resources. It is a case of recognizing the limits of what you would like to have and what you can afford. To complicate matters, the United States has built up a significant set of unfunded liabilities over the past 40 years at the federal, state and local level where retirement promises were never funded. For U.S. policymakers, there was a tendency to choose the unconstrained vision of what we ought to have rather than the constrained vision of what we can afford.

Figure 1



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

It is a matter of pay me now or pay me later.

In the immediate future, the fiscal cliff will require some compromise, and yet it is important to note that the compromise is unlikely to move the federal spending commitments in line with the pace of real economic growth. In our essay of June 20, 2012, we anticipated that uncertain fiscal policy will begin to weigh on growth over the second half of this year, and this has certainly been true as evidenced by the sharp decline in durable goods orders as well as the continued gains in temporary hiring that do not necessarily lead to an upswing in permanent hiring.[4] It is a matter of pay me now, fund the liabilities, or pay me later, through inflation and effective default or even greater taxes. This fiscal policy impact on economic growth has been compounded by the uncertainty associated with the inadequately specified details of health care and financial regulations that increased the risk premium to hiring and credit extensions and further reduced the incentives for growth and investment.

Labor, capital and knowledge are the elements of growth.

Labor, capital and knowledge (which embeds technology and entrepreneurship) are the elements of growth, and we can see that the debt-to-GDP ratio, which we will discuss further in Figure 4, is made more imbalanced by the change in these underlying economic fundamentals in recent years.[5] As for labor, there has been a persistent decline in the participation rates for men and women in recent years, in part due to the demographics of the aging baby boomers, but also likely reflecting the changing tax and income support programs that have altered the work incentive. In addition, regulations and mandates at the micro level, such as higher minimum wage levels and mandated health care, have raised the price of hiring young, relatively unskilled labor and are associated with the rapid decline in youth participation rates in the labor force.

Capital, meanwhile, has been deployed globally where it achieves its highest return, which is often in the growing markets of Asia. For the United States, increased regulatory costs in excess of perceived benefits provide an incentive to move production and jobs overseas to serve global customers. Investment follows the customer. Meanwhile, the past four years have witnessed an increase in debt to finance spending in excess of what could be financed out of subpar economic

[4] **Wells Fargo Economics Group. (June 20, 2012). *The Fiscal Cliff: Likelihood and Economic Impact*.**
[5] **Romer, David. (2006). *Advanced Macroeconomics* (3rd ed.). McGraw-Hill. Chapter 1.**

growth. Unfortunately, this debt has not improved the capacity of the U.S. economy to pay its federal government bills or its competitiveness to grow by way of exports. For decision makers, the lack of growth and the commensurate rise in debt implies an economic outlook that raises questions on the future path of the dollar, interest rates and inflation. Moreover, at the state and local government level, a legacy of unfunded liabilities of state worker pensions and retiree health care, likely will not be met in a world of 2 percent growth and no access to a printing press. At both the federal and local government level, the unfunded liability issues reflect a failure of effective decision making. In brief, there is a time inconsistency problem where one generation of policymakers made promises on programs such as Social Security, Medicare and state pensions, for example, and inadequately funded those promises, leaving a new generation of policymakers who need to make good on these promises.

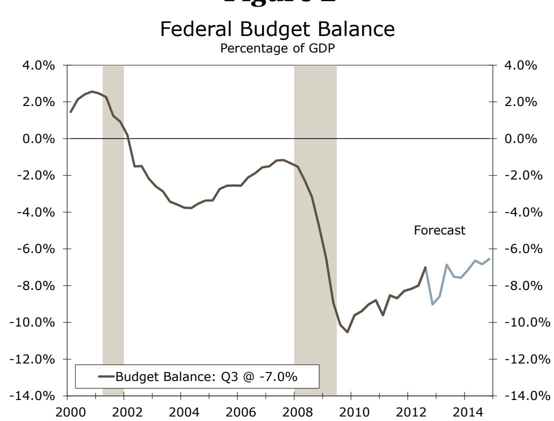
New Territory: Going Where No One Has Gone Before

The current search for a short-run political compromise to avoid the fiscal cliff is not likely to adequately address the long-run economic imperatives facing our country. A report last year by analysts at the Pew Charitable Trusts studied the evolution of the U.S. federal debt position from 2001 to 2011 (Figure 2). The main drivers were legislated changes, not economic fluctuations, with spending the major contributor to deficits and tax cuts another 27 percent.[6]

Federal promises of benefits must match the ability of the economy to deliver those results.

Looking ahead, federal promises of benefits must match the ability of the economy to deliver those results. The disconnect currently reflects the time inconsistency problem where promises for entitlements and public retiree benefits were made by one generation of policymakers in a different, faster economic growth era, and these benefits must now be delivered by different policymakers in a very different, and slower growth, era. The 21st century economic reality for the United States is quite different than it was during the decades of the 1950s-1970s. This anchoring bias, whereby policymakers continue to look at the past decades as the benchmark for economic decisions, accounts for the failure to reevaluate spending programs, especially entitlements, for the 21st century.

Figure 2



Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

Moreover, starting from where we are now and advocating a balanced approach fails to address the past four years of rapid spending. Starting from current spending levels would lock in that high pace of spending. In effect, the federal spending horse has left the barn, and now is not the time to start a balanced approach from a much higher level of spending. Instead, much of the spending in recent years needs to be reduced to reestablish a historical spending-to-GDP ratio closer to the 40-year average of 20.7 percent from the current 23 percent. Moreover, this ratio

[6] Pew Fiscal Analysis Initiative, The Pew Charitable Trusts. (April 2011). *The Great Debt Shift: Drivers of the Federal Debt Since 2001*. See also, Wells Fargo Economics Group. (Aug. 1, 2012). *U.S. Fiscal Primer I: The Deficit and Debt*.

would increase in coming decades under the CBO's "alternative scenario," so reduced spending today is even more imperative to avoid greater economic burdens and distortions in the future.[7]

"*A democratic government is the only one in which those who vote for a tax can escape the obligation to pay it.*"

- Alexis de Tocqueville, *Democracy in America,* Vol. I[8]

Current debates are not properly focused on long-term solutions.

On the tax side, current debates are not properly focused on long-term solutions. Beginning in the 1980s, greater and greater numbers of income earners have become exempt from paying federal income taxes. The tax burden has increasingly been removed from the lower-middle and middle-income groups, contrary to the concept of vertical equity which advocates at least some net tax contributions from all income levels. The largest burden of the tax currently falls on the upper-middle and upper-income groups. Everyone benefits from defense spending, interstate highways and infrastructure, and under the benefit principle of taxation there should be some tax burden.[9] Over the years, the eligibility incomes for many transfer payments and entitlement programs have risen. Such relaxation might have worked for a short time in a 4 percent growth economy, but it certainly is not affordable in a 2 percent growth economy.

Over the long-term, taxes have averaged 18 percent-19 percent with the high of 20.9 percent during WWII (specifically in 1944). Raising taxes to 21 percent or more should be viewed with caution given that such a tax increase would be out of the historical experience with uncertain implications for the growth and jobs in the economy. Without reform in entitlements, permanent tax increases to chase the recent acceleration in federal spending simply does not address the spending problem and likely would worsen the subpar growth problem in the current recovery.

Wealth is not the same as income.

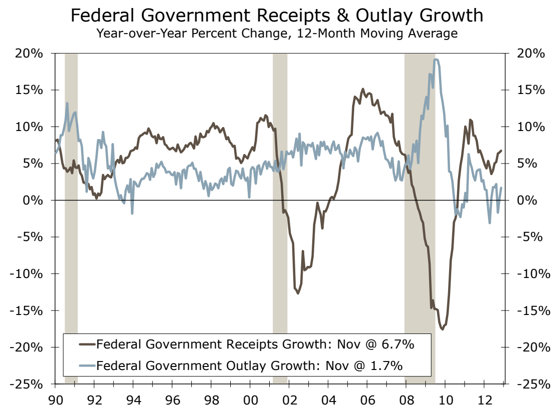
Second, wealth is not the same as income. The argument to tax the rich has really meant tax those whose current wage and salary income is high. However, let's offer the reader a choice—who is richer—the $30 billion-plus portfolio manager or the $1 million salaried worker? The problem is that we are defining rich based on current income without any accounting for wealth. Therefore, it is no surprise that so many billionaires in terms of wealth have no problem raising taxes on the millionaires in terms of income (actually, $200,000 single and $250,000 married couple).

Outlier or Precursor to the Future: Receipts and Outlays Since 2008

As highlighted in Figure 3, the latest economic period from 2008 to now has been very unusual, with a rapid rise in federal government outlays and a rapid drop in federal receipts. In fact, these movements represent the largest jump in discretionary outlays and the biggest drop in receipts since the 1990s. The rapid rise in outlays represents discretionary actions, while the drop in receipts is primarily the result of a weak economy. For policymakers in the private and public sectors, the risk here is to base long-term decisions on recent economic performance, the recency bias, where such recent economic behavior represents outliers rather than the true underlying behavior of the economy.

[7] **Wells Fargo Economics Group. (Sept. 10, 2012). *U.S. Fiscal Primer II: Federal Government Spending*.**
[8] **de Tocqueville, Alexis. (1835). Chapter XIII. *Democracy in America.*Vol. I.**
[9] **For a note on the benefits principle, see Stiglitz, Joseph E. (1988). *Economics of the Public Sector* (2nd ed.). W.W. Norton. Pp. 403-404.**

Figure 3



Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

Stimulus spending did not deliver the intended economic results.

Stimulus spending did not deliver the economic results in terms of growth or the lower unemployment rates that were expected, in part, owing to the very difficult financial market environment. In addition, much of the spending was not net new spending (instead a substitute for local government spending) or was spending with very little prospect of economic returns relative to cost (green energy). Spending simply did not make a difference in people's lives, and too many resources were directed to special interests rather than the general welfare. Shifting resources through public policy always runs the danger that such resources are allocated for political rather than economic reasons, and, therefore, there is an inefficient allocation of resources in society. Multipliers do not work simply by spending money, but by spending money wisely over time. Economic growth depends on making an effective application of labor, capital and technology, not simply spending dollars. Poorly targeted fiscal stimulus has a cost in terms of long-term growth, as resources are squandered, while also creating distortions in interest rates, inflation and tax burdens over time. The future economy bore no resemblance to the version of the future that the proponents of the stimulus imagined.

On the tax side, decision making under pressure of the fiscal cliff or under the Bowles-Simpson plan fails to address the entitlement issue and provide for real tax reform in the 21st century economy. For Bowles-Simpson, Obamacare was off the table, and there were no structural reforms advanced for Medicare or Social Security. Programs such as Bowles-Simpson are more of a distraction than a help to deal with both the spending and tax side of long-term fiscal reform. Policymakers need to address the real fiscal problem—the historical promise on entitlements that cannot be delivered with the current pace of economic growth.

Moreover, running fiscal policy based on the opinion polls of who should get taxed is not an intelligent form of policymaking. Of course a majority of the opinion favors taxing a minority. This is the worst form of taxing the man behind the tree. As indicated above, the problem is that the tax base has been narrowed too much both in terms of incomes taxed and our definition of rich. Such opinion polls represent the tyranny of the majority for a majority that is unwilling to tax themselves for the benefits they receive. This is not a sustainable policy over time, as evidenced by the long-term economic consequences for Louis XVI, Juan Peron and most recently, Greece.

Raising taxes excessively will discourage growth, saving and investment.

Finally, raising taxes excessively will further discourage growth, saving and investment and therefore further weaken any chance of meeting the entitlement promises of policymakers. Policy will become the cat that is chasing its tail and never catches it unless the real fundamental spending issues are addressed. Finally, as cited by Greg Mankiw, "Fiscal policy is not made by angels but by an imperfect political process."[10] Let's trust we can limit the imperfections.

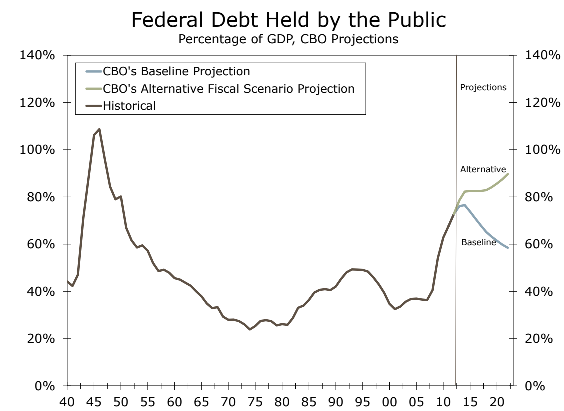
[10] **Mankiw, Greg. (2007). *Principles of Economics* (4th ed.). Thomas South-Western. P. 487.**

As we argued in our *Fiscal Primer III*, "the current policy mix is unsustainable….Regardless of the election outcome in November, important fiscal policy changes will be needed in order to keep our country on a long-run path to fiscal stability."[11]

Stark Alternatives for the Future: Pay Me Now or Pay Me Later

In Figure 4, we can see two alternative fiscal policies presented by the CBO.[12] The baseline scenario allows for the expiration of the alternative minimum tax relief, payroll tax, bonus depreciation, unemployment benefits and the Bush-Obama tax cuts. This is the pay-me-now scenario. In this case, taxes are raised, as are deficits, thereby reducing future interest expense over time. The alternative scenario, which represents the more politically acceptable position right now, does not alter the above provisions. However, the burden of the debt rises fairly sharply, implying a greater debt/tax burden in the future—or pay me later. This scenario represents an explosive departure from any debt/GDP equilibrium and threatens future economic collapse as such a debt/GDP ratio is not sustainable over time.[13]

Figure 4



Source: Congressional Budget Office and Wells Fargo Securities, LLC

Modest, thoughtful fiscal restraint will slow economic growth but lead to more sustained growth over time.

Our reading of these alternatives is that the current path of spending and revenues is not sustainable and that continued fiscal profligacy will inhibit economic growth over time. Instead, modest, thoughtful fiscal restraint will slow economic growth but will lead to more sustained growth over time. A stitch in time saves nine. Unfortunately, much of the commentary on fiscal restraint points to Greece as the model, whereas we would argue this is a red herring and a distraction from the better course of modest, thoughtful restraint. The current fiscal profligacy inhibits growth, as we have witnessed in 2012, for a number for reasons. First, the current policy is clearly, and correctly, perceived as unsustainable over time, and, therefore, adjustments will be made. So, decision makers face a limited time horizon for making long-term decisions, thereby postponing the decisions until the policy horizon is clear. We have witnessed this in 2012 as firms have hired temporary, not permanent, workers and have postponed capital spending in the second half of the year. Decision makers are forward looking, and what they anticipate are higher taxes, uncertain federal contracts and rising debt/inflation finance. Greater-than-expected inflation could make an unscripted return. Second, there is a sharp shift in the control of economic resources toward government and away from the private sector, which intimates that more resources are being allocated for political rather than economic goals. Such an allocation leads to inefficient allocation and slower growth over time—witness the Soviet Union. Third, there is a distinctly higher claim on credit resources for federal financing, which drives out private finance and will increase effective, after-tax interest rates over time, thereby further inhibiting private sector investment and growth. Fourth, the same fiscal expansion that leads to higher

[11] Wells Fargo Economics Group. (Oct. 18, 2012). *U.S. Fiscal Primer III: Federal Revenues*. Pp. 5-6.
[12] Congressional Budget Office. (June 5, 2012). *The 2012 Long-Term Budget Outlook.*
[13] Reinhart, Carmen M., and Kenneth S. Rogoff. (2009). *This Time is Different*. Princeton Press.

interest rates also leads to an appreciation of the currency and reduces the trade competitiveness of the home currency.[14] Finally, there is the issue of the reaction of the central bank to rising deficit finance, rising interest rates and the appreciating home currency and the risk that such debt finance will become increasingly monetized by the central bank, again, as corroborated in many other countries throughout history in an effort to keep interest rates low and reduce the appreciation of the currency. Unfortunately, we have begun to see these exact outcomes emanating in the United States today, even though one of the stated goals of the central bank is to lower unemployment rates.

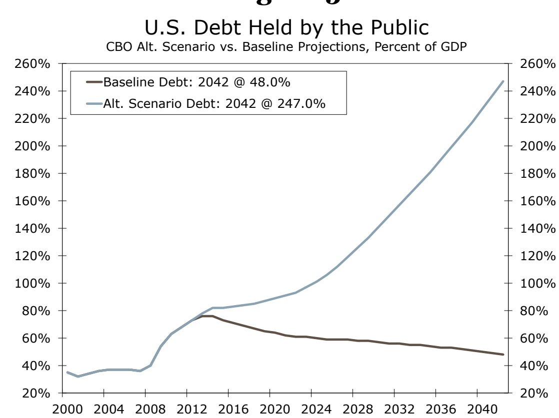
Therefore, it may appear surprising to those who focus only on the very short-run demand side effects, but a policy of modest fiscal restraint, sustained over a long period, will allow a country to achieve a higher rate of growth over time, as witnessed in Canada and Ireland in the past. Neither the fiscal cliff discussions nor the Bowles-Simpson approach offer a sustained long-run fiscal policy of constraint given their avoidance of the core fiscal issues of entitlement reform and tax reform to suit an economy growing at 2 percent in a globally competitive environment.

Unstable Financial Dynamics

As the intrepid decision maker looks at Figure 5, it is clear that the current path of debt finance is very unstable for the United States.[15] As implied by the CBO, under the alternative fiscal scenario, in which deficits continuously widen, the debt-to-GDP ratio explodes, which clearly is not sustainable. Over the next 20 years, non-interest spending exceeds revenues in the alternative fiscal scenario by an average of about 4 percent of GDP per annum. If borrowing costs rise to 5 percent, as the CBO assumes, then nominal GDP would need to grow 9.5 percent per annum, which seems unlikely for a sustained period, to stabilize the debt-to-GDP ratio under the alternative fiscal scenario.

The current path of debt finance is very unstable for the United States.

Figure 5



Source: Congressional Budget Office and Wells Fargo Securities, LLC

This alternative fiscal scenario, which unfortunately is materializing as the most politically acceptable alternative of kicking the can down the road, is clearly undesirable. Not only would another downgrade of U.S. sovereign debt become inevitable under this scenario, but research shows that highly indebted countries tend to grow at a slower rate, everything else equal. Carmen Reinhart and Kenneth Rogoff recently found that real GDP growth falls by about 1 percentage point when the debt-to-GDP ratio exceeds 90 percent.[16] Therefore, the U.S. economy could be relegated to an era of unsatisfactory economic growth if meaningful, sustained fiscal consolidation does not eventually commence.

Highly indebted countries tend to grow at a slower rate.

[14] **Dornbusch, Rudiger. (1980). *Open Economy Macroeconomics*. Basic Books. Chapter 11.**
[15] **Wells Fargo Economics Group. (Aug. 1, 2012). *U.S. Fiscal Primer I: The Deficit and the Debt*.**
[16] **Reinhart, Carmen and Kenneth Rogoff. (February 2011). A Decade of Debt. NBER Working Paper, No. 16827.**

If the debt-to-GDP ratio explodes, the U.S. economy would face a long period of slow growth.

The debt-to-GDP ratio of the federal government has risen markedly in recent years. If policies remain unchanged, the debt-to-GDP ratio likely will explode. In that event, the U.S. economy would, in a best-case scenario, face a long period of slow growth. More ominously, the United States could face a deep downturn if financing for the federal government completely dried up as the recent example of Greece readily demonstrates. Under the CBO's baseline scenario, taxes rise at the end of the year and spending reductions start to go into effect, which could lead to a modest recession in 2013.

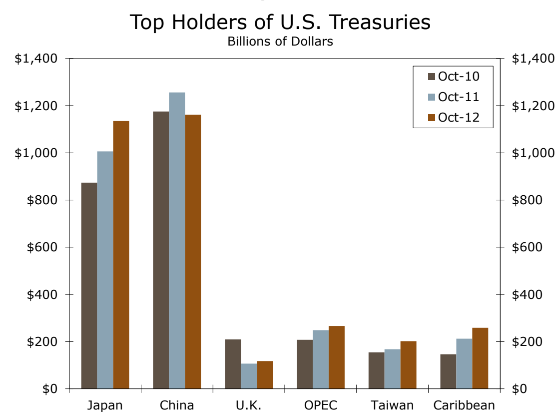
Either way, the federal government must reduce its deficits in the years ahead by some combination of spending restraint and revenue enhancement. The combination of these two variables that the country chooses is a political decision, and it is not for us to say what the "correct" combination is. However, decision makers must be wary that the politically acceptable outcome comes at a price of economic sustainability and long-term growth.

Recent years have witnessed a series of poorly structured short-term fiscal policies that were temporary, politically acceptable stop gaps but provided no long-term benefit to the economy. Instead, they imposed a very expensive rising debt burden and the resulting downgrade that reflected the failure of political leadership to address the long-term debt imbalance. An ineffective series of economic policies over several administrations failed to address the underlying problems of growth, labor markets and the globalization of the production function, thereby limiting the ability to meet the rising promises of numerous political campaigns.

Market Risk: Too Few Buyers for Rising Treasury Debt Supply

Pricing of U.S. Treasury purchases are dominated on the demand side by three large purchasers, Japan and China, as illustrated in Figure 6, and the Federal Reserve as the central bank. For decision makers this sets up several risks. Today, the United States has the good fortune to borrow at negligible interest rates seemingly without limit and without dollar depreciation or rising inflation—but for how long our skeptical decision maker asks?

Figure 6



Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

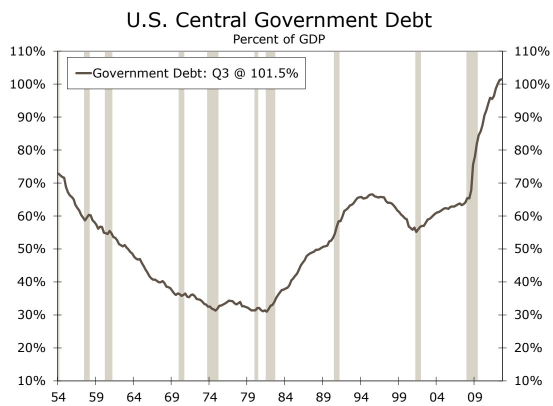
It is not possible to obtain a true private market pricing of debt.

First, there is the significant risk that pricing financial assets based on a benchmark risk-free rate is very difficult and therefore, the investor will find it challenging to gauge whether there is proper compensation for risk in the marketplace. The three dominant buyers—Japan, China and the Fed—do not mark-to-market and are not true profit-maximizing investors; therefore, it is not possible to obtain a true private market pricing of debt. The Fed now owns one of every six dollars of national debt. As a result, market interest rates do not represent free market pricing but are subject to the whims of political fortune and the goals of three non-market buyers. Japan and China are buyers of Treasury securities as a means of stabilizing their exchange rates in the face of an unsustainable long-term fiscal policy in the United States. The central banks of China, Japan and the United States are the market. The Federal Reserve is attempting to lower the unemployment rate via suppressed Treasury rates. Therefore, there is a risk to investors that any one of these three actors could alter their buying for reasons that have little to do with the actual market value they see in the Treasury rate itself. For the equity markets, it is imperative to separate the reality of fundamental economic growth and real corporate earnings from the illusion of central bank financed prosperity. For decision makers, little can be inferred from current bond prices and yields except that these prices and yields are the ones government wants to impose.

Second, there is the problem that the preponderance of Treasury debt issued is short-term debt and the refinancing of such debt could take place in an environment when interest rates rise, thereby further adding to upward pressures on interest rates and accelerating the pace of capital losses for any given interest rate move. As illustrated in Figure 7, the rising debt finance of the central government likely will take place in a rising interest rate environment, thereby compounding the spending problems of the central government as entitlements and interest expense come to dominate federal spending in the future.[17]

The rising debt finance of the central government will likely take place in a rising interest rate environment.

Figure 7



Source: U.S. Dept. of Commerce, U.S. Dept. of the Treasury and Wells Fargo Securities, LLC

Third, current nominal Treasury rates out to 10 years are below the pace of inflation as measured by the consumer price index. Therefore, the real return on small savings and risk-averse Treasury buyers is actually negative even before taxes. This is an unstable situation in the markets and could correct very quickly with a decline in risk aversion; this would lead to a swift rise in market interest rates and capital losses.

Finally, the suppression of market rates by the Federal Reserve can only be a short-term phenomenon. Over time, such "financial repression" will give way to some combination of higher interest rates, inflation or a depreciating currency. Unsustainable short-term policies, even when politically acceptable, are not economically positive for growth or for moderate inflation for a sustained period of time.

Outlays: A (Permanent) Shift in Government's Share of GDP?

Federal outlays as a share of GDP historically rise quickly in a recession period and then fall back during an expansion. However, as evidenced in Figure 8, the current level of outlays as a share of GDP remains remarkably high and very little progress has been made in reducing that outlay share of GDP. This intimates a structural shift in the share of the economy accounted for by federal government outlays.

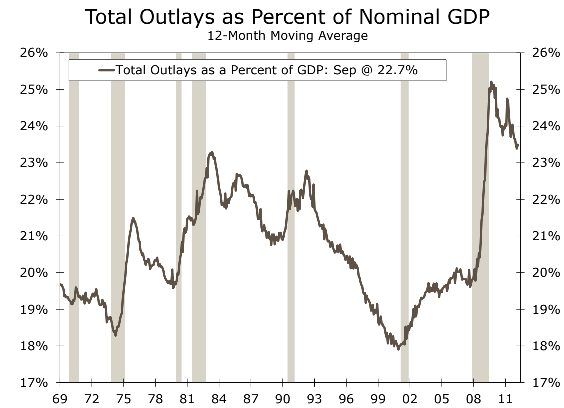
Federal outlays as a share of GDP rise quickly in recession, then fall back in expansion.

In addition, the large share of federal spending may also be overstating the current strength of the economy as such spending is being financed by foreign capital inflows and central bank purchases. Therefore, if such spending had been financed in the private marketplace, interest

[17] **Congressional Budget Office. (June 2012). The Impacts of Growing Deficits and Debt. *The 2012 Long-Term Budget Outlook*. Pp. 3-4.**

rates likely would be much higher and, as such, financing for homes, autos and business investment would be more limited.

Figure 8



Source: U.S. Dept. of Commerce, U.S. Dept. of the Treasury and Wells Fargo Securities, LLC

The four largest federal fiscal deficits have occurred over the past four years.

In this way, current economic growth is overstated—like in southern Europe before 2008—and this advocates that we need to adjust our expectations for long-term growth in an environment of more free market pricing of credit. The rapid rise in federal spending in the prior 10 years outpaced the reality of underlying private sector economic growth to support the tax payments for the expanded state. It is important to note that the four largest federal fiscal deficits in U.S. history have occurred over the past four years. This is the result of the outsized growth of federal outlays relative to the tax base to support that growth. Our society could raise taxes to finance the higher level of spending—the effective choice is to ratify the enlarged size of government in our society. In the short run, we have come to rely on foreign and central bank financing of the shortfall with the potential long-run negative consequences of inflation, interest rates, the dollar exchange value and the U.S. standard of living relative to the world.

Conclusion

The period of avoiding hard choices is fast closing.

For our faithful decision maker, there are no free lunches. The period of avoiding hard choices for federal policymakers is fast closing down as the global markets seek growth elsewhere, increasingly in Asia and other emerging markets such as Brazil, Turkey and South Africa. Meanwhile, capital markets are also very sensitive to the over-reliance of U.S. debt finance on a small set of three buyers who are effectively setting the return of Treasury debt below the rate of inflation and in contrast to free market pricing. The real choice for the United States is the size of government and the cost of financing that government—not in taxes, but in private sector growth, capital market prices and the long-run standard of living for its citizens.

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