Fiscal Challenges: A Way Out

Economist Niall Ferguson of Harvard wrote an article entitled “Complexity and Collapse” for the March/April issue of Foreign Affairs, a publication of the Council on Foreign Relations. Ferguson uses the visual image of a series of paintings by Thomas Cole, The Course of Empire, which currently hangs at the New York Historical Society, to illustrate his point that every society goes through five stages. He says that Cole “beautifully captured a theory of imperial rise and fall to which most people remain in thrall to this day.”

The first, *The Savage State*, pictures a handful of hunter-gatherers eking out a bare existence surrounded by a lush wilderness.

The second, *The Arcadian or Pastoral State*, shows an idyllic setting where the people have cleared the trees and rocks, planted fields, and have built themselves a temple of worship.

The third painting, *The Consummation of Empire*, highlights the transformation of the people into citizens of a benign state, opulently clad, enjoying their existence.

The fourth painting, *Destruction*, shows cities ablaze, citizens fleeing an avenging horde.

The fifth and final painting, *Desolation*, shows no inhabitants, only a few decaying columns that remind one of the poem “Ozymandias”:

> I met a traveler from an antique land ?Who said: Two vast and trunkless legs of stone Stand in the desert. Near them, on the sand, Half sunk, a shattered visage lies, whose frown, And wrinkled lip, and sneer of cold command, Tell that its sculptor well those passions read Which yet survive, stamped on these lifeless things, The hand that mocked them, and the heart that fed; And on the pedestal these words appear: “My name is Ozymandias, king of kings: Look upon my works, ye Mighty, and despair!” Nothing beside remains. Round the decay of that colossal wreck, boundless and bare the lone and level sands stretch far away.

Ferguson quotes the British political philosopher Henry St. John, First Viscount Bolingbroke, who wrote in 1738 that even “the best instituted governments carry in them the seeds of their destruction: and, though they grow and improve for a time, they will soon tend visibly to their dissolution. Every hour they live is an hour less that they have to live.”

Precipitating Collapse

Ferguson then relates a series of evidences and examples, including the topic discussed here, to illustrate and support Cole’s theory of imperial rise and fall. Where Ferguson sheds light that would be helpful in understanding the current crisis facing the United States is that, in general, politicians make the mistake of focusing only on the short term. Accordingly, “political leaders in almost any society — primitive or sophisticated — have little incentive to address problems that are unlikely to manifest themselves for a hundred years or more." Ferguson then reviews the Congressional Budget Office's various alternative scenarios concerning the country's public debt and concludes: "It hardly seems to matter which number is correct. Is there a single member of Congress who is willing to cut entitlements or increase taxes in order to avert a crisis that will culminate only when today's babies are retirees?"

Ferguson then incisively makes his point: The crisis may come sooner, much sooner. As he puts it, "A very small trigger can set off a 'phase transition' from a benign equilibrium to a crisis — a single grain of sand [that] causes a whole pile of sand to collapse." Ferguson continues:

> These numbers are bad, but in the realm of political entities, the role of perception is just as crucial, if not more so. In imperial crises, it is not the material underpinnings of power that really matter but expectations about future power. The fiscal numbers cited above cannot erode U.S. strength on their own, but they can work to weaken a long-assumed faith in the United States' ability to weather any crisis. For now, the world still expects the United States to muddle through, eventually confronting its problems when, as Churchill famously said, all the alternatives have been exhausted…. But one day, a seemingly random piece of bad news — perhaps a negative report by a rating agency — will make the headlines during an otherwise quiet news cycle. Suddenly, it will be not just a few policy wonks who worry about the sustainability of U.S. fiscal policy but also the public at large, not to mention investors abroad. It is this shift that is crucial: a complex adaptive system is in big trouble when its component parts lose faith in its viability.

Ferguson then ends his article: "Empires behave like all complex adaptive systems. They function in apparent equilibrium for some unknowable period. And then, quite suddenly, they collapse. To return to the terminology of Thomas Cole, the painter of *The Course of Empire*, the shift from consummation to destruction and then to desolation is not cyclical. It is sudden."

In a presentation to the Peterson Institute for International Economics, Ferguson referred to his article in *Foreign Affairs*, and then addressed the central question: What are the ways out of America's debt crisis? He stated:

> That surely should be the burning question in the western world today, on both sides of the Atlantic. What do we do now that we are in this situation? Well, ladies and gentlemen, in theory, there are six ways out, which I will share with you now. One is to raise the growth rate of your economy. The second is to lower the interest rate on your borrowing. The third is to get bailed out by somebody. That's the route that at the very last minute the Greeks were able to go down. The fourth, of course, is fiscal pain. You increase taxes or you cut public spending and you try to run a primary budget surplus; you start, if you possibly can, to pay off the debt. The fifth is that you print money. That fancy term seigniorage is just a fancy term for printing money in order to inflate the debt away. And the sixth option is to default. There are all kinds of wonderful words for default that you need to know because they'll be appearing in the *Wall Street Journal* and the *Financial Times* quite frequently in the months ahead. You can have repudiation, standstill, a moratorium, restructuring, rescheduling, and so on. But it all boils down to changing the terms of the original loan — default.

Unfortunately, I have to strike out three of these six options right away because certainly from the vantage point of the United States, they're very unlikely to materialize. It's very hard for me to believe, given our present predicament, that we're going to see a sudden upsurge in economic growth in the United States. I think one consequence of the financial crisis has been to lower the growth path of the United States. At this point we've seen some slight recovery [in US bonds], but that, of course, reflects a flight to safety as investors have exited Europe. At the moment the view persists that US treasuries are a safe haven, the safe haven for investors. But as I pointed out in the *Financial Times* some months ago, US treasuries are a safe haven the way Pearl Harbor was a safe haven in 1941; *safe but not for much longer*. [Emphasis added.]

> The nasty fiscal arithmetic sooner or later catches up with all sovereign borrowers no matter how strong they feel themselves to be — which just leaves fiscal pain, inflation, or default.

Cut, print, or default. Ladies and gentlemen, history affords only one example of a country that managed to get itself out from excessive debt-to-GDP burden without either inflating or defaulting. The only case that I can find is Britain after 1815. For a long century, Britain paid down its debt through growth and through running primary budget surpluses. There was no default. There was no inflation. But this, unfortunately, is the only case that history offers us. And remember Britain did have some unusual advantages at that time. It was, of course, the first country to enjoy an Industrial Revolution. It also had the world's biggest empire to draw on, and it had a nondemocratic franchise throughout the period, which meant the propertied were represented and the propertyless essentially were not. That makes it much easier to make tough fiscal decisions, -believe me.

Back From the Abyss

Despite Ferguson's discouraging appraisal, he failed to remind his audience of what happened in New Zealand in the late 1980s and '90s. Maurice McTigue, a former member of the New Zealand Parliament, made a presentation at Hillsdale College in 2004, outlining his country's successful ability to "step back from the brink" of financial disaster. In his remarks, he said:

> New Zealand's per capita income in the period prior to the late 1950s was right around number three in the world, behind the United States and Canada. But by 1984, its per capita income had sunk to 27th in the world, alongside Portugal and Turkey. Not only that, but our unemployment rate was 11.6 percent, we'd had 23 successive years of deficits (sometimes ranging as high as 40 percent of GDP), our debt had grown to 65 percent of GDP, and our credit ratings were continually being downgraded.

Government spending was a full 44 percent of GDP, investment capital was exiting in huge quantities, and government controls and micromanagement were pervasive at every level of the economy. We had foreign exchange controls that meant I couldn't buy a subscription to **The Economist** magazine without the permission of the Minister of Finance. I couldn't buy shares in a foreign company without surrendering my citizenship. There were price controls on all goods and services, on all shops and on all service industries. There were wage controls and wage freezes. I couldn't pay my employees more — or pay them bonuses — if I wanted to. There were import controls on the goods that I could bring into the country. There were massive levels of subsidies on industries in order to keep them viable. Young people were leaving in droves.

When his reform government was elected in 1984, it identified three problems: too much spending, too much taxing, and too much government control. McTigue said, "As we started to work through the process, we asked some fundamental questions of the agencies. The first question was, 'What are you doing?' The second question was, 'What should you be doing?' Based on the answers, we then said, 'Eliminate what you shouldn't be doing — that is, if you are doing something that clearly is not a responsibility of the government, stop doing it.'"

The results? At the start of the process, the Department of Transportation had 5,600 employees. At the end, it had *53*. The Forest Service had 17,000 employees at the start, and at the end it had *17*. The Ministry of Public Works initially had 28,000 employees, and when the downsizing process was completed, McTigue himself *remained the only employee*.

When challenged about having killed all those jobs, McTigue made an interesting discovery: "I visited some of the forestry workers some months after they'd lost their government jobs, and they were quite happy. They told me that they were now earning about three times what they used to earn — on top of which, they were surprised to learn that they could do about 60 percent more than they used to!"

> Some of the things that government was doing simply didn't belong in the government. So we sold off telecommunications, airlines, irrigation schemes, computing services, government printing offices, insurance companies, banks, securities, mortgages, railways, bus services, hotels, shipping lines, agricultural advisory services, etc. In the main, when we sold those things off, their productivity went up and the cost of their services went down, translating into major gains for the economy. Furthermore, we decided that other agencies should be run as profit-making and tax-paying enterprises by government. For instance, the air traffic control system was made into a stand-alone company, given instructions that it had to make an acceptable rate of return and pay taxes, and told that it couldn't get any investment capital from its owner (the government). We did that with about 35 agencies. Together, these used to cost us about one billion dollars per year; now they produced about one billion dollars per year in revenues and taxes.

In summary, after reform, the size of the New Zealand government as measured by the number of employees *dropped 66 percent*. The government's share of the country's GDP dropped from 44 percent to 27 percent. Federal debt dropped from 63 percent of GDP to 17 percent.

The benefits of such radical downsizing are still being felt today. According to Wikipedia, "New Zealand has a modern, prosperous, developed economy [with] a relatively high standard of living with an estimated GDP per capita of US$31,067 in 2010, comparable to Southern Europe. Since 2000 New Zealand has made substantial gains in median household income [and NZ citizens] have a high level of life satisfaction." Marketing ads for New Zealand claim, "New Zealand is now an entrepreneurial power house," is "ranked first as the least corrupt," is the "5th freest economy in the world," and is "first in the world for protecting investors."

At a recent Cato University conference, this writer interviewed John Boscawen, a Member of Parliament of New Zealand, who was present during the economic revival. The reason for the success, he stated, was "the awareness among our people that we were in desperate shape financially. We had to do something, and the Labor Party had disintegrated. Our coalition was able to push through the reforms that were needed, with remarkable results."

If the United States is to have any chance for a similar recovery, it is going to require increasing awareness and understanding of how the country came to such a pretty pass. As Thomas Jefferson put it:

> I know of no safe depository of the ultimate powers of the society but the people themselves; not enlightened enough to exercise their control with wholesome discretion, the remedy is not to take it from them, but to inform their discretion. Enlighten the people generally and tyranny and oppressions of body and mind will vanish like evil spirits at the dawn of day.