Invited Essay

DEBT PANIC AS STRATEGIC MISREPRESENTATION IN MANAGEMENT OF GOVERNMENT FISCAL STRESS AND CRISIS

L. R. Jones

ABSTRACT

The theme of this article is that for reasons related more closely to politic incentives rather than fiscal reality there is a tendency among some policy makers to make wrong choices in attempting to manage fiscal stress and crisis, preferring to use more easily negotiated "quick fixes" such as across-the-board cuts in spending for programs that do not contribute much to deficits and debt. In fact such cutting usually makes the fiscal situation worse rather than better because they reduce economic growth in the private sector needed to pull out of debt and economic recession (Bureau of Economic Analysis, 2012). Typically, such budget reductions result in increased unemployment as public sector jobs are cut, further reducing revenues to government while increasing unemployment insurance cost of government. Fiscal stress is defined as when revenues fall short of expenses but a government or other public entity in debt remains able to obtain loans to finance current operations and debt restructuring, albeit at increasingly higher level of interest while they participate in some form of debt restructuring. Fiscal crisis occurs when governments no longer can get loans and are not able to sell their debt in financial markets at any price. This article examines US fiscal stress conditions and management approaches and then compares the US experience to that of the European Union and the Eurozone. It explains that while there is genuine need for changes in fiscal policy, such changes should be proposed, analyzed thoroughly, negotiated and implemented carefully over time rather than yielding to political expedience using debt panic as a means of forcing the adoption of quick but unworkable approaches to resolution of the real problems that cause both short and longer-term fiscal stress.

Keywords *- Debt Panic, Fiscal Crisis, Fiscal Stress, Government Financial Management, Strategic Misrepresentation*

Corresponding Author: lrjones@nps.edu

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INTRODUCTION

In analyzing the recent circumstance of international financial stress we have come to understand that the initiatives implemented by governments in the US, Europe and elsewhere, although different in many respects, are both macroeconomic and microeconomic in nature. For example, the financial bailout and stimulus "rescue" plans undertaken in the US and in some other nations have involved a combination of monetary and fiscal policy. Looking back more that three years ago in the US experience the approximately $700 billion Troubled Assets Relief Program (TARP) authorization passed by the US Congress in October, 2008 and the economic stimulus and recovery legislation (The Emergency Economic Recovery Act) passed by Congress and signed by President Obama in February 2009 were accompanied by actions of the Federal Reserve Bank to hold interest rates low and to push money into the economy. Both monetary and fiscal policy instruments continue to be used, managed by the US Treasury and Federal Reserve Bank under the support of Congress and the President. These and other economic stimulus actions have increased the annual US deficit and total debt. The tradeoff for increased debt is assistance in stimulating the US economy into moderate recovery from recession in 2011 and into 2012 as GDP rose at an annual rate of approximately 2% during this period.

U. S. FISCAL POLICY CHALLENGES

With respect to fiscal policy, annual budget deficits have resulted in the growth of debt as a percentage of GDP in the US and elsewhere. The $1.3 trillion annual deficit in 2008 at the end of the Bush administration represented 9.3% of the US GDP. The fiscal year deficit for 2012 is projected in the FY 2013 President's Budget to be 8.5% but this number is what many believe to be an overly optimistic projection by the President's Office of Management and Budget. The annual budget deficit level as a percentage of GDP projected for FY 2012 may be compared to FY 2004 when it was 3.6 percent, or to 1983 for example when it was 6 percent of GDP. The President's budget proposal presented to Congress in February 2012 continues a four year trend of the largest US annual budget deficits as a percentage of GDP since World War II. This trend line is a result of the costs of multiple financial "bailout" and "rescue" authorization and appropriation legislation passed by Congress and signed into law by the President as noted above. Also adding to the deficit were costs incurred for other financial stress related legislation enacted between 2009 and 2012, e.g., to stimulate employment, cut the pace of housing foreclosures and to stimulate the recovery of housing and other industries. Further government economic stimulus measures already passed or now under consideration in the US Congress, including the recently approved extension of Bush era tax cuts until the end of 2012, will reduce tax revenues to the federal government.

The trend of increasing debt as a percentage of GDP and the necessity to pay off Treasury debt as it comes due (debt service) is projected to continue as a result of efforts to counter the lasting effects of the 2008-2011 economic recession. Any new stimulus initiatives, added to the continuously rising costs of providing health care and income support to an aging population, will add more to a cumulative US debt that will be somewhere between $16.2 to $16.4 trillion before the end of 2012.

A sizable portion of US debt is owed to foreign investors including two major purchasers, China and Japan. As of the beginning of 2011 foreign investors held 47% of US debt compared to 5% in 1970 and 19% in 1990 (OMB, 2011). Of this amount China held $884 billion or 5.9% and Japan $862 or 5.7% billion of the total debt of $15 trillion (CRS, 2011). Since that time both the total debt and ownership by China have increased; total debt as of March 2012 is nearly $16 trillion and China's percentage of this is nearly 8%. Public fears about foreign debt ownership are thus somewhat unfounded for several reasons. Japan, a close US ally, holds almost as much US debt as China. Secondly, for reasons related to the amount of dollars these nations hold, neither wants to see the US dollar devalued. Thirdly, both of these nations want and need to sell their products in the huge US market. Thus, both China and Japan have a strong interest in the status of the US economy as it emerges from recession. Further, presently the US is able to sell its debt at relatively low rates, e.g., about 2%. This reduces somewhat the burden of repaying the debt in the future. All of the above supports the primary theme of this article that there is no financial reason for debt panic in the US given current low interest rates, low rate of inflation and positive GDP growth.

Both elected officials in Washington, D. C. and the American public have become much more aware of the fact that US federal government annual budget deficits and total debt have increased substantially and are going to increase further in the near future until solutions are devised to address projected shortfalls in financing for costly entitlement programs including Medicare and Medicaid. While the President's Fiscal Year 2013 budget request to Congress (OMB, 2012) proposes to cut the size of the annual budget deficit for 2013 down to $901 billion or 5.5% of GDP (down from $1327 billion in 2012 and 8.5% of GDP), this does little to ease worries about the increasing size of the total debt and corresponding growth of entitlement program obligations, added to existing public concern about job creation, the state of the economy, the health of the nation's schools, the human and financial costs of war, the survival of federal government pension systems and their ability to meet legally required obligations and so on. Still, looking further out, if adopted by Congress as proposed the President's budget (which almost never occurs) projects reduction of total annual deficits as a percentage of GDP to 3.9% in 2014, and 2.7% by FY 2018. We must observe as have others that the numbers in the President's budget are susceptible to "cooking" to some extent by his budget office, OMB. If we look at the projections of the Congressional Budget Office that has to serve members of Congress from both political parties we find the following among the many and somewhat confusing deficit and debt projections provided by this agency in estimating the results from analysis of the President's FY 2013 budget (CBO, 2012): total debt at approximately 9% of GDP for FY 2012 and annual deficits averaging 5.4% for the period 2013-2022. However, beyond the projections of annual deficit percentages of GDP are estimates by CBO of the size of the total debt of the US federal government as a percentage of GDP.

Figure 1 does not reveal any problem. It shows what is known as the "baseline" i.e., what would result if spending and programs remained at current levels, which it won't as explained subsequently in this article. The more disconcerting data are shown in Figure 2; what will happen if Congress and future Presidents do not change current spending policies: total debt percentages will rise from approximately 69% of GDP in 2011 to 87% in 2020 and 146% by 2030. After this date the projection are too far out in the future to be considered reliable, in part because they show debt levels that literally could not be bourn by the US government or by taxpayers.

What is clear from these projections is that while there is no reason for debt panic presently, demographics will increase entitlement spending to unprecedented and unsustainable levels unless changes are made in the fiscal policies that drive up costs in these politically sensitive trust funds. Based on the history of US fiscal policy and the performance of elected officials in the past since the beginning of the nation (Jones and McCaffery, 1979; McCaffery and Jones, 2001) it is fair to assume that at some point the changes needed will be made but, perhaps not until actual fiscal crisis is very near. The political impact of this, when it occurs, is difficult to predict because of the conflicting preferences of the US public. On one hand people want a fiscally responsible government. On the other, they don't want changes in any programs that affect them.

Figure 1: CBO Baseline Projections; No Real Problems in Sight

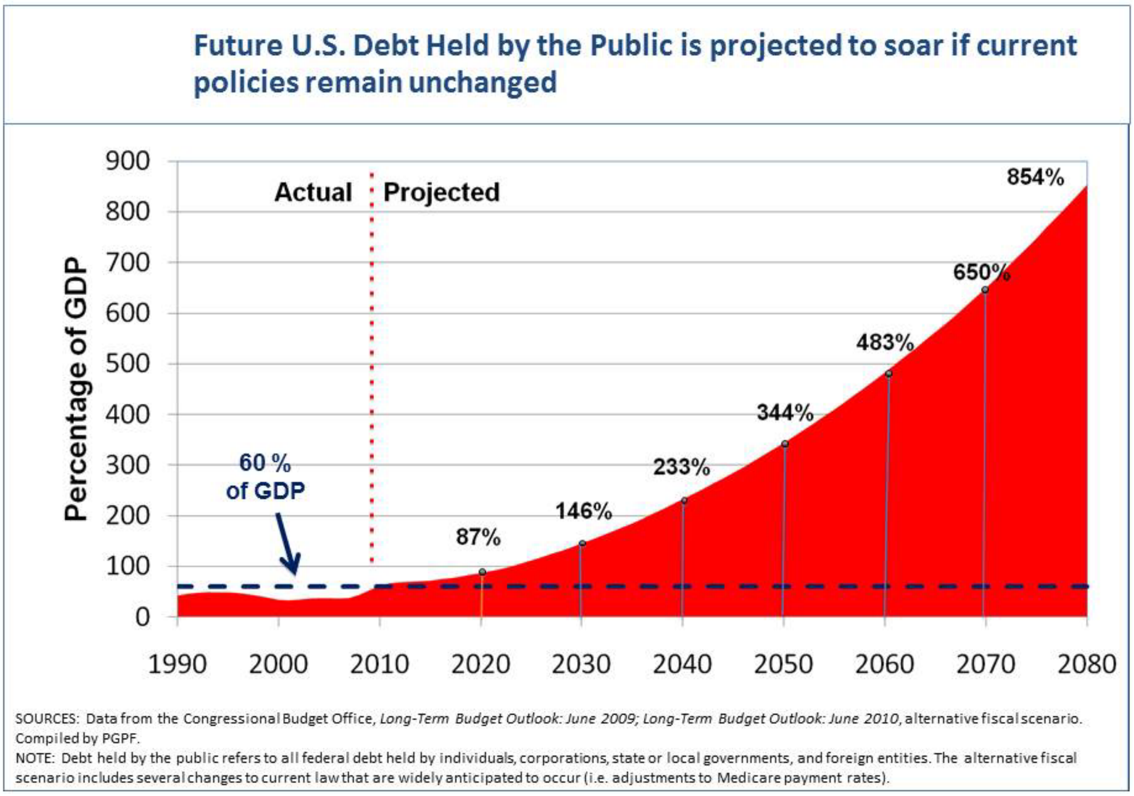
CBO's Baseline Projections of Federal Debt

(Billions of dollars)

	Actual, 2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Debt Held by the Public at the Beginning of the Year	7,545	9,019	10,164	11,153	11,773	12,148	12,463	12,840	13,169	13,473	13,820	14,181
Changes to Debt Held by the Public												
Deficit	1,294	1,284	973	510	265	205	278	231	211	259	277	279
Other means of financing	181	-138	16	110	110	110	99	99	94	88	84	82
Total	**1,474**	**1,145**	**989**	**620**	**375**	**315**	**377**	**329**	**304**	**347**	**360**	**360**
Debt Held by the Public at the End of the Year	9,019	10,164	11,153	11,773	12,148	12,463	12,840	13,169	13,473	13,820	14,181	14,541
Memorandum:												
Debt Held by the Public at the End of the Year (Percentage of GDP)	62.1	67.3	71.2	72.8	71.6	68.7	67.2	65.8	64.3	63.1	62.0	61.0
Debt Held by the Public Excluding Financial Assets[a]												
In billions of dollars	8,005	9,306	10,266	10,766	11,027	11,219	11,492	11,714	11,913	12,158	12,421	12,686
As a percentage of GDP	55.2	61.7	65.5	66.5	65.0	61.9	60.1	58.5	56.9	55.5	54.3	53.2
Gross Federal Debt[b]	13,529	14,797	15,927	16,663	17,178	17,679	18,276	18,879	19,475	20,090	20,711	21,346
Debt Subject to Limit[c]	13,511	14,779	15,910	16,646	17,162	17,664	18,261	18,864	19,461	20,077	20,697	21,333

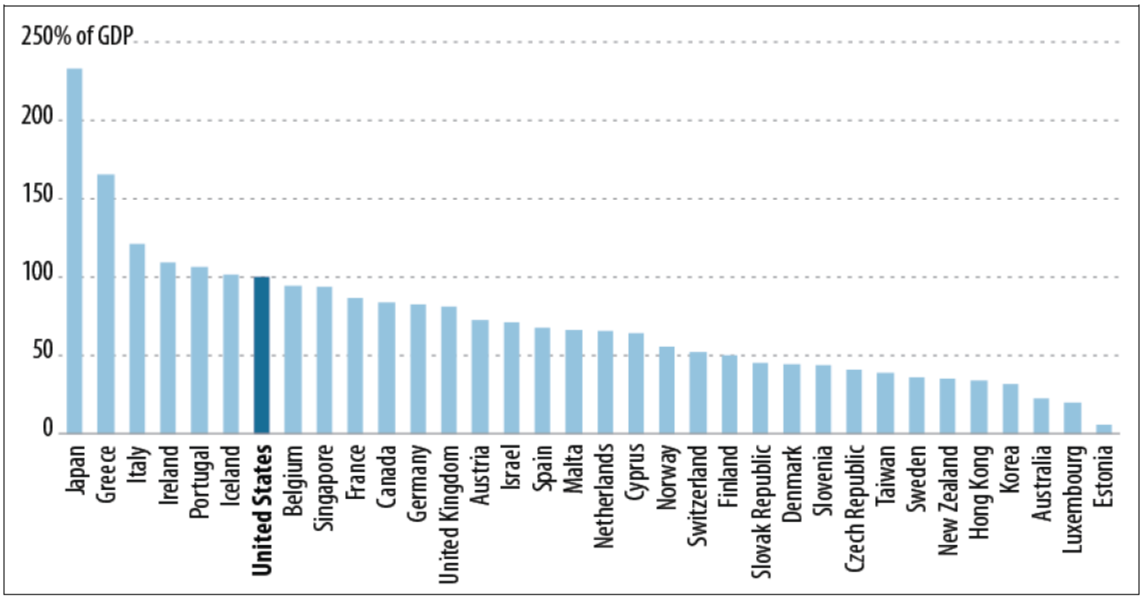
Source: CBO, 2011. CBO defines the baseline as follows: "Each January CBO prepares 'baseline' budget projections spanning the next 10 years. Those projections are not a forecast of future events; rather, they are intended to provide a benchmark against which potential policy changes can be measured. Therefore, as specified in law, those projections generally incorporate the assumption that current laws are implemented" (CBO, 2012a: 1).

Figure 2: Federal total debt as a percentage of GDP 1990-2080 - Very Real Problems in Sight



With respect to the data shown in Figure 2 it must be noted that other nations have levels of debt as high as what the worst projections show for the US if policies aren't changed. For example, Japan currently has a debt that is about 235% of GDP; Italy about 118% of GDP (See Figure 3 below). However, in Figure 3 we see the total debt of nations that includes state and local government debt. For this reason the US percentage is shown in this display at about 100% of GDP. The point is that from a US taxpayers' point of view, or the views of taxpayers in other nations, all of the debt shown, whether federal or not, has to be repaid primarily from the same sources, i.e., individual citizens and corporations. However, once again the data also support the point of this article that there is no reason for debt panic presently other than for use as a political scare tactic. More will be noted on this dynamic subsequently in this article.

Figure 3: Total Public Debt as a Percentage of GDP in Developed Nations in 2011



Source: *IMF World Economic Outlook*, September 2011.

Source: CRS, 2012.

It is fact that increased transparency and media attention, some might say obsession, in an election year about government budgeting and finance has led to heightened interest in how government spends and proposes to spend taxpayer and borrowed money, and whether the amount of debt owed is healthy for the US economy. While the US economy grew at an annual average rate of about 3% in 2011, significantly increased oil and gasoline prices beginning in February 2012, along with continued relatively high unemployment and underemployment should worry the citizenry. A burst of inflation could lead to Federal Reserve Bank and commercial bank interest rate hikes, higher borrowing costs for the US government, increases in prices of goods generally throughout the economy and other "bad things" that could retard economic recovery and stifle economic growth. The last thing any treasury secretary or finance minister in any nation wants to confront is the deadly dragon of stagflation.

The response among the public to greater political and media concentration on the "poor" state of the economy is the addition of even more fear to what is already highly distressing about the potentially dire consequences of what a government that is already held in very low esteem might decide to do with respect to fiscal policy. This is especially evident when considered in the context of a highly divided and politicized debate over the direction of the nation the often features seriously misguided proposals about how to confront and manage fiscal stress. Combined with the fact of continuing high unemployment it is no wonder that sample polls of US citizen satisfaction with Congress and the federal government reflect continuing consternation and frustration about the present and future ability of government to address the serious long-term issues that could weaken the US economy.

Amidst this climate of fear let us dig further into the details of fiscal policy. As most of us are aware, when the deficit goes up the opportunity cost for paying for increased debt service sometime result in cuts in federal government programs, especially in the discretionary part of annual spending, e.g., social programs and national defense. The discretionary portion of annual US federal government spending (for domestic programs and national defense) represents only 32% of total spending, with 68% spent in support of federal entitlement programs including Social Security, Medicare and Medicaid, i.e., programs and trust funds that are difficult to cut or even hold in check as demographics and rising health care costs "automatically" drive up spending. Given this understanding the implications and potential consequences of high debt over the long-term become clearer. Unless political decision makers change the course of current policies, total debt will rise and both discretionary and entitlement programs will face greater budget reduction pressure in the coming years. Further, because the US finds itself in the position of fighting a long and expensive war and the fact that the Bush and Obama administrations already have cut social program spending significantly, a longer term trend that began under the Reagan administration in the 1980s, finding ways to reduce spending just in the discretionary budget that are agreeable to both Congress and the President will be even more difficult. Thus, the financial rescue plans already implemented in the US, in European and other nations that involve increased debt have serious longer term consequences.

Part of the debate over the use of government debt to finance the bailout of the troubled US banking systems in the wake of the sub-prime housing mortgage market collapse in the US in 2008 which affected many non-US banks and foreign treasuries that had invested in US mortgage financing and associated (risky) derivatives, centers on the question of how deeply governments should intervene financially to save private sector institutions. In the US such government investments have included absorption of the debt of two huge federally guaranteed home lending institutions (Fannie May and Freddy Mac), purchase of equity in numerous private banks, funding to support the US automobile industry, and outright purchase of private firms such as the AIG insurance corporation. Finding answers to the questions of who to bailout, when and why in devising approaches to stabilize the economy are among the significant unanswered issues that will inevitably be faced by future Presidents of the United States and Congress. The US is not alone in having to devise ways to finance and manage monetary, fiscal and economic stress as similar challenges confronted the leaders of governments and national and private banking institutions around the world.

DEBT PANIC

A critical point needs to be made about how to define and differentiate between fiscal stress and fiscal crisis, and as a result to be able to determine whether the US and other nations are in an economic and fiscal "crisis" or a fiscal "stress" condition presently. While for political reasons it is understandable why elected officials, including President Obama, sometimes use the word "crisis" to characterize the current situation, i.e., to persuade others such as members of Congress to act in response. However, scholars who conduct research on financial stress and crisis in governments from the period of the 1830s and before to the present point out that a crisis really only occurs when governments can no longer get loans to finance current operations and proposed investments. Such is not the case for the US presently.

In part due to genuine concerns over the projected effects of a continuing large total US debt position and, consequently, the solvency of the US government over the next ten to forty years, and in part because of the dynamics of election year politics, concerns have been raised about fiscal policy that have been reported continuously and at high profile in the media. The resulting response among politicians and the much of the public may be characterized as "debt panic". Debt panic has been raised intentionally, as a political tactic of the Party out of power, and unintentionally as the result of the rising costs of Social Security and federal health care spending. Debt panic has been applied by members of the Republican party in attempt to gain leverage against President Obama and the Democratic party; but this is simply politics as usual, especially in an election year. What is of concern is that virtually all of the fiscal policy (taxing and spending) efforts of the Congress, and particularly the House of Representatives, thus far have focused on the need to cut the discretionary part of federal government spending with little attention to the real problems pushing the debt higher each day that result from spending on entitlements. In attempt to show that Congress was trying to take action on the debt, in the process of raising the total debt limit ceiling that must be stipulated in law, it passed what is now referred to as the "Budget Control Act" (PL 112-25) in early August 2011 that set a ceiling for the Fiscal Year 2013 discretionary budget of $1.028 billion. This targeted national defense and domestic programs for approximately a 10% reduction but did nothing to control entitlement spending. This reinforced alarm because seasoned observers of fiscal policy have known for at least the past decade and in some cases for a number of decades that the real debt problem is caused by the rapid pace of growth of entitlement program spending not affected by this Act.

I have two reactions to the misperception and misrepresentation of debt panic. First, it is dishonest. Anyone who says that the US can reduce its debt substantially by cutting discretionary programs comprising roughly 32% of total federal spending is misrepresenting the facts - period. In truth, federal spending on politically and socially sensitive entitlement programs including Social Security and very large health care financial assistance programs has to be reduced or, at minimum, rates of growth must be curtailed. Resolving the Social Security issue should not be a problem. Solutions are so simple that one wonders why this hasn't been done already. As was accomplished by Congress and the Reagan administration in 1983, the solvency of this program can be restored by raising the age at which people become eligible to receive benefits and raising the Social Security (FICA) taxes paid by working Americans and their employers. No need for panic here.

The second aspect of "debt panic" that bothers me is that by international standards taxpayers in the US pay dramatically less for Social Security than do taxpayers for similar or even more lucrative social support (safety net) programs in most of the rest of the world. Cutting spending on health care is a much more complex and difficult task and accordingly it is likely that it will take Congress and Presidents years to work out resolutions to this problem.

The central thesis of this article is there is way too much that is stressed about related to the federal government debt and the state of the economy in the US presently than is warranted. Much of this concern will fade, for better or worse, after the general elections are over in November of this year. More importantly, the US has faced similar debt problems in the past, e.g., after the Revolutionary war, not just in the 1930s but in the 1830s (Roberts, 2012; see also Roberts, 2010), in the post-Civil war period, in 1987 when the stock market "collapsed", in the early 1990s and 2000s and at many other times (McCaffery and Jones, 2001). The solution has usually come from increased production and productivity in the private sector that results in higher tax revenues which reduce annual deficits and, potentially, total debt, e.g., as a result of the information technology driven economic stimulation in the 1990s that led to four straight years of balanced annual US budgets. Additionally, as noted, the US's debt position is not as high as it is portrayed relative to that of some of the other nations in the developed world.

We must acknowledge that fiscally and politically federal government spending is very difficult to cut. Part of the problem is that most Americans want all kinds of services provided by governments at various levels but we don't want to pay for them. From an economics point of view, don't we all want to be "free riders"? Isn't this economically and psychologically rational? The answer is resoundingly "yes" but eventually the piper must be paid. The grasshopper must emulate the ant. Spending must be curtailed but in the right areas, taxes must be raised, saving must increase, sound investments must be made, the foibles of easy credit and the financial system excesses that led to the collapse of 2008 must be avoided, and the economy, which is the key, must recover and thrive.

The third aspect of debt panic relates to my first concern, i.e., that rapid and drastic cuts in government spending and employment are not in any way a wise or even viable way of resolving long-term debt and solvency problems. Cutting government spending rapidly whether it be on social programs, education, national defense or whatever else, results in just the opposite effects that proponents of this approach claim. Here we have a dreadful recent example to support this point.

Under Prime Minister David Cameron the UK government did exactly what I have indicated is unwise policy: government budgets and employees were slashed very rapidly without much or any concern for the consequences of these reductions on the many clientele groups affected. However, Cameron either didn't know or chose to ignore the advice of numerous domestic and international economists who warned of the larger economic impact effects of deep and dramatic budget and service cuts. And quite obviously he ignored evidence from the history of management of fiscal stress (Oborne, 2012). The result of what may be characterized as "Cameron's folly" is that GDP for the UK in 2012 is projected at about zero. In fact, it could be negative. What about 2013? The answer is about the same: zero for 2012 and a perhaps only a very small increase in GDP in 2014.

In summary one might say Cameron ignored what economists and others knew and told him, "It's the economy stupid!" Increasing the revenue streams needed to grow out of a recession come from the private sector economy and the consumption of taxpayers. To the extent that government budget cuts increase unemployment then revenues go down. And to the extent that investment and productivity in the private sector are affected negatively by government budget cuts, revenues to government likewise go down. When revenues go down the deficit and debt of government go up, not down. The lessons of Cameron's folly should be studied widely, i.e., you cannot successfully cut your way out of an economic recession. Further, political ideology postulating success by cutting widely and deeply is preached by false prophets thrives by exploiting public fears which always accompany economic recession. From this example it would appear that politicians advocating drastic spending cuts don't really care about solving the real problems presented by economic dips. Instead, they fan the flames of fear in pursuit of their own political fortunes by propagating and overstating the severity of fiscal and economic problems so as to stimulate increased debt panic that gives them the political leverage to cut back what they view of as the excesses of the welfare state. This perspective typically includes the belief in the US that we do not want to become a "socialist" welfare state like those in Europe, a perception that fails to meet the criterion of accuracy. The US already is so much like Europe that any perceived difference doesn't really matter, as explained by the late David Brooks years ago (Brooks, 2012).

CONTRASTING THE US WITH THE EUROPEAN UNION IN MANAGEMENT OF FISCAL STRESS

Extrapolating from the UK experience one wonders about the entire strategy of the European Union leadership and the European Central Bank in its imposition of very harsh spending and public employment reduction requirements on Greece and additional members of the Eurozone that face fiscal stress or crisis, e.g., Italy, Spain, Portugal, Ireland and Belgium. We need to ask whether this fiscal policy approach is part of the solution or rather part of the problem in attempts to reverse the economic recession in Europe. An additional criticism of the EU approach is its monetary policy that has featured maintenance, over a considerable period of time after fiscal stress conditions arose, of comparatively high interest rates compared to the low interest rate strategy of the US. More recently the European Central Bank has moved closer towards the US approach by lowering interest rates and by pumping more than 1 trillion Euros into the Eurozone economy in two 3 year Long Term Financing Operation (LTRO) packages. However, the lowering of interest rates has stimulated criticism, particularly from the German Bundesbank and others who oppose further lowering of interest rates due to fears of inflation. In fact some critics are in favor of increasing rates with Germans arguing that the time has come for the ECB to exit the "crisis-fighting mode" in managing European fiscal stress.

To ground the consequences of the EU strategy in fact, the most recent projections on GDP for Europe indicate zero growth for this year and next year as well (Krugman, 2012). It appears that Europe is headed into a second phase of serious economic recession that the US has avoided by stimulating the economy rather than adopting measures that lead to economic retraction rather than growth. In addition, if we look at Sweden which did not impose such drastic government budget cuts we find the most successful nation in Europe in managing fiscal stress. Current GDP growth in Sweden exceeds not only all other nations in the Eurozone but most of the nations in the world that report GDP statistics, revenues and expenses honestly and accurately.

Understanding fiscal stress and what to do about it requires in depth comprehension of the conditions in each individual nation facing such stress. For example, Italy has traditionally run very high levels of debt as a percentage of GDP so the critical question is how much more is harmful versus just more of the same, i.e., coping with continuous fiscal stress but coping none-the-less. Ireland may be in better shape that the other nations in this set of fiscally stressed nations. In November 2010 it obtained a $89.5 billion line of credit with the European Union and International Monetary Fund and thus far has borrowed $63.5 billion from it at a rate of 3.3% (Associated Press, 2012a). While it seems likely that Ireland will not default on its debt and will be able to reenter the international market to sell its debt on the market in 2012, such debt must be sold offering higher rates of return for investors, e.g., 7% (as is the case at the time of this writing) which creates longer-term debt servicing problems and the need to commit more money to debt repayment at the expense of providing public services.

The history of financial collapse in Europe is very long, and should provide lessons to the EU in attempting to manage fiscal stress and crisis. As noted by Peter Oborne,

> ...the most important problem is the failure to study history. Here the facts are devastating, and bear repetition. Portugal has defaulted on its national debt five times since 1800, Greece five times, Spain no less than seven times (and 13 times in all since 1500). The importance of these statistics is very great. They show that the widespread assumption by bureaucrats, senior politicians and commentators alike that eurozone countries could never go bankrupt is simply wrong. In fact, the opposite is the case. The normal and indeed the automatic response of Spain, Portugal, Greece and many other European countries to major financial crises such as the one we are living through today has been to renege on their debts. So it would be extraordinary were they not to do so. History also shows that currency unions such as the eurozone invariably fail: the most relevant case in point is the Latin monetary union formed by France, Belgium, Italy and Switzerland in 1865, with Spain and Greece joining a few years later. Once again, these failures are invariably sparked by grand financial crises of the kind the world faces today Oborne, 2012).

The primary purpose in pointing out that each nation needs to be addressed individually rather with a "one size fits all" set of rules forced on fiscally troubled nations in Europe or elsewhere is that this is not the right approach. Solutions need to be and in reality are in fact tailored to the nature of the specific national economic context of individual nations at the point where significant debt restructuring occurs. Unfortunately, the ECB, the Chancellor of Germany and others who support the one size fits all approach that characterizes the methodology adopted and implemented by Eurozone leadership appears to ignore this observation. In addition, critics point out what is easily recognizable from a political viewpoint. Citizens of the wealthier nations of Europe really don't want to finance the bailout of the less prosperous nations in the Eurozone (Krugman, 2012).

German Chancellor Angela Merkel has to walk a tightwire in trying to cope with Eurozone fiscal stress and crisis while still placating the voters who have kept her in office (Horn, 2012). And this is not just Merkel's problem. It is a problem of high importance and visibility related to the survival of the Euro as a currency for all of the Eurozone -- or alternatively survival of the Euro as the currency for only for some of the members. This is recognized by some nations that have prepared to join the Eurozone. Turkey for example, which has long pushed its own fiscal policy instrumentation to qualify for entry into the Eurozone, has had second thoughts and at present has halted most efforts to climb aboard what may be perceived as either a sinking ship or one that may be splitting apart, rich versus poor. Serbia also has implemented a number of initiatives to join the EU but now faces additional obstacles to entry based on new EU requirements. While it may remain attractive to Serbia to try to join the EU, resistance from citizens and political parties in wealthier EU nations resulting from the current fiscal crisis may make it harder for Serbia and other nations to join the EU. The case for Serbia is made stronger because this nation has experienced recent GDP growth.

It is interesting to note that some other nations wishing to join the EU have more to change in addition to what is required to meet EU regulations. Croatia for example is a small nation in which, due to its history, has a very large proportion of its GDP produced by the government itself, e.g., approximately 40%. Thus to gain entry to the EU Croatia would first need to privatize a substantial part of its product and service industries, not an easy task given that most of the populace prefers the traditional means of provision by the public sector and much of the nation's employment is composed of government workers. Further, in small nations like Croatia or Montenegro the government cannot run high deficits because doing so would make it more costly in terms of interest offerings (and debt service costs) needed to sell its debt and, at some level of debt, impossible to borrow money from international investors. This creates a very real check on tendencies to run annual budget deficits that increase the size of the national debt.

In face of this line of criticism, what has the EU done to manage fiscal stress most recently and does it fit the previous "one size fits all" pattern? The answer is that recent measures mirror the approaches taken in the past. On March 2, 2012 the leaders of twenty-five European (EU) nations (out of the total of 27) signed a "treaty" (fiscal compact) stipulating another one size fits all set of fiscal requirements that attempt to instill even greater fiscal discipline and austerity. It must be noted that the UK and the Czech Republic refused to sign this agreement. About this new initiative European Council President Herman Van Rompuy said, "It will bring...the economic and monetary union that is finally walking on two legs"(Associated Press, 2012b). This agreement is intended to further prevent a specific set of seventeen members of the EU from spending beyond their means, and to increase pressure for them to enforce tax increases and other austerity measures.

The first problem with this approach is that it is more of the same; it does not differ in basic form from the single set rules and control-oriented approach that has proven unenforceable and unsuccessful thus far in the EU, although the new criteria are intentionally slightly less rigorous in this edict than in those that preceded it. However, other problems with this new initiative are more serious. Because all EU members did not sign it, this creates the need for a separate "treaty" to be negotiated for the two dissenting nations rather than integrating the new rules into EU law. This, in turn, prevents the European Commission (the EU's executive body) from forcing the new requirements across the entire EU. To bring the new rules into effect requires participating nations to approve it individually by either legislative or popular vote. If 12 of the 17 affected nations approve it by a majority vote then it will go into effect. Whether this will happen and how long it will take, even if it is successful, is unknown. Two public referenda votes in Ireland over similar initiatives failed to receive approval.

What is known is that the leaders of EU nations and the public in those nations affected by the austerity measures (and all of Europe for that matter) are growing increasingly weary of the effects of economic recession, accompanying high unemployment rates, etc. and are losing confidence in the EU's use of what many perceive as "German style" fiscal discipline. Likewise, wealthier EU nations are getting tired of supporting poorer nations, which is understandable given that one wave of loans, debt payback time extensions and debt forgiveness follows another. This brings confidence in the EU (and the Euro as a common currency) even lower. Most notably it creates a common ground of mistrust wherein neither those nations providing assistance nor those receiving it find it easy to sustain confidence in EU fiscal stress management capability. If and when individual governments in the region that have supported EU are austerity initiatives are voted out of office, the stability of the EU and the Euro will face an even great challenge (Associated Press, 2012b).

From my perspective, the overall problem with the EU's approach, as noted, is that it will retard economic growth that is needed to increase revenues sufficient for the region to crawl out of economic recession. In fact, it will likely have just the opposite effect; it will make the overall economic stagnation in Europe worse rather than better.

WHAT ABOUT GREECE?

For some of the poorer, heavily debt ridden nations in the Eurozone, the word crisis is an apt description of their economic and fiscal condition. The nation receiving the greatest attention is Greece, which is in the midst of major debt restructuring and already is in partial default on its debt. It is paying off older debt as it comes due with newly acquired debt ("rolling it up" in banking terms). Greece also has been supported by EU sponsored "bond swaps" of 107 billion Euros ($144 billion), a primary means of defeasing debt, and is currently asking some bank lenders to accept debt repayment at 50% of what is owed (more defeasance). Greece also is attempting to generate new revenues through privatization of government enterprises (e.g., its Public Gas Corporation) and sale or leasing of valuable public assets. Greece has received EU and IMF rescue loans in waves since May 2010. The first such set of loans in 2010 provided 73 billion Euros which was then followed by a 130 Euro billion ($172 billion) loan package. The problem with this series of bailouts is, bluntly, that they haven't succeeded in doing any-thing beyond delaying the nation's default. At the end of the first week of March, 2012 credit rating agencies downgraded Greek bonds to the lowest levels in their rating systems, noting that investors holding existing bond were set to receive repayments through bond swaps at 53.5% of their nominal value, with actual losses to investors estimated at approximately 74% (Moody's, 2012).

It seems very likely that Greece will eventually go bankrupt (i.e., into complete default) regardless of the continuing lending initiatives of the EU and European Central Bank, the International Monetary Bank, the Government of China and others. The issue probably isn't whether but when this will occur and for whom it matters most. The short answer is it matters most to holders of Greek debt, e.g., Western European banks including selected banks in France. The larger question is what difference this will make in terms of the stability of the EU, the Euro and European stock markets?

In this last regard we can note the apparent irrationality of stock markets. In the beginning of March 2012 the Finance Ministry of Greece reported that despite (or perhaps because of) government austerity measures in place since late 2010, the nation had recorded a deficit of $652 million for the month of January in contrast to a surplus for the same period in 2011 (Associated Press, 2012b). In response to this report from Greece, and then after a new loan package agreement was approved by the EU in mid-March 2012, European stock markets dropped but not by as much as anticipated. Perhaps investors believe in miracles or maybe they are playing it risky, continuing to reap short-term gains as stock markets fluctuate up and down, with the intention of pulling out once a Greek default appears imminent? In addition, there is considerable bond speculation intended to make a profit if Greece defaults.

How much will a default by Greece matter to the US stock market? While all of this is merely speculation, we may assume that stock market investment is motivated by two primary factors, (a) an understandable desire for profit, and (b) the fear of loss, with the latter the most important behavioral driver in the circumstance of fiscal crisis. So, as Greece defaults partially on its debt and if it defaults entirely after the next elections that bring in a new prime minister as a result of a change in the balance of seats in their coalition government, the European stock market will be hit hardest. In the US one might anticipate there could be some decline in the Dow Jones Industrial Average (DJIA) and other US market indices. However, after initial reaction out of fear, investors in the US stock market will likely become more rational and ask, "How does this really affect the stocks in our market? Interest rates are a key element here. If the Federal Reserve Bank keeps interest rates low, once investors in US stock markets become more "rational" they are likely to see some good buying opportunities and dive back into the market so that within a relatively short period of time the market will climb back up to a DJIA of about 13,000 and over time probably higher. Why? Because the US is recovering from the recession much more rapidly that the Eurozone or the UK for that matter. Once investors look more carefully at projected positive US GDP growth in the period 2012 - 2014, then getting back into the market is likely to appear to be more attractive. I make no claim to wisdom regarding stock markets - and I don't gamble big in Las Vegas or elsewhere either. I say this not as a joke but rather as a sincere assessment that investing in stocks during periods of economic and fiscal instability is akin to casino gambling and I choose to err on the safe side. Still, we all realize that financial risk preferences differ by individual investor, investment bank and other institutions. Further, stock market volatility is profitable to some participants including day trading investors who guess right and buy and sell at the appropriate times, and to the bond dealers who make money based on buy and sell transactions. One other observation may be made about fiscal stress and crisis: the media have an incentive to use the word crisis whenever possible to attract the attention of their consumers. Crisis is a much more powerful word than mere stress. Thus, media bias in this respect is predictable, and this influences investor confidence.

What is explained above with respect to Greece shouldn't surprise anyone who has watched other European nations that already have gone into default or have move ever more closely towards it while restructuring their debt. Greece has drawn international attention because of the degree of opposition of a sizable part of the Greek populace to the spending restraint measures forced by the EU and the fact that not much has been written about the default of Iceland (2008), or partial defaults of Hungary, Romania and other nations in this area of the world. A number of European nations are in fact on the brink of default and are deeply involved in debt workouts that have become a normal facet of international public sector finance over the past decade or so, e.g., the successful debt workout solution to the Argentina default in 1999 and 2000. However, the condition of the world economy was in far better position then than it is now for lenders to provide financial assistance, particularly for the US which contributed debt supporting bond coverage to finance part of the Argentine bailout.

RELATIONSHIPS BETWEEN NATIONAL SECURITY AND ECONOMIC RECOVERY

In present circumstance the US faces continuous threat from militants and terrorists around the globe and remains engaged in an active shooting war in Afghanistan. It remains a challenge to President Obama, the Department of Defense and Congress to sustain support for war and anti-terrorism funding more generally during a period in which the American public has become tired of and increasingly more disapproving of the war in Afghanistan. Recent public opinion polls show significantly diminished support by the American public for this war. Given this fact, how long can we expect the President to propose and Congress to continue to appropriate funding to sustain this war effort and all that it involves?

Members of Congress have to respond in some way to public opinion to get reelected, as does the President. The January 2012 US announcement of an earlier date for cessation of armed conflict in Afghanistan and accelerated troop withdrawal reflect the Obama administration's awareness of public discontent with the war and war spending. This is particularly when polls show that the mood of the public has changed to support funding for programs to create jobs, rebuild America's aging public works infrastructure, address the very serious issues of increasing poverty and the weakness of the nation's public education system. The reality is that any nation that neglects the long-term education of its populace, and under-invests in support of those things that regrettably have come to be taken for granted including public safety, a clean environment, well maintained highways and transportation systems, financing to enable home ownership, and the benefits of application of better low and high technology -- all those things that have supported a fast fading lifestyle for a vast but shrinking US middle income class -- will create the conditions of its own economic demise in an increasingly competitive international economic marketplace. However, it is important not to lose sight of the fact that economic recovery and growth depend on the security of nations to engage in international commerce. Recent events related to continuing tensions between Iran and Israel and concerns about Iran's nuclear weapon intentions demonstrate how quickly markets and commerce can be affected by quickly emergent security threats, in this case of the type that increase the price of oil and its derivatives including gasoline. Given that such threats to the national security of the US, Europe and other regions of the world are present and the fact that threats posed by terrorists are increasing rather that diminishing, it is imperative to consider the consequences of precisely how spending on national security is reduced.

SUMMARY AND CONCLUSIONS

It may be helpful during this period of global economic stress to recall the words of a newly elected President Franklin D. Roosevelt in his first inaugural address delivered in March, 1933, "The only thing we have to fear is fear itself" (Rosenman, 1938).While Roosevelt was right, it took a long time for financial markets and economic conditions to improve after he delivered this statement, and the consequences of the global economic depression of the 1930s changed the world in ways that few at the time anticipated. From a national security perspective the global financial stress of the 1930s contributed to the rise of the Third Reich in Germany and led to the events that started World War II. For this reason US and policy makers in other nations need to think beyond the purely domestic economic effects of budget reduction as the only element of strategy to manage fiscal stress and crisis.

Now let us review some of the major conclusions drawn from this study, as follows:

1. Debt panic is motivated by political incentives and not current debt and fiscal reality. This is to be expected in a general election year. Current initiatives proposed in the US Congress to date to cut the annual deficit and national debt appear to be driven more by political positioning/posturing than they are by immediate fiscal crisis imperatives. This explains in part why some members of Congress claim that the need to cut discretionary spending is urgent when doing so will have little real impact on reducing national indebtedness. In fact, rapid cuts are likely to weaken the economy and reduce revenues so as to make the problem worse rather than better. Further, the bottom line is that the problem of the annual deficits and cumulative debt are not yet at the point of crisis despite what those campaigning for office or the media report. However, as noted, the long-term solvency of the US is at risk and the development of well reasoned approach-

L. R. Jones. Ph.D., Distinguished Professor and Wagner Chair of Public Management,
Graduate School of Business and Public Policy, Naval Postgraduate School, Monterey, California, USA. E-mail: lrjones@nps.edu

es to matching revenues to spending is imperative. The conclusions of this research project indicate that actions to address long-term solvency need to be very carefully constructed, analyzed thoroughly and negotiated using care to resist political incentives to act quickly out of fear and in debt panic. Actions taken in panic typically lead to disaster. We have time to do what is needed but the rush towards "quick fixes" should be avoided because the risks of getting it wrong are too high.

2. The size of annual deficits and long-term debt are significant problems that need to be resolved, and sooner is better than later in this regard. Trust fund solvency is of utmost importance because such debt contributes mightily to annual deficits and total debt. For example, since 2009-2010 the Social Security Trust Fund has been spending more that it receives in income, which adds to the federal government debt, whether we count such debt as "on-budget" or "off-budget". Debt is debt and must be addressed as such. However, the apparent significance of the deficit and debt problems depends to a great extent on how deficits and debt are measured, e.g., whether Social Security is included, and against what base deficits and debt are measured. Thus, when current US debt is compared to that of other developed nations it is evident that there is no cause to panic in part because the US economy is recovering from recession relatively well and better times probably are in sight. Still, the number of citizens qualifying for entitlement payments of various types increases every day.

3. Real solutions to reduce annual deficits and long-term federal debt must include at least three components: a) increasing revenues through reform of both general and special tax incidences and rates, b) holding discretionary spending at roughly the rate of inflation, c) modifications to current policies to reduce entitlement spending growth and introduction of methods to increase revenues for federal trust funds and entitlement programs, e.g., Social Security and Medicare/Medicaid. This claim follows the logic of experts in the field (e.g., Bowles-Simpson Report, 2010; Peterson Foundation, 2011; Bipartisan Policy Center, 2012). The most pressing problem for the US is deciding how to control fast rising health care costs as the population ages and as the costs of new and better medical technologies that everyone wants to use increase.

4. The fiscal and financial situation in the Eurozone is presently quite bleak, as is the case in the United Kingdom, particularly concerning Greece and a select number of other fiscally troubled EU nations. Greece is in fact in fiscal crisis using the definitions developed in this article. The only loans Greece can get are from the EU and IMF. Greece is paying off debt to bank lenders at roughly 50% of what is owed and investing banks and other institutions are taking almost 75% losses on their investments in Greece. This constitutes default by any definition. As defined in this article, during fiscal stress conditions nations and other entities can still sell their debt or get loans. However, fiscal crisis is defined as the point when a nation cannot any longer finance itself through borrowing because no investors will buy their debt instruments regardless of the interest rates offered. Crises are made worse when external agents, particularly the EU and European Central Bank, the IMF and other large scale participants in debt restructuring impose spending and employment reductions that cannot realistically be achieved. Further, the application of the same "one size fits all" debt resolution rules and requirements such as those currently applied by the EU damage the economies of

nations upon which austerity rules are imposed to the point that economic recovery becomes virtually impossible within any short period of time. In cases such as Greece it will take many years to recover from the depth of their fiscal problems that have been brought on over a long period of time by weak or no tax law enforcement, overly generous qualifications for benefits that are too easily met and are not in alignment with policies and practices in other nations in the Eurozone or elsewhere.

5. The problem of no GDP growth in the UK is largely a result of the misguided policies of PM David Cameron and the platform of ideology represented by his government. Deep cuts to government agency budgets that reduce employment quickly and substantially as a means of managing fiscal stress do just the opposite of what they intend. They weaken the economy so that revenue flows to the government drop and the size of the deficit actually reduced by budget cutting is virtually irrelevant compared to the revenue losses when the economy stalls. This is not to mention the sacrifices forced onto consumers of UK public services. Cameron's folly has made economic recovery from recession in the UK a much more problematic and longer-term matter.

6. Finally, despite all the attention generated by politicians, amplified beyond all recognition by the media, government actions to control spending seldom succeed as announced. In reality most governments do less than they promise to balance annual budgets and reduce total debt because political incentives encourage increased spending rather than cutting it (Wildavsky and Jones, 1994). Rather, government deficits and debt are reduced by increases in production and productivity in the private sector and by increased consumer confidence, spending and consumption. Having arrived at this conclusion however does not relieve fiscally beleaguered nations from the necessity to introduce more effective restraint over spending in entitlement programs that will, if not adjusted over the long-run, bankrupt the US and any other nation that ignores this imperative. Yet cost control alone is not enough. While it is economically rational to want to be a "free rider" and to consume services without paying for them, or paying far less than the full price for what is consumed or provided by government, is a way of life that is unsustainable. This is true in Greece, throughout the Eurozone and in the US where citizen resistance to tax and other means of increasing government revenues is something akin to a cultural moray or folkway. Now it is time to pay the piper.

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