

OPINION

And the Crisis Winner Is? Government

By David Malpass

Across Europe and the United States, the fiscal crisis is setting up an epic battle among government services, pensioners, government employees, creditors and taxpayers. There is simply not enough money coming in to pay all the promises politicians have made. The shortfalls and fights are challenging our democracies and shifting wealth from the private sector to ever bigger government.

From Greece to Washington to New York state, there's no effective mechanism to control spending.

The hope has been that Europe's debt crisis would force government downsizing in time to meet cash flow requirements. Newfound fiscal discipline would provide a silver lining to the debt crisis. But that's not working out.

Germany's insistence on centralized fiscal discipline for the euro zone will lead to a massive expansion of bureaucracies in Brussels, Frankfurt and Berlin. They'll include temporary and permanent bailout funds, dangerously intrusive powers for the International Monetary Fund and the European Central Bank, endless summits, new taxes on property, and recessions.

With Europe's government structures assured of getting even bigger, the U.K. reacted immediately by opting out. U.S. lawmakers are already objecting to the European plan to

expand the IMF. As in Greece, IMF programs are antigrowth, imposing austerity on the private economy, not the government. Greece has raised value-added and property taxes, then projected revenue increases that never materialize in order to keep payments flowing to creditors and the government's entourage.

Governments on both sides of the Atlantic are trying to use the crisis to grow rather than shrink. News of Europe's fiscal incompetence abounds, but Washington had no budget at all in 2010 or 2011 and the federal deficit grew at record pace. President Obama sailed through 2011 without any significant spending cuts or government downsizing.

With year-end approaching, the federal budget horizon has contracted to two weeks. Common practice is for Congress and the president to spend as much as possible in December and then adjourn, hoping voters will forget about it after New Year's Eve.

Financial markets are so sensitive to the \$3.6 trillion in annual federal spending that they would likely see huge gains if Congress simply adjourned without the normal year-end blow out. Even better would be for the president to call a January cabinet meeting with the purpose of cutting spending and regulation to encourage private job growth.

In February, President Obama will be able to impose another \$1.2 trillion debt-limit increase using special voting rules forced through Congress

last August to avoid a government shutdown. It should be clear by now that politicians will not voluntarily reduce government or government debt. The so-called debt limit is harmful because it threatens default and broad government shutdowns, both unacceptable, but doesn't limit spending at all.

The debt limit should be replaced with a new debt ceiling that forces Washington to cut spending. When the debt-to-GDP ratio is above target, Washington should suffer escalating penalties on its power, benefits and spending authority. There should be no threat of debt default or government shutdown. Instead, Washington should face a benefits straitjacket

that is so uncomfortable for the president, his senior executives and Congress that they work around the clock to enact spending cuts and asset sales to bring debt back below target. They should get a bonus if they get the job done and embarrassing, escalating penalties if they don't.

Here are some possible penalties: 1% pay cut per month for the 10,000 highest-paid government employees with a prohibition on it being restored; suspension of limousines for assistant secretaries and higher; market-rate monthly fee for free government parking. During periods of excess debt, the president should have impoundment authority but also be required to write a monthly letter to Congress stating preferred spending cuts equal to 20% of the fiscal deficit.

Grappling with out-of-control government spending in southern Europe, Germany is seeking automatic penalties when fiscal deficits are too large. The problem is that governments will probably write the penalties so they hit taxpayers and the private sector. It's unlikely European governments will write penalties aimed at themselves. There's already talk of the bloated Italian government taxing the property of the Catholic Church to avoid spending cuts and asset sales.

Even at the state and local level, which is supposed to be closer to the people, governments find ways to

grow. In an age-old government shell game, tax increases are projected to cause big revenue gains, which governments rush to spend. When actual revenues fall short, the government blames the economy, borrows the shortfall, and proposes new taxes, creating a debt cycle.

This budgeting trick is replayed year after year around the nation. New York state demonstrated this last week with Gov. Andrew Cuomo's \$2 billion increase in annual income taxes to "balance the budget." The increase in projected tax revenues will allow a major increase in state spending in 2012. And despite balanced budget requirements, New York state and local debt has surged above \$300 billion.

One of the few hopeful signs in the two-continent budget mess is that a few U.S. states and localities are experimenting with different political responses, some of which will promote growth. Wisconsin's government stopped collecting union dues, changing the balance of political power. Heavily Democratic Rhode Island passed a law allowing a hybrid 401(k) pension system, a key structural reform that would transform the nation's fiscal outlook if widely adopted.

The fiscal questions facing Europe and the U.S. are central to our democracies. Can politicians be incentivized or penalized enough to lead a downsizing of government? Which unaffordable contracts and promises should be reduced? How fast will the outlays grow for lifetime pensions and retiree health care?

To win elections, politicians have promised practically endless government spending and covered up the cost, leaving generations of taxpayers obligated to pay off the debt. That's wrong, but neither the U.S. nor Europe has a plan to stop it. A first step would be to use more effective debt and deficit limits to force governments to spend less and end to the debt cycle.

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