The Covid Fiscal Crisis Is About Debt and Taxes

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Alas, it's time to talk about what the coronavirus pandemic means for your tax bill. The good news is that the damage to your wallet or purse might not be as serious as you fear. The bad news is that the broader economic destruction will be a lot worse than you imagine.

Policy makers and voters alike are waking up to the fact that those trillions of dollars and euros and pounds our governments spent were real money. The Congressional Budget Office (CBO) last week pegged the federal budget deficit at $2.7 trillion for the October through June period. Britain's Office of Budget Responsibility this week warned that the fiscal deficit for this financial year could clock in anywhere between 13% and 21% of gross domestic product. Don't ask about Italy, France or Spain.

The conventional explanation for why this should alarm us is that taxes inevitably must rise to repay those debts. Such fearmongering has the virtue of being true. Expect politicians on the left to seize on high pandemic deficits and debt loads as an opportunity to overhaul taxation, and not for the better.

A President Biden will welcome the excuse to reverse the 2017 Trump tax reform while sidestepping the boost the tax cuts gave to economic growth—"because the deficit." Britain's Labour Party is itching to raise tax rates on corporate profits, which were slashed after 2010, and debate about a wealth tax is kicking into gear. The European Union will seize its moment to impose tech taxes on American digital firms.

Yet one can be cautiously optimistic that the tax-hike damage will be limited. Your tax bill may go up for a few years. But we set taxes at their current levels to boost economic growth. Gravity will reassert itself long before the pandemic debt is paid off as voters tire of paying for coronavirus twice over, first under government-imposed lockdowns and then via extraction of resources from the productive private economy.

Which is why the bigger economic danger by far posed by pandemic debt is that it will remain precisely that—debt.

An underappreciated aspect of our growing mountain of government debt is the political pressure it places on central banks, not least the Federal Reserve, to suppress interest rates for the purpose of making debt service affordable. If you're doubtful, consider some numbers.

The only thing worse than how we'd pay for pandemic relief is what will happen when, inevitably, we don't.

Back in January—remember January?—the CBO issued one of its regular 10-year fiscal projections. Even without trillions in debt-fueled pandemic spending, the CBO estimated net federal debt would surge to $31.4 trillion, or 98.3% of GDP, by 2030. A nontrivial portion of that would arise from mounting interest payments on the debt, which the CBO expected to rise to $819 billion, or 2.6% of GDP, in 2030 from $376 billion, 1.8% of GDP, in 2019.

The CBO quaintly assumed, however, that the Fed eventually would raise interest rates. An upward drift in the yield on the 10-year Treasury note to around 3% by 2030 from about 2% as of January accounted for an extra $284 billion in annual interest costs. Conversely, holding rates steady at around 2% for the next 10 years (and holding everything else equal) would shave $1.3 trillion off the total debt by 2030.

This all assumes a much lower 10-year yield than we had as recently as the 1990s, and right now it's nearer 0.6%. And the deficit and debt situation has grown monumentally worse since January.

The U.S. thus finds itself stuck in a debt trap, alongside the rest of the developed world. Economists at the Bank for International Settlements coined that term to describe a situation in which prolonged low interest rates induce the accumulation of so much unproductive government and private debt that to raise rates would risk a catastrophic financial-system or fiscal crisis.

No central banker will ever chance it, as much as they'll strenuously deny they worry about government debt financing. The path of least resistance instead becomes to keep rates low forever, in turn encouraging more debt.

This baleful interaction between pandemic fiscal policy and the political economy of central banking will impose an enormous hidden cost on our economy for years. Ultralow interest rates aren't a free lunch. They stimulate wasteful government spending and fruitless private investment at the expense of genuine investment and innovation to boost productivity. After a point—which we probably crossed some time ago—low rates weigh on growth rather than encourage it.

The result is a brittle economy that churns out too many houses, financial assets and overindebted retailers, and too few productive job opportunities—and creates one financial crisis after another. That's a fate worse than any tax hike. The worst part is we'll probably get both the taxes and the financial crisis before this pandemic-debt story is done.