It seems strange that the big budget discussion focuses on issues such as Medicare, Medicaid and Social Security reforms, whose fiscal impacts are decades away. Why do we need to fix the 2025 budget today? Two words: bond market.

Now the "bond market" isn't some mysterious group of Wall Street traders. It's you and me. Are you buying U.S. Treasurys for your 401(k)? Is your pension fund buying them on your behalf?

Your worry is inflation. The U.S. can always avoid technical default by printing money to pay off debt and fund extra spending. But being paid back in worthless money is the same as not being paid back at all.

To buy a 30-year Treasury at its current 4.5% yield and get a decent 2% return, you have to bet that inflation will not exceed 2.5% for the next 30 years. You have to bet they will solve the 2025 deficit. If you decide that the government will just keep kicking the deficit can down the road, sell your 30-year Treasurys. Sell fast, before everyone else does—because if we all try to sell, we just drive down the price and long-term interest rates rise. So as long as we don't solve 2025, we are at risk of a spike in long-term rates if investors dump long-term U.S. debt.

It gets worse. Our government borrows money for relatively short terms. Every few years it has to borrow new money to pay off the old debt. But if we, the bond market, decide that the government will end up inflating its way out of its fiscal problems, we refuse to roll over short-term debt. Then the government must print new money to pay off the maturing debt, bringing us inflation right away.

Short-term debt is the fuel of financial crises. It's safe to lend for a year, even to an insolvent government, if you think everybody else will roll over your loan next year. But if you get a hint that others won't lend the government new money next year to pay back your loan, run now. This is basically what happened to Greece, Portugal and Lehman Brothers. They didn't need money for immediate deficits or even to pay interest; they needed money to roll over maturing short-term debt. The market ran away because it didn't trust a long-run solution. We are vulnerable to the same sort of run.

Like any run, we get few warning signs. People think it could never happen, just as they thought house prices could never fall nationwide, euro-zone sovereign debt could never get in trouble, or a major investment bank could never fail. We can go a long time, even with long-run fiscal policy that is labeled...
"unsustainable" by the administration proposing it and the Congressional Budget Office scoring it, so long as markets believe that sooner or later it will be fixed. And then, suddenly, markets no longer believe it.

Policy makers here may denounce "speculators" and "contagion" as they did in Europe, but that witch hunt won't help. The fact that other countries are in trouble too is no consolation. Investors who want to dump U.S. Treasury debt can buy real assets such as stocks, real estate and commodities. We can experience a global run on sovereign debt.

It would have been lovely if the U.S. government had financed its long-term deficits with long-term bonds. Then bad news would only affect long-term rates and we'd have some breathing room to solve the long-term budget problem before inflation breaks out. Alas, despite the attraction of absurdly low long-term rates, the U.S. is still overwhelmingly financed by rolling over relatively short-term debt, leaving us exposed to a run. Why? I suspect that short-term debt seems cheap to the Treasury, just as it did to Bear Stearns and to Lehman Brothers. It is cheap precisely because it is dangerous.

Our only hope is growth. No country ever solved a debt problem by raising tax rates. Countries that solved debt problems grew, so that reasonable tax rates times much higher income produced lots of tax revenue. Countries that did not grow inflated or defaulted.

Those who like high tax rates for ideological or redistributionist reasons have to face the fact that high rates won't balance the 2025 budget. If you raise tax rates, income declines: People work less hard and start fewer businesses, and people and businesses move abroad. The government may get additional revenue for the higher rates for a few years. But Laffer's famous curve is much more dramatic for long-term problems, as lower growth compounds.

For example, suppose national income is expected to grow 3% but higher tax rates reduce that to 2%. National income is only 1% lower in the first year. But after 30 years, when a newly issued bond is retired, national income at the lower rate would be 34% larger.

The path to higher economic growth and higher tax revenue is to lower tax rates, broaden the tax base by eliminating deductions and breaks, simplify the obscenely complex tax code, and remove growth-suffocating regulation.

Everyone recognizes that middle-class entitlements are the government’s long-term spending problem. Means-testing and voucherizing are the obvious solutions. Voucherizing is the only hope to put some competition back in the health market and lower costs. The vast bulk of federal spending does not go to poor people. We do not have to be a heartless society to have a solvent government.

We are still a great nation. The challenge is whether we will accept a vaguely rational tax system and a set of entitlements that protect the vulnerable without bankrupting the Treasury. It's not rocket science.

But we don't have much time. The bond market won't wait. The budget and debt problems will be much harder to solve if long-term interest rates spike, the dollar falls further, and inflation breaks out.

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