**The U.S. Debt Spiral: A Lesson from Italy on the Consequences of Fiscal Dominance**
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I'm heartened by the seemingly ever-increasing interest in and alarm regarding America's fiscal deficits. The fiscal trajectory we've been on for the last several decades is unsustainable — something has to give, and it's going to be painful no matter what.

One of the major issues with our current system is the Federal Reserve's compliance in this. In an ideal world, Congress would set its budgets so that any deficits are financed by a combination of seignorage *chosen by* the Fed and bond sales to the public. In this case, the monetary authority is in the driver's seat in terms of determining the growth of federal budget deficits. Instead, what we have is the opposite: Congress independently sets budgets and then relies on the Fed to minimize its borrowing costs by pushing down interest rates via purchases in secondary markets of existing debt.

As the government runs ever larger deficits, without sufficient surpluses to repay this accumulated debt, it begins to roll over past debts. A certain point is reached where the ability to repay past debts without implicit default (inflation) or even explicit default comes under question. As people become pessimistic about the government's fiscal health, they withhold their money from further purchases of government debt, forcing the government to offer higher interest in response — further raising the amount of debt. When the government, aided by the central bank, begins repaying past debts via seignorage, you end up with a scenario highly reminiscent of the myriad hyperinflations generated by governments that trod down this path.

There are several illuminating historical episodes on this head that are quite extreme (Weimar Germany, Zimbabwe, Venezuela), and therefore, probably not applicable to the U.S. However, there are other examples that are especially relevant to our situation. For instance, Italy in the 70s and 80s. Beginning in 1972, previous deficits and spending largess generated a tremendous spike in the inflation rate that reached at an annual rate of 19% by 1974. On an annual basis, it hovered around 12 - 17%, until it peaked at 21% in 1980. What drove this? A massive welfare state expansion. As usual, the major element of that expansion was pensions. Italy's public pension program was about 5% of GDP in the early 1960s,[1] 7.4% by 1970, and grew to 10.2% by 1980.[2] This expansion was almost entirely political — not demographically driven. You also had substantial increases in public employment (a hallmark of inflationary regimes): 3.5% increase per year in Italy between 1970 and 1976. 16% of the total labor force in Italy was employed in the public sector by 1984.[3] This growth was paired with strong union pressure to raise wages for public workers (causing public sector wage growth to outpace wage growth in the rest of the economy), which compounded the bill for the government. At the

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[1] International Monetary Fund. "Italy - Background Economic Developments and Issues: Supplementary Information Appendices", *IMF Staff Country Reports* 1995, 037 (1995), Article A003.

[2] Franco, Daniele. "Italy: a never-ending pension reform." In *Social security pension reform in Europe*, pp. 211-262. University of Chicago Press, 2002.

[3] OECD. 1986. *OECD Economic Surveys: Italy 1986*. Paris: Organisation for Economic Co-operation and Development, p. 44.

beginning of the 1960s, income per employee was 50% higher than in the private sector.[4] One of the key mechanisms here, agitated for by the unions, was the *scala mobile,* which was a wage indexing system that generated a wage-price feedback loop.

By the mid-80s, these deficit-funded expansions came home to roost in the form of inflation. The era of fiscal dominance began in roughly 1975 when the Bank of Italy became obligated to backstop government debt issuance through the purchase of residual Treasury securities. This debt-monetization scheme ultimately led to the landmark "divorce" between the Treasury and the Bank of Italy in 1981, after which point several fiscal and monetary reforms led to a gradual disinflation back to sane levels at the end of the decade.

All of this is highly instructive for the U.S. — we have a pension system (Social Security) that, as of 2024, accounted for roughly 22.4% of the total federal budget. A common thread among countries that transform into fiscally dominant regimes that generate persistent bouts of inflation is a public pension program.[5] Our so-called "trust funds" for social security have begun running deficits since 2021.[6] Additionally, in 2024, interest payments on our debt overtook military expenditure and Medicare.

As a result, we have an ever expanding public pension program (that is unfunded) in tandem with massive fiscal outlays on interest payments. The Fed's holdings of Treasury securities grew from $2.1 trillion in September of 2019 to $5.8 trillion by May of 2022. It has now reached what appears to be a new "steady state" of $4.2 trillion, which means we have a central bank whose monetary objectives are becoming increasingly subordinated to the needs of the federal government. Additionally, we're experiencing above-target inflation that has remained persistent and, as a result, we face higher interest rates than what has historically been "normal."[7] These effects are mutually reinforcing and, combined, will work to accelerate government deficits and inflation.

The trajectory is clear if we don't make substantial fiscal adjustments: more deficits, more borrowing, more monetization, higher inflation, and higher interest rates; even more borrowing, even more monetization, even more inflation and even higher interest rates. The vicious circle is already present in the United States and trending in the predictable pattern exemplified by Italy in the last century.

Something will have to give. As the largest element of our spending, it is inconceivable that any serious reform wouldn't be accompanied by a major overhaul of our social security system. This is a matter of pay now (cuts) or pay later (inflation, default). The historical

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[4] OECD. 1985. *OECD Economic Surveys: Italy 1984/1985*. Paris: Organisation for Economic Co-operation and Development, p. 11.

[5] In addition to Italy, in the 70s - 80s, see Greece before the Euro crisis, Argentina in the 1990s, and Brazil in the past several decades.

[6] As many (but not enough) people know, the government uses the surplus revenue in this fund for unrelated spending, which the Treasury has issued bonds in exchange for — meaning the government has to raise the tax revenue necessary to restore the surplus funds it already had in the trust fund.

[7] There has been much talk about a new and heightened equilibrium level for the neutral rate of interest (r-star), with some speculating that this is owing to savings dynamics. Clearly, fiscal disfunction is a sufficient condition to give rise to the same observations.

laboratory is open to all. If we refuse to learn from the mistakes of others, how on earth can we expect to fare any better than them?