Managing Federal Debt: A Two Phased Approach

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In 2008 a financial crisis was sparked by a sudden rise in delinquencies of the US subprime mortgages which cut their market value and threatened financial institutions around the world. Drastic US discretionary fiscal and monetary policy measures were adopted to stabilize the financial sector and provide fiscal stimulus. Absent significant policy changes, the US national debt is projected to rise sharply. Political disputes over the merits of tax reform or spending reform have led to a policy showdown. At risk is the role of the US dollar as a reserve currency and the inability to fund government through borrowing. *In 2008 a financial crises was sparked by sudden rise in delinquencies of the US subprime mortgages which cut their market value and threatened financial institutions around the world. Drastic US discretionary fiscal and monetary policy measures were adopted to stabilize the financial sector and provide fiscal stimulus. Absent significant policy changes, the US national debt is projected to rise sharply. Political disputes over the merits of tax reform or spending reform have led to a policy showdown. At risk is the role of the US dollar as a reserve currency and the inability to fund government through borrowing.*

HISTORY

The "great recession" of 2007-2009 was very severe, and the effects are still lingering (Bernanke, 2012). Unemployment remains above 8%, and the combined effects of reduced tax revenues and increased spending have caused the federal budget deficit to triple since 2007. For the year 2011 the federal budget deficit was $1.3 trillion (and the Federal Reserve System purchased three-quarters of all new federal debt issued) (Congressional Budget Office, 2012). The result is that the national debt has exceeded $15 trillion for the first time, and under current policy is projected to rise much more. Over the fiscal years 2009-2011, the federal budget deficit has averaged 9% of GDP. (See Bernanke, 2012). Note that this national debt does not include certain unfunded liabilities, such as Social Security, Medicare, Fannie Mae, Postal Service and others that are 5-8 times as large as the official national debt in the hands of the public.

Every recession is accompanied by falling tax revenues and rising government spending (Gordon, 2011). Typically after a recession, rapid economic growth leads to a surge in tax collections and a drop in public assistance, so the deficit is reduced quickly. The situation is different in the recent recession, however, because it resulted from a financial crisis that simultaneously affected markets around the world. In addition, there are significant US structural changes underway in the economy that make it difficult to achieve a successful fiscal policy. The huge baby boom generation has started to retire, and it will be replaced in the work force by a smaller number of younger workers. The impact of this shift on Social Security is large, as the number of retirees will grow rapidly for 20 years, and they are living longer. Equally important, there will be fewer workers paying into Social Security to fund the benefits. The ratio of workers to retirees was 4.9 in 1960, and it dropped to 2.8 by 2010. That ratio will fall to 1.9 by 2035, and the Social Security Trust Fund is projected to be depleted by 2036 (Social Security Administration, 2011). Reform of benefits and contributions to balance the books will be difficult to achieve, but essential.

Another major concern is the cost of health care. This cost has been rising, and the baby boom effect also will add to the cost of Medicare and Medicaid. A long-term solution to these problems will require significant reform of entitlement spending and the tax code. The recently passed healthcare reform bill (The Affordable Care Act) is subject to debate and Supreme Court review, and the outcome of that issue will play an important part in future fiscal policy.

THE LONG TERM PROBLEM

Long Term Trends for Spending

Under current policy the national debt in the hands of the public is projected to reach 85% of GDP by 2035, well above the current level of 65%. Using the more realistic Alternative Fiscal Scenario of the CBO, public debt may approach 190% of GDP by 2035. As shown in Figure 1, such an outcome would exceed the debt to GDP ratio at the end of World War II.

FIGURE 1

Federal Debt Held by the Public, 1790 to 2035

(Percentage of gross domestic product)

Source: Congressional Budget Office, *The Long-Term Budget Outlook* (June 2010); *Historical Data on Federal Debt Held by the Public* (July 2010).

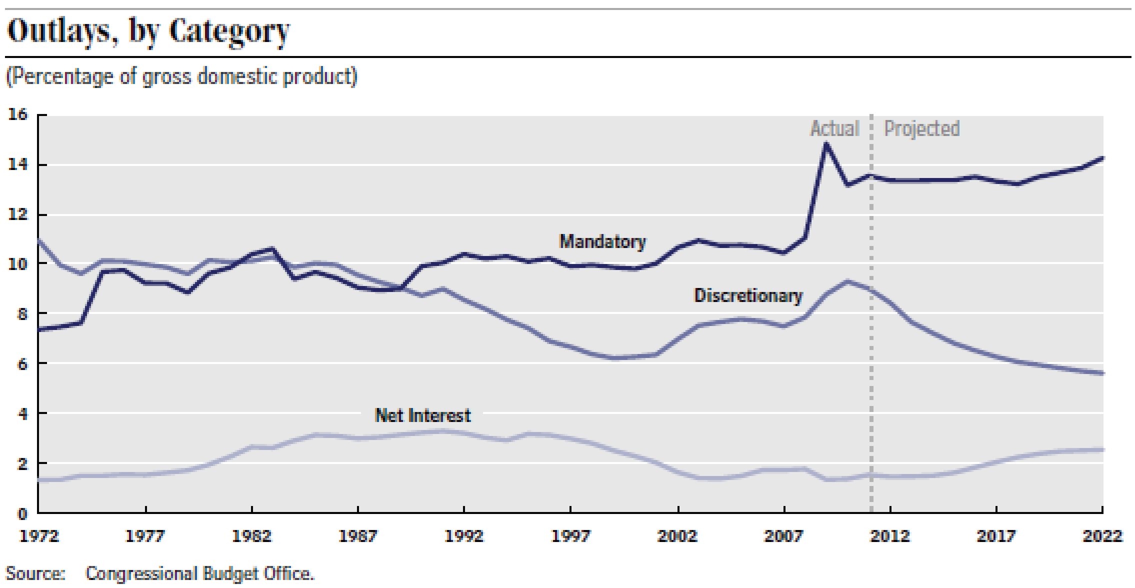
Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2020 (with adjustments for the recently enacted health care legislation) and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period.

These projections assume annual Social Security outlays will almost double to $1.3 trillion in 2022, and annual Medicare expense will almost double to $1 trillion. Net interest on the national debt would almost triple to $624 billion in 2022. These are mandatory items that all agree must be paid.

The alternative fiscal scenario of the CBO is considered more likely by Congress watchers. It assumes that the expiring tax cuts of 2001-2003 will be extended, that the 27% cut in Medicare payments to doctors now scheduled for early 2012 will be reversed, and that the alternative minimum tax will be indexed for inflation after tax year 2011. It is expected that these changes will be enacted as part of the extension of unemployment benefits and reduced payroll taxes. If not the political backlash would be unacceptable to politicians in an election year (Congressional Budget Office, 2011).

Under current policy passed by Congress, illustrated by Figure 2, mandatory spending is assumed to remain constant near 14% of GDP until 2022. However, healthcare costs and Social Security costs may force these figures higher. Discretionary spending is set to decline from 9% of GDP currently to 7% by 2022. A major reason for the cut in discretionary spending is reduced military spending. The same reason drove down such spending in 1993-1997. However, the world political situation may not allow this trend to continue.

FIGURE 2



Long Term Trends for Tax Revenue

Since 1972, individual income tax revenue has averaged about 8% of GDP. Under the CBO baseline projection, shown in Figure 3, that figure will approach 12% of GDP by 2022. This large increase may encourage tax avoidance or income shifting. This increase of 50% in individual income tax revenue is an important assumption that may not be valid. Payroll (Social Security) tax revenue is slated to be steady until 2022, but will soon be insufficient to pay projected Social Security benefits (Congressional Budget Office, 2011).

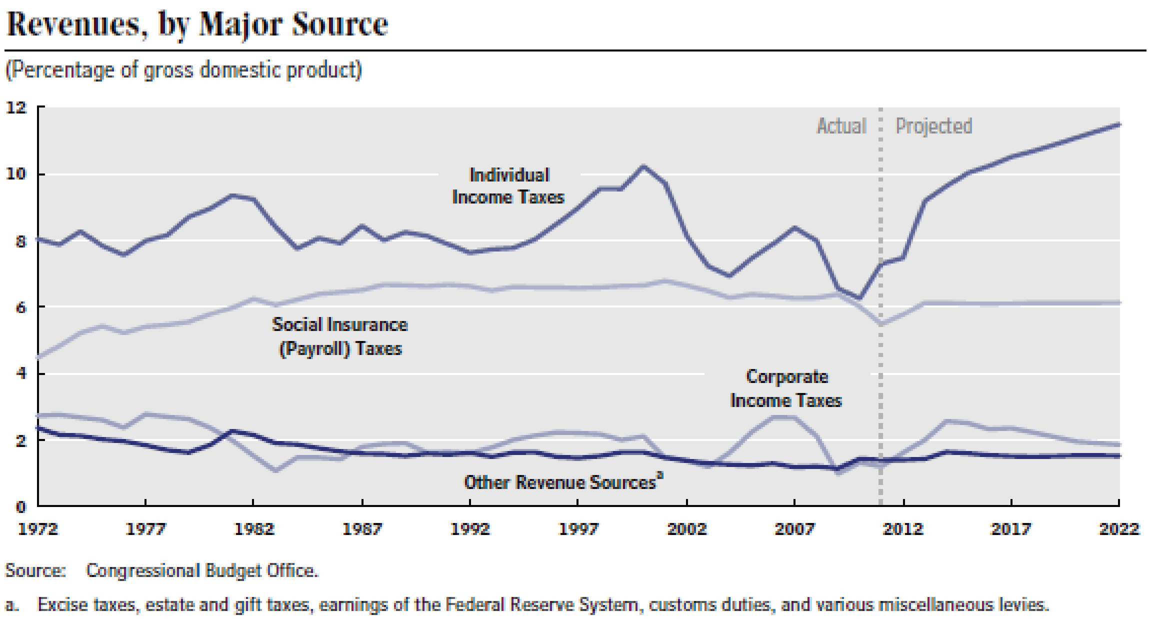
THE OUTLOOK FOR BUDGET DEFICITS

Adverse Effects of Rising National Debt

The combination of federal revenues and outlays will determine future budget deficits. Table 1 shows deficits continuing through 2022 in the area of $200 billion per year. However the more realistic "Alternative Fiscal Scenario" shows a much different picture. It shows deficits starting to grow above $1 trillion by 2018 and continuing to rise. Such an outcome is unsustainable given current interest rates. If interest rates or inflation increase sharply, the day of reckoning will come even earlier.

There are many reasons a high and rising national debt will harm the economy and the people. As the national debt continues to rise, interest rates will be higher than they would otherwise be. This effect will tend to discourage private investment in the US, and may encourage private investment overseas. A shortfall in investment will slow the growth in labor productivity and employment. The result will be fewer jobs, especially at the lower skill levels (Congressional Budget Office, 2010).

FIGURE 3



The Interest Rate Danger

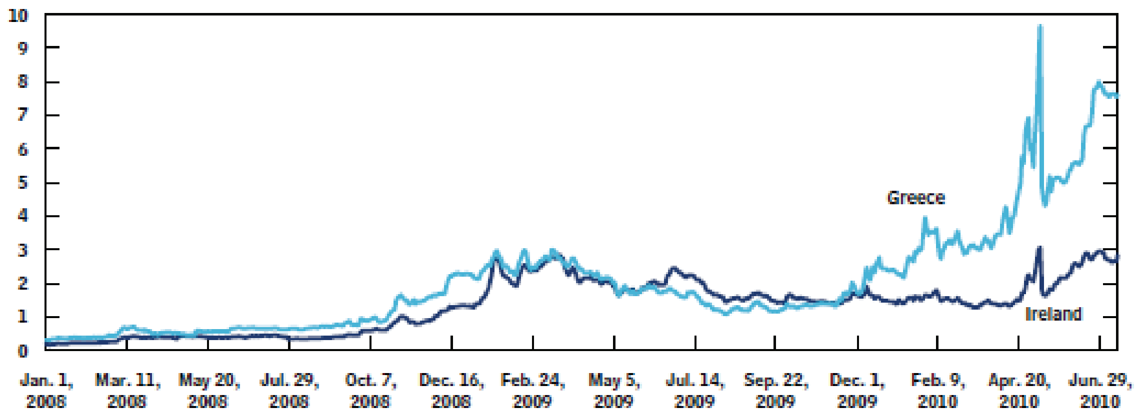
Historically the US has enjoyed low interest rates compared to other nations. This is because of stable Federal Reserve policy, and because the US is seen by most investors as a safe haven, especially in times of stress. Even when US government bonds recently were downgraded to A++ with a "negative outlook" by Standard & Poor's, US bond prices rose and yields fell in the market as investors moved into US debt rather than out of it. If US debt and deficits continue to rise, there is a danger at some point that investors will seek other currencies as a safe haven. OPEC has in the past discussed using a basket of currencies rather than the US dollar to price oil. If this were to happen, then US domestic interest rates would increase substantially, raising the annual interest expense associated with the huge federal debt. Figure 4 shows how this situation has affected Greece and Ireland, recently the subjects of investor flight and concern about their fiscal health. Here we see that Greece's interest expense has more than tripled since early 2010.

The national debt often is discussed in terms of the debt held by the public, including domestic and foreign governments, firms, and individuals. However the remaining part of the national debt is held by US government agencies, such as the Social Security trust fund. This non-public debt also is important, because it must be paid unless we are willing to default on promises made. The total national debt is now approaching 100% of GDP, up from 68% in 2008, and 94% at the end of 2010. In addition to the size of the debt, the more important problem is the rapid growth of the debt in just the last 4 years (Gordon, 2011).

FIGURE 4

Interest Rates on 10-Year Debt Issued by Greece and Ireland

(Percentage points above the rate for comparable German bonds)



Source: Bloomberg.

Note: German bonds, denominated in euros, are generally perceived as stable and reliable investments. The difference in interest rates between German bonds and other countries' euro-denominated bonds reflects investors' relative level of confidence in the safety and security of those other countries' debts.

While the danger of excessive debt is clear, no one can predict at precisely what point it becomes a crisis. The financial success of the US and other developed economies since World War II has lulled many policymakers into a false sense of security. As Federal Reserve Chairman Bernanke said recently: "Even the prospect of unsustainable deficits has costs, including an increased possibility of a sudden fiscal crisis". (Bernanke, 2012).

ENTITLEMENT REFORM

There has been much discussion and little action on entitlement reform. The President's budget proposed for FY 2012, that was released on February 13, 2012, avoids any mention of entitlement reform. The Social Security System was established in 1935 as a pay-as-you-go system. However, the baby boom generation will place a severe burden on the system as 10,000 people retire everyday for the next 20 years. In addition life expectancy has increased from 65 years in 1939 to 88 years today, extending the need for benefit payments. Over the years benefits were increased, but the taxes paid by participants were not fully adjusted to cover the expanded benefits (The White House, 2012).

THE SIMPSON BOWLES COMMISSION

In February 2010, the President appointed the National Commission on Fiscal Responsibility and Reform, with a charge to report in December 2010 (after Congressional elections). The Commission of 18 members was co-chaired by Alan Simpson and Erskine Bowles. Their task was to craft a set of proposals to guide fiscal policy toward a sustainable resolution of debt and deficits. Their recommendations were projected to cut $4 trillion from deficits over 10 years. There were strong objections to each part of the Commission report (mostly political), and neither the President nor Congress pursued the Commission recommendations. In 2011 a bi-partisan "super" committee was appointed to achieve $1.25 trillion in deficit reduction, as a part of the debate over raising the debt limit. They failed to reach agreement, triggering automatic cuts to both defense and non-defense spending starting in 2013 (The White House, 2010).

TABLE 1

Deficits Projected in CBO's Baseline and Under an Alternative Fiscal Scenario

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total 2013-2017	Total 2013-2022
In Billions of Dollars													
CBO's January 2012 Baseline													
Revenues	2,523	2,988	3,313	3,568	3,784	4,039	4,243	4,456	4,680	4,926	5,181	17,692	41,179
Outlays	3,601	3,573	3,658	3,836	4,086	4,259	4,439	4,714	4,960	5,205	5,520	19,413	44,251
Deficit	**-1,079**	**-585**	**-345**	**-269**	**-302**	**-220**	**-196**	**-258**	**-280**	**-279**	**-339**	**-1,721**	**-3,072**
Debt Held by the Public at the End of the Year	11,242	11,945	12,401	12,783	13,188	13,509	13,801	14,148	14,512	14,872	15,291	n.a.	n.a.
Alternative Fiscal Scenario													
Revenues	2,500	2,680	2,904	3,126	3,324	3,556	3,732	3,915	4,100	4,305	4,513	15,589	36,154
Outlays	3,611	3,661	3,820	4,024	4,305	4,516	4,738	5,059	5,353	5,649	6,008	20,328	47,136
Deficit	**-1,111**	**-981**	**-917**	**-899**	**-981**	**-960**	**-1,005**	**-1,144**	**-1,253**	**-1,344**	**-1,495**	**-4,739**	**-10,981**
Debt Held by the Public at the End of the Year	11,275	12,374	13,402	14,414	15,499	16,560	17,661	18,895	20,232	21,657	23,232	n.a.	n.a.
As a Percentage of Gross Domestic Product													
CBO's January 2012 Baseline													
Revenues	16.3	18.8	20.0	20.2	20.2	20.5	20.5	20.6	20.7	20.9	21.0	20.0	20.4
Outlays	23.2	22.5	22.1	21.8	21.8	21.6	21.5	21.8	21.9	22.0	22.4	21.9	21.9
Deficit	**-7.0**	**-3.7**	**-2.1**	**-1.5**	**-1.6**	**-1.1**	**-0.9**	**-1.2**	**-1.2**	**-1.2**	**-1.4**	**-1.9**	**-1.5**
Debt Held by the Public at the End of the Year	72.5	75.1	74.8	72.6	70.5	68.5	66.8	65.5	64.2	63.0	62.0	n.a.	n.a.
Alternative Fiscal Scenario													
Revenues	16.1	16.8	17.5	17.7	17.8	18.0	18.1	18.1	18.1	18.2	18.3	17.6	17.9
Outlays	23.3	23.0	23.0	22.8	23.0	22.9	22.9	23.4	23.7	23.9	24.4	23.0	23.4
Deficit	**-7.2**	**-6.2**	**-5.5**	**-5.1**	**-5.2**	**-4.9**	**-4.9**	**-5.3**	**-5.5**	**-5.7**	**-6.1**	**-5.4**	**-5.4**
Debt Held by the Public at the End of the Year	72.7	77.8	80.9	81.8	82.9	84.0	85.5	87.4	89.5	91.7	94.2	n.a.	n.a.
Memorandum:													
Deficit: Alternative Fiscal Scenario Minus CBO's January 2012 Baseline													
In billions of dollars	-33	-396	-572	-630	-679	-740	-810	-886	-973	-1,065	-1,156	-3,018	-7,909
As a percentage of GDP	-0.2	-2.5	-3.5	-3.6	-3.6	-3.8	-3.9	-4.1	-4.3	-4.5	-4.7	-3.4	-3.9
Policy Alternatives That Affect the Tax Code (Billions of dollars)													
Effect on revenues	-23	-309	-410	-442	-460	-483	-511	-541	-579	-621	-668	-2,104	-5,024
Effect on outlays	0	1	39	41	42	43	43	43	42	42	42	166	378
Effect on the deficit[a]	-23	-309	-449	-483	-502	-526	-554	-584	-622	-663	-710	-2,270	-5,403

Source: Congressional Budget Office.

Notes: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. Outlays under the alternative fiscal scenario also include the incremental interest costs associated with projected additional borrowing.

GDP = gross domestic product; n.a. = not applicable.

a. Negative numbers indicate an increase in the deficit.

CONCLUSION

There is little doubt that in the short term, any deficit reduction must come from some combination of spending cuts and revenue increases. Spending cuts could come in "mandatory" or "discretionary" areas. Tax revenue increases could come from higher tax rates on selected income groups, reduced tax deductions and preferences, or new categories of taxes. There is a political constituency for each alternative.

The President's Budget for 2013 proposes $1.4 trillion on deficit reduction over 10 years, evenly split between tax increases and spending cuts. The tax increases would fall on those with income above $250,000. The spending cuts in Medicare and Medicaid would come from reduced payments to providers. Defense cuts also are proposed, making room for increased spending in favored areas, such as infrastructure spending and mortgage relief. No Social Security reform is mentioned, but it must be addressed.

Carmen Reinhart and Ken Rogoff, in their recent book *This Time Is Different*, studied 800 financial crises over the last 1,000 years around the world. They found that the cases of successful reforms after financial crises generally were based on 85% spending cuts and 15% tax revenue increases (Reinhart and Rogoff, 2009). This mix should be the starting point in the current budget negotiations.

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