

United States

America's Fiscal Train Wreck

July 06, 2009

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America's long-awaited fiscal train wreck is now underway. Depending on policy actions taken now and over the next few years, federal deficits will likely average as much as 6% of GDP through 2019, contributing to a jump in debt held by the public to as high as 82% of GDP by then - a doubling over the next decade. Worse, barring aggressive policy actions, deficits and debt will rise even more sharply thereafter as entitlement spending accelerates relative to GDP. Keeping entitlement promises would require unsustainable borrowing, taxes or both, severely testing the credibility of our policies and hurting our long-term ability to finance investment and sustain growth. And soaring debt will force up real interest rates, reducing capital and productivity and boosting debt service. Not only will those factors steadily lower our standard of living, but they will imperil economic and financial stability.

Familiar challenges. Sound familiar? Warning about these challenges has long been a staple for economists. Five years ago, for example, I summarized my concerns about our coming fiscal problems, along with the interplay among them and unexpected longevity, inadequate thrift and saving infrastructure, mediocre education outcomes, and inadequate energy policy (see *America's Long-Term Challenges*, May 21 and May 24, 2004). I was merely the latest in a long line of alarmists; for example, Pete Peterson famously noted more than 20 years ago that "America has let its infrastructure crumble, its foreign markets decline, its productivity dwindle, its savings evaporate, and its budget and borrowing burgeon. And now the day of reckoning is at hand" (see "The Morning After," *Atlantic Monthly*, October 1987). The Congressional Budget Office (CBO) has since 1997 - under directors from both sides of the aisle - carefully laid out ever-more depressing fiscal scenarios in its annual *Long Term Budget Outlook*, the latest of which appeared last week.

The problem, ironically, is that the day of reckoning hasn't come. This has seriously undermined doomsayers' credibility and, more importantly, it has made the electorate and elected officials complacent about the threat from unsustainable fiscal policies. Some even proclaimed that "deficits don't matter."

Fast forward to today. Yet the last five years have brought our ever-distant fiscal crisis rapidly forward. Some of the deterioration is obviously cyclical: Courtesy of the financial crisis and recession, aggressive fiscal stimulus, and ongoing military outlays, the federal deficit has ballooned to US\$1.8 trillion or 13% of GDP in fiscal 2009. But the bulk of the threat is structural: The fiscal stimulus package included spending increases with minimal bang for the buck, leaving more debt than growth. In its FY2010 budget, the administration proposes to extend several tax cuts enacted in 2001 and 2003, provide relief from the alternative minimum tax, and increase both mandatory and discretionary spending compared with current law. Most important, by 2019 the full force of rising entitlement outlays and debt service will begin to hit

the budget. No rosy growth scenario will provide sufficient resources to meet all the claims on future federal revenue. And while tax hikes or a broader tax base will likely be part of the solution, the real cure is to curb the growth of entitlement spending.

Against that backdrop, voters and politicians are nervous: Two recent polls suggest that Americans are more worried about deficits than healthcare by a ratio of 2:1. But despite voters' deficit anxiety, near-term action to reduce long-term deficits seems highly unlikely for two reasons. First, no one wants to endanger a still-fragile economy by raising revenues or cutting spending until they are sure of economic recovery. Second, while there is no shortage of fiscal scolds inside the Beltway, the political will to change popular entitlement programs is still absent.

Healthcare the main culprit. Analysis of those programs makes it easy to see why. The rise in federal healthcare outlays under Medicare and Medicaid is the main long-term factor boosting deficits. These popular programs create a safety net for the elderly and disadvantaged that has been a band-aid for our flawed system of financing healthcare.

The base is already large: In 2010, some 100 million Americans will be enrolled in Medicare, Medicaid and SCHIP (the State Children's Health Insurance Program), and outlays amount to 5% of GDP. Longer term, Medicare enrollment will rise significantly as the population ages. More importantly, future per capita cost growth for both programs is well in excess of per capita GDP, meaning that outlays for these three programs will double to 10% of GDP by 2035 and nearly double again by 2080. Translated into budget outcomes, according to CBO, these programs will account for virtually all of the likely growth in primary federal spending - total spending less interest on debt held by the public - in relation to GDP, and thus all the likely expansion of the deficit and debt. In contrast, social security cost increases will play a relatively minor supporting role.

There is no lack of options to alter the unsustainable path for Medicare and Medicaid outlays. At the end of 2008, for example, CBO analyzed 115 of them, any handful of which could significantly slow the growth of spending or find the means to pay for it. To name two: Raising the age of eligibility for Medicare by two years (to 67) starting in 2014 would save US\$85 billion by 2019. Limiting the tax exclusion for employment-based health insurance to amounts below the 75th percentile for such premiums and doing the same for health-insurance deductibles for the self employed would net US\$452 billion over 2009-18. Note that the second option would raise additional revenue, but would not address burgeoning entitlement spending. Yet the prospects for actually adopting any of these measures are dim. There is no serious discussion in Washington of, or appetite for, curbing eligibility for federal health programs. Nor, more important, is there the will to rein in the growth of per capita costs.

Meanwhile, the current healthcare reform effort aims at the apparently conflicting goals of curbing costs and increasing access and quality. In the long run, those

goals may turn out to be complementary. But in the near term, politics likely dictate that increasing access will take priority over cutting costs. And increasing access to today's health options will be expensive. For example, preliminary CBO estimates of Subtitles A through D of Title I of the proposed "Affordable Health Choices Act" indicate that expanding access to health insurance for 39 million Americans by granting subsidies will cost US\$1 trillion over the next decade. Proposals to cut costs may yet emerge to fulfill the president's requirement that any healthcare reform be deficit-neutral. But political agreement will be hard to come by; witness the storm of opposition to a "public insurance plan" when the outline for any such plan is still vague. Thus, in the short-to-intermediate term, increasing access first means bigger deficits are likely. Pundits are describing the president's ability to deliver a healthcare reform package that improves Americans' lives and contains costs as a defining moment for his leadership. As I see it, it is also a bellwether for our willingness to tackle our fiscal challenges.

Deficit disorder. America's now chronically rising deficit will almost surely expand debt beyond the appetite of global investors to hold it without significant concessions in the form of higher interest rates or a big enough decline in the dollar to make it look cheap, or both. Soaring deficits and debt imply higher real interest rates. That hasn't happened in the current recession, of course, because of the weakness in private credit demands resulting from the collapse of corporate external financing needs and the deleveraging of the American consumer. But rates likely will rise significantly when recovery begins to lift private credit demands. Standard estimates suggest that a 20-point sustained increase in debt/GDP - what we will experience between 2008 and 2010 - will boost real rates by 70-110bp.

But many question whether rising deficits and debt will have significant longer-term market consequences. Optimists cite the example of Japan, where massive deficits boosted government debt to 160% of GDP with apparently no effect on interest rates. The comparison is not apt for two reasons. First, Japan's lost deflationary decade pulled down nominal yields, but there were serious consequences for real yields. Real 10-year JGB yields averaged 1.7% over that period, much higher than the 30bp of annual real growth experienced in Japan. Indeed, my colleague Robert Feldman points out that this positive gap between real rates and real growth clearly boosted Japan's deficits and debt unsustainably (see *Fiscal Reform and the r-g Problem*, June 17, 2005). Second, Japan's massive current account surplus, which averaged 3% of GDP, means that Japan has no need to rely on foreign saving inflows.

In contrast, America's budget deficits are worsening our persistent internal and external saving-investment imbalances. Our chronic external deficit has shrunk to 2.9% of GDP in recession, but rebounding oil prices and imports suggest it will grow in recovery. Even a coming sea change in consumer behavior and the incipient rise in our personal saving rate to 7-10% of disposable income (5-8% of GDP) won't be enough to offset federal dissaving. State and local governments are awash in red ink, now more than 1% of GDP and growing. Consequently, we still need sizeable inflows of saving from abroad to finance federal deficits.

Fiscal credibility deteriorating. Some are concerned that our reckless fiscal policy will trigger a downgrade of the US sovereign debt rating, making the financing of our burgeoning deficits more difficult. While worries that the US will default on its debt are illogical, global investors and officials are concerned about the credibility and the sustainability of our fiscal policies. So am I. They fear that we will adopt policies that will undermine the dollar and the domestic value of dollar-denominated assets through a combination of risk premiums and inflation. I worry about that too, although such policies probably would be accidental rather than deliberate. As a result, interest rates may have to rise significantly to compensate investors, including reserve portfolio managers and sovereign wealth funds, for such dangers. While the dollar will for now retain its reserve-currency status, such concerns put it at risk.