



## Heading for a fiscal cliff?

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Is the Federal government spending us into financial ruin? The current numbers and budget projections suggest so. Yet I think that the scary numbers reflect an unresolved conflict over the role of government more than a threat of bankruptcy.

The national debt of the United States, the accumulated borrowing since the Republic's founding, stands at \$21.85 trillion. The deficit, or amount borrowed to cover spending in excess of tax revenues, for fiscal year 2018 was \$780 billion.

A sense of magnitude is difficult to maintain once we get into the "illions" – meaning millions, billions, and trillions. A good way to size up Federal red ink is as a percentage of U.S. GDP, the value of all the goods and services produced in a year, which is currently \$20.1 trillion. So 2018's deficit and the national debt are 3.9 and 109 percent of GDP respectively.

A second debt figure, the debt held by the public, confuses the matter. What is the difference? Some Federal government agencies hold debt, including Social Security and the military and civilian pension plans. As this debt is sometimes described as "owed to ourselves," some experts focus on debt held by the public, which is currently \$16 trillion (78 percent of GDP).

Which measure matters more? Debt held by the public is the amount the U.S. Treasury borrows in global credit markets. Interest rates are prices adjusting to bring demands for borrowing – by businesses and households in addition to government – into line with the supply of funds from savers and investors. Publicly-held debt potentially crowds out productive investment.

The intra-government debt is also real. The \$800 billion the Treasury has borrowed from the Department of Defense's pension program is supposed to pay retirement benefits, but was used for other Federal spending. If not repaid, military pensions would need to be paid out of current taxes.

Does the national debt spell inevitable bankruptcy? Warren Buffett has observed that the debt is not necessarily a problem because it was higher relative to GDP at the end of World War II. Mr. Buffett's observation highlights the importance of budget projections. We borrowed to fight World War II, and investors expected spending to decline precipitously after the war. It did, and debt fell below 40 percent of GDP during the 1950s.

By contrast, spending is expected to increase significantly in the future. The most recent Congressional Budget Office (CBO) 30-year forecast projects Federal spending to increase from 20.6 to 27.9 percent of GDP. An aging population using more medical care will increase spending on Social Security, Medicare, and Medicaid. The CBO expects debt held by the public to reach 152 percent of GDP by 2048. This will be uncharted territory for the U.S. and could trigger a debt cycle through rising interest rates.

Will debt at 150 percent of GDP mean bankruptcy? Perhaps. Greece has teetered on the verge of bankruptcy with debt at 180 percent of GDP. But Japan remains sound despite debt at 220 percent of GDP.

Debate over insolvency obscures a common assumption that tax revenues will not rise significantly. The CBO, for instance, projects Federal revenues of 19.5 percent of GDP in the 2040s, only three percentage points higher than today. A Cato Institute analysis of fiscal imbalance kept tax revenue at current levels.

Potential Federal insolvency demonstrates that we cannot afford a European-style welfare state without European-style taxes. This tension, I think, goes back to Ronald Reagan, who pursued tax cuts even though his desired spending cuts proved politically unachievable. Reagan set Federal spending on a collision course with our distaste for taxes, likely hoping that his tax cuts would eventually force spending cuts. Maintaining Social Security and Medicare as they are given demographic changes will require paying more taxes.

I am not advocating for higher taxes and would prefer downsizing government. We cannot, however, afford a Cadillac on the payments for a Chevy and will soon have to decide whether we are truly willing to pay for big government.