BARRON'S

What, Me Worry?

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Sep. 28, 2013

As President Barack Obama and Congress continue to bicker over passing the federal budget and raising the government's debt ceiling, a report published by one of the nation's most credible agencies warns that the U.S. could face economic disaster within 25 years due to excessive government spending.

Obamacare is part of the problem, but so are Medicaid, Medicare, and Social Security. The cost of these programs will mushroom as tens of millions of baby boomers reach retirement age.

The report was published on Sept. 17 by the nonpartisan Congressional Budget Office. Its most optimistic forecast shows the federal debt growing to 100% of annual economic output by 2038, from an "already quite high 73%" today. That would make the U.S. like France, which in terms of fiscal strength is none too good.

But the CBO implicitly concedes that the outcome is likely to be a lot worse than that, and so it included its "alternative fiscal scenario," which is far more realistic. It projects the federal debt will grow to 190% of the nation's annual economic output by 2038. That would make us worse than Greece today, which has a 27% unemployment rate and periodic bloody riots over its dreadful economic conditions.

A Barron's cover story on the federal debt compared the potential fiscal crisis in the U.S. to that of Greece ("Debt Crisis: Next Stop, Greece," Feb. 18). Some critics of that shocking analogy failed to notice that it did not originate with Barron's, but with the CBO itself. In its September 2013 report, the CBO stood by that analogy.

It is a truism of American democracy that politicians' time horizons rarely extend beyond the next election. That's why you have to go back nearly 15 years to find a president squarely addressing the baby-boom budget bomb. In his State of the Union address in January 1999, Bill Clinton urged Congress to seize "an unsurpassed opportunity to address a remarkable new challenge, the aging of America." With the winds of a budget surplus at his back, Clinton declared that "now is the moment for this generation to meet our historic responsibility to the 21st century."

So much for responsibility. The big opportunity slipped away, and fiscal planning has since devolved into a series of standoffs verging on defaults and shutdowns. The latest one has Washington paralyzed right now.

DEMOGRAPHICS ARE A KEY DRIVER of future spending. By 2038, there will be 79.1 million U.S. residents 65 and over, up from 44.7 million today. The working-age population, 18 to 64, will grow at a much slower rate, to 214.7 million from 197.8 million. As a result, this "dependency ratio" will plummet to 2.7 working-age people to support each senior in 2038, from 4.4 today, as illustrated by the above chart.

But since the elderly population won't begin to reach critical mass until the mid-2020s, the rising tide of red ink will be relatively contained for the next decade. Under the alternative fiscal scenario, the increase in the debt-to-economic-output ratio will be relatively modest over the next 10 years, rising just eight percentage points, to 81%, before exploding to 138% by 2033 and 190% in 2038.

The math is pretty straightforward. Retiring baby boomers are pushing up the cost of elder-care entitlements. Mainly as a result, spending will rise much faster than revenues. Deficits will therefore be incurred ever year, adding to the debt. That the federal government can no longer be expected to balance its budget, however, is not in itself the reason the CBO calls the trend unsustainable. The trend cannot be sustained because yearly deficits will be so large that the debt will grow faster than the economy's ability to pay for it.

Because most standard projections extend just 10 years, however, the media has helped stoke complacency about the budget, ignoring repeated warnings from the CBO about the misleading nature of the 10-year outlook.

The CBO's new 25-year projections should again make the message clear: The next decade is the relative calm before the coming storm. Any short-term improvement in the budget during the recent upswing in the business cycle is negligible when measured against looming long-term shocks.

The next 10 years, in other words, should be treated as an opportunity to avert the fiscal iceberg before solutions must be so Draconian that they do damage to people involved. It is difficult enough to put 50-year-olds on notice that entitlements they expect at 70 will probably not be available. To give them this bad news when they're 60 or 65 is inhumane.

Obama seems wedded to a time frame that does not even exceed his years left in office. Three days after the release of the CBO projections, the president in a speech returned to his often-repeated point that "our deficits are now coming down so quickly that by the end of this year we'll have cut them by more than half since I took office."

That boast is hollow at best, given that those deficits were all-time records. In any case, the CBO has taken all that progress into account and still deems the budget to be on an unsustainable course. If the president's Office of Management and Budget disagrees, it should explain why.

The nation might thus be likened to a family with about 10 good working years left that needs to cut spending in order to save for a rapidly approaching old age. But alas, it's a dysfunctional family incapable of rational planning. That may be one reason that rabble-rousing Republicans seek to exploit the debt-ceiling crisis as a way to reduce the debt. As Rahm Emanuel, the president's former chief of staff, once famously said, "You never want a serious crisis to go to waste. And what I mean by that is an opportunity to do things you think you could not do before."

Such as curbing the government's addiction to debt and deficits.

IN PRESENTING THE CBO REPORT at a news conference, the agency's director, Douglas Elmendorf, said the "bottom line remains the same as it was last year," clearly referring to his agency's last long-term budget projections, released in June 2012. Three things have changed since then, altering that bottom line for the better. To begin with, a tax bill was passed in January, hiking the top marginal rate to 39.6% on earnings of more than $450,000 for married couples and more than $400,000 for individuals. In addition, the CBO assumed lower spending, based mainly on slowed growth in spending on medical care. Also, gross domestic product, the denominator of the debt/GDP ratio, has been upwardly revised going back to 1929, reflecting a broader definition of GDP.

But these changes for the better have achieved very little. The CBO's alternative fiscal scenario now puts the debt/GDP ratio at 190% by 2038, as the chart on the facing page indicates, while the June 2012 version of the same scenario put the debt/GDP ratio at 190% by 2036 -- a two-year improvement.

The alternative fiscal scenario is the most realistic of those put forward by the CBO. As the agency explains, it "incorporates the assumptions that certain policies that have been in place for a number of years will be continued and that some provisions of law that might be difficult to sustain for a long period will be modified." For example, the CBO's "baseline" scenario assumes that the law requiring cuts in physicians' fees paid by Medicare will be implemented, even though Congress has rescinded these cuts every year for the past 10 years, a maneuver famously dubbed the "doc fix." The alternative fiscal scenario more realistically assumes that the doc fix is permanent.

Similarly, the alternative fiscal scenario assumes that the automatic spending cuts under the sequester, which are unpopular with Democrats and some Republicans, will be ended, although less Draconian spending caps under the Budget Control Act will continue. As Cato Institute fellow Chris Edwards, editor of DownsizingGovernment.org, says, "The CBO's alternative fiscal scenario more realistically reflects the budget culture currently prevailing in Washington."

The CBO stipulates that its "budget projections are inherently uncertain," and of course they are. They are also too plausible for a responsible government to ignore. For starters, they are driven by demographics -- the plunge in the dependency ratio -- and if demographics is not always destiny, in this case, it should be approximately right. In fact, the fiscal accident-waiting-to-happen could also occur much sooner than the CBO expects.

For example, the agency's baseline projection for real GDP growth, which determines the denominator of the debt/GDP ratio, is 2.3% per year over the next 25 years. Since annual growth has been just 1.7% since 2000, that could be far too optimistic. Also, interest costs on the debt, projected under the alternative fiscal scenario at 6% by 2038 versus 1.3% today, might be far too low. As Director Elmendorf stressed, the projected costs of debt servicing are based on past patterns, in which the debt-to-GDP ratio rose and fell.

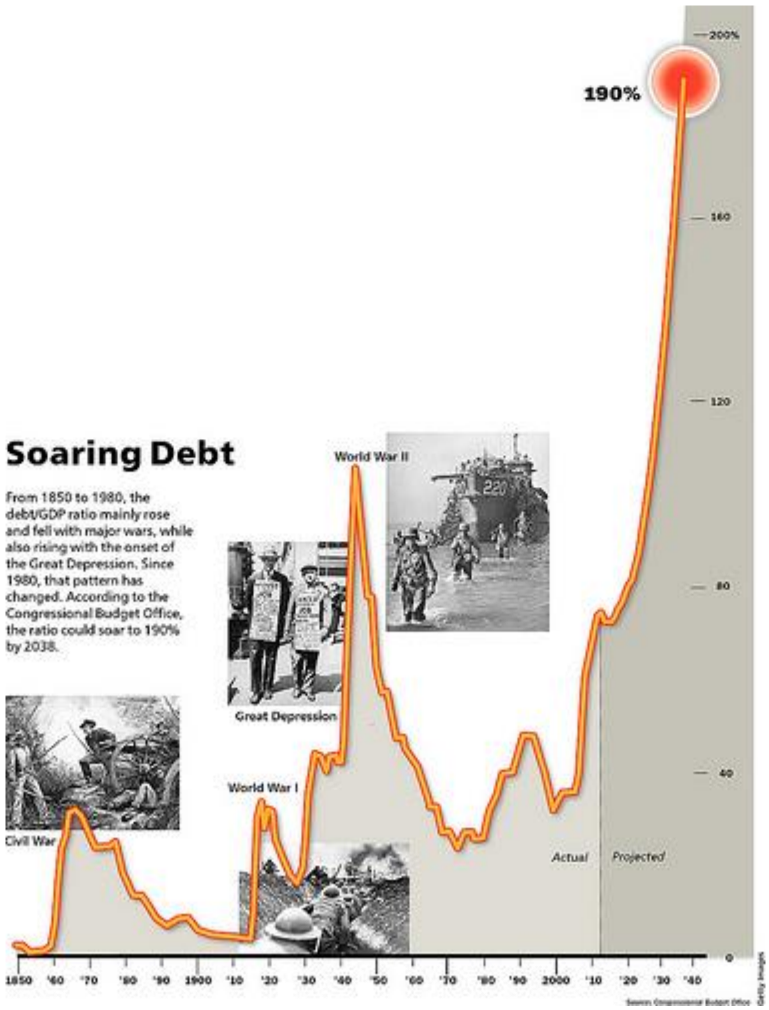
The future debt trajectory, however, will be unprecedented, with the debt inexorably rising faster than GDP. As the market becomes aware of this dire prospect, there is no telling how high interest rates might go.

In line with the scary projections for the debt, the CBO report reiterated its previous warnings about the "risk of a fiscal crisis -- in which investors demand very high interest rates to finance the government's borrowing needs." If interest on Treasury debt reaches levels normally associated with junk bonds, interest on private-sector debt could reach levels that impair the private sector's ability to function.

Those who deny that the debt can ever be a worry for the U.S. often point out that the debt is denominated in the same U.S. dollars the Federal Reserve has the ability to print. Ergo, there needn't be defaults on that debt. But funding the debt by running the printing press could be like pouring gasoline on a fire. In fact, in his 2007 memoir, The Age of Turbulence, Alan Greenspan warned about the dangers of monetary expansion in response to the fiscal "tsunami" brought on by retiring baby boomers, and expressed the hope that the future Fed chairman would resist pressures to expand.

As Greenspan pointed out, rapid monetary expansion not only could bring price inflation, but also could cause a decline in the dollar's exchange value against other currencies. Price inflation and exchange-rate devaluation would in turn bring a plunge in the value of the dollar in which the debt is denominated, both for domestic and foreign holders of that debt. The full faith and credit backing U.S. debt would therefore be less than full, since the debt would be paid in depreciating dollars. Result: a selloff in these bonds, bringing the surge in interest rates that the CBO warned about.

While defaults on the debt would take the form of payments in depreciating dollars, defaults on entitlement programs for the elderly will probably be in terms of actual dollar cuts. But the cuts would take the form of, say, a diminished number of drugs and treatments approved for reimbursement by Medicare, or a cap on the cost-of-living escalator governing Social Security payments, especially painful as price inflation accelerates. When government tightens our belts, it rarely does so in explicit terms.



THE CHART "Soaring Debt" tells a grim story. From 1850 to 1980, the debt/GDP ratio rose with major wars -- the Civil War, World War I, and World War II -- and then in each case rapidly fell. The Korean War of the early 1950s, and the Vietnam War of the late 1960s and early 1970s, were not accompanied by increases in the ratio. Within this 130-year interval, there was only one other time the debt-to-GDP ratio rose: with the onset of the Great Depression of the 1930s.

By 1980, however, the ratio began to show a noticeable tendency to rise in the absence of a major war or major downturn. It rose in the 1980s when the tax cuts pushed through by President Ronald Reagan were unaccompanied by commensurate spending cuts. As David Stockman, budget director during Reagan's first term, has written in his recent book, The Great Deformation, "Notwithstanding decades of Republican speech-making about Ronald Reagan's rebuke to 'big government,' it never happened."

Stockman's rogues' gallery of profligate presidents also includes George W. Bush. But he exempts Bill Clinton, whose "courageously balanced budgets were the last hurrah of the old fiscal orthodoxy."....

Commentary

We offer four observations that few people will enjoy.

First, when we profligately spend money on ourselves, we are destroying the standard of living of our posterity, including young people who are alive today. The money will need to be paid back, through either crushing taxation or ruinous inflation. Regardless, we are literally *planning* to make our own children miserable. Any time you see government at any level wasting a nickel, remember that your child will have to pay that nickel back one way or another.

Second, there is no single solution to this demographic and fiscal catastrophe. We need to reduce our spending on entitlements (particularly for future old folks who *could* be saving their own money or having more loving children now), we need to tilt government policy as aggressively as possible in favor of economic growth, and we need to structure our immigration decisions to support the admission of people who will bring money, brains, and ambition.

Third, we wonder if "social democratic" welfare state policies do not contain the seeds of their own destruction. Does a safety net reduce the fertility rate to the point where it makes it almost impossible to sustain the safety net? This is a question social scientists would examine closely if they were not predisposed to support social democratic welfare state policies.

Finally, we wonder if the left's denial of the American fiscal crisis is not the direct analog of the right's denial of anthropogenic global warming. Except, of course, that the American fiscal catastrophe is far more certain and will happen much more quickly.

Release the hounds.