Half a Trillion is Still a Big Deficit

By Martin Hutchinson *Thu, Oct 9, 2014*

"If the next 20 years are similar to the last five, with very slow growth and median incomes declining, then the budget deficit will grow inexorably larger and Social Security payments after 2033 will be far lower than they are at present," worries our ever-bearish guest columnist.

The latest estimate by the Congressional Budget Office of the federal deficit in the year to last Tuesday was $506 billion. The deficit is expected to improve marginally this year, then jump back above $500 billion next year and worsen steadily for the next decade and thereafter. Given that we are five years into an economic "recovery," this won't do. Fourteen years of sloppy fiscal policies have left the U.S. fiscal position in a parlous state, only partly disguised by two decades of cheap money. Drastic action needs to be taken.

Probably the largest currently hidden danger to the federal budget is the Affordable Care Act's long-delayed implementation. We are hearing currently about how the premium increases that had been expected for Obamacare's second year of operation in 2015 don't appear to be occurring, but that several of the more popular insurance offerings through the federal and state websites are being cancelled.

This almost certainly means that insurance companies and healthcare providers have now figured out how to game the immensely complex system of subsidies included in the legislation and are successfully unloading more and more of those costs onto the federal budget. By doing this, they can present spuriously attractive offerings to the public, capturing a greater share of the business, while reimbursing themselves with a larger rebate from taxpayers.

Given the rate at which the Feds do their accounting, it's likely we will not know about the increased costs from this until the new budget is presented in February 2015. Even then, the additional subsidies will be buried in the fine print, with only an unexpected increase in the ever-growing costs of the federal government being presented as a post-election surprise.

Obamacare costs merely add to worries over the fiscally unsustainable cost of the U.S. medical system. While its cost increases have tapered off recently, it still represents close to 18% of U.S. GDP, a percentage that is steadily increasing. Remarkably, the government share of U.S. medical costs, in terms of GDP, is now higher than the cost of the British National Health System, without of course offering anything like its near-universal free

coverage, albeit of spotty quality. The CBO estimates that the on-budget costs of healthcare will increase by 87% in the next decade, to $1.8 trillion. Given the likely cost overruns from insurance companies and healthcare providers “gaming” Obamacare, that is almost certainly a gross underestimate.

Not all the time-bombs sitting under the federal budget are medical. Defense costs also are about to soar. We can argue all day about the correct strategy to pursue in the Middle East, but China is showing itself by no means entirely friendly and is ramping up its economic power to surpass the U.S. in 2017 or so. Meanwhile Vladimir Putin’s Russia, admittedly an economic midget, is using its complete lack of scruple and greatly superior tactical sense to re-establish the Soviet empire and destabilize NATO. The Middle East itself represents a considerable terrorist threat to U.S. citizens if groups such as ISIS are not properly contained, even though we can perhaps agree that full-scale intervention in that unstable, unfriendly region would be exceptionally foolish.

Therefore, the U.S. simply must rebuild its defense spending from the current 3.4% of GDP to something like the 5% of GDP at which it stood in the late 1980s (after the Reagan defense build-up had ended and far below the peak peacetime level of 10% of GDP in the late 1950s). That additional 1.5% of GDP, perhaps an additional $300 billion in current dollars, will have to come from somewhere; it is no longer possible simply to whang it onto the national credit card.

Social Security is another factor making the budget problem worse. For the last three decades, it had been running at a surplus, as the trust funds built up to finance baby-boomer retirements. From 2016, the net effect of these off-budget items (including the Social Security Trust Fund, the Medicare Trust Fund and the Disability Insurance Trust Fund) will turn into a deficit, a small one at first but widening inexorably as the boomers grow older, reaching $238 billion in 2024 and causing bankruptcy of the Social Security trust fund in 2033.

In a sense this doesn’t matter much. Even by standard bookkeeping, the only effect of the Social Security Trust Fund’s bankruptcy will be to reduce the pensions that can be paid out by 23% from 2034 onwards. That sounds severe, but bear in mind that Social Security entitlements are indexed to incomes not prices, so that if we have enjoyed a decent rise in real incomes between 2014 and 2033, the pensions payable from 2034 on may still be higher than those payable today.

The problem comes down to getting the economy right. If the next 20 years are similar to

the last five, with very slow growth and median incomes declining, then the budget deficit will grow inexorably larger and Social Security payments after 2033 will be far lower than they are at present. The CBO's economic estimates look to me optimistic on all three factors affecting the budget balance: growth, inflation and interest rates. If in reality growth is lower, inflation higher and interest rates higher than the CBO projects, the budget deficit will widen far beyond the ability of any reasonable policies to balance it.

The CBO is highly optimistic on outlays as a whole. While "mandatory" outlays are forecast to increase 72%, probably a realistic actuarial estimate if inflation remains low, "discretionary" outlays are expected to increase only 18%, and to decline from 6.8% of GDP to 5.2%. Apart from the need to increase defense spending discussed above, this assumes an altogether unrealistic austerity among legislators never noted for such austerity in the past. The CBO also assumes no further financial-sector bailouts or hidden losses from the FHA's expansionary home-mortgage guarantees of the past decade or from the $1 trillion student loan mess, all highly implausible assumptions.

The final potential hole in the CBO's budget projections is debt interest. The CBO has net debt held by the public increasing only from 74% of GDP to 77% in the next decade, but even under its favorable assumptions net interest payable trebles from $231 billion to $799 billion. In other words, the CBO can only make the numbers add up by assuming an outbreak of peace for the next ten years, an altogether unlikely austerity in discretionary spending and implausibly favorable economic assumptions in all directions. Even then it is running a deficit of close to a trillion dollars annually by the end of the period. In reality, the CBO's sums don't add up and, whether or not we suffer another recession as a result of Fed over-expansionism in the past six years, we are going to suffer a budget funding crisis well within the next decade.

There are three potential avenues to improving the budget picture sufficiently to make it sustainable: tax increases, spending cuts and structural improvements to the U.S. economy that raise its long-term growth rate.

Tax increases are the favorite vehicle of the left, advocated at every possible opportunity along with bursts of Keynesian "stimulus" spending (the latter being a large part of what got us into this mess). They have already been implemented in substantial measure, by the "fiscal cliff" deal of 2013, which had the merit of significantly improving the budget picture. However on income tax rates, with state taxes in many jurisdictions having also been raised in the last few years, we are close to the limit at which the Laffer Curve takes over and tax increases reduce revenues.

Corporate taxes need to be reformed, to eliminate foolish loopholes like those surrounding Master Limited Partnerships and offshore cash. But in order for such loophole-elimination to work, the top nominal rate must be brought down from its current 35% to a level closer to 25%; thus corporate tax loophole-closing will produce only modest additional revenue.

However, individual tax loopholes are egregious and expensive, and eliminating many of them could have a substantial effect on the deficit without significantly dinging growth. The tax-deduction for health insurance, a favorite target of "reformers," should probably be replaced with a health insurance tax credit as part of an overall revamping of the healthcare system, so that replacement won't raise much revenue. But the home mortgage tax deduction, which costs $74 billion annually, and above all the charitable donation tax deduction, which costs $59 billion annually and flows almost entirely to the very rich are over-ripe for pruning, as are other charity tax benefits. The latter change at least would probably improve the economy's performance as the dampening effect on economic spirits of the non-profit miasma would be reduced.

On the expenditure side, Governor Rick Perry, when asked in a 2011 debate which three federal agencies he would eliminate, could not remember the third, in spite of helpful suggestions from fellow-candidate Ron Paul. This time around, his response should be "All of the above, except for Treasury, some of State and small portions of the Defense Department." It's not that the other agencies, such as education, commerce, energy and environment, are in themselves so expensive, but that eliminating them all would make only a modest, though useful dent in federal discretionary spending. However, their true purpose is to introduce economically damaging regulation at all levels, over-ruling state systems of regulations and to hand out special crony-capitalist benefits to favored sectors, all of which the U.S. economy would be better off without.

Together with a monetary policy that rewards savings properly, allowing the U.S. savings to be rebuilt, this bonfire of government departments is the true key to reviving growth in the economy and returning its productivity growth to the levels of the 1950s and 1960s (possibly with some interim catch-up). It would allow the system to generate sufficient revenues without tax increases to fund the pruned government that remains. Any dispassionate observer looking at a chart of U.S. economic outcomes sees downward kinks in 1973, caused by the tsunami of regulation; in 2000, caused by newly sloppy monetary policy; and in 2008, caused by a pernicious combination of both. We need to make those curves bend upward again, to avoid progressively worse impoverishment and eventual bankruptcy. Half-measures and moderation will no longer do the job.

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