Testimony

The Unsustainable Fiscal Outlook

DOUGLAS HOLTZ-EAKIN | JANUARY 28, 2020

United States Senate Committee on Homeland Security and Governmental Affairs

* *The views expressed here are my own and not those of the American Action Forum.*

Chairman Johnson, Ranking Member Peters, and members of the Committee, thank you for convening this hearing and providing me with the opportunity to address one of the preeminent risks to the U.S. economy: the federal fiscal outlook. In this short testimony I wish to make four basic points:

- The federal budget is on an unsustainable trajectory that cannot be fixed by tax increases or faster growth alone;
- Trust funds are budget management tools; their projected exhaustion is a symptom of the problem and not the problem itself;
- Recent commentary to the contrary, the low-interest-rate environment does not alter the basic need to address the fiscal outlook; and
- The absence of a financial crisis does not mean that excessive debt is harmless.

Let me discuss these in turn.

The Budgetary Outlook Is Unsustainable

The federal government faces enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions. The core, long-term issue has been outlined in successive versions of the Congressional Budget Office's (CBO's) *Long-Term Budget Outlook*. In broad terms, the inexorable dynamics of current law will raise federal outlays from an historic norm of about 20 percent of gross domestic product (GDP) to nearly 30 percent of GDP. Spending at this level will far outstrip revenue, even with receipts projected to exceed historic norms, and generate an unmanageable federal debt spiral.

This depiction of the federal budgetary future and its diagnosis and prescription has remained unchanged for at least a decade. Despite this, meaningful action (in the right direction) has yet to be seen, as the most recent budgetary projections demonstrate.

In August 2019, CBO released its updated budget and economic outlook for 2020-2029. (At 2:00 p.m. today, CBO will release the outlook for 2021-2030.) The basic picture from CBO is as follows: tax revenues eventually return to pre-recession norms, while spending progressively grows over and above currently elevated numbers. The net effect is an upward debt trajectory on top of an already large debt portfolio.

Figure 1: The Budget Outlook by the Numbers

		2020	2021	2022	2023	2034	2025	2026	2027	2028	2029	2020-2029
Revenues	$ Billions	3,620	3,792	3,971	4,163	4,392	4,585	4,900	5,206	5,390	5,619	45,637
	% GDP	16.4	16.6	16.7	16.9	17.2	17.3	17.8	18.2	18.1	18.2	17.4
Outlays	$ Billions	4,628	4,826	5,130	5,344	5,543	5,869	6,174	6,466	6,868	6,997	57,845
	% GDP	21.0	21.1	21.6	21.7	21.7	22.1	22.4	22.6	23.1	22.7	22.1
Deficit	$ Billions	-1,008	-1,034	-1,159	-1,181	-1,151	-1,284	-1,274	-1,260	-1,479	-1,378	-12,208
	% GDP	-4.6	-4.5	-4.9	-4.8	-4.5	-4.8	-4.6	-4.4	-5.0	-4.5	-4.7
Debt	$ Billions	17,755	18,841	20,042	21,264	22,457	23,784	25,102	26,407	27,917	29,322	
	% GDP	80.7	82.4	84.5	86.4	88.0	89.7	91.2	92.4	94.0	95.1	

According to CBO, tax revenue will average 17.4 percent of GDP over the next 10 years, on par with the average level of taxation over the past 50 years. The federal government is projected to spend nearly $58 trillion over 10 years, maintaining spending levels about 2 percentage points above historical levels. Mandatory spending, which comprised 28 percent of the federal budget in 1968, will reach 64 percent in 2029. Interest payments on the debt comprised 6 percent of the budget in 1968 and 6 percent in 2016. These payments will rise to 11.5 percent of the budget. Debt service payments will reach 2.6 percent of GDP by 2029 – well in excess of the 50-year average of 2.0 percent.

Sources of Rising Debt

The problem facing the United States, and reflected in CBO's budget projections, is that spending rises above any reasonable metric of taxation for the indefinite future. There is a mini-industry devoted to producing alternative numerical estimates of this mismatch, but the diagnosis of the basic problem is not complicated. The diagnosis leads as well to the prescription for action. Over the long-term, the budget problem is primarily a spending problem and correcting it requires reductions in the growth of large mandatory spending programs – particularly entitlements such as Social Security and federal health programs.

Medicare spending is projected to grow at an average annual rate of 7 percent over the next decade and is currently running a cash deficit of over $360 billion. Social Security retirement spending is projected to grow at an average rate of 6.1 percent, while currently running a cash-flow deficit of $80 billion. Medicaid and the insurance subsidies associated with the Patient Protection and Affordable Care Act (ACA) are growing at 6 percent on average every year. The economy that underpins the financing of these obligations is projected to grow at 5.2 percent annually. The growth of tax revenues is projected to average in the 4.5 percent range. The costs of the nation's entitlements are increasingly dominating federal expenditures and are also swamping growth in projected tax revenue.

Clearly the U.S. economy is not going to grow at rates approaching 8 percent; we simply cannot "grow our way" out of the federal fiscal problem. Similarly, we cannot simply "tax our way" out of the problem. To see this, imagine that revenues grew at an 8 percent rate over the 10-year budget window. Taxes in 2029 would be $1.8 trillion higher than in the CBO baseline and would be over 25 percent of GDP. It will be desirable to grow as fast as possible. Congress and future administrations may decide to raise more revenue. But it is inevitable that these policies will be accompanied by reforms to slow the growth of mandatory spending.

Trust Fund Exhaustion Is Not the Problem

The fundamental mismatch between projected spending and projected revenues is the fiscal policy problem. Some observers instead focus on Social Security and other entitlement programs "going bankrupt" when their trust funds are depleted, however. This is a symptom of the problem, but not the problem itself.

The federal government uses several trust funds; that is, accounting mechanisms to link earmarked receipts with corresponding expenditures. The federal budget has numerous such trust funds; by far the largest are the Social Security Old-Age and Survivors Insurance (OASI) Trust Fund, the funds dedicated to the government's military and civilian personnel retirement funds, and Medicare's Hospital Insurance (HI) Trust Fund.

The key feature of trust funds are “accounting” and “mechanism” because trust funds do not contain actual economic resources that can be used to meet the budgetary demand for expenditures. When a trust fund receives cash that is not needed to pay expenses (e.g., Social Security benefits), the trust fund swaps that cash for non-marketable Treasury securities. In this way, the cash reduces the amount that Treasury must borrow from the public to finance governmental activities. When revenues fall short of expenses, the securities are sent back to Treasury in exchange for the needed cash; this, in turn, raises the amount that the Treasury must borrow from the public.

Trust funds can be an important legal mechanism; the balance represents the amount that can be legally spent. But the balance of a trust fund at any point is simply a measure of the cumulative difference between revenues and expenses and will be held in the form of Treasury securities. While these securities are an asset to the program (e.g., Social Security), they are simultaneously a liability of the Treasury. For the federal government as a whole these net out. The only real source of capacity to redeem the trust fund securities and pay expenses is the capacity of the Treasury to tax or borrow. For this reason, the best way to evaluate the financial health of the government and its programs is to ignore trust funds and focus on the flows of revenue and spending.

Low Interest Rates Do Not Change the Need for Action

There has been a wave of revisionist thinking on the undesirability of federal deficits and debt. Proponents of the view that excessive debt is not harmful range from advocates of Modern Monetary Theory (MMT) on the progressive left, to recent research by Olivier Blanchard and commentary by Lawrence Summers and Jason Furman on the center-left, to the indifference of the Trump Administration toward the budgetary outlook on the populist right. Traditionally, deficits were viewed as undesirable (except when fighting a recession necessitated them) because they competed with the private sector’s need for funds to finance productive investment or were financed by foreign capital that then had claim to the future income from U.S.-based investments. In either instance, the burden of the debt was ultimately borne by future citizens in the form of a diminished standard of living. Is it possible that there is no burden to the federal debt, or even that it makes us better off?

At the heart of the recent discussion is the reality of low interest rates, i.e. interest rates that are below the growth rate of the economy. The simple arithmetic of debt accumulation indicates that if interest rates remain low – relative to the growth of GDP – it is easier to handle federal debt.

To see this, let D be the debt in the hands of the public, Y be GDP, r the interest rate, g the growth rate of GDP, E federal expenditures, and R federal revenues. P is the “primary deficit,” the amount by which E exceeds R. The debt-accumulation identity is:

$$D_t = (1+r)D_{t-1} + (E_t - R_t)$$

Dividing both sides by the level of GDP gives:

$$(D_t / Y_t) = (1+r)(D_{t-1}/Y_t) + (P_t/Y_t)$$

Since $Y_t = (1+g)Y_{t-1}$ this is:

$$(D_t / Y_t) = (1+r)(D_{t-1}/(1+g)Y_{t-1}) + (P_t/Y_t)$$

Finally, using lower-case letters to denote ratios to GDP, this means:

$d_t = (1+r)/(1+g)\ d_{t-1} + p_t$

In English, the debt-to-GDP rises with interest costs but falls with growth in the economy. Of course, running primary deficits automatically demands more debt. This has the implication that if r > g, you need primary surpluses (p < 0) to keep debt from rising. That is, controlling the debt is hard fiscal work. But if g > r and p = 0, then the debt will (eventually) shrink away (relative to GDP). Finally, if g > r, you can run primary deficits and still shrink the debt. Perhaps managing the debt is not such hard work after all?

An important contribution of Blanchard is to note that the current situation of low interest rates is more the rule than the exception. I was surprised by this, but my thinking was too much conditioned by the experiences of the ’70s to the ’90s, when the reverse was true. The contribution of Summers and Furman was to argue that policymakers should not try to reduce deficits – just that they should not make them worse. So, in their view, all that is needed is that if a new spending program is enacted, then new taxes should be raised, or other spending cut, to offset the new program. The position of the Trump Administration has been that growth is the key; it has made no serious attempt to address budget issues.

But in each case, one still must eventually at least stabilize debt, if not reduce it. To see how the alternatives fit together, consider that the CBO projects a primary deficit for 2029 of $571 billion. It also projects that the debt-to-GDP ratio is 95 percent (d=0.951). It further projects that the growth rate of (nominal) GDP is 3.9 percent (g=0.039) and that the interest rate is 3.1 percent (r = 0.031). Since g > r, the claim is that we can still run a primary deficit and keep the fiscal house in order. Unfortunately, if you merely want to stabilize the ratio of debt-to-GDP (not have it decline), the primary deficit in 2029 has to be $225 billion. In the parlance of D.C., that means you would have to cut the primary deficit by roughly $350 billion – or $3.5 trillion over 10 years. That is serious fiscal work.

Worse, the calculation is very sensitive to interest rates and growth rates. 3.1 percent is the current projection for 10-year rates. If one instead uses the projected 10-year rate of 3.7 percent from January 2019, then the primary deficit has to be $56 billion to stabilize the debt. That means, for all practical purposes, balancing the primary (non-interest) budget. By recent standards of conduct, that is hard to imagine. At the other end of the spectrum, if one assumes that the economy will grow at 5 percent (the Trump Administration’s assumed 3 percent real growth with 2 percent inflation) and interest rates are 3.1 percent, then the debt will stabilize relative to GDP with a primary deficit of $530 billion – almost exactly what CBO projects. With fast growth, the administration’s budgetary indifference makes more sense.

To me the upshot is clear. There is no free pass for federal debt. Believing that there is no work to do means betting the ranch on either very low interest rates or very high growth rates, or both.

Economic Consequences of the Fiscal Outlook

Unless current law is changed, the federal debt will grow inexorably until creditors effectively refuse to continue to finance our deficits by charging ever-higher interest payments on an increasingly large debt portfolio. Unchecked accumulation of debt would precipitate a fiscal crisis that would upend world financial markets and do lasting harm to the nation’s standard of living.

In a hypothetical fiscal crisis, the policy response most readily available to lawmakers would be ill-targeted insofar as it would likely leave untouched the large drivers of the debt itself – health and retirement and entitlement programs. Such programs do not lend themselves to immediate reduction. Accordingly, a fiscal consolidation that was forced by creditors would likely take the form of tax hikes and cuts to discretionary spending. These tax hikes and discretionary spending increases would be sharp and immediately felt.

The nation would also face immediate and steep interest penalties on financing its shorter-term debt portfolio. About half of all U.S. debt held by the public is of 3 years or less in duration. All else being equal, the higher costs of rolling over this portfolio, would also have to be borrowed or absorbed through significant, additional tax increases and spending.

An immediate fiscal contraction from a debt crisis would have a deleterious effect on the economy. From a purely budgetary perspective, large and immediate tax increases and spending cuts would reduce growth, and immediately reduce the revenue collected from tax increases. Spending would also increase as certain automatic stabilizers come into force as the economy flags.

Some observers note that financial markets – bond markets in particular – appear quiescent, and that countries like Japan have had large increases in debt without facing a sovereign debt crisis. Where is the harm, they ask?

Absence of a crisis is hardly a policy success. Mechanically, federal debt issuance must come at the expense of either the private sector – traditional crowding out – or by attracting an inflow of foreign capital. In the former case, the growth in physical, intellectual and human capital is slowed, productivity growth is diminished and the standard of living is harmed. In the latter, the economy continues to grow, but the incomes it generates increasingly accrues to foreign investors, and the standard of living is harmed. In short, the unsustainable fiscal outlook will sap the vitality of the U.S. economy, and may be doing so already.

Thank you. I look forward to your questions.