The Nation's Gloomy Long-Term Fiscal Outlook

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Introduction

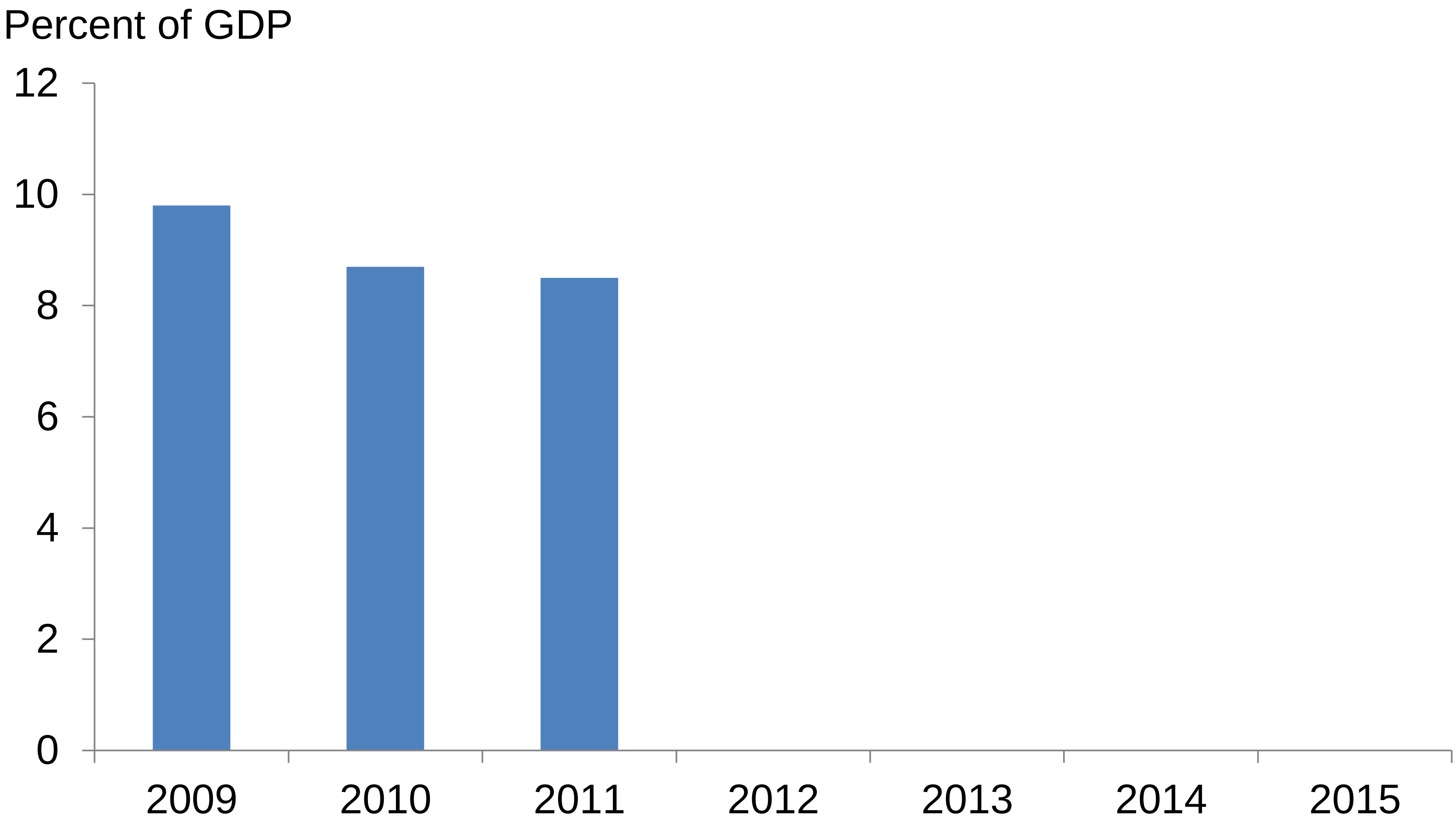
- Recent media reports have trumpeted improvements in the nation’s deficit picture
- Yet Chairwoman Yellen has decried the nation’s fiscal trajectory and urged action to address it
- Favorable short-term deficit trends said to reverse themselves over the next ten years
- Over the next 75 years, it is projected that the national debt will reach historically high levels
- How high will national debt become – and how difficult would it be to change course?

Outline

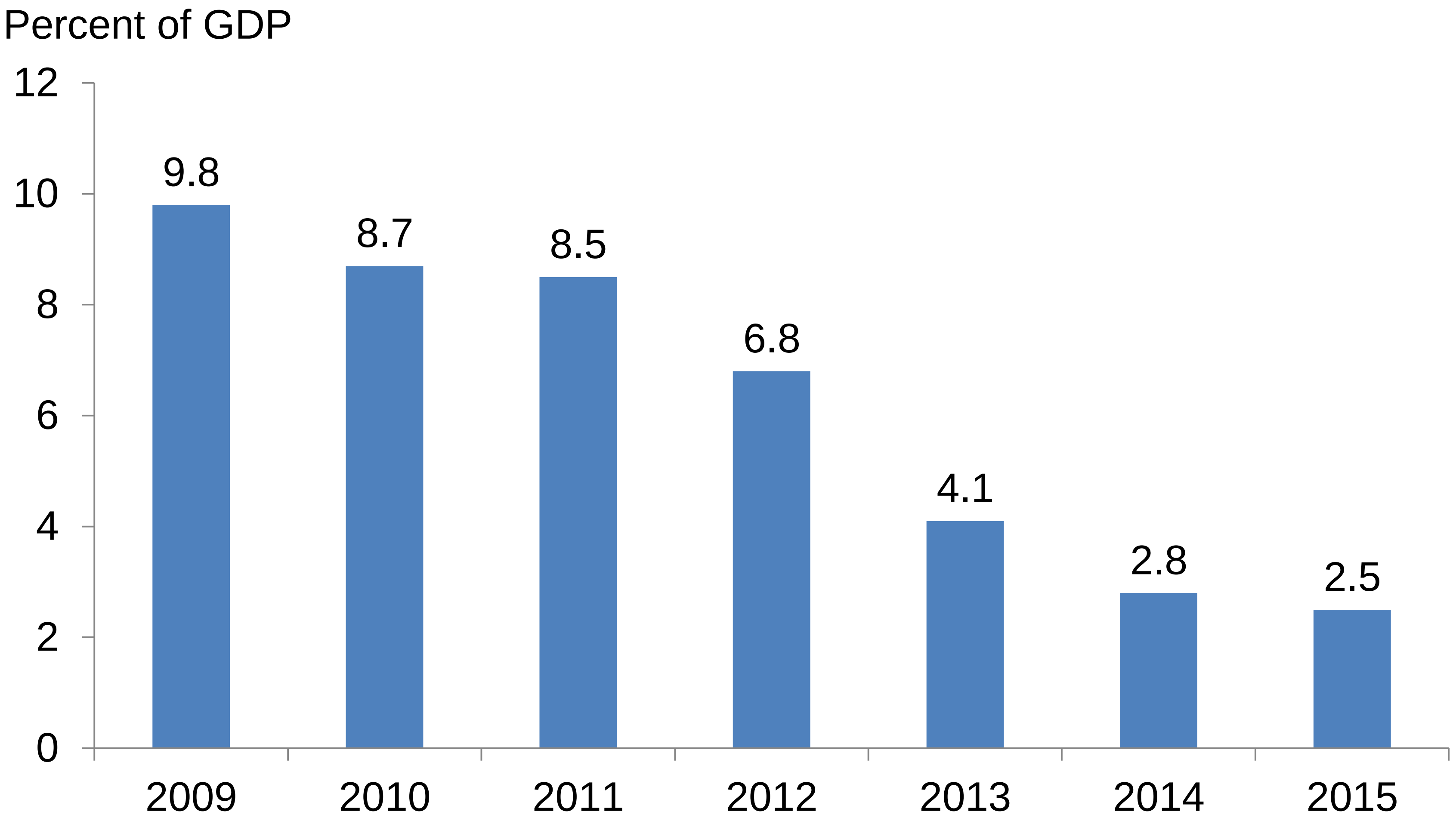
- Have deficits fallen in recent years?
- What is the short to medium run fiscal outlook?
- Is the long run outlook actually gloomy?
  - Have Social Security and Medicare contributed?
- How will the national debt change if the nation's fiscal challenges are left unaddressed?

RECENT HISTORY

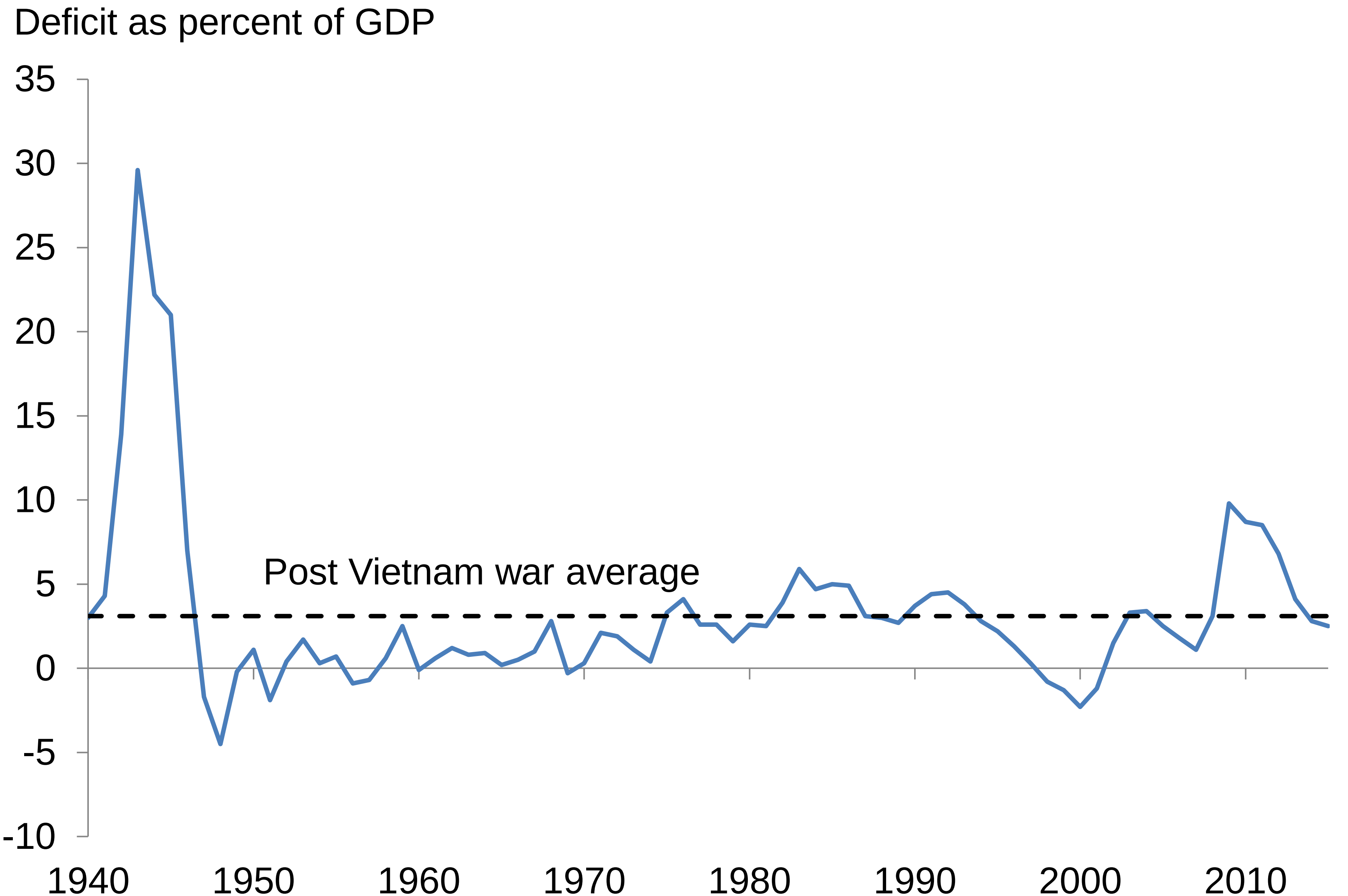
Three years of high deficits during the Great Recession…



…were followed by four years of rapidly declining deficits



A return to normalcy?



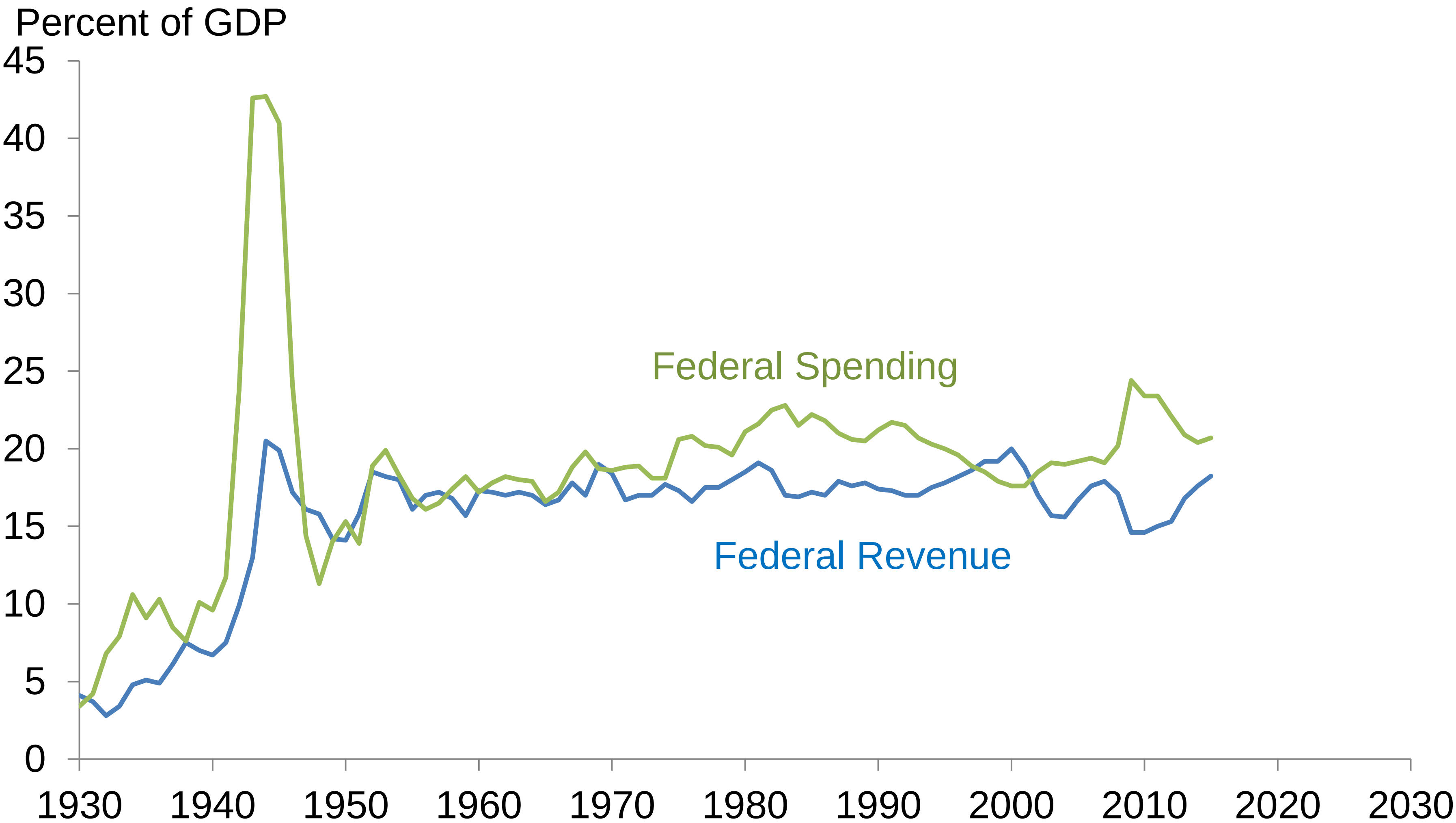
Why did deficits fall so quickly?

- Improvement can come from either more revenue or less spending
- Federal revenue rose from 15 percent to 18.2 percent of GDP
- Federal spending fell from 23.4 percent to 20.6 percent of GDP
- But what were the drivers of these trends?

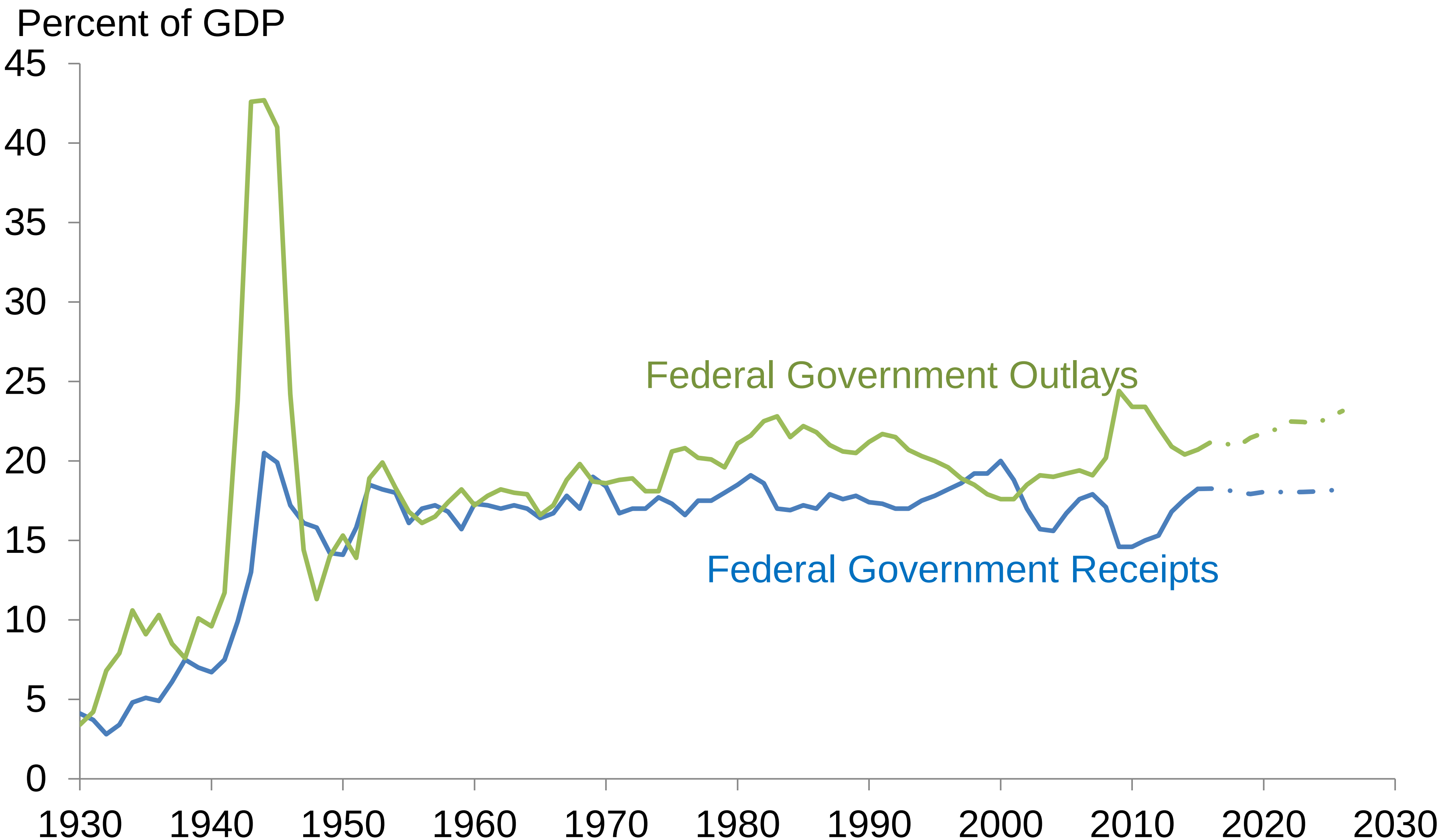
Main driver of smaller deficits: an improving economy

- Higher income tax payments
- Lower demands on safety net
- Somewhat higher tax rates
- Historically low interest rates
- Unusually slow health care cost growth

Great Recession gap between spending and revenue has substantially closed

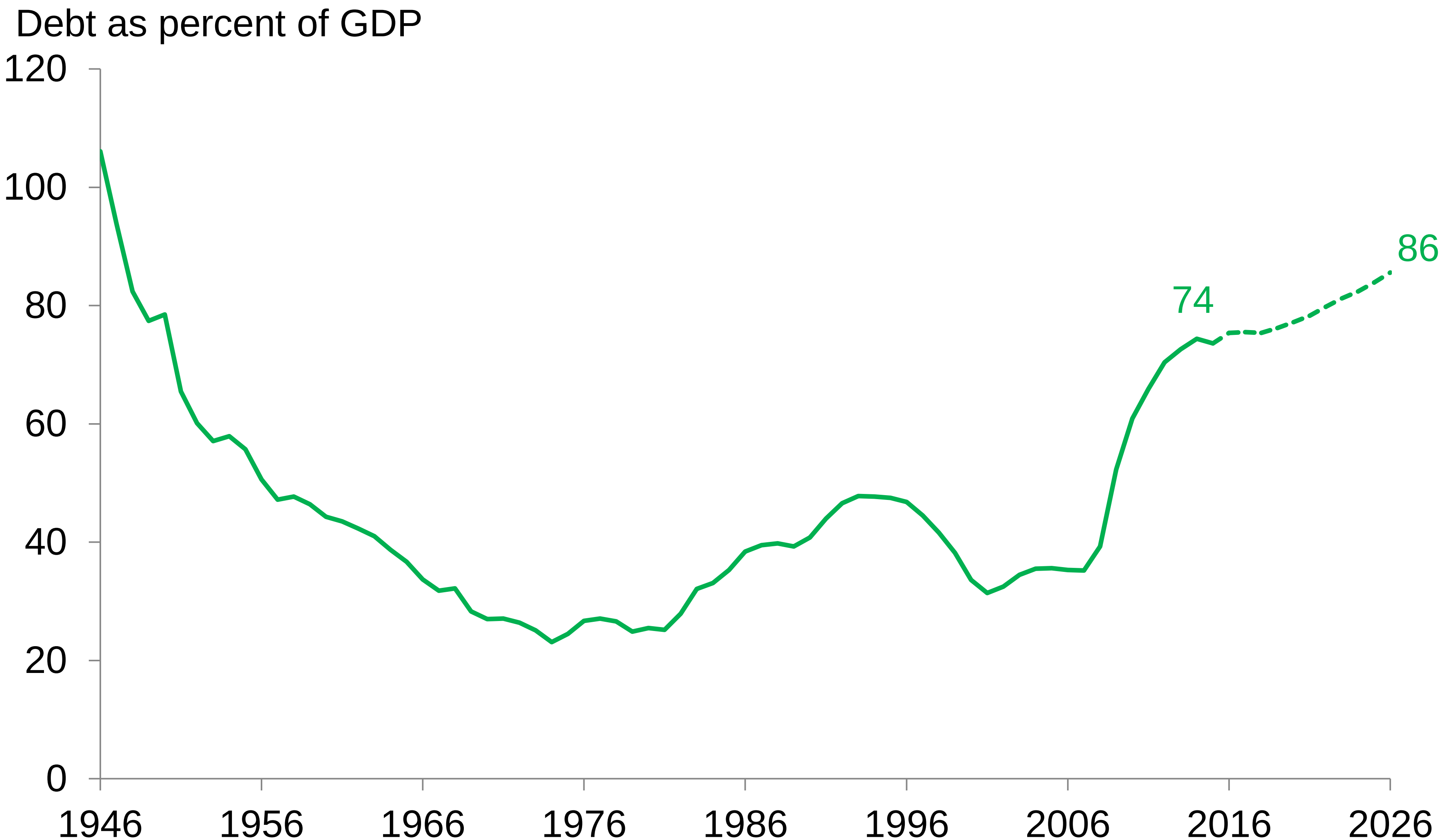


But the gap is expected to steadily widen over the next decade…



NOTE: Dashed lines are projections.

…causing debt to reach 86 percent of GDP by 2026



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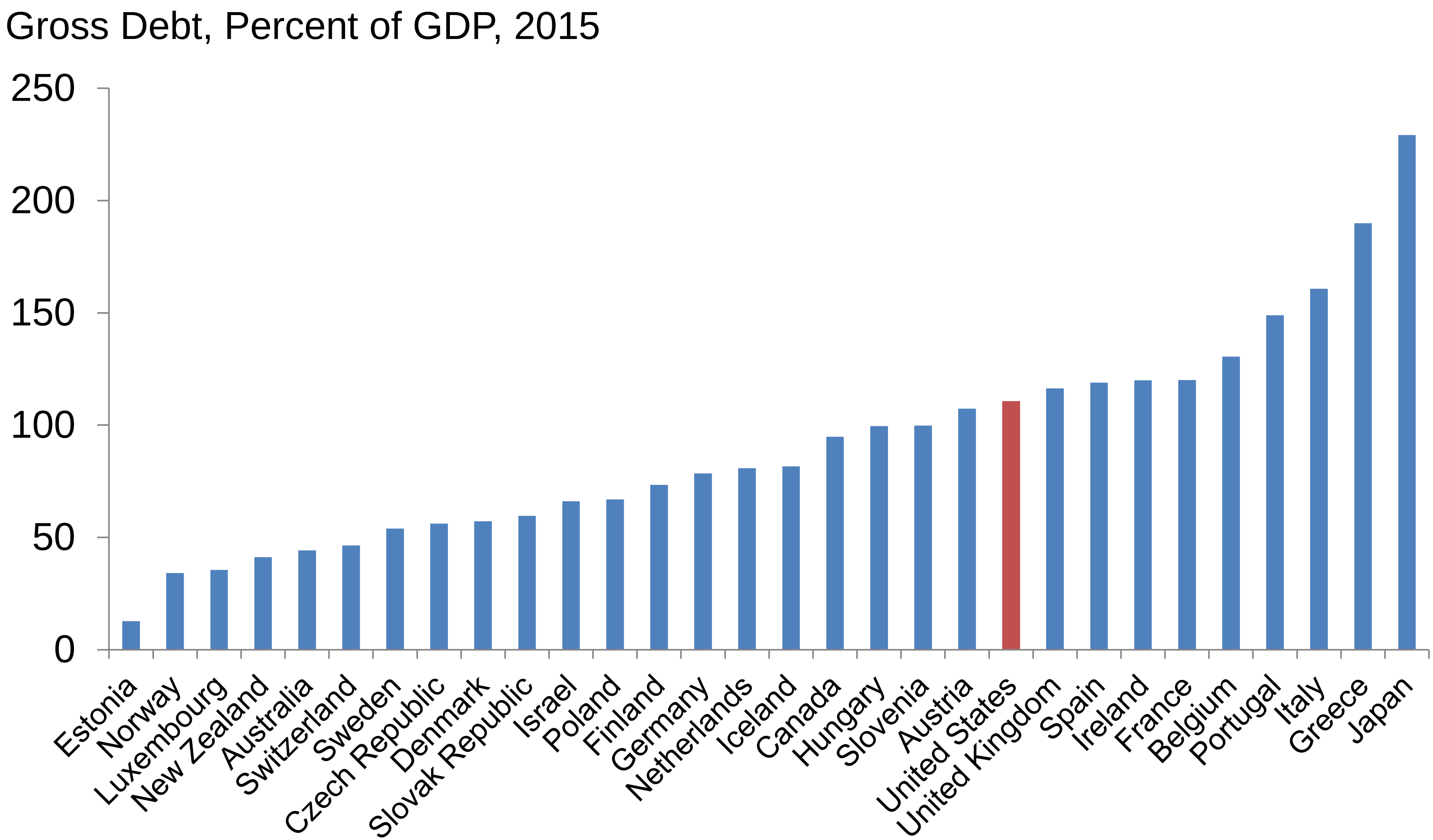
Debt is somewhat higher than most of our developed-world competitors



SOURCE: OECD – Economic Outlook No. 98, Annex Table 32, General Government Gross Financial Liabilities

Does government debt matter?

- Yes, in the long run
- Higher debt => lower saving and investment
  - Smaller capital stock, lower future standard of living
- In theory, these impacts could be neutralized if people offset higher government debt with more personal saving
  - “Ricardian equivalence” of debt and taxes
- In practice, people don’t change their saving behavior enough when gov’t debt rises
  - Japan may be an exception

How does government debt impact fiscal policy and economic growth?

- Higher interest payments “crowd out” domestic spending
- More difficult to use fiscal policy during the next crisis
- Increased borrowing “crowds out” private investment, may slow economy
- Less faith that the U.S. will fully repay its creditors
  - 2011 debt-limit debacle, recent “haircut” comments

Yet it can be appropriate to run large deficits and accumulate debt

- Appropriate to run above-average deficits when economy slows
- Appropriate to run above-average deficits in unusual circumstances, such as wartime
  - Deficits spiked in World War II and few argue that spending should not have been undertaken
- But, is it appropriate to do so simply because we wish to receive more in services than we pay in taxes?

A LONGER TERM PERSPECTIVE

Looking to the long run

- The U.S. fiscal imbalance – the structural gap between taxes and spending – gradually worsens over the next decade
- Does it continue to worsen thereafter?
- Yes, primarily because of entitlements like Social Security and Medicare

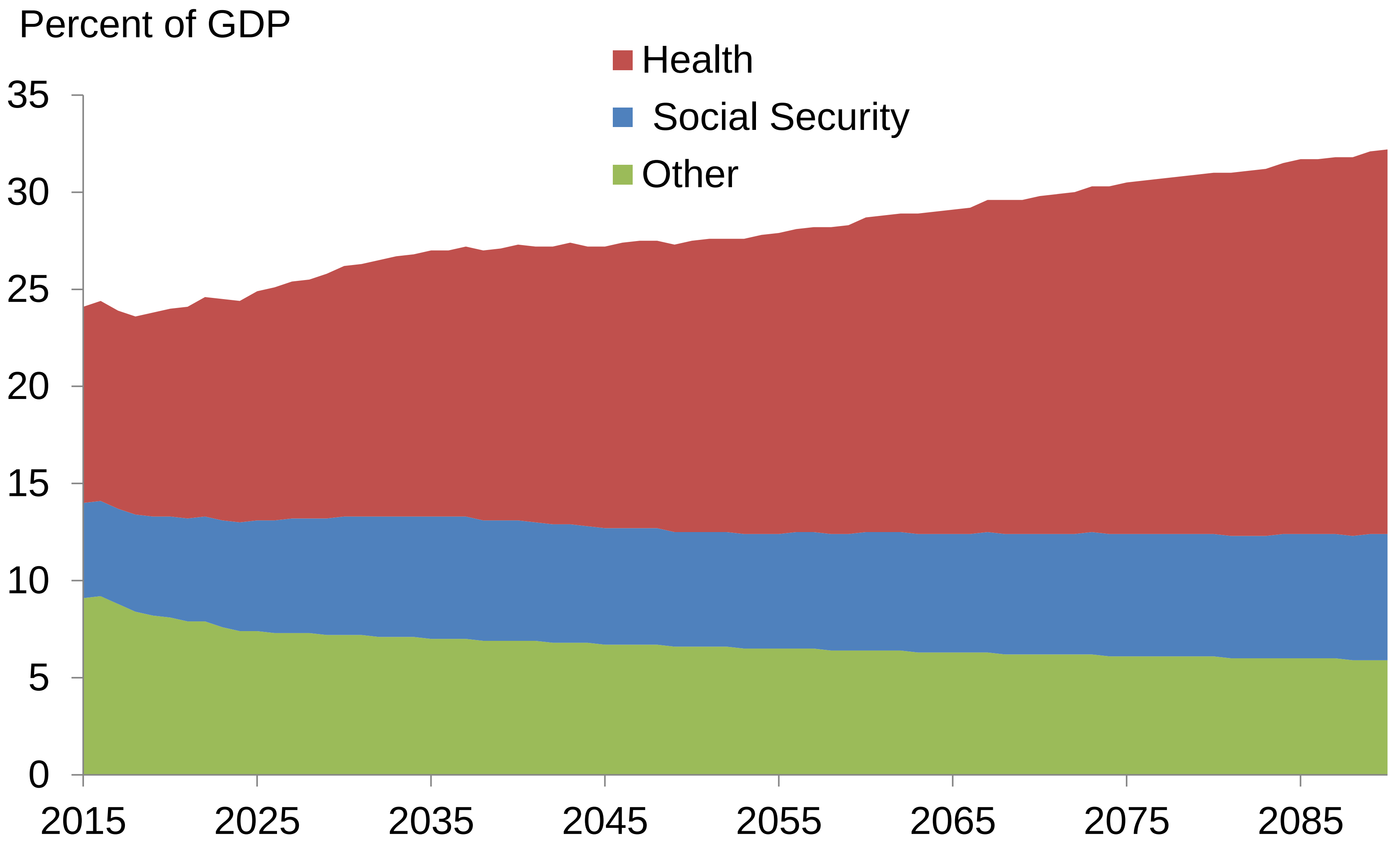
Entitlements like Social Security and Medicare drive long run

- Key deficit driver that has proven difficult to address
- As originally conceived, each generation would pre-fund its own retirement
- Quick realization – people near retirement wouldn’t receive much in benefits
- Solution: retirees would be funded by current workers instead of themselves

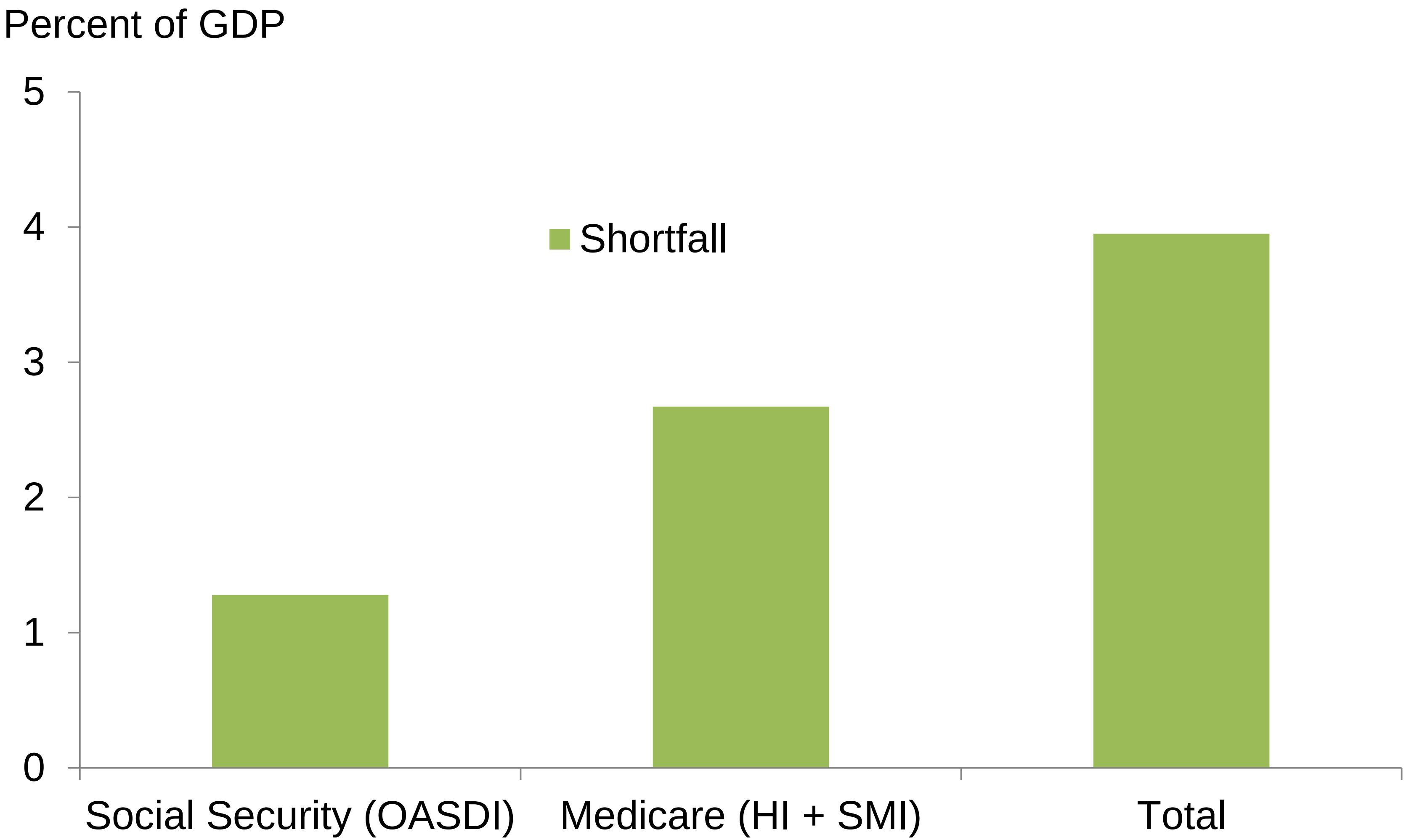
“Pay as you go” model overtaken by events

- “Pay as you go” works, other things equal
- Yet other things didn’t stay equal
  - Longer life expectancy
  - Lower birth rates
  - More expensive medical technology
- These phenomena improve quality of life – but at a cost

Entitlements, especially Medicare, drive noninterest spending inexorably higher



Higher entitlement spending creates a 75-year unfunded liability of 4 percent of GDP ($41.4T) in present value terms



Putting the liability in perspective

- The unfunded liability for Social Security and Medicare is:
  - 3x current government debt
  - 10x current government spending
  - More than half as large as the country's capital stock
- How could this liability be repaid, assuming we wished to do so?

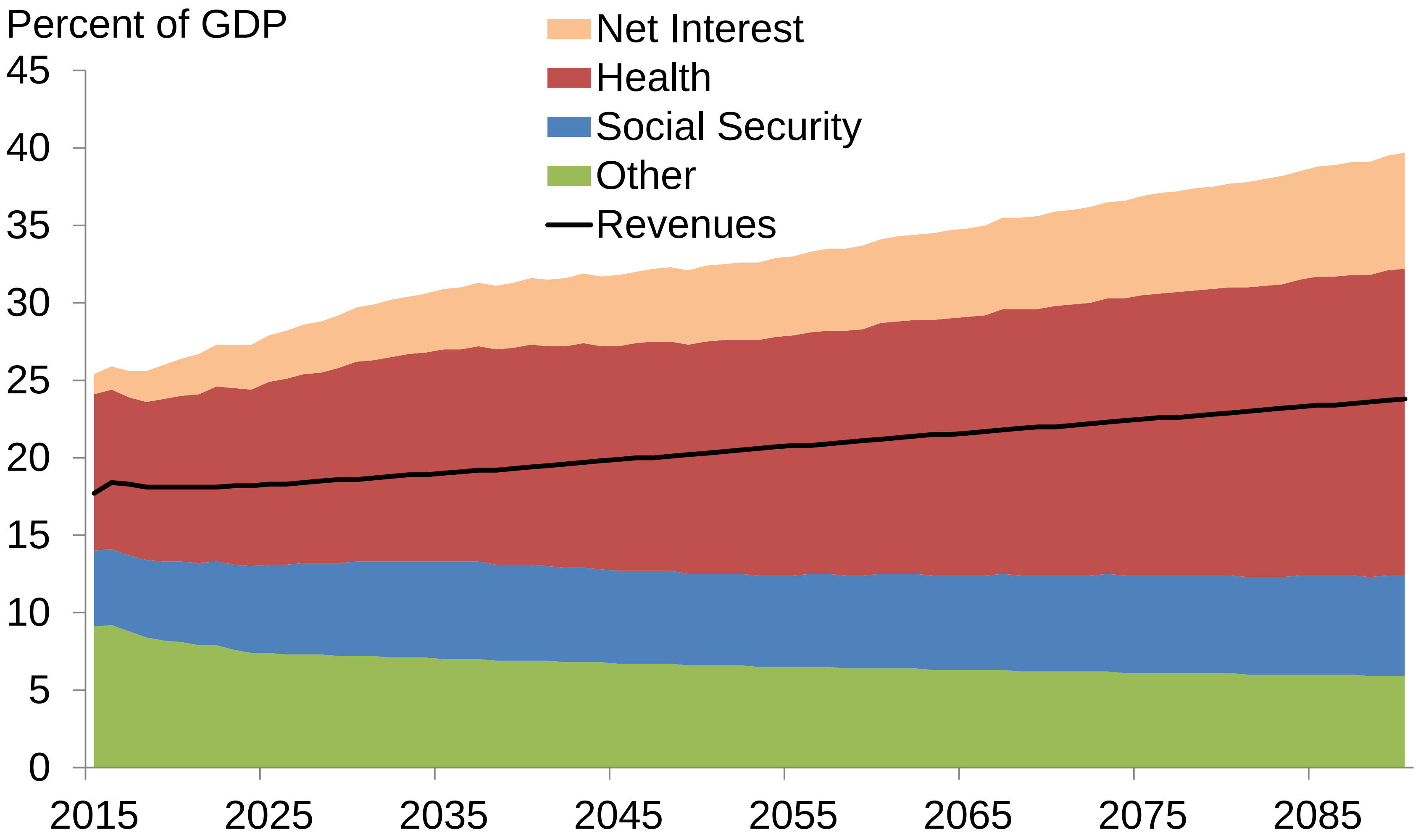
Dealing with the liability

- Could raise taxes or reduce services
  - 40 percent income tax hike, 60 percent discretionary spending cut
- Could scale back promised benefits
  - Raise retirement age, limit cost of living increases
- Could do nothing, for now

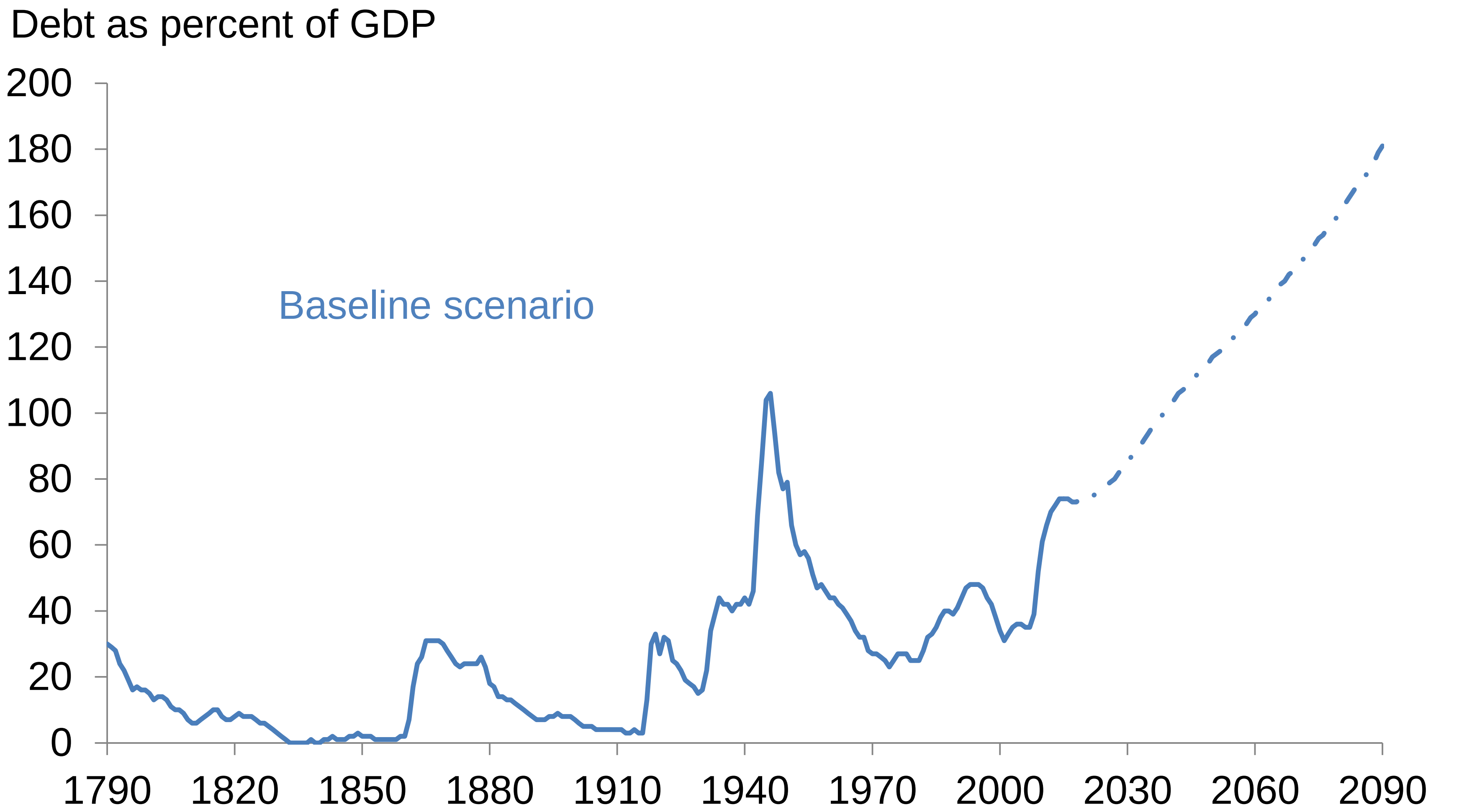
Drastic times call for drastic measures?

- If these responses seem severe, it’s because they are
- But, choosing to leave the entitlement issue unaddressed doesn’t cause it to go away
  - Pay now, or someone else pays later
- And there is still the issue of interest

Interest quintuples to 7.5 percent of GDP, second only to Medicare



Federal debt hits record 106 percent of GDP in 2043, reaches 181 percent by 2090



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Must this future come to pass?

- These projections assume current law continues over the next 75 years
- Can avoid this future if common ground can be found, and action taken
- But, can't avoid the reality that fiscal sacrifice will be required to do so