FEDERAL RESERVE BANK *of* ST. LOUIS

FBBS 2017 Investment Seminar

The Long-Term Budget Outlook for the U.S.

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CENTRAL TO AMERICA'S ECONOMY®

The U.S. Long-Term Budget Outlook

- What are the budget facts?
- What are the underlying driving forces of spending growth? Which can be changed?
- What realistic policy choices do we have?
- Why don't bond markets seem to care about our long-term budget problems?

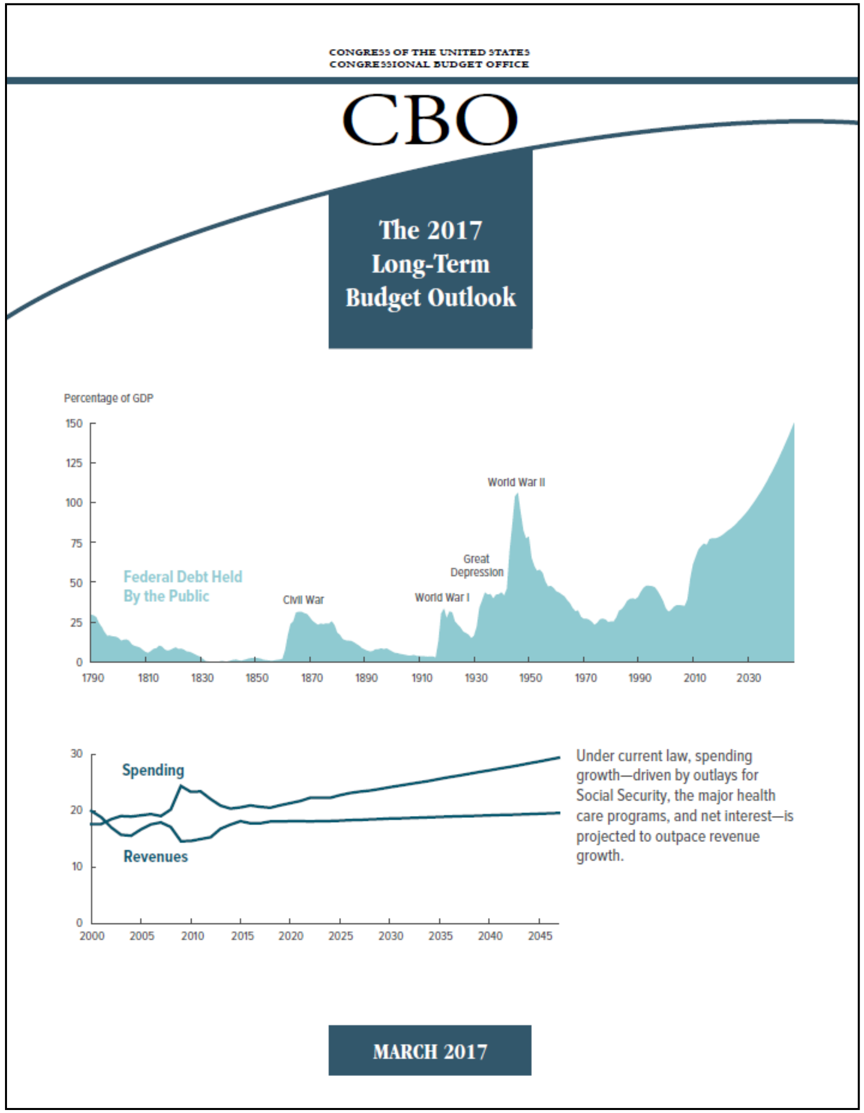
How to Characterize the Long-Term Budget Outlook?

Avoidable.

…according to a true "deficit hawk"

A Dismal, Dangerous, Avoidable Situation

www.cbo.gov/publication/52480



What Are the Budget Facts?

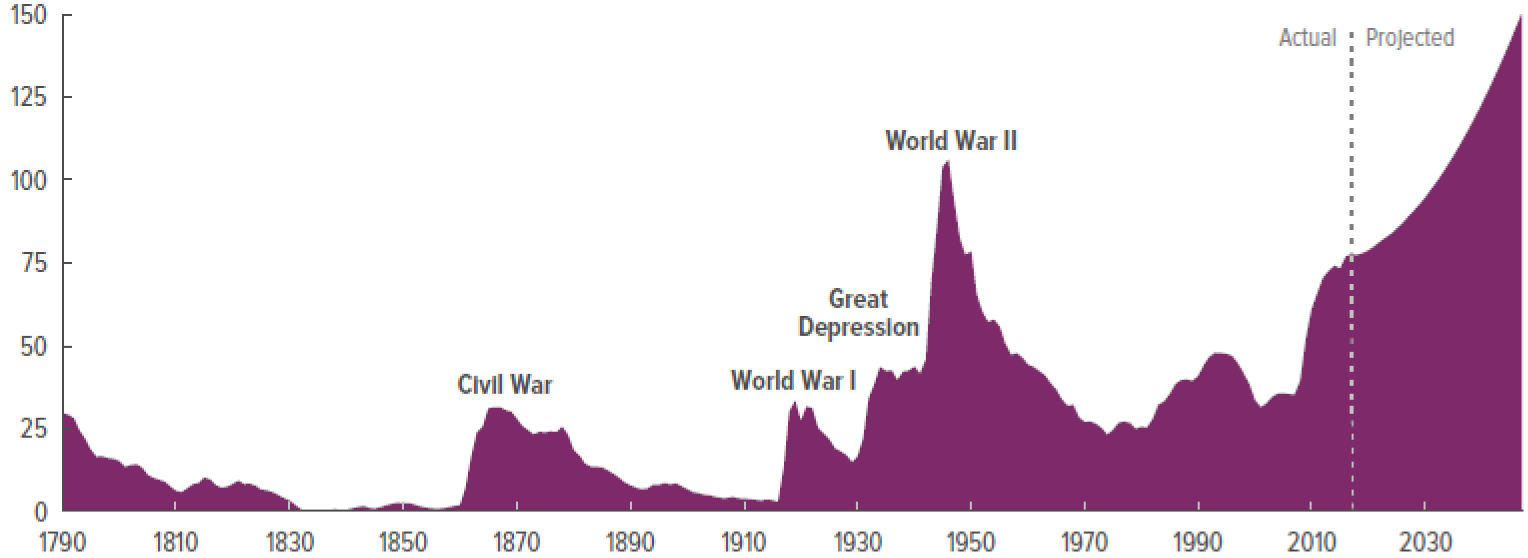
- Federal debt today is at its highest level since the end of World War II, measured as a share of GDP.
- The Congressional Budget Office (CBO) expects the U.S. fiscal situation to get much, much worse—the debt ratio will double within 30 years (already having doubled in the last 10), far exceeding any previous peak.
- The current long-term budget outlook arguably is the worst in U.S. history.
- Growing debt burden will stoke inflation, reduce economic growth and undermine national security.
- Measures to avoid these bad outcomes are well-known but politically unpopular.

Worst Fiscal Outlook in U.S. History

Figure 2.

Federal Debt Held by the Public

Percentage of Gross Domestic Product



Source: Congressional Budget Office. For details about the sources of data used for past debt held by the public, see Congressional Budget Office, *Historical Data on Federal Debt Held by the Public* (July 2010), www.cbo.gov/publication/21728.

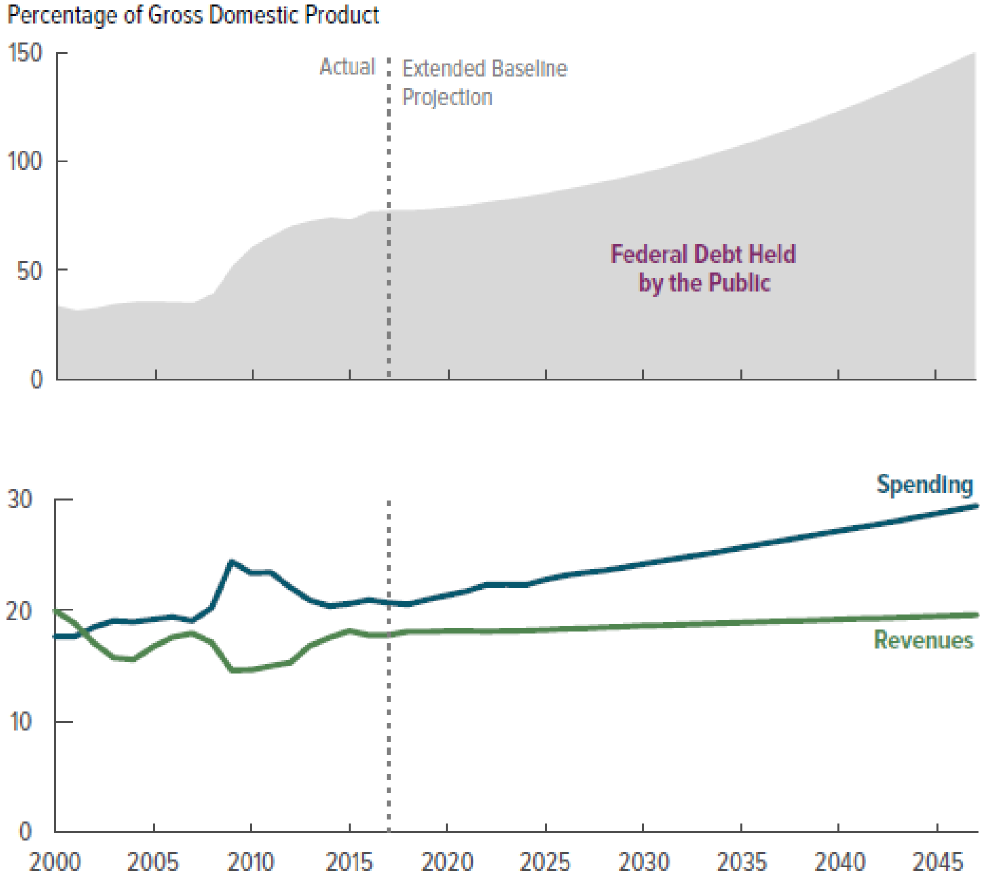
Causes of the Dismal Long-Term Fiscal Outlook

- We're at a bad starting point—we knew we should prepare for the challenges ahead, but we didn't.
- We've had both bad luck—falling birth rate; weak productivity growth—and good luck—end of the Cold War; strong foreign demand for Treasurys.
- Our mess is of our own making—bad policies.
- Starting from a deep hole today, future outlays will grow much faster than revenues, precisely as forecast many years ago if policies didn't change.
- Growing budget deficits will require growing Treasury debt issuance.
- Eventually, we'll be eaten alive by interest payments on the debt… fiscal/financial crises likely.

Spending Will Outgrow Revenues

Figure 1.

Federal Debt, Spending, and Revenues



In CBO's extended baseline, **federal debt held by the public** rises . . .

. . . because growth in **total spending** outpaces growth in **total revenues**, resulting in larger budget deficits.

Source: Congressional Budget Office.

The extended baseline generally reflects current law, following CBO's 10-year baseline budget projections through 2027 and then extending most of the concepts underlying those baseline projections for the rest of the long-term projection period.

GDP = gross domestic product.

Which Programs Are Driving Outlays Higher?

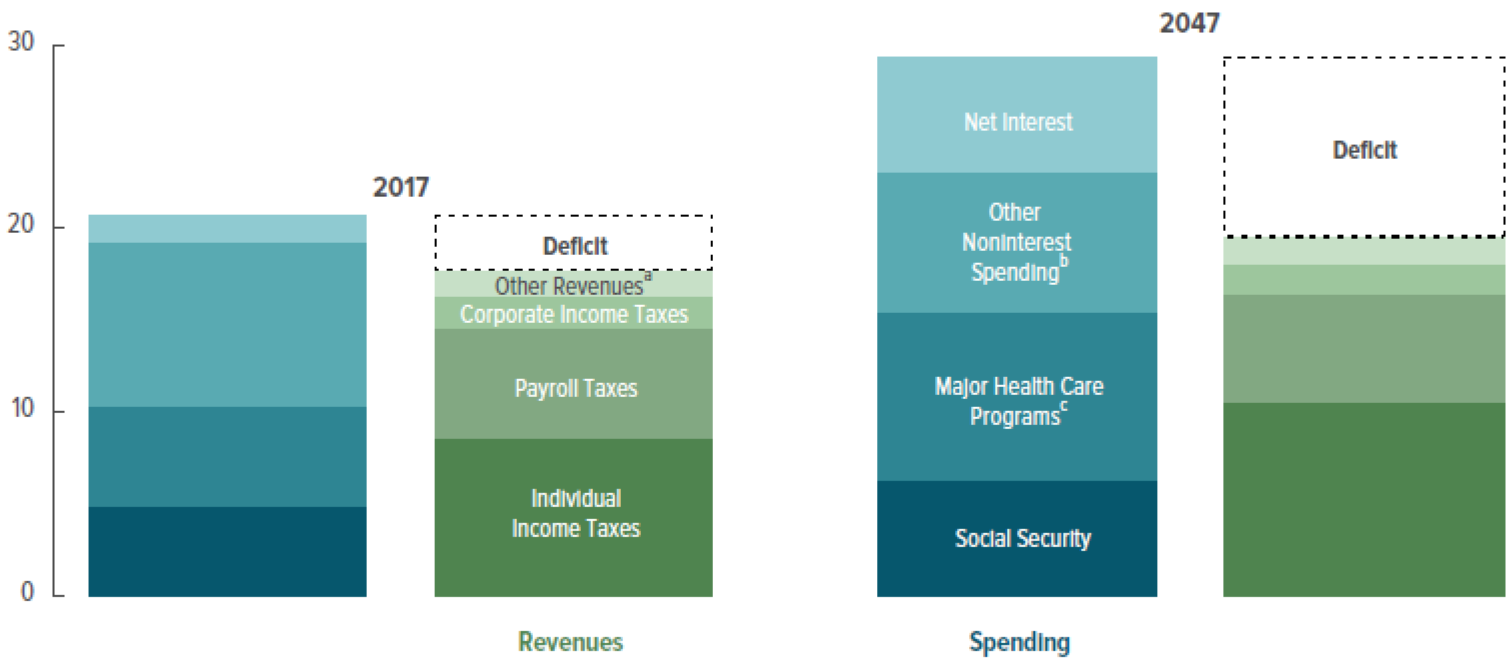
- Social Security
  - Largest single program: 61 mn. people, $940 bn.
  - Old Age and Survivors Insurance
  - Disability Insurance
- Health care
  - Medicare: 58 mn. people, $600 bn. outlay (net of Medicare premiums paid by enrollees)
  - Income-based insurance subsidies: $460 bn.
    - Medicaid (78 mn. people)
    - CHIP (Children's Health-Insurance Program; 6 mn.)
    - Exchange subsidies (13 mn.)
- Interest on government debt: $270 bn.

Spending Grows; Revenues Stagnate

Summary Figure 1.

The Federal Budget Under the Extended Baseline

Percentage of Gross Domestic Product



Source: Congressional Budget Office.

The extended baseline generally reflects current law, following CBO's 10-year baseline budget projections through 2027 and then extending most of the concepts underlying those baseline projections for the rest of the long-term projection period.

a. Consists of excise taxes, remittances to the Treasury from the Federal Reserve System, customs duties, estate and gift taxes, and miscellaneous fees and fines.

b. Consists of all federal spending other than that for Social Security, the major health care programs, and net interest.

c. Consists of spending for Medicare (net of premiums and other offsetting receipts), Medicaid, and the Children's Health Insurance Program, as well as outlays to subsidize health insurance purchased through the marketplaces established under the Affordable Care Act and related spending.

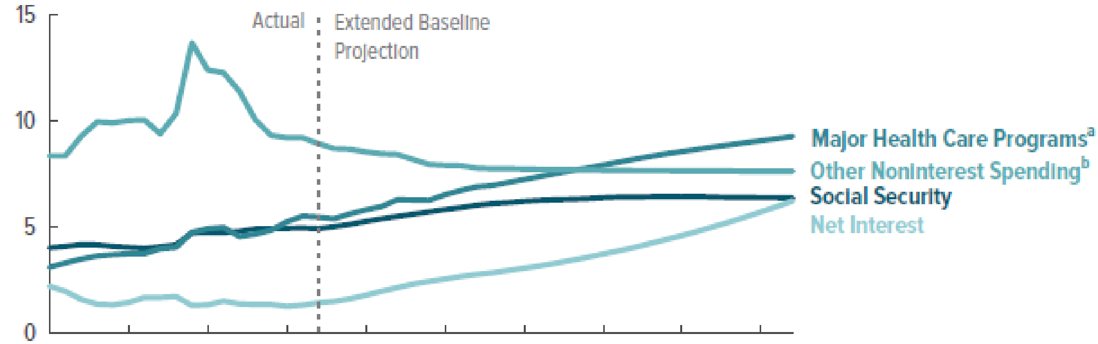
Health Care and Interest Rise Fastest

Figure 1. Continued

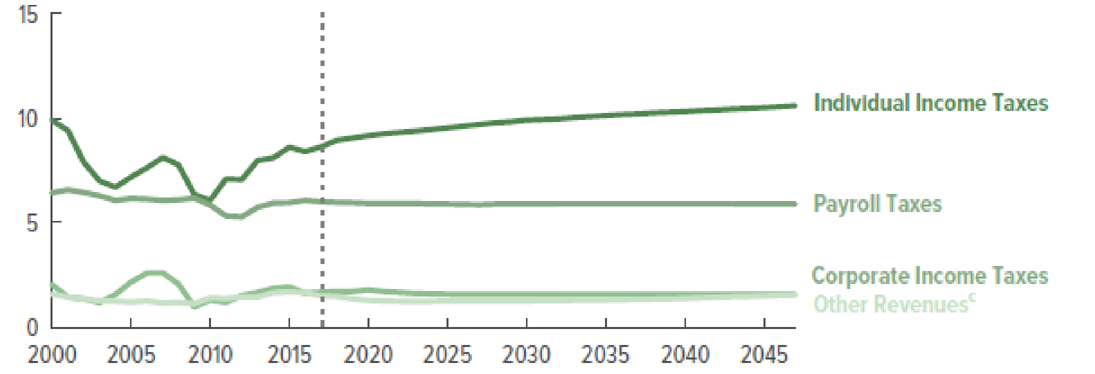
Federal Debt, Spending, and Revenues

Percentage of Gross Domestic Product

Certain **components of spending**—Social Security, the major health care programs, and net interest—are projected to rise in relation to GDP; other spending, in total, is projected to decline.



A projected boost in one **type of revenues**—individual income taxes—accounts for the rise in total revenues in relation to GDP. Receipts from all other sources, taken together, are projected to decline slightly.



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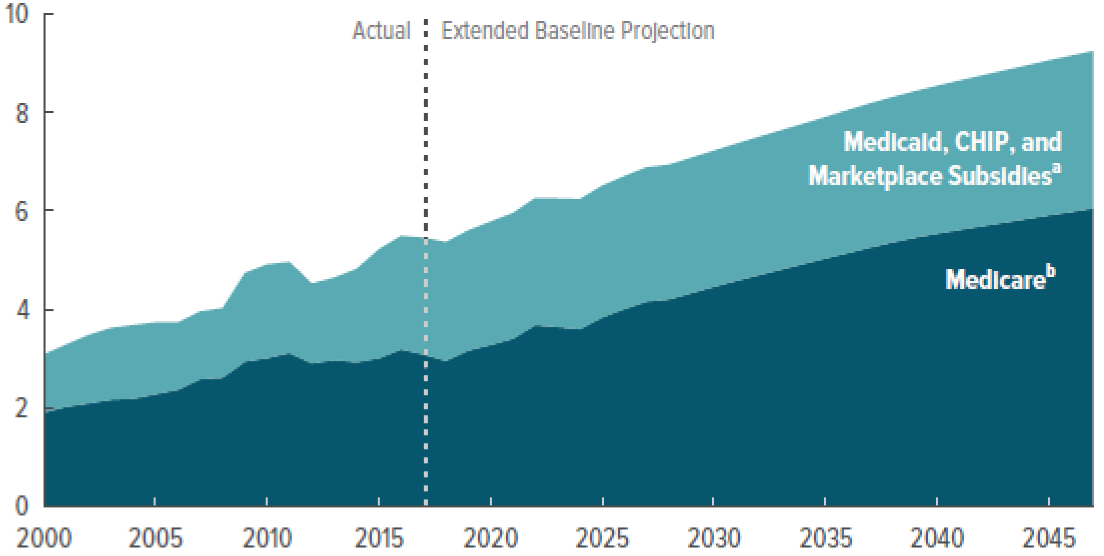
Medicare Dominates Health-Care Spending

Figure 7.

Federal Spending on the Major Health Care Programs, by Category

Percentage of Gross Domestic Product



The projected rise in federal spending for the major health care programs results from the aging of the population and the expectation that health care costs per person will continue to grow more quickly than potential GDP per person.

Source: Congressional Budget Office.

The extended baseline generally reflects current law, following CBO's 10-year baseline budget projections through 2027 and then extending most of the concepts underlying those baseline projections for the rest of the long-term projection period.

CHIP = Children's Health Insurance Program; GDP = gross domestic product.

a. "Marketplace Subsidies" refers to spending to subsidize health insurance purchased through the marketplaces established under the Affordable Care Act and insurance provided through the Basic Health Program and spending to stabilize premiums for health insurance purchased by individuals and small employers.

b. Refers to net spending for Medicare, which accounts for offsetting receipts that are credited to the program. Those offsetting receipts are mostly premium payments made by beneficiaries to the government.

What Are the Underlying Forces Driving Outlays? Which Can be Changed?

- Population aging
  - Baby-boom generation moving into retirement.
  - Lower birth rate.
  - Lengthening lifespans.
  - Less immigration.
- Can population aging be changed enough to “bend the cost curve?”
  - No.

What Are the Underlying Forces Driving Outlays? Which Can be Changed?

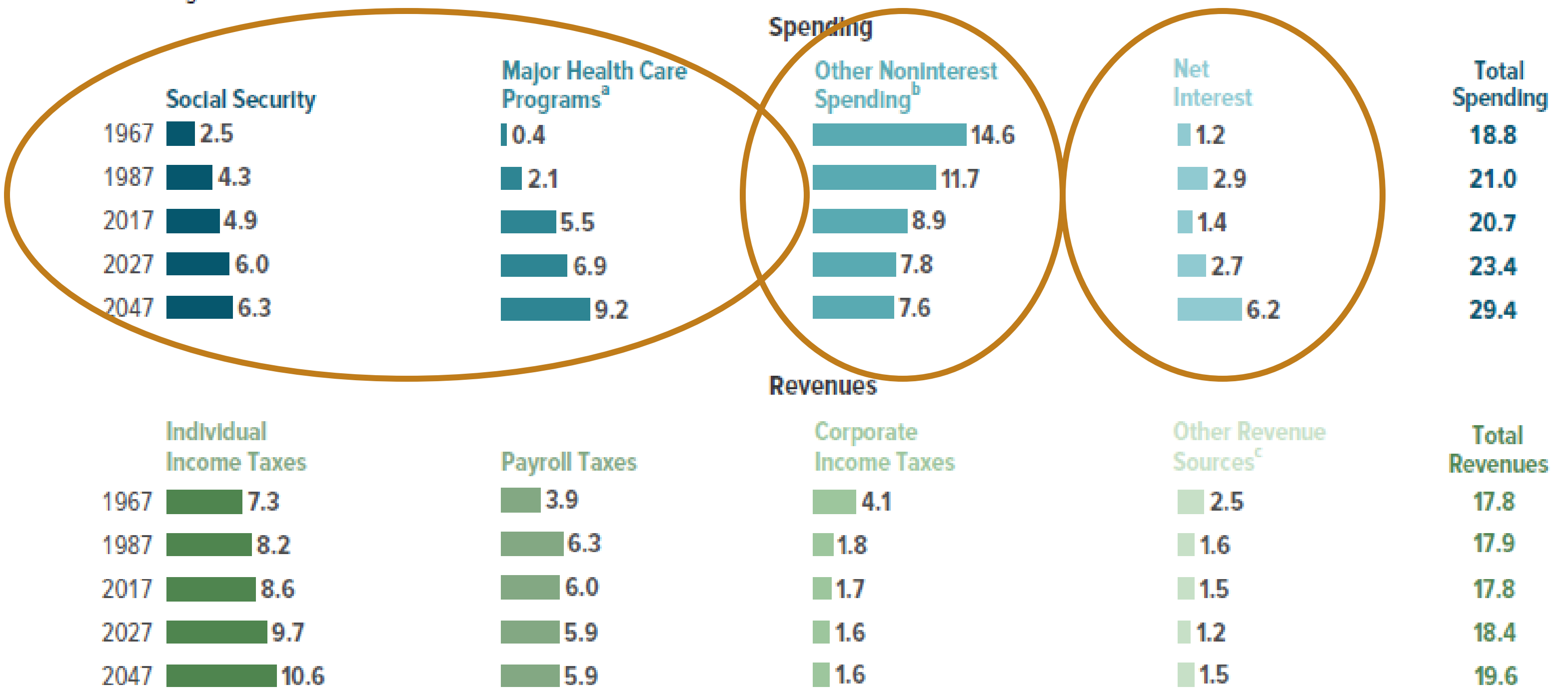
- Excess health-care cost growth
  - Per-person cost of medical care exceeds inflation.
    - A good thing: Innovation.
    - Bad: Inadequate competition among providers, suppliers.
    - Bad: Inadequate risk-sharing (malpractice suits).
    - Bad: Health-care consumers are poorly informed and often do not face the cost consequences of their choices, leading to more treatment and expense.
- Can excess health-care cost growth be changed enough to “bend the cost curve?”
  - Probably not.
    - Aging population wants and needs more medical care.
    - Too many vested interests to solve structural problems.

Keys: Old Age, Defense and Interest

Figure 5.

Spending and Revenues in the Past and Under CBO's Extended Baseline

Percentage of Gross Domestic Product



Source: Congressional Budget Office.

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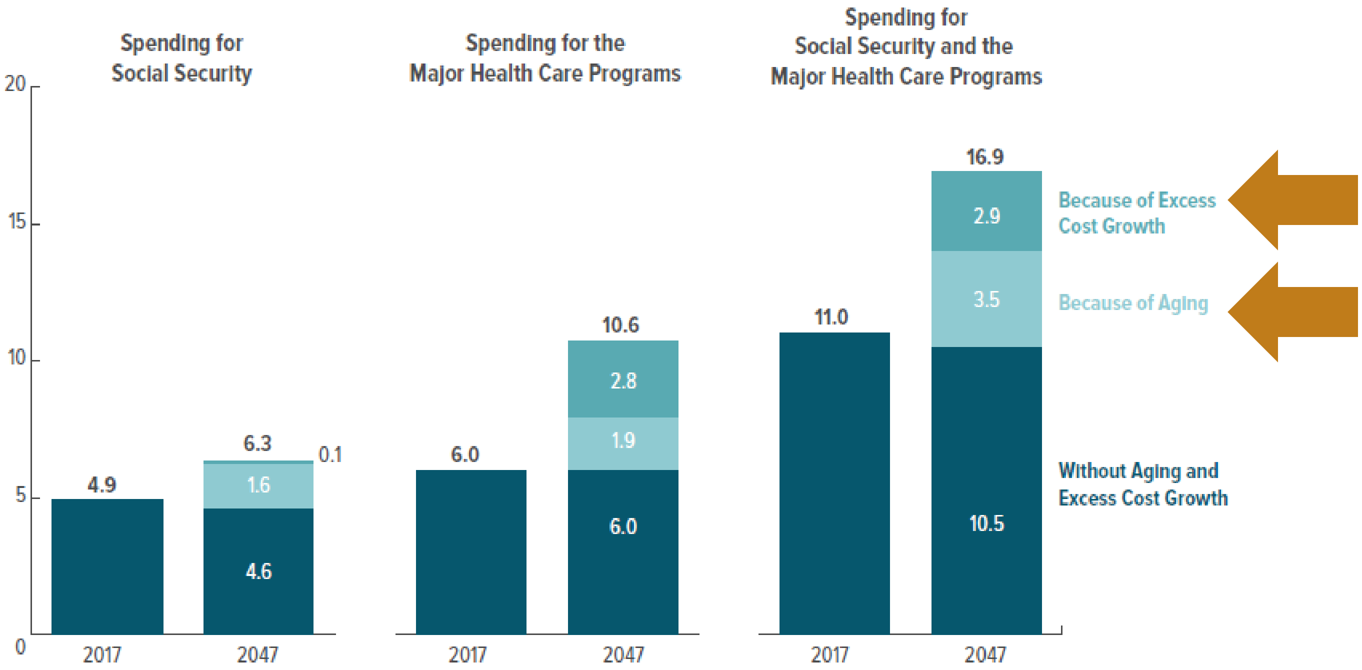
Cost Drivers: Aging and Excess Health Costs

Figure 8.

Causes of Projected Spending Growth in Social Security and the Major Health Care Programs in CBO's Extended Baseline

Percentage of Gross Domestic Product



Source: Congressional Budget Office.

The extended baseline generally reflects current law, following CBO's 10-year baseline budget projections through 2027 and then extending most of the concepts underlying those baseline projections for the rest of the long-term projection period.

Outlays for the major health care programs consist of gross spending for Medicare (which does not account for offsetting receipts that are credited to the program), Medicaid, and the Children's Health Insurance Program, as well as outlays to subsidize health insurance purchased through the marketplaces established under the Affordable Care Act and related spending.

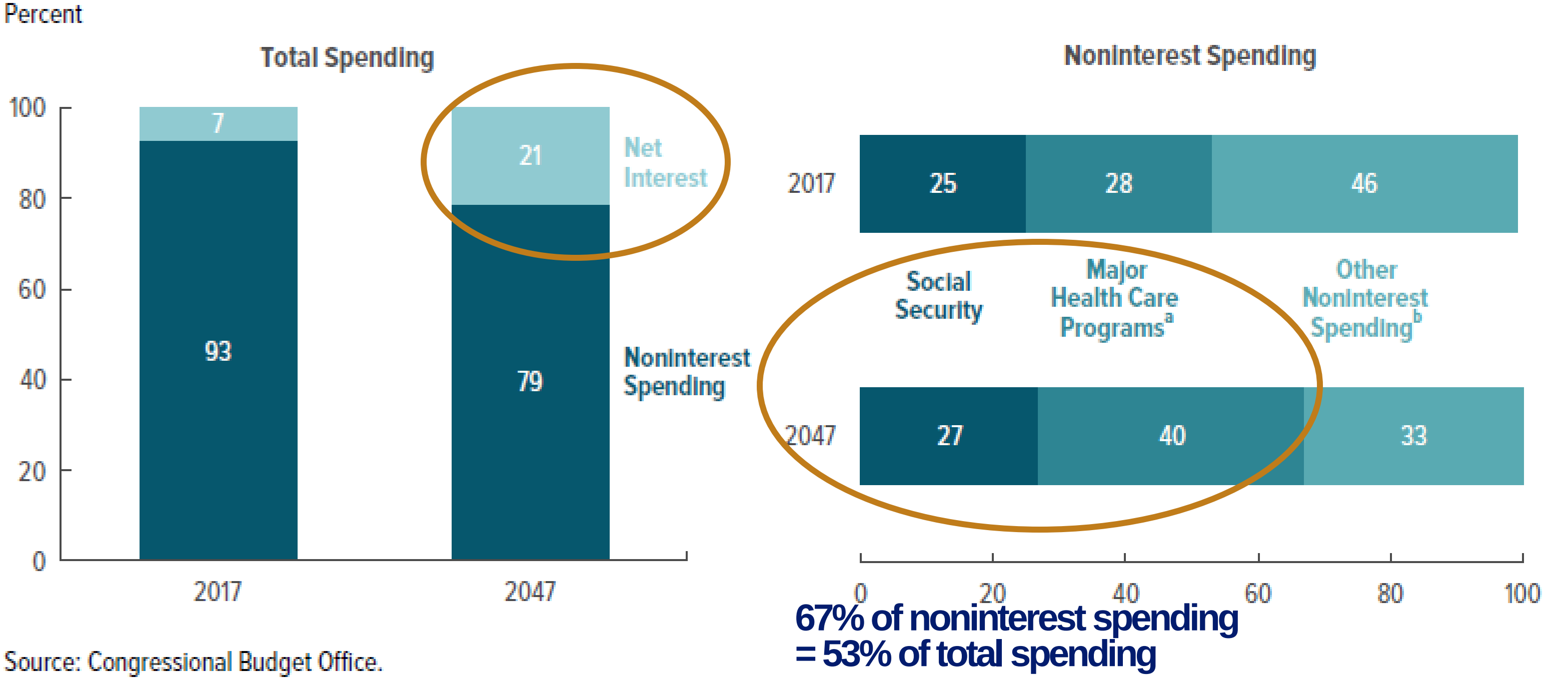
Excess cost growth refers to the extent to which the growth rate of nominal health care spending per capita—adjusted for demographic characteristics of the relevant populations—exceeds the growth rate of potential gross domestic product per capita. (Potential gross domestic product is the maximum sustainable output of the economy.)

This figure highlights the most important effects of aging and excess cost growth. Other effects, such as the effect of aging on the number of Social Security Disability Insurance beneficiaries, are smaller.

Health & SS: 53%; Interest: 21%; Other: 26%

Figure 6.

Composition of Federal Spending Under CBO's Extended Baseline



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b. Consists of all federal spending other than that for Social Security, the major health care programs, and net interest.

What Realistic Policy Choices Do We Have?

1) Major spending cuts that hurt the old and the poor.
   - Biggest targets for spending cuts:
     - Social Security
     - Medicare
     - Medicaid, CHIP, exchange subsidies
   - Nothing else is big or expendable enough to make much difference.
     - All discretionary spending, including defense, will be less than healthcare spending alone within 15 years.
     - Cuts in non-defense discretionary spending also hurt the middle class and poor the most.
       - Education, transportation, housing assistance, veterans' health care, health-related research and public programs, administration of justice, international affairs….

Cut Medicare?? Strong Public Support for Government Role in Health Insurance

"Do you think the government should be responsible for ensuring medical coverage?"

- Yes: 61%
  - National health insurance: 30%
  - Private-public combination: 31%
- No: 39%
  - But keep Medicare and Medicaid: 34%
  - No role for government: 5%

95%

Apparently do not understand that Medicare and Medicaid are government programs.

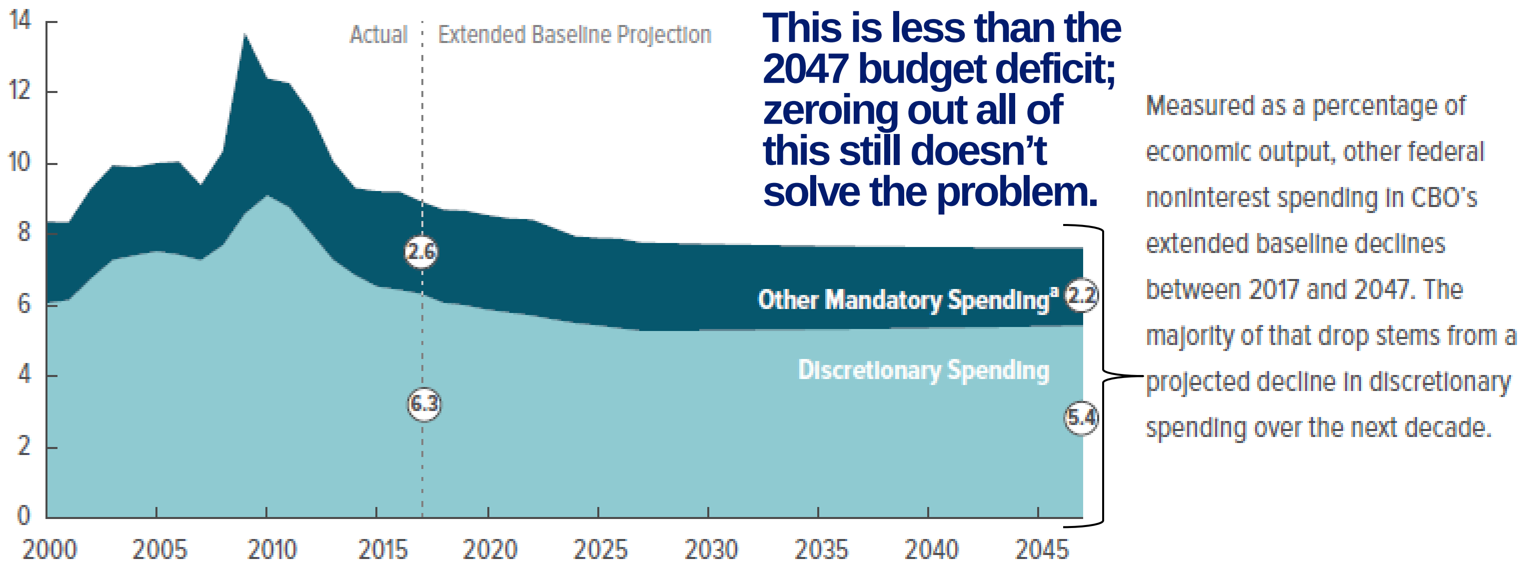
Source: Pew Research Center, Jan. 4-9, 2017; 1,502 adults nationwide. Excludes respondents who were unsure or had no opinion.

Other Targets for Cuts Are Small and Shrinking

Figure 9.

Other Federal Noninterest Spending Under CBO's Extended Baseline

Percentage of Gross Domestic Product



Source: Congressional Budget Office.

The extended baseline generally reflects current law, following CBO's 10-year baseline budget projections through 2027 and then extending most of the concepts underlying those baseline projections for the rest of the long-term projection period.

a. "Other Mandatory Spending" is all mandatory spending other than that for Social Security and the major health care programs. It includes the refundable portions of the earned income and child tax credits and of the American Opportunity Tax Credit.

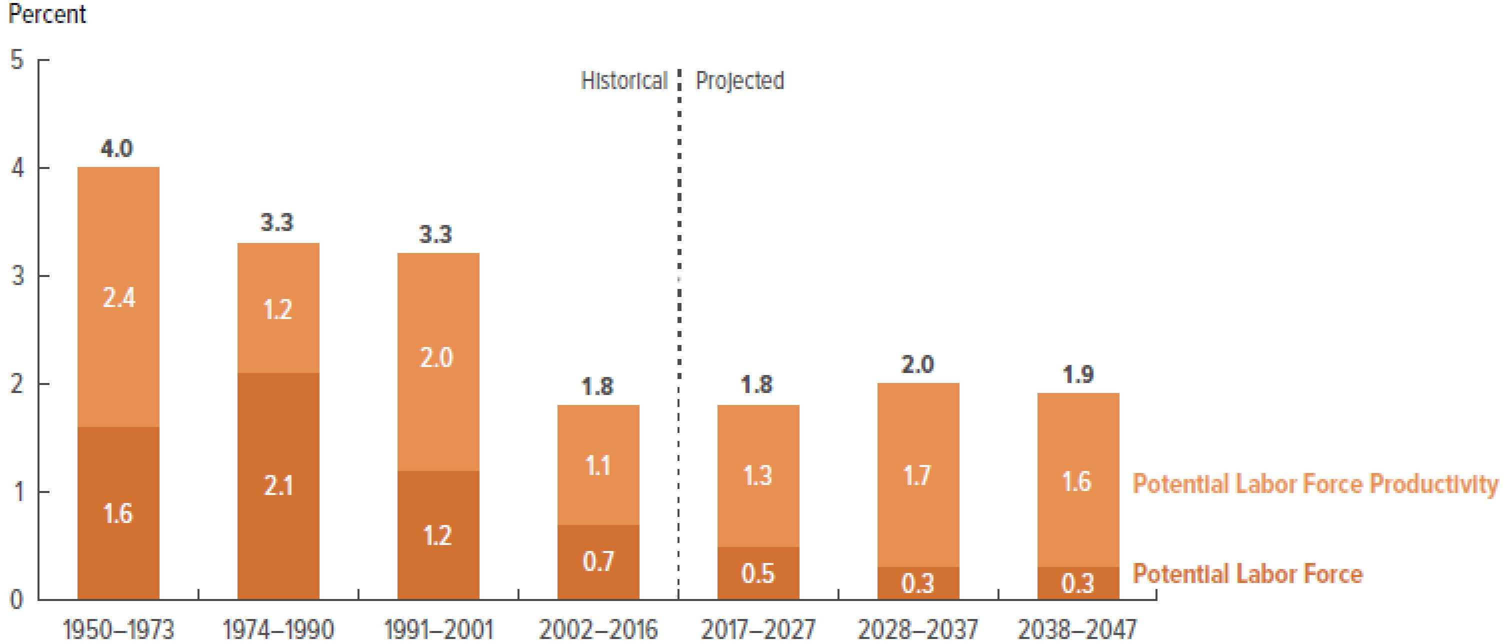
What Realistic Policy Choices Do We Have?

2) Major revenue increases that hurt high-income and rich people.
   - Our progressive income tax raises most of its revenue from high-income people.
   - How much does the current income-tax structure (personal and business) harm economic efficiency?
     - Some controversy exists among economists.
     - My judgment of majority opinion among tax experts: Current tax structure is “mildly” harmful but far from the “wrong side” of the Laffer Curve.
     - Significant additional income-tax revenue could be raised with “modest” additional harm to economic efficiency.
     - The trade-off: Tax distortions vs. exploding debt.

Could Tax Reform Spur Growth and Revenues?

Figure 4.

CBO's Estimates of Average Annual Growth of Real Potential GDP



Source: Congressional Budget Office.

Real potential GDP is the maximum sustainable output of the economy adjusted to remove the effects of inflation. The two contributing factors are potential labor force productivity (the ratio of potential GDP to the potential labor force) and the potential labor force (the labor force adjusted for movements in the business cycle).

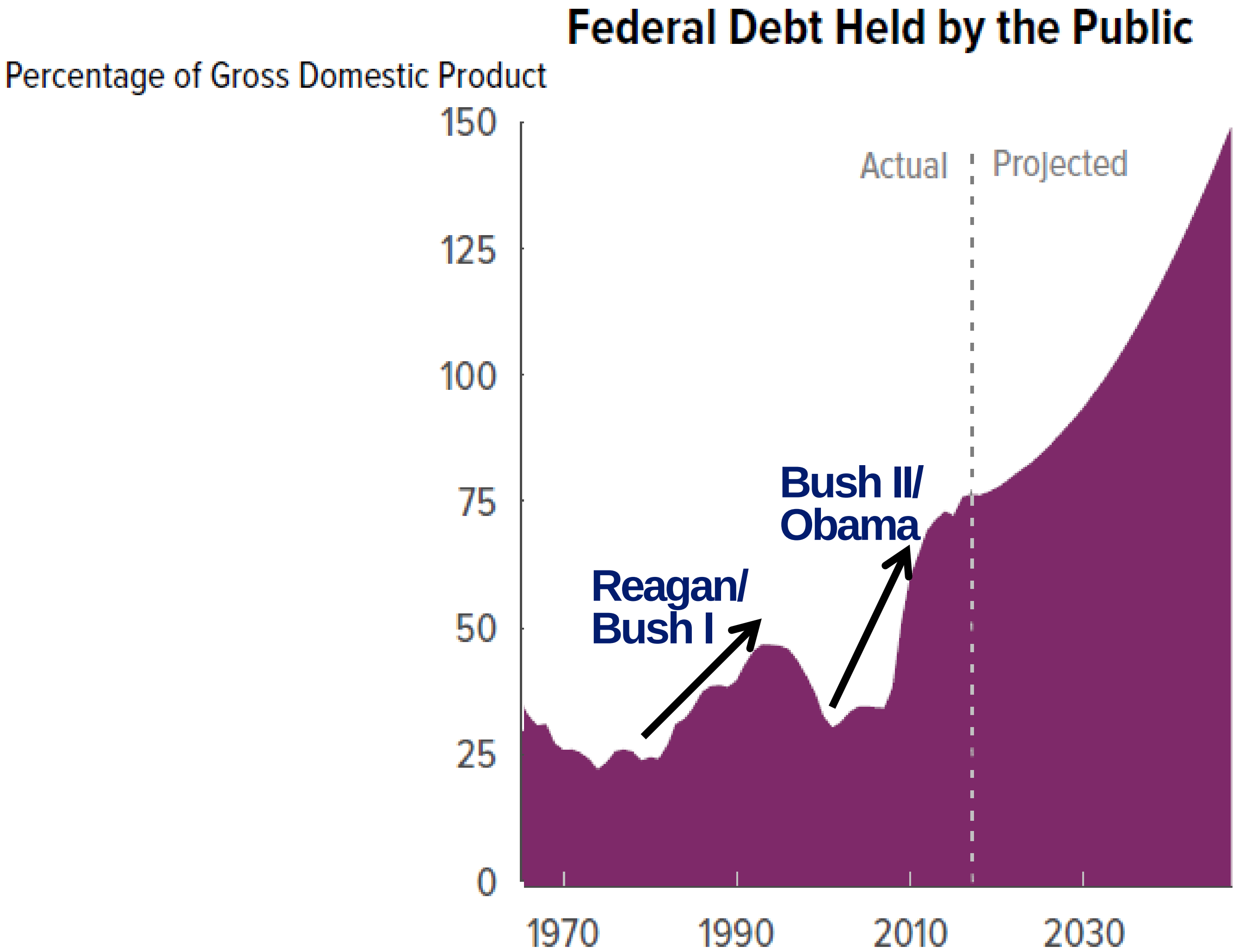
GDP = gross domestic product.

What Realistic Policy Choices Do We Have?

3) Major revenue increases resulting from a more efficient tax structure (e.g., lower marginal rates).

- What about a more-efficient tax structure that leads to faster growth and greater revenues?
  - Consensus among mainstream economists: "Supply-side economics" does not work in the U.S.
  - Revenue losses from lower rates cannot be made up from faster economic growth.
- What about a consumption tax or VAT, which most economists say is less harmful to work incentives?
  - Would shift some of tax burden to lower-income people, who spend more of their incomes.
- The best ideas: A land-value tax and a carbon tax.
  - Efficient taxes but they're political non-starters.

We Tried Supply-Side Economics Twice and It Failed Both Times—That's Why We're In a Hole Now!



What Should We Do? What Will We Do?

		Biggest losers	What we "should do"	What we are likely to do
Policy choices				
	▪ Spending cuts	▪ Old ▪ Poor	X	
	▪ Revenue increases	▪ High-income/ Rich	XXX	
Accidents				
	▪ Default on bonds (incl. $↓)	▪ Everyone ▪ Young ▪ Foreigners		
	▪ Inflation surge	▪ Everyone ▪ Old		

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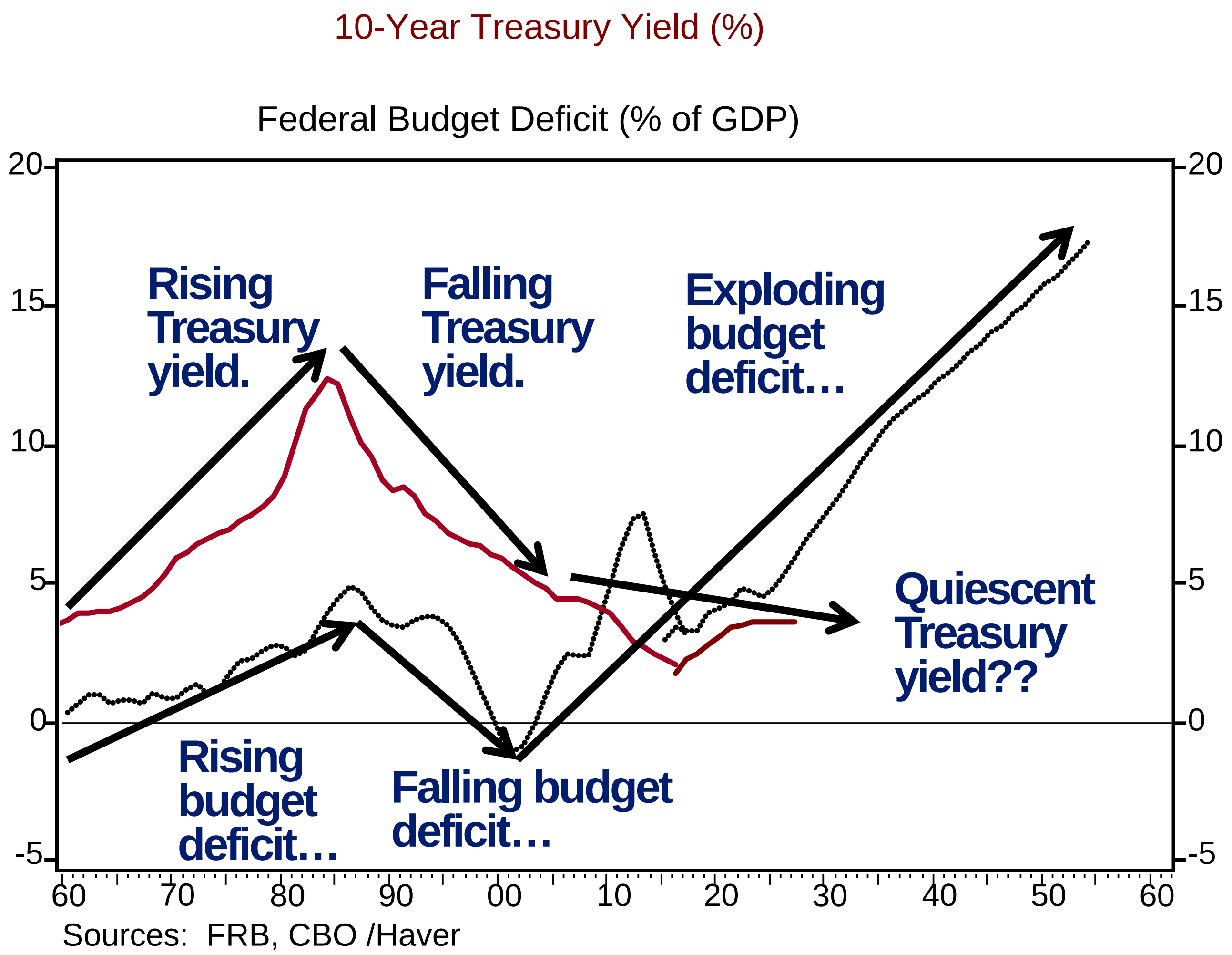
Accidents				
	▪ Default on bonds (incl. $↓)	▪ Everyone ▪ Young ▪ Foreigners		X
	▪ Inflation surge	▪ Everyone ▪ Old		X

Why Doesn’t Bond Market Fear Exploding Deficits?



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In Sum:

The U.S. Long-Term Budget Outlook is Dismal, Dangerous and Avoidable

- Today's long-term budget outlook may be the worst in U.S. history.
- Realistic and effective policy changes require sacrifices, especially through higher taxes.
- Failure to act makes accidents more likely.
- Major risk to financial institutions: Bond market may wake up to looming fiscal disaster.