

Achieving Long-Run Fiscal Sustainability

William R. Emmons,
Assistant Vice President and Economist
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What Happens When an Irresistible Force ...



... Meets an Immovable Object?



Can We Avoid a Fiscal Train Wreck?

- The irresistible fiscal force
 - Non-defense spending growth



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- The immovable fiscal object
 - Tax revenues as share of GDP



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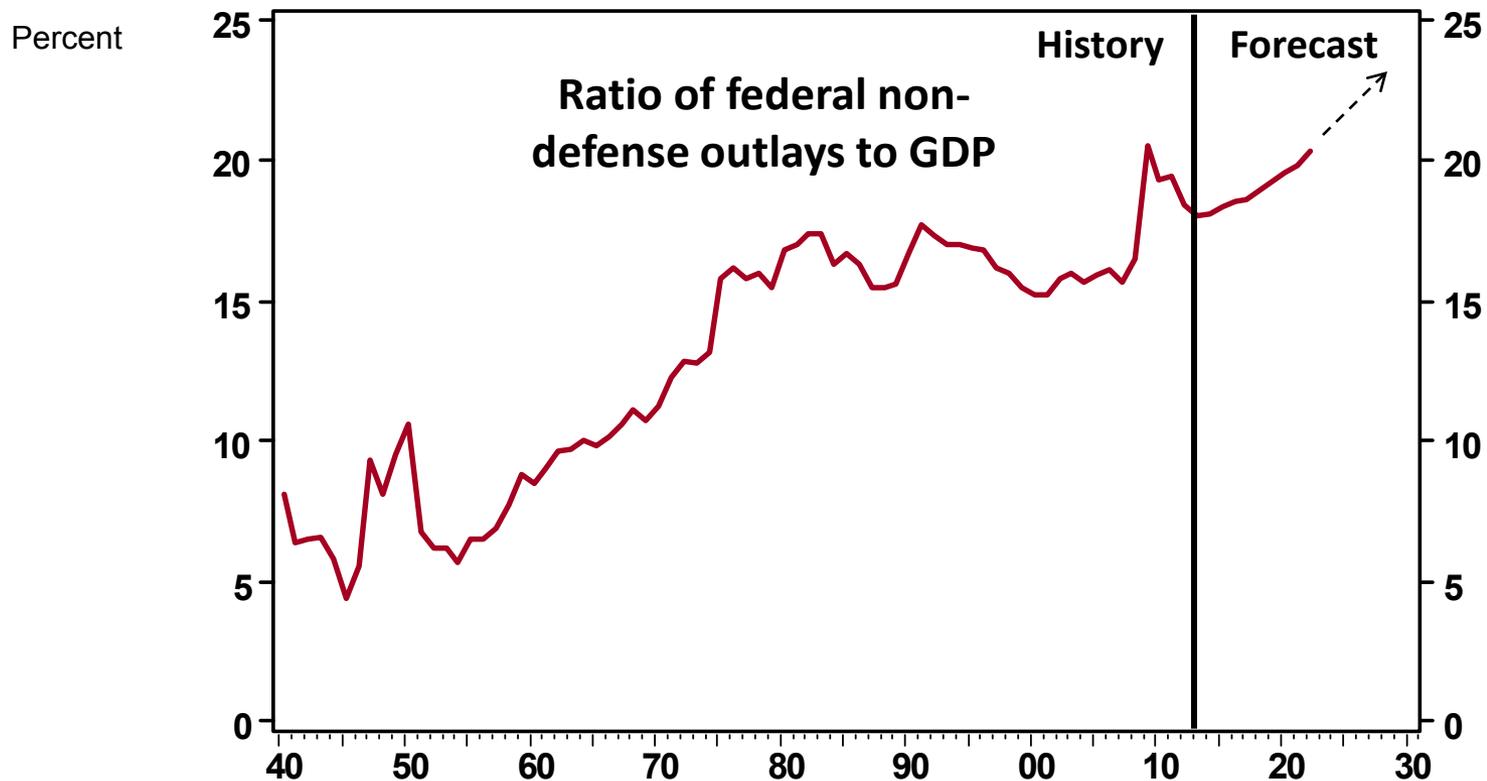
- What would a fiscal train wreck look like?
 - High inflation
 - Default on government debt
 - Drastic benefit cuts and tax increases



Overview of the Discussion

- Trends in federal spending and taxes relative to GDP
- How have we avoided a fiscal crisis so far?
- Can we achieve long-run fiscal sustainability?

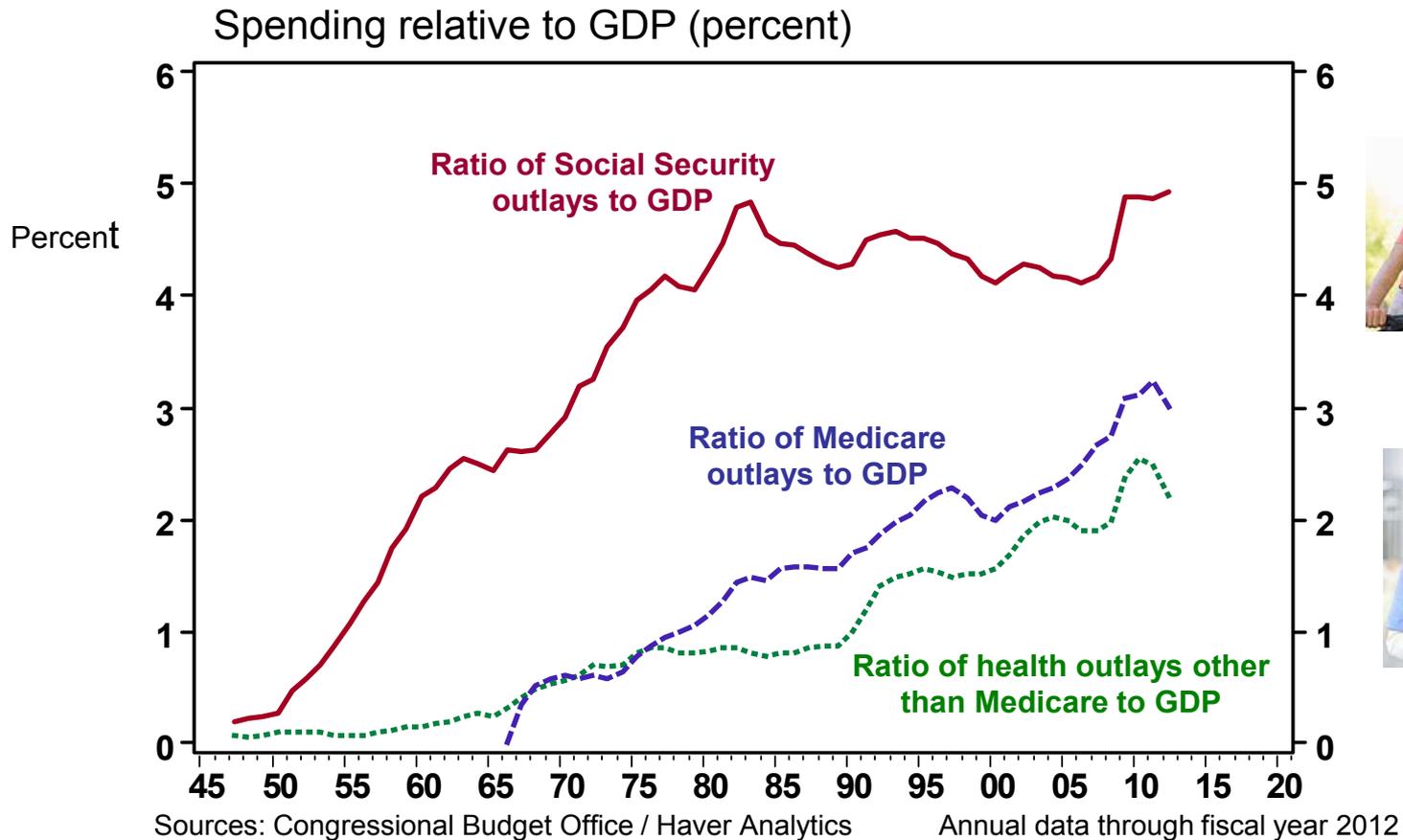
Federal Non-Defense Spending-to-GDP Ratio Has Quadrupled Since 1945



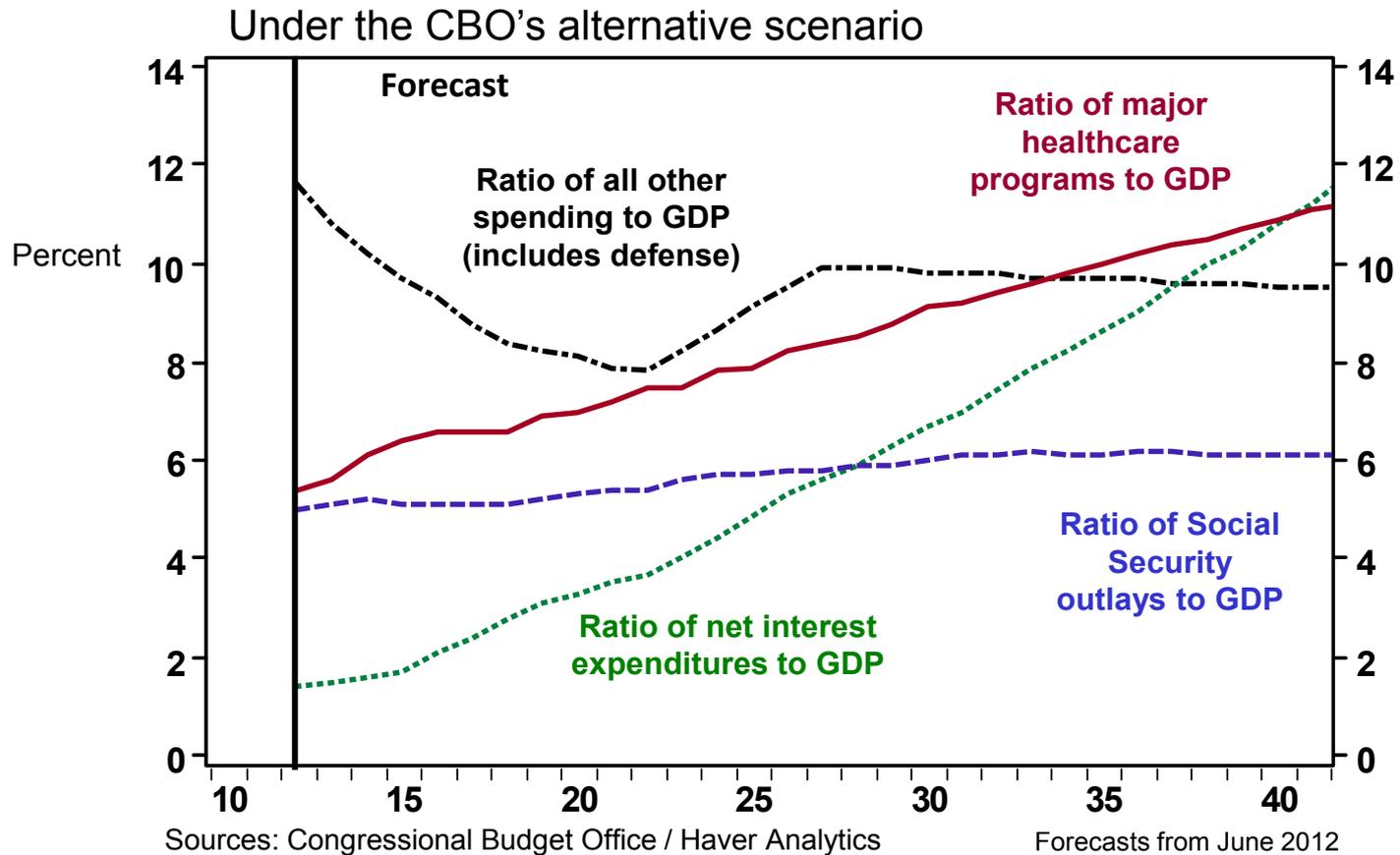
Sources: Congressional Budget Office / Haver Analytics

Annual data through fiscal year 2012;
2013-23 projections as of Feb. 2013

Health and Retirement Spending Has Increased from Zero to 10 Percent of GDP



Health, Retirement and Interest Payments Are Projected to Rise Further



Can We Slow Spending Growth?

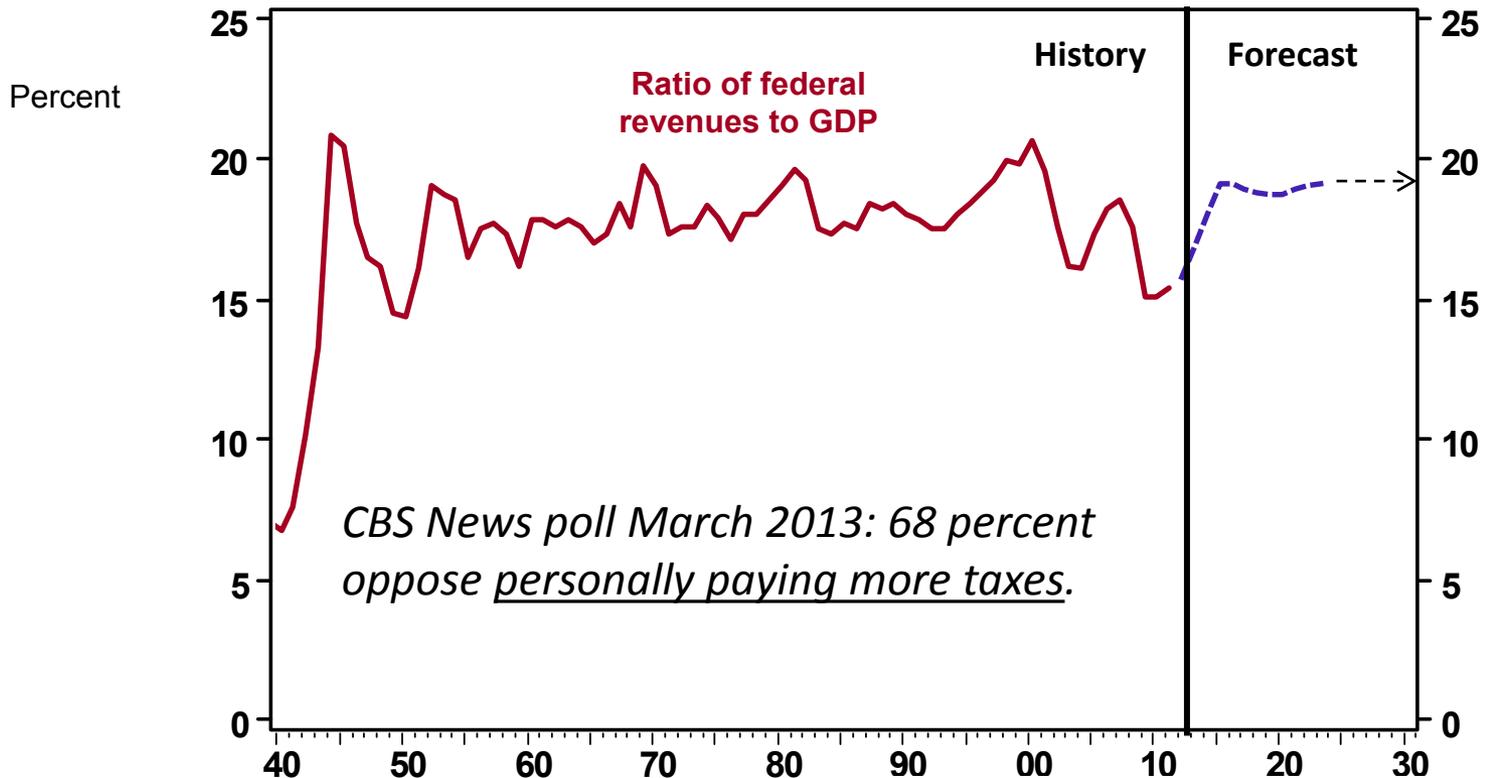
1. The major federal programs are extremely popular.
 - A March 24, 2013, CBS News poll asked respondents what cuts they would make to reduce the budget deficit. Of those giving an opinion:
 - 82 percent opposed reducing spending on Medicare.
 - 81 percent opposed reducing spending on Social Security.
 - 60 percent opposed reducing spending on defense.

Source: CBSNews.com, "Poll: 80% of Americans unhappy with Washington," March 26, 2013

Can We Slow Spending Growth?

2. Program cost drivers are very difficult or impossible to affect.
 - A substantial and permanent aging of the population is inevitable.
 - Health care costs have risen faster than GDP for many decades and are expected to continue to do so.
 - We are not winning the “war on poverty” — millions of U.S. citizens face genuine need.

Meanwhile, Federal Revenue-to-GDP Ratio Has Been Flat Since 1945

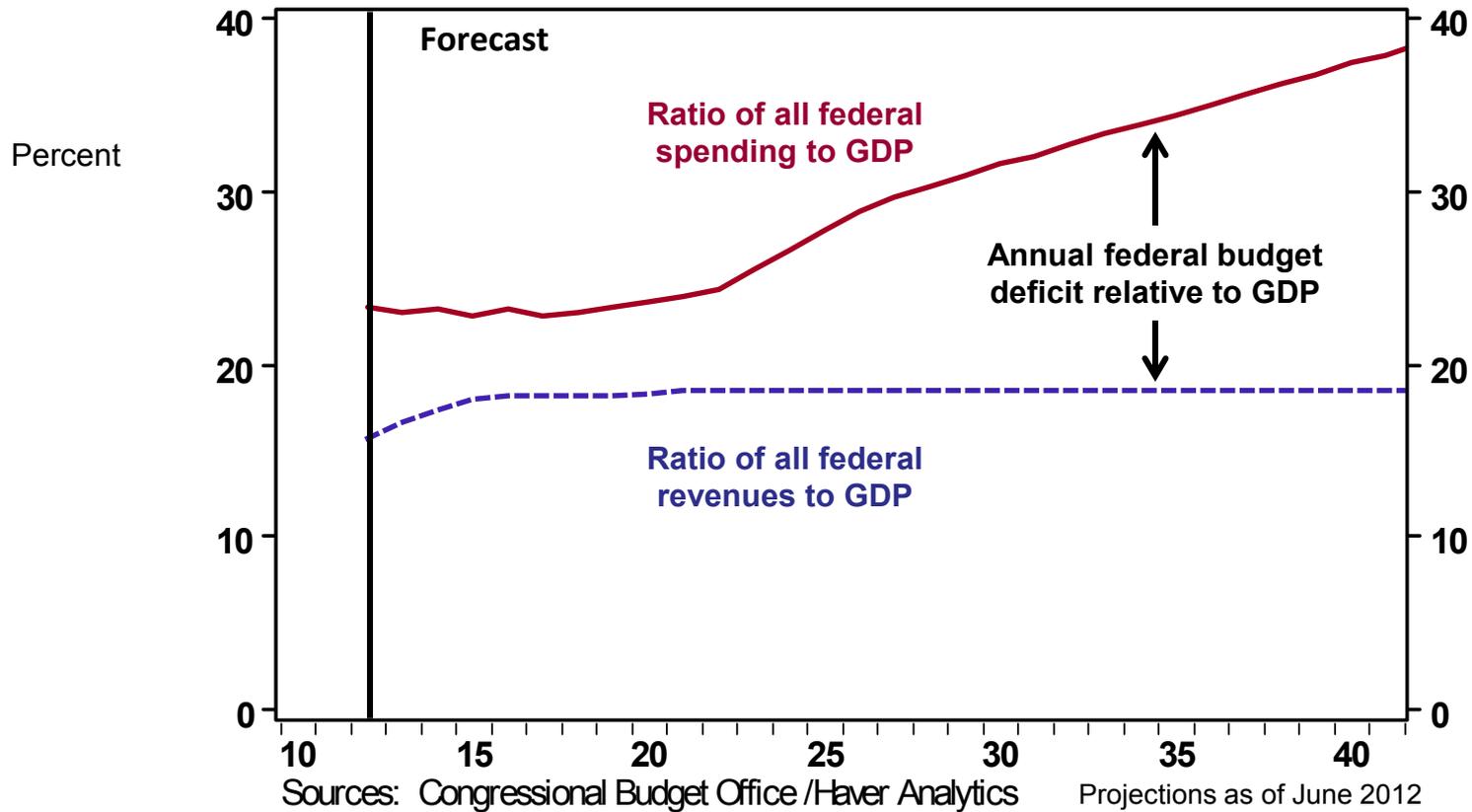


Sources: Congressional Budget Office / Haver Analytics

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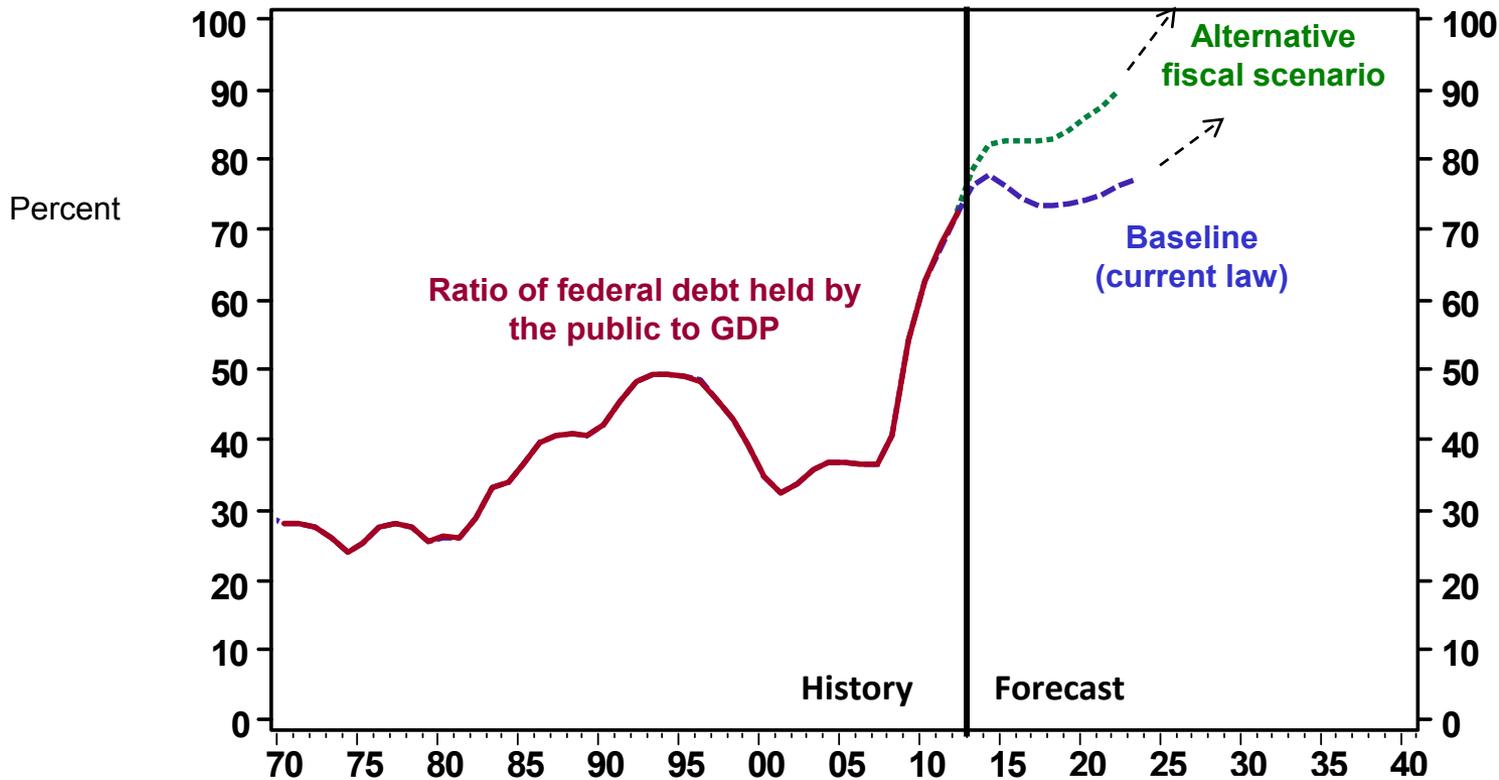
Result: Budget Deficits Will Explode ...

Under the CBO's alternative scenario



... And Federal Debt Held by the Public Will Reach Dangerous Levels

Federal debt held by the public as a percentage of GDP



Sources: Congressional Budget Office /Haver Analytics

Annual data through fiscal year 2012;
2013-23 projections as of Feb. 2013

Both are unsustainable trajectories.

Even the CBO's best (unrealistic) fiscal scenario results in long-run disaster.

So Why Haven't We Had a Fiscal Crisis Already?

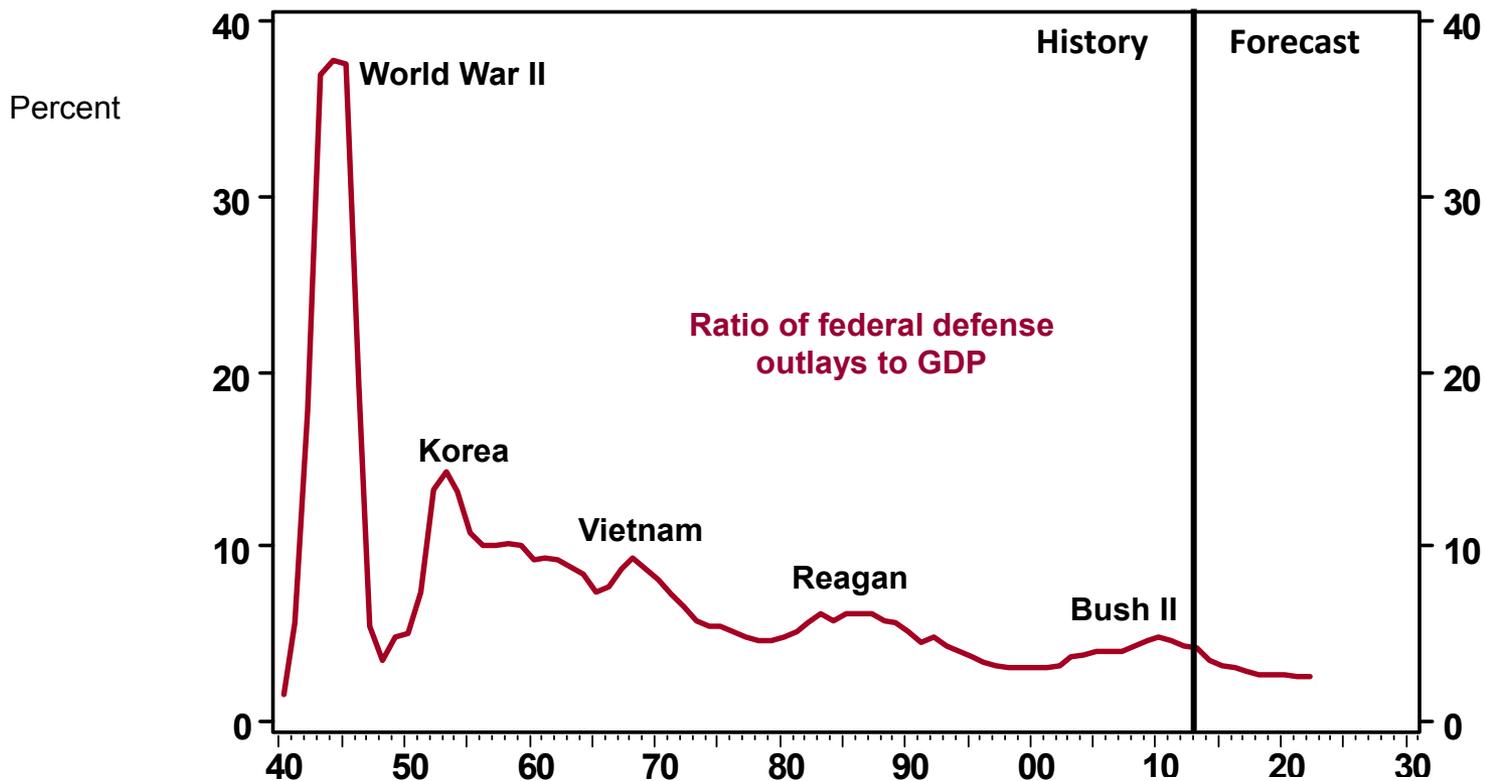
- An extended peace dividend
 - Defense spending was very high after World War II and Korea.
 - Even with Vietnam and defense buildups under Presidents Reagan and G.W. Bush, defense spending declined over decades relative to GDP.
- A demographic dividend
 - Baby Boomers (born 1946-64) swelled the labor force, boosting economic growth and tax revenues.
 - Women continued to join the paid labor force, boosting economic growth.

So Why Haven't We Had a Fiscal Crisis Already?

- Some good luck and good policy in the 1980s and 1990s
 - Economic growth and the stock market were strong, reducing deficits.
 - The Cold War ended, allowing rapid demilitarization after the Reagan defense buildup.
 - Policy changes (tax increases, spending restraint, balanced-budget amendment) were less painful because of the first two pieces of good luck.



Defense Spending Continues to Decline From WW II Peak

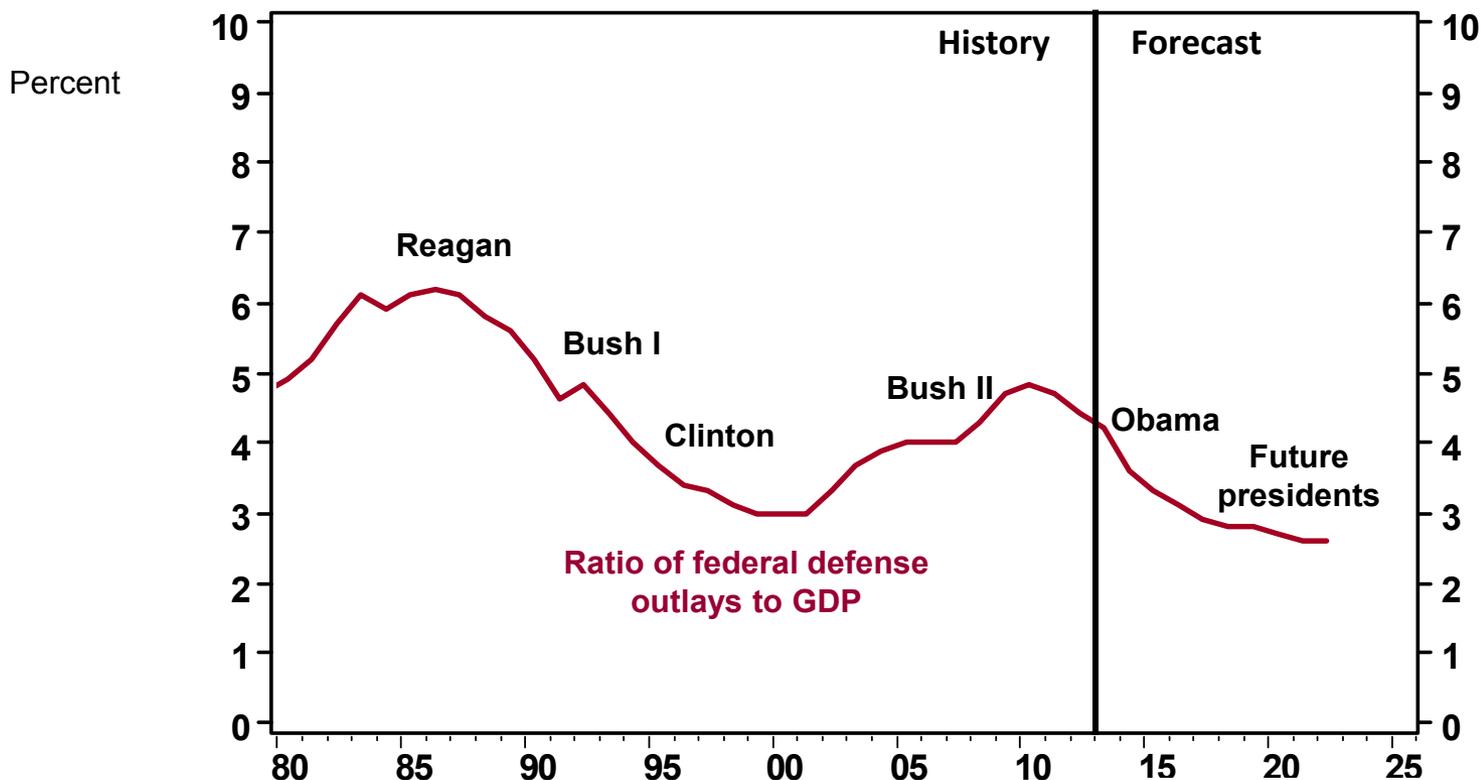


Source: Office of Management and Budget /Haver Analytic

Annual data through fiscal year 2012;
2013-23 projections as of Feb. 2013



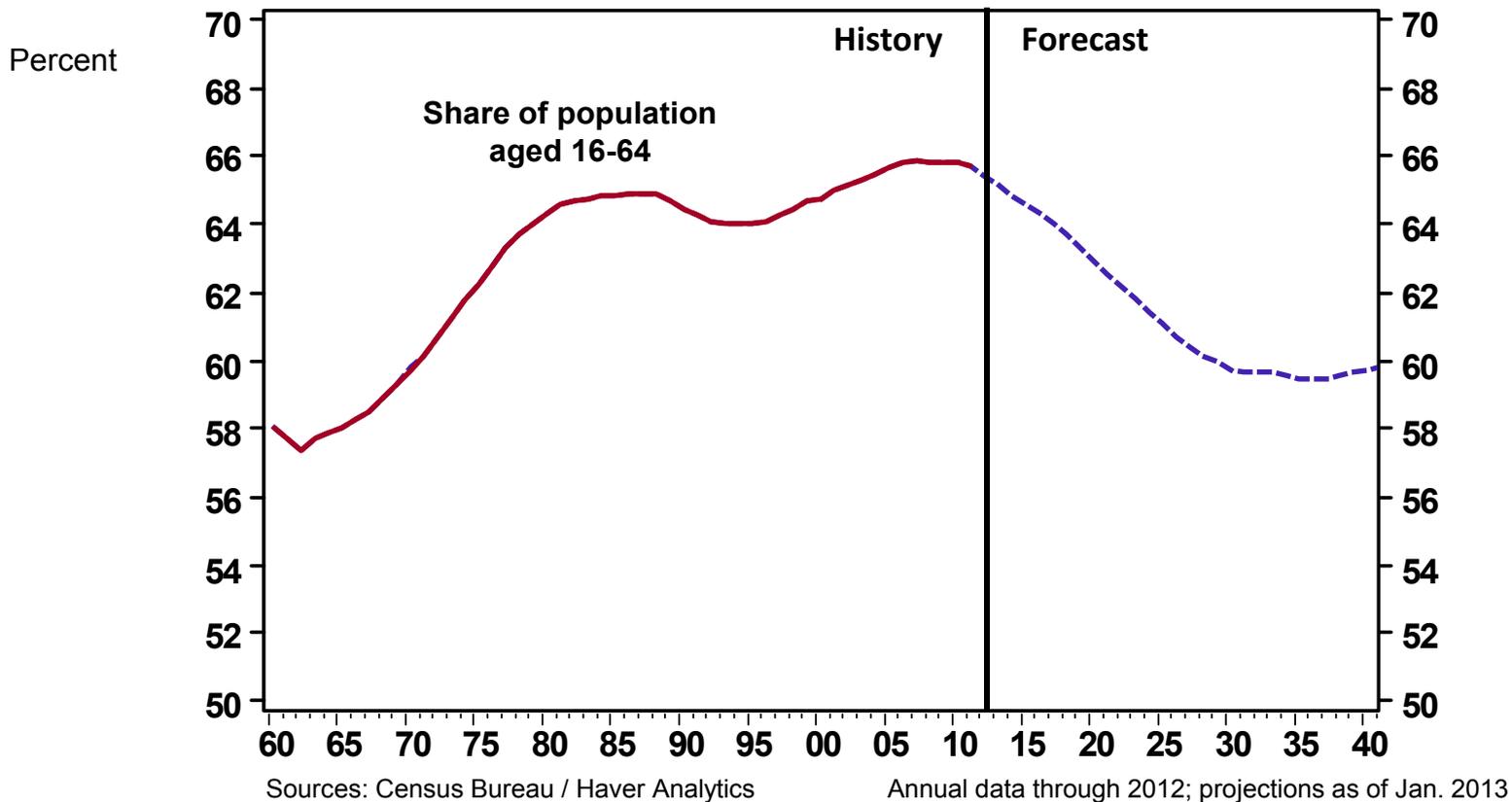
Not Much Defense Left To Cut!



Source: Office of Management and Budget /Haver Analytic

Annual data through fiscal year 2012;
2013-23 projections as of Feb. 2013

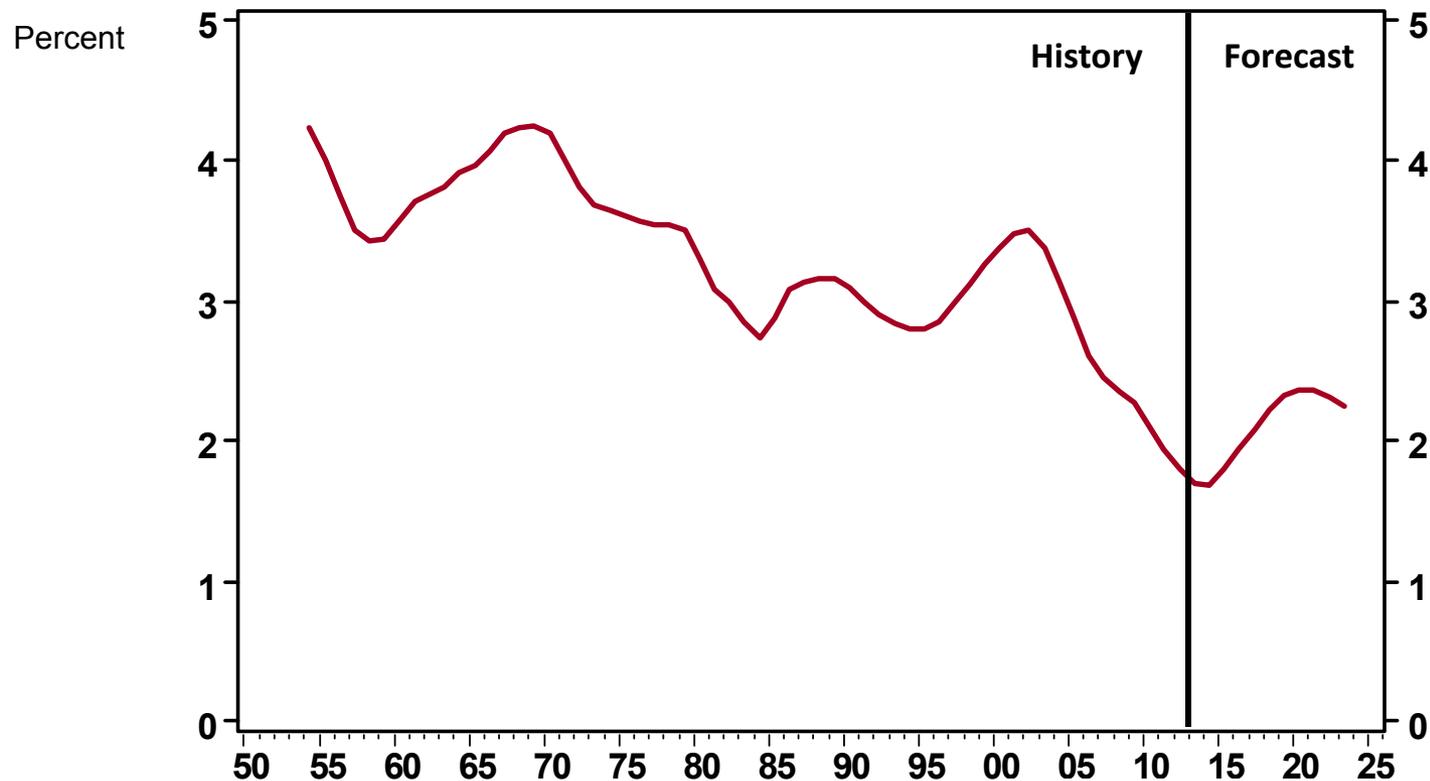
The Demographic Dividend Will Become a Demographic Deficit



One Consequence: Our Economic Growth Potential Has Declined Significantly

Five-Year Trailing Average of CBO Estimate of Real Potential GDP Growth

Annualized percent change



Source: Congressional Budget Office / Haver Analytics

Annual data through 2012; CBO projections of 2013-24 as of Feb. 2013

In Light of These Obstacles, Can We Achieve Long-Run Fiscal Sustainability?

➤ Neither of the political factions *nor the public* are willing to address political and economic reality.

■ The irresistible fiscal force:

One faction will not admit that the welfare state is extremely popular and cannot be significantly curtailed through democratic means.



■ The immovable fiscal object:

The other faction will not admit that the tax revenues needed to pay for the ever-expanding welfare state are neither politically nor economically feasible under current tax system.



What Is a Fiscal Crisis?

- History is full of countries that lost control of their fiscal situations, ending in crisis.
 - See Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009, especially chapters 4-9 and 12.
 - Default on sovereign debt is more common than you might think.
 - For example, Spain has defaulted 15 times during the last 450 years and may do so again in the near future!

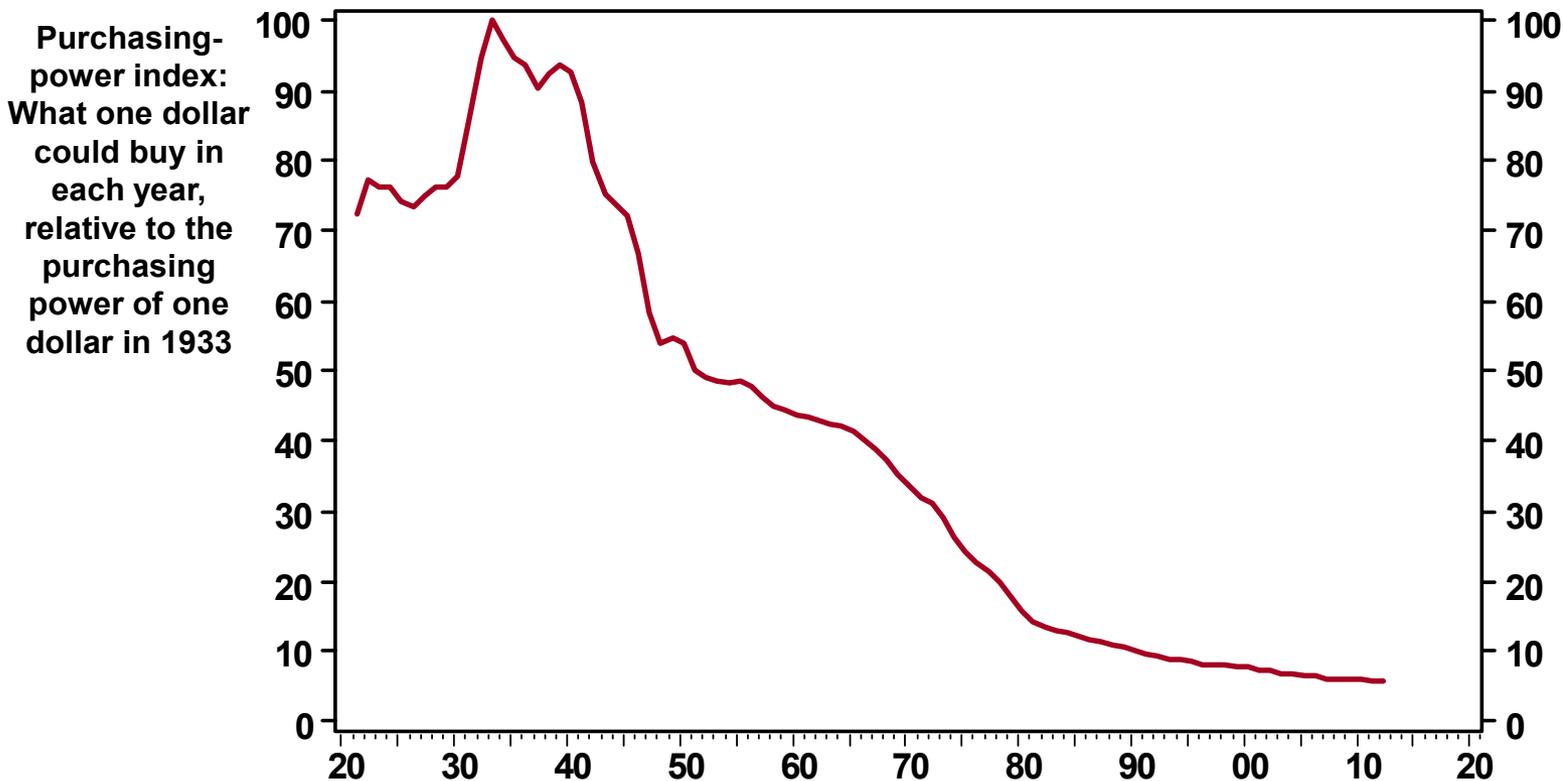
Implicit Defaults Are Defaults, Too

- Implicit default on debt through inflation or currency devaluation is less obvious, but no less common.
 - The United States effectively reneged on its financial promises three times during the 20th century:
 - Devalued the dollar against gold in 1933
 - Broke the link between the dollar and other currencies in 1971
 - Inflated away most of the purchasing power of a dollar

Implicit Default: One Dollar in 1933 Is Worth 5.6 Cents Today

Purchasing Power of One Dollar, in Cents

Base period is 1933



Sources: Bureau of Labor Statistics / Haver Analytics

Annual data through 2012

Reasons Not To Worry

- The U.S. government will not default on its debt in the foreseeable future.
 - The U.S. Treasury can borrow for 30 years at less than 3 percent.
- The Federal Reserve will not allow inflation to surge in the foreseeable future.
 - Investors demand a tiny 2.5 percentage points of annual compensation for inflation risk during the next 30 years.

Reasons To Worry

- These “easy” ways to escape an unbearable fiscal burden (explicit default and high inflation) are off the table. The only way to achieve fiscal sustainability is through political action.
- But our political system currently seems gridlocked—and is designed to be resistant to change.
- Most members of the public do not want to sacrifice.

We Need Two Big Changes To Achieve Long-Run Fiscal Sustainability

- Our political leaders must help the public understand spending and taxing realities.
 - Health care costs and the aging population are the main cost drivers.
 - Tax reform is needed to raise more revenue.
- The public must agree to make sacrifices—not all equally, but everyone should be involved.

Changing the Discussion: Be Honest About the Cost of Benefits

- A step in the direction of fiscal sustainability: Separate the insurance function of government from redistribution.
 - Make the actual cost of government insurance programs transparent so that everyone knows how much it costs to provide services—especially health care and retirement annuities.
 - If we decide to subsidize some recipients, make that transparent, too.
 - Bottom line—discuss insurance and redistribution separately.

In Sum: Can We Achieve Long-Run Fiscal Sustainability?

- Federal non-defense spending and tax revenues are, respectively, an irresistible force and an immovable object.
- We've avoided fiscal crisis since 1945 by declining defense spending and the youth of the Baby Boomers.
- Those fixes are gone.

In Sum: Can We Achieve Long-Run Fiscal Sustainability?

- The only plausible route to long-run fiscal sustainability is through political courage and leadership and public acceptance of the need for shared sacrifice.
- A more transparent separation of government's insurance functions from redistribution would help, too.