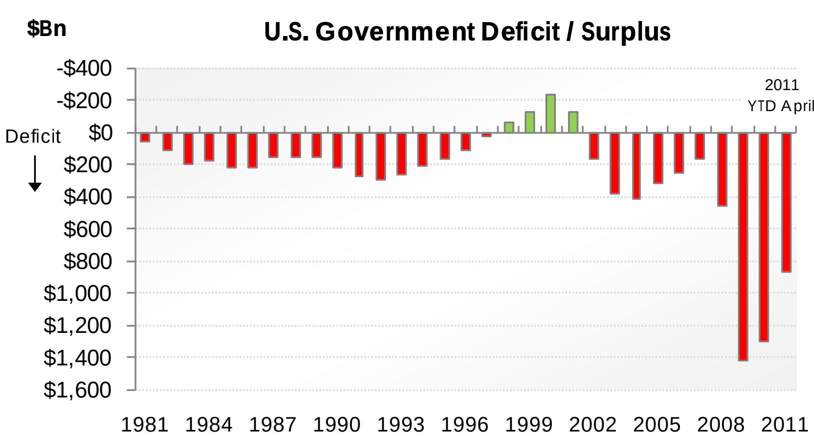
American consumers are not the only ones who got in over their heads during the decade of the 2000's; the Federal government did its share of debt-fueled spending as well. As recently as ten years ago, the government's fiscal future was headed in the right direction. In 1998, President Clinton presided over the United States' first balanced budget in 30 years, and for the next four years the government actually took in more money than it spent. Talk turned to how the country would use its newfound windfalls. The Treasury stopped issuing 30-year bonds in 2001, and financial market participants wondered what would happen if the U.S. no longer needed to issue debt to finance its long-term deficit. The tide then turned quickly. In the first decade of the 21st century, the bursting of the dot-com bubble, the ensuing recession, the 9/11 terrorist attacks, two subsequent wars, and generous tax cuts all took their toll on the economy and the budget, and the deficit began to grow once again. The economy was then hit with the worst recession since the Great Depression: Tax revenues sank, government spending skyrocketed, and the federal deficit literally went off the charts.

"President Clinton announced Wednesday that the federal budget surplus for fiscal year 2000 amounted to at least $230 billion, making it the largest in U.S. history and topping last year's record surplus of $122.7 billion."

"President Clinton announces another record budget surplus," CNN.com, Sept. 27, 2000

Longer-term fiscal concerns have lingered in the political background for some time, especially the ability of entitlement programs like Social Security and Medicare to absorb the retirement of the Baby Boomer generation. Politicians have shied away from addressing the problems facing these programs, however, since most Americans hold the social safety net near and dear to their hearts. The recession, budget shortfalls in states and municipalities, and the very real possibility of default by several European countries all have called attention to fiscal issues in general. A downgrade to the outlook for U.S. debt by one of the largest rating agencies raised questions about the U.S. federal government in particular. Now, American politicians are forced to address the situation. In this report we examine how dire the situation may be for the United States, and what Washington is and is not doing to set the country on a more sustainable fiscal path.

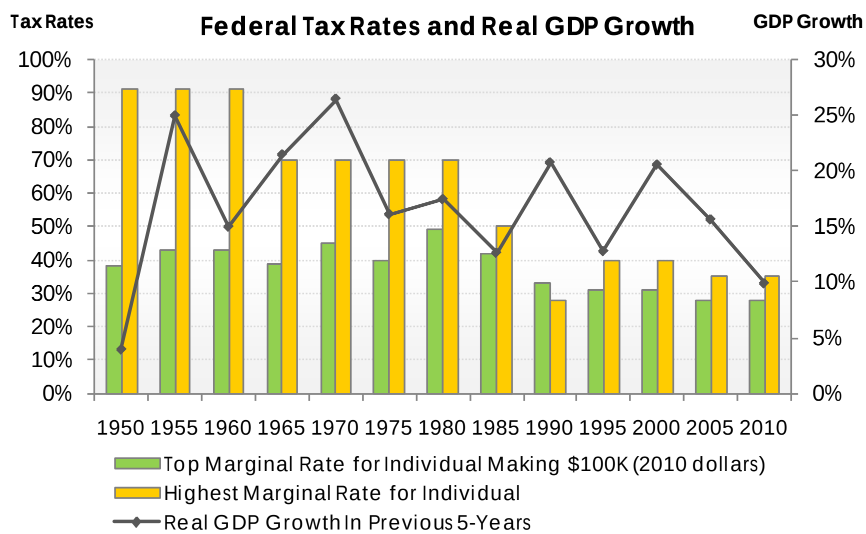


Source: "Monthly Receipts, Outlays, and Deficit or Surplus," fms.treas.gov

Q: How Did We Get Here?

A: Washington-Style Compromise

When normal people think of "compromise," they imagine both sides giving up something in order to get a portion of what each wants. In Washington, D.C., however, that is not necessarily a requirement. Washington-style compromise on fiscal issues has been tantamount to everybody getting what they want - lower taxes and higher spending - and simply kicking the consequences down the road. The government has been able to do this by taking a lopsided "Keynesian" approach[1] to spending. While Keynes advocated boosting spending during a downturn to stimulate growth, he also intended spending to be lower and taxes higher when growth was strong. Washington failed to save through the strong-growth period of the mid-2000's, and instead spent the rewards of a booming economy. In the last decade, Congress kept taxes low and government spending high, both in good times and in bad, and left no margin of error for a downturn.



Source: The Tax Foundation, Bureau of Economic Analysis

Tax rates in the United States have been near their lowest levels in modern history since George W. Bush lowered rates in his first term as President. The chart above shows the top marginal tax rate (green) for an individual earning $100,000 per year (in 2010 dollars, adjusted backward for inflation). The yellow bar shows the top marginal tax rate paid by individuals earning the highest incomes. The marginal rate paid on an income equivalent to $100,000 today has remained relatively stable since 1950, although it is lower now than in previous years. The maximum tax bracket has declined steadily, but real GDP growth also has trended lower in the past several decades. Lower growth and lower taxes do not prepare a country for the deficit spending sometimes necessary in a recessionary environment.

[1] According to economist John Maynard Keynes, lowering interest rates was not sufficient to pull an economy out of a severe recession; instead, he recommended boosting government spending and cutting taxes to mitigate periods of sluggish economic growth.

Q: Why Has This Issue Turned into a Crisis All of a Sudden?

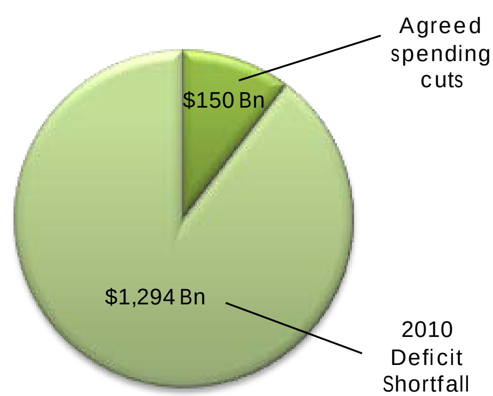
A: The Downgrade, the Debt Ceiling, and the Election

Stimulus spending measures passed during the recession caused the last several annual budget deficits to land in the red, but the current frenzy of fiscal awareness has occurred for several reasons. One of those reasons is that last month Standard & Poor's cut the outlook on the long-term credit rating of the U.S. from "stable" to "negative" for the first time since World War II. Many people considered this change in outlook a warning shot across the bow. In other words, if the U.S. doesn't get its fiscal house in order, it is in danger of losing its AAA credit rating. A downgrade would be disastrous for the country, and likely would entail the dollar losing its safe-haven status, reduced demand for Treasury bonds, and permanently higher borrowing costs for American consumers. With more than half of our Treasury bonds owned by foreigners, the U.S. is highly vulnerable to a shift in sentiment.

Two of the other reasons for the increase in attention are intertwined: The immediate-term problem of breaching the debt ceiling, and power-jockeying for the 2012 election. The nation reached its $14.3 trillion debt limit in mid-May, but thanks to some creative accounting by the Treasury the day of reckoning has been pushed back to August 2. If the ceiling is not raised by that time, the government is at risk of defaulting on its debt (at worst), or not being able to meet other obligations like Social Security payments, student loan outlays, or military payroll (at best). The debt ceiling itself is an arbitrary level, passed by Congress, which limits the amount of borrowing the country can undertake. Some members of Congress are holding the debt ceiling hostage until demands for spending cuts are met. While we agree that meaningful steps toward balancing the budget are important and necessary, putting the country's credit rating at stake is not the way to make that happen. As Austan Goolsbee, the chairman of the Council of Economic Advisors, said recently, "To tie this [long-term deficit reduction] to the debt limit is, in my view, quite insane…to hit the debt ceiling is like trying to lose weight by cutting off your head." The financial markets are increasingly betting that the Treasury could default on its debt. Since the beginning of April, the cost of insuring against the U.S. government missing a debt payment (by holding a one-year credit default swaps) has more than tripled.

Q: What Is Being Done Right Now?

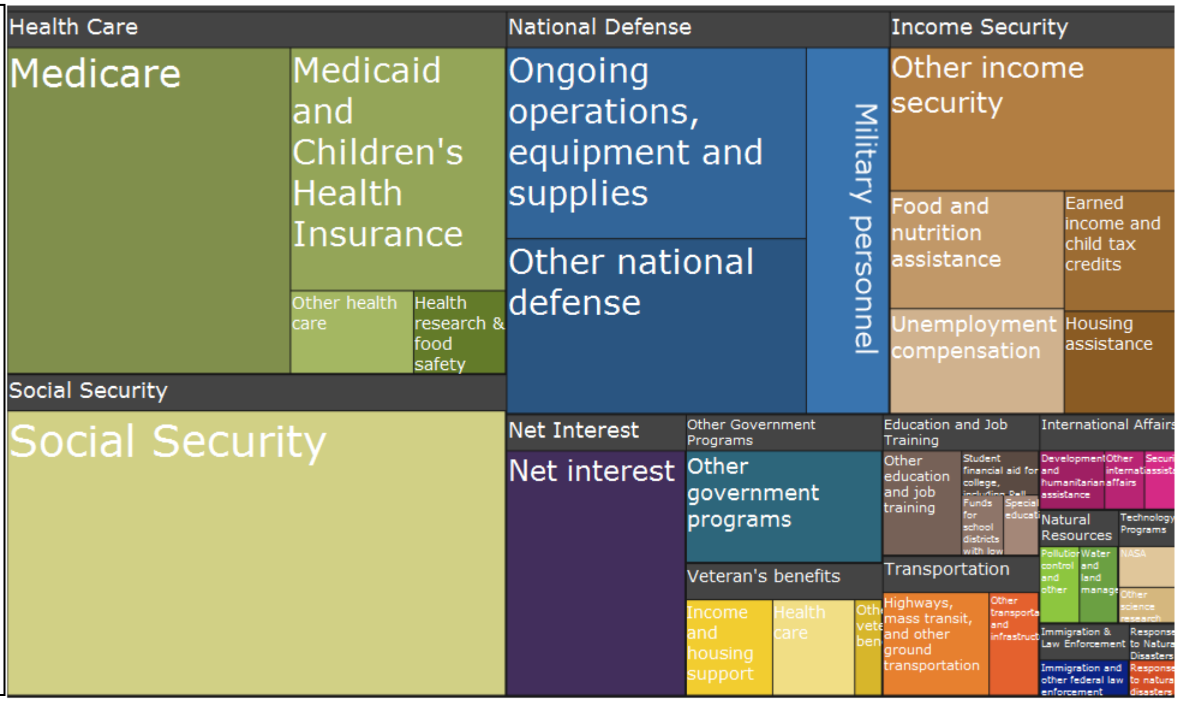
A: Nothing Very Meaningful



Both political parties have extended ideas for minimally reducing the deficit, but in terms of meaningful changes Congress has largely reached an impasse. "The Gang of Six," an informal group of Senators led by Vice President Biden, has taken matters into its own hands. The group has been meeting to draw up a bipartisan debt-reduction plan so that the debt ceiling can be raised, but of the more than $1 trillion dollars of cuts needed to balance the budget, only $150 billion have been identified. The budget cuts necessary to meaningfully reduce the deficit over the next decade total $4 trillion.

Cuts to discretionary spending are the middle ground on which all parties can agree, but The Group of Six also reached an impasse when entitlement reform was put on the table. One of the Republican members has even bowed out of the negotiations "temporarily" when his demands for additional cuts to Medicare where quashed. Spending on programs like Social Security, Medicare and Medicaid make up over 40 percent of the budget, yet fears of political backlash from constituents have kept both parties from embracing cuts in these areas. The graphic below from the White House Office of Management and Budget shows a scale representation how the budget breaks down. Congress is largely haggling over cuts to the small boxes in the lower right corner, while ignoring the "big elephants" in the top left corner.

Click on the image to open in more detail on the White House web site.



Source: The White House Office of Management and Budget

In our opinion, much of the failure to agree is political and not philosophical. Democrats have long championed the social safety net and vowed to protect entitlement programs to satisfy the party's base constituency. Republicans recently proposed reforms to entitlement programs in Representative Paul Ryan's budget under the assumption that fiscal conservatives would support the position, but when polls showed the reforms' bipartisan unpopularity they reversed course. Politicians have it wrong. Both parties ignore that the majority of Americans don't want political maneuvering; they want real solutions that make the country better off in the long run.

Q: Are Americans as Uninformed About Fiscal Matters as the Polls Make it Seem?

A: Not When the Questions are Asked in the Right Way

A study in which Americans were given the task of reworking the budget with actual figures and detailed policy tradeoffs produced very different results from most poll results reported in the media. The study, commissioned by Program for Public Consultation[2], first provided the sample's respondents with information on 31 policy issues and then gave them a range of options for addressing them. While Democratic and Republican leaders can only agree on reducing the deficit by cutting social programs - and doing little or nothing with taxes - Americans in this study would proceed by cutting defense spending, increasing spending on social programs targeted at higher education and job training, and raising taxes on the wealthy by making them more progressive. In fact, survey respondents proposed about three times more revenue from tax increases than even the Obama administration has budgeted. The end result was far deeper deficit reduction than anything proposed to date by either the Democrats or Republicans.

Congress does not realize that a failure to act is itself taking options off the table. Allowing the fiscal profile of the country to deteriorate could result in permanently higher borrowing costs. A "tax" on every American in the form of higher interest rates and a lower U.S. dollar could result, putting the U.S. at a disadvantage to the rest of the world. Europe might be in a quandary right now, but if the Euro-zone undertakes painful steps toward austerity and the U.S. does not, the economic powers' fortunes could reverse.

Even from a political perspective, if both parties took a step back to see the big picture they would realize that a balanced budget would make their partisan goals much more attainable. Republicans want lower taxes and Democrats want discretionary social spending; if the budget were balanced there would be less political pushback against each of these goals.

Q: What Must Happen to Put the Country on a Sustainable Path?

A: Tackle the Big Issues, and Make Some Political Sacrifices

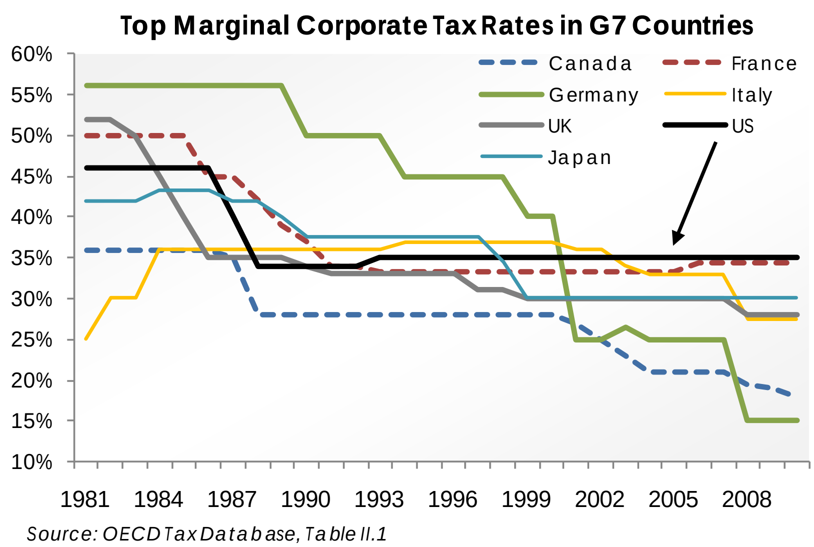
According to Republican Senator Tom Coburn - the Gang of Six member who left the negotiating table - by 2022, the costs of sustaining Medicare, Medicaid, and Social Security plus interest on the debt will take up the entire federal budget. Chances are that before that point is reached, the international financing that the U.S. counts on in the form of foreign purchases of Treasury bonds would dry up. Something must be

[2] Program for Public Consultation (PPC), is affiliated with the School of Public Policy at the University of Maryland. The study was fielded by Knowledge Networks. http://public-consultation.org/studies/budget_feb11.html

done domestically before the rest of the world deems the United States a poor credit risk.

Republicans have proposed a long-term budget that would transform Medicare into a subsidized program in the private insurance system. Their proposal would in essence transfer much of the risk of rising healthcare costs to retirees. The party's older constituents - a key Republican demographic - oppose bearing the burden of rising costs, and with another election approaching many Congressmen have distanced themselves from the proposal. Leaders of the Republican Party previously had tied the proposed Medicare plan to their conditions to raise the debt limit, but have since cooled to that idea. Democrats have gained public support merely by opposing what the Republicans are proposing, but have not put forward any effective ideas of their own. Similar to the Republicans' (counter-partisan) fear of a public backlash against entitlement reforms, Democrats have been reluctant to enthusiastically support meaningful revenue increases, i.e. tax hikes.

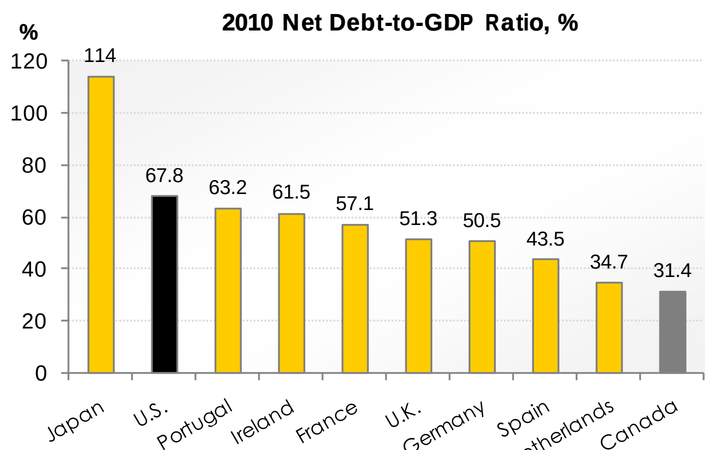
The Federal government has kicked the can down the road for so long so it is unlikely that an easy solution is within reach. One, or both, political parties must oppose the populist tide and lead the way in reform. Entitlement programs must be addressed, and beneficiaries will likely experience some reduction of benefits or an increased burden of cost. Tax revenues need to rise, whether that is through directly raising income tax rates, or addressing the loopholes that generate enormous distortions and a loss of revenues. The U.S. has one of the highest corporate tax rates in the developed world as shown in the chart to the right, but loopholes mean that every corporation has a different and uncertain tax profile. Without a doubt, uncertainty over the future tax environment for corporations stifles investment in both people and infrastructure. Many U.S.-based multinational corporations are keeping their free cash offshore, or using it in cash-financed mergers and acquisitions abroad, to avoid the high (and uncertain) tax environment at home. Addressing this situation would give companies clarity and incentive to invest domestically.



Q: Have Any Other Counties Successfully Tackled a Similar Situation?

A: Yes, Canada Made Significant and Lasting Fiscal Reforms in the 1990's

The federal deficit in Canada hit 5.6% of GDP in 1993, while the debt-to-GDP ratio approached nearly 70% - similar to where the U.S. is today. Nearly half of Canada's bond market also was owned by foreign investors at that time. Years of untamed spending on both sides of the political spectrum, as well as debt rating downgrades, finally led to a breaking point. The federal government took painful steps to reverse its course - including higher taxes, spending cuts, privatization of some government functions, and even reforms to social security. The country presented its first balanced budget in more than 30 years in February 1998, just three weeks after the United States did the same.



Source: OECD, GluskinSheff

The austerity measures were painful, but in less than a decade, the Canadian government sustainably balanced its budget and paid down billions of dollars on the national debt. The country's AAA credit rating was restored, and borrowing costs (the 10-year bond yield) fell by almost half. The average Canadian reaped the benefits of the austerity measures not long after they were implemented. In 2001, the federal government was able to cut the marginal tax rate for people earning $60,000 to $100,000 Canadian dollars per year. The Canadian dollar also strengthened significantly after the reforms were enacted, and provided consumers with greater purchasing power in the global market place. Despite the importance of commodities to Canada's economy, the country was able to balance its budget in 2008 even as commodity prices plunged. There is a blueprint for resolving America's structural problems, but our leaders must show the political strength to follow it.

Treasury bonds have been in a secular bull market for several decades, lowering borrowing costs for Americans. That trend is in danger of reversing if nothing is done to address the fiscal situation. We believe that the United States recently has benefitted from the problems in Europe as the "lesser of evils" in the debt and currency markets of major developed economies. Europe has a long way to go, but it is already on the painful path of correcting its excesses. The U.S. will be pressured to come up with meaningful reforms in the near term or risk falling behind Europe, or even emerging economies, as a safe haven currency and debt market. We believe that the risk of losing safe haven status is not imminent, and likely correctable, but our leaders must put the country's fiscal needs ahead of their own re-election prospects. If and when lasting fiscal reforms are enacted in the United States, interest rates could fall even lower than today's levels. In the words of George Will, "Leadership is, among other things, the ability to inflict pain and get away with it - short-term pain for long-term gain."

May 31, 2011

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