THE U.S. DEBT AND DEFICIT CRISES
2008-2011

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WHERE IS THE U.S. NOW AS A COUNTRY

- After repeated attempts at monetary and fiscal stimulus since 2009, the U.S. is now growing slowly; est. 2% GDP growth in Q4, 2011 and 2.1% for 2012

- More than 24 million working-age Americans remain unemployed or underemployed, and the employment-to-population ratio lingers at a near-historic low of 58.5%.

- Business investment continues at very low levels as companies accumulate cash. Consumption expenditures remain weighed down by household deleveraging of the massive private sector debt.

- Recovery from what already has been dubbed the “Great Recession” has been weak thus far. Real GDP has yet to surpass its previous peak, and the probability of a double-dip recession remains at 20%.

- The principal problem has not been government inaction. It has been inadequate action, related to mainly to a political stalemate in Congress.

- The U.S. currently has the second highest real total debt level in our history.
SOME SOBERING FACTS ABOUT THE U.S. ECONOMY

- In 2011, nominal wages grew only 1.7% while all consumer prices, including food and energy, increased by 2.7%.

- Wages and salaries have fallen from 60% of total personal income in 1980 to 51% in 2010. Government transfers have risen from 11.7% of personal income in 1980 to 18.4% in 2010, a post-war high.

- Massive, widely disparate economic inequality has historically led to bad — and in some cases, extremely bad — outcomes. It contributes to social unrest, excessive political populism, and mob violence.

- The middle class is shrinking, and this threatens our social fabric and stability. We are becoming a bi-modal society.
SOBERING FACTS (Continued)

The wealthiest among us

- The wealthiest 1% now take home about 24% of the total individual annual income in the country.

- Their real household income tripled from 1979 to 2007 while middle incomes grew by 40%.

- The wealthiest 1% own 40% of individual assets in the country.

- The wealthiest 1% own half (yes, 50%) of the country's traded Stocks, Bonds and Mutual Funds.

- The wealthiest 1% carry just 5% of the nation's personal debt while the bottom 90% hold 73% of the total debt.

- The wealthiest 1% are taking more of the nation's individual income than at any time since the 1920's while benefitting from the lowest marginal top tax rate that they have paid since 1932.
Growth in real after-tax income, 1979-2007

%
TOTAL NATIONAL DEBT BY PRESIDENTIAL TERM

- **FORD**
  - GDP: 36% of GDP
  - Debt: $654B
  - Term: 1972

- **CARTER**
  - GDP: 33% of GDP
  - Debt: $930B
  - Term: 1977

- **REAGAN**
  - GDP: 53% of GDP
  - Debt: $2,684B
  - CAGR: 14.3%
  - Term: 1982

- **BUSH (I)**
  - GDP: 66% of GDP
  - Debt: $4,177B
  - CAGR: 11.7%
  - Term: 1987

- **CLINTON**
  - GDP: 58% of GDP
  - Debt: $5,662B
  - GAGR: 3.8%
  - Term: 1992

- **BUSH (II)**
  - GDP: 74% of GDP
  - Debt: $10,700B
  - GAGR: 8.3%
  - Term: 1997

- **OBAMA**
  - GDP: 97% of GDP
  - Debt: $14,543B
  - CAGR: 8.0%
  - Term: 2002

The graph illustrates the increase in national debt over time, with each president's term marked by an increase in debt as a percentage of GDP.
EVENTS LEADING UP TO THE FINANCIAL CRISIS

- In late 90’s, and thru most of first decade of this century, emerging market capital flows reversed with substantial excess capital coming into the U.S.
  - Downward pressure on interest rates
  - A rapid growth in credit availability
  - An intense search for yield as interest rates fell

- Excessively loose monetary policy, by the Fed (beg. 2001), over an extended period, helped boost consumption and investment

- With Capital Imbalances, lending standards were relaxed; with a continuing political mandate for increased mortgage lending to low-income and minority groups – sub-prime mortgages began to grow

- The result – Asset Price Inflation, particularly housing
  - Generating a “wealth effect” and further individual consumption
LEADING UP TO THE FINANCIAL CRISIS – Cont’d

- There were Numerous Financial Innovations on “Wall Street” (derivatives - MBS, CMO, CDO and securitization), all supported a,

- Large Rise in Mortgage Credit to households, particularly lower credit quality households (Turning point for Fannie and Freddie began in Q III, 2004)

- Additional Contributory Factors
  - Regulatory Arbitrage, Lending Malpractices, Excessive Use of the Originate and Distribute Model, Securitization of Sub-prime Loans and their Bundling into AAA Tranches on the back of Rating Agency Ratings

- The Result - excessive leverage in both financial market entities and households
  - Financial Services Sector Balance sheets were expanded dramatically; little regard to risk, individual and systemic
  - Many Financial Industry Executives did well with a “stacked deck”
EVENTS LEADING UP TO THE FINANCIAL CRISIS – Cont’d

- Beginning early 2005 Fed rate accommodation was gradually lifted and rates continued upwards into 2007

- Some banks and shadow banks were squeezed; the wheels start to come off
  - Feb. ‘07 - Fannie & Freddie would no longer buy risky sub-primes
  - House prices begin relentless decline leading to increasing mortgage defaults
  - Apr. ‘07 - New Century Financial files for Chap. 11
  - Aug. ‘07 - Fed starts series of discount rate cuts again

- All of this occurred amid a systematic dismantling of banking and financial industry regulations - began in earnest in 1980), peaked in 1999, and climaxed with an SEC ruling in April 2004
THE PRESIDENT’S PROPOSED BUDGET FOR 2012
Total: $3.729 trillion.

Percentages in parentheses indicate percentage change compared to 2011. This budget request is broken down by the following expenditures:

Mandatory Spending: $2.109 trillion (-3.2%)

- $761 billion (+4.6%) - Social Security
- $468 billion (-4.1%) - Medicare
- $269 billion (-2.5%) - Medicaid and the State Children's Health Insurance Program (SCHIP)
- $598 billion (-16.2%) - Unemployment/Welfare/Other mandatory spending
- $240 billion (+17.1%) - Interest on National Debt (Public Portion)
Discretionary Spending: $1.344 trillion (-3.1%)

- $553.0 billion (+0.7%) - Department of Defense
- $126.3 billion (-23.3%) - Overseas Contingency Operations - Iraq, Afghanistan
- $79.9 billion (-1.8%) - Department of Health and Human Services
- $77.4 billion (+6.2%) - Department of Education
- $58.8 billion (+3.1%) - Department of Veterans Affairs
- $49.8 billion (+0.5%) - Department of Housing and Urban Development
- $50.1 billion (-0.9%) - Department of State and Other International Programs
- $43.2 billion (-0.9%) - Department of Homeland Security
- $29.6 billion (+4.2%) - Department of Energy
THE PRESIDENT’S PROPOSED BUDGET FOR 2012 - Contd.
Total: $3.729 trillion.

Discretionary Spending: $1.344 trillion – Contd.

- $28.2 billion (-7.2%) - Department of Justice
- $23.8 billion (-7.1%) - Department of Agriculture
- $18.2 billion (-6.7%) - National Aeronautics and Space Administration
- $13.4 billion (-4.1%) - Department of Transportation
- $14.0 billion (+0.8%) - Department of the Treasury
- $12.1 billion (+0.3%) - Department of the Interior
- $12.8 billion (-8.3%) - Department of Labor
- $63.9 billion (-3.9%) - Other On-budget Discretionary Spending

Total Discretionary Budget (Less Defense and Homeland Security) = $622 BILLION
WHERE DO WE GO FROM HERE?

- The U.S. has total outstanding debt of $15.2 trillion (101% of GDP), and a projected fiscal 2012 deficit of $1.1 trillion
  - Not likely to reduce spending until 2013, but we will still carry a deficit in 2013
- What is needed to Reduce Deficits and Debt over 10 years to achieve fiscal equilibrium ≈ Total Debt @ 65% of GDP and sustainable Deficits @ up to 2.0% of GDP
  - Projected 2021 GDP (modest growth) = $19.5 trillion with debt target of approx. $13 trillion
  - Debt will be approx. $16.4 trillion as of 12/31/2013
  - Oct. 31, 2011 CBO projections show deficits stabilizing at $500 billion level beginning in 2014 under current plans

BOTTOM LINE ESTIMATE

2013-2014, Congress will need to find another $600 billion/yr.
2015-2021, Congress will need to find another $500-550 billion/yr.
WHERE DO WE GO FROM HERE? – Cont’d

The Debt and Deficit Reduction Proposals Include

- **All Spending Cuts Approach** – requires $500 - $600 billion in cuts each year, over 10 years, on top of the $1.1 trillion over 10 years, in mandated cuts to be implemented on 1/1/13 (*recall failed Super Comm*).

  - Recall that the entire discretionary budget (2012), excl. Defense & Homeland Security = $635 billion

  - Suppose we assume an on-going 15% nominal yearly reduction in all discretionary spending (HHS, Education, Energy, Agriculture, Justice, EPA, NIH, etc), roughly $100 billion in 2013

  - This means that entitlements would have to be cut $500 billion in 2013 (-22%)

Congress would still be looking for another $500B/yr. thereafter

And just how would this be accomplished without devastating our standard of living?
The Debt and Deficit Reduction Proposals Also Include

Combination Spending Cuts and Revenue Increases

- Revenue increases can be generated by:
  - **Raising income taxes** – broadening base and reducing rates; revenue loss from "tax expenditures" is enormous, about $1.2 T in 2010 – deductions for just Mortgage + Health + Retirement Savings ≈ $440 B
  - **Just limiting deductions to a 28% bracket would raise** ≈ $160 B / over 10 Yrs.
  - **A 15% LIMITATION ON DEDUCTIONS WOULD YIELD** ≈ $1,200 B over 10 Yrs.

- **Implement Energy & Excise Taxes** – A Carbon Tax, Increase Fuel & Excise Taxes
  - A 50¢/ gallon increase in gasoline tax would raise $60 B /Yr., (the U.S. carries the second lowest gasoline taxes in the OECD); it is easy to raise $20 B in excise taxes

- **Implement a Small VAT** – 5% (Average in OECD is 18%)
  - **A VAT is an easy to enforce consumption tax, but it is regressive**
  - With exemptions for Education, Medicare, Medicaid and Charitable Contribution, a 5% VAT is estimated to raise $340B in 2013

- **Many ways to accomplish objectives**. As one example only: Assume 50% of fiscal needs will come from increased government revenues; say an average $250 billion/yr. in revenue increases, and $250 billion in spending cuts. **There are between $436 and $540 B in annual deficit and debt reductions shown above**
SO, WHAT DO WE DO?

The Problem is that No One Really Knows

- Most agree that deficits must be trimmed, debt level reduced, but when?
- Are we willing to live in caves and chew on roots? My guess is NO!
- Accordingly, Congress must both reduce deficit spending and raise revenue
- How can we equitably reduce spending and raise revenues?
- Revision of the tax code is a priority – simpler, fewer special gimmees!
  - Progressive vs. Regressive are considerations in fairness; so is amounts
  - Fair Tax vs. Flat Tax vs. revised current system with fewer, lower marginal rates and few deductions, credits
  - Should a VAT or other consumption-based tax be introduced?

Understanding Our National Priorities; A Critical First Step
- What Kind of Society Do We Want to Be?