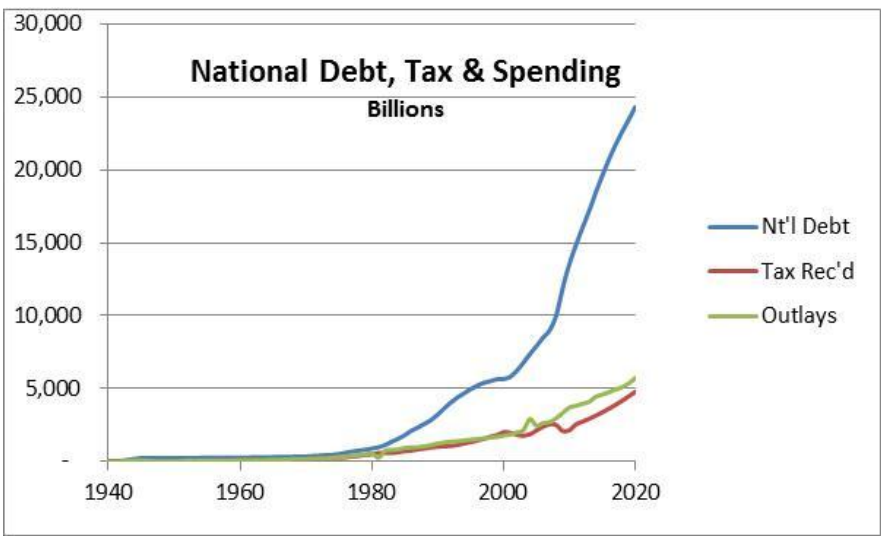
Where is this country heading?

A difficult problem with a tough-to-implement solution. The national debt now is about $14.5 trillion. It is increasing because of the annual deficit which this year will be about $1.26 trillion. That's the difference between $3.83 trillion outlays compared to only $2.57 trillion tax income. Not reported by the government are the unfunded obligations for entitlements, e.g., social security, Medicare, Medicaid, government pensions and unemployment compensation. The present-value of future entitlements is about five times the national debt. Businesses have to report such obligations as liabilities, but the government does not—based on the misleading and convenient excuse that entitlements can be reduced by law any time—a policy that politicians endorse to hide the follies of their promises.

Projecting the future: I don't pretend to see the future any better than anyone else, and am confused as most about the way the government relates deficits and off-budget items like the Post Office losses and Social Security to the debt. Nevertheless I'll try to portray why I believe that, even with optimistic assumptions, we are headed for a financial disaster. The chart below displays the history prior to 2011 and a projection of what my rough analysis shows what would happen to the national debt, tax received and federal outlays if, until 2020, the deficit is held to approximately $1 trillion each year, tax receipts increase 7.2% annually and government spending is constrained to 2.5% growth per year. To eliminate the deficit, by 2020, tax receipts would have to increase by an Alice-In-Wonderland 9% each and every year while holding government growth less than inflation—something I don't believe it has ever done.



Government tax receipts growth: To keep the debt from going through the roof, I've assumed that government tax receipts will grow at 7.2% <u>each</u> year. This not only requires a substantial increase in tax rates, it assumes that there will be enough growth in employment, wages and economy to provide this kind of government income—a huge hurdle.

Government spending growth: Increased taxes alone are nowhere near enough to restrain debt growth. Reduced government spending is the more powerful tool. In order to restrain deficit growth to about $1 trillion a year, I have to assume government spending will grow by only 2.5% each year—less than likely inflation. That will be an immense struggle requiring both little inflation and low growth in Medicare and Medicaid—both of which are scheduled to cover millions of additional people as will the aging of our population. Also more people will be eligible for Social Security and government pensions.

Interest paid on debt: I've assumed that the interest rate the government pays on its debt will increase slowly from current low values of about 3% to pre 2000 rates of about 6% a year. The increases in national debts combined with the increase in rates make interest payments unaffordable without other sacrifices. Interest payments start out at 17% of federal income in 2011 but increase to 34% of federal income by 2020. Although it's possible to rationalize that we might be able to make such large interest payments, they come at the expense of non-interest spending and, importantly, ever increasing debt and lower credit ratings.

National Debt Growth: The final result is horrifying in spite of very optimistic assumptions about the fundamentals. The debt grows at an average rate of 5.8% a year. There have to be serious questions about whether there would be nations that would be willing to fund us to that extent. You have to wonder how long Moody's and Fitch will uphold their AAA bond rating for the US and how long the Chinese, Saudis and others will consider US bonds an acceptable risk paying such low interest rates. If we can't roll over the debt as government bonds mature, we will have to come up with the cash ourselves--which clearly isn't there.

Catch 22: In the past, the government relied on inflation to maintain high debts: Inflation made the past debts look smaller each year and the government got to pay the debt and interest with less valuable dollars. (Example, with 3% inflation, the principal on a 30 year bond drops to 41% of its original value.) Now, however, inflation-adjusted entitlements are such a large part of the budget that inflation's power will be much less effective. And higher inflation will bring even higher interest rates! Higher interest rates make the debt problems worse. Much worse!

The public needs to know: I know that there are many who feel that the way to approach this problem is to increase spending and get the economy moving again. It would be interesting to see how these people would chart our future using actual numbers in projections of debt and details of tax receipts and outlays so that our children know what to expect. Also, what are the implicit assumptions about economic growth, inflation, tax rates and government spending? We need a believable scenario and to see a plan to achieve those results.

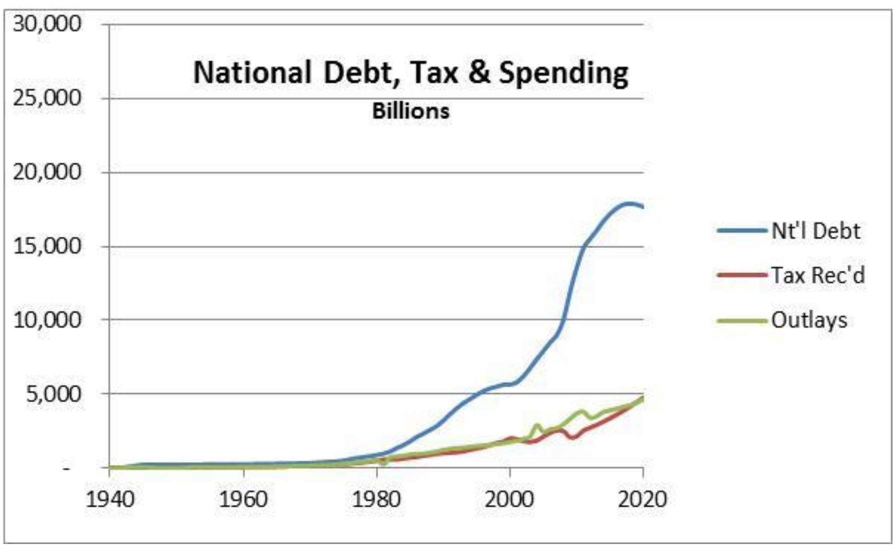
A hidden problem is ready to emerge: Neither my assumptions above, nor those in any projections I have seen, account for the accumulated personal savings shortfall over the last two decades. People have to try and catch up on saving which will be a mighty effort and obviously constrain spending because consumption has to go down when people save more. The majority of baby boomers have little or no savings. Younger people have even less. These will be economic killers as the boomers retire without savings and so can't spend, and the younger people recognize that they have to save more than 10% of their income for retirement. They can't both spend and save more. Personal spending will be forced to go down, not up.

Reduced personal spending means reduced demand for products and services: Reduced demand makes it difficult to grow the economy. When the demand for goods and services falls, it's almost pointless to try and encouraging businesses to invest more. If industry has no one to buy their products, expansion is worthless.

It makes a difference where higher taxes come from. If we try to tax corporations more to reduce the burden of individual income taxes, then businesses buy more supplies from abroad and/or increase prices to compensate for the additional cost of the taxes. Somehow, people forget that taxes are just another cost of business and will get passed on to buyers—at even higher prices in order to maintain profit margins. Higher U.S. prices not only reduce our competitiveness with foreign producers, they make us want to buy the less expensive products from abroad. Therefore imports grow and exports decline. That's certainly bad for the U.S. job market.

Where are we going? I think that those who favor expanded government spending have an image of a future where the (diminishing) working population supports the (increasing) elderly population and where every retired person has the same (limited) spending allowance and (limited) medical care. This image of the future is like that of our past agrarian society where several generations lived on a farm together and everyone worked until disabled. Then the disabled were supported and cared for by their children. Success was largely dependent on having many children, something we don't have today as the population ages due both to medical advances and very low birth rates.

There is a possible solution: It will be painful for perhaps a decade but would not destroy the country economically. Eventually it will give people a chance to save some more and get the economy on an even keel. The key is to cut government spending in 2012 back to 2009 levels. But even more is required: tax increases of 7.2% each year and constraining government growth to 2.5% per year. This is depicted below where we see that in the year 2020 the debt is at $17.7 trillion instead of $24.3 in the first scenario. More importantly, debt is on its way down, not up—IF we can find a way to collect substantially more tax while growing the economy.



The key is to take the bold steps quickly both to cut government spending and increase tax revenues, perhaps with a value added tax like in Europe and reduced corporate taxes and fewer government roadblocks to bring work and profits back to the U.S. We said these things years ago when the problem was not as large. But it was politically impossible. Perhaps people are starting to see that there is a real problem and are willing to sacrifice something in the near term to abate what otherwise promises to be a real disaster. Those individuals that will do well in this environment are those who practice frugality, save a good deal of their income and pay attention to their health to reduce their own medical costs in the future.

8/23/11, Henry (Bud) Hebeler
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