April 2024

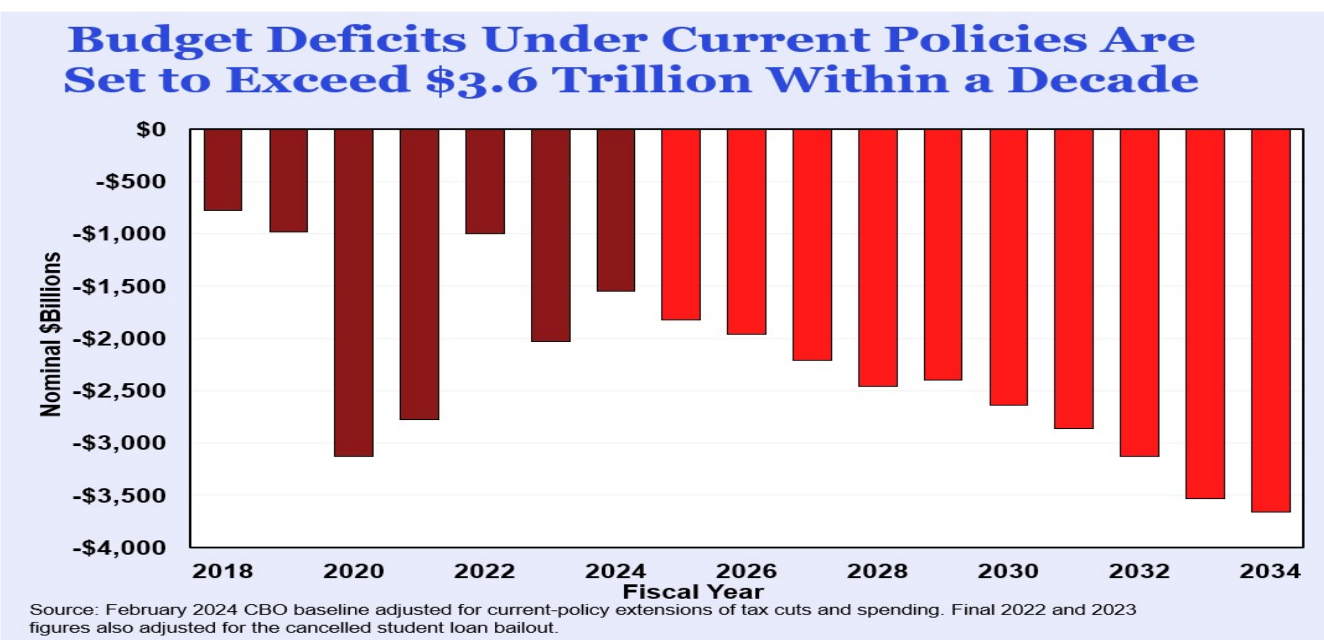
The Quiet Part Out Loud

In 2001, the Federal government had a budget surplus of $128 billion. The national debt was $5.77 trillion, and gross domestic product (GDP) was $10.56 trillion, resulting in a debt-to-GDP ratio of 54.6%. Projections at the time by the Congressional Budget Office predicted continued surpluses, such that by the end of that decade, uncommitted government funds would **exceed** the remaining government debt.

In the 22 years since these projections, there have been terrorist attacks, recessions, financial crises, pandemics, and a general expansion of government spending. As a result, the government has been running a deficit every ensuing year. For the fiscal year that ended last October, the budget deficit was $1.69 trillion. This resulted in a national debt of $33.17 trillion - which has already increased to $34.49 trillion! GDP has grown over that time to $26.90 trillion, resulting in a debt-to-GDP ratio of 123%.

During this time, budget deficits and the national debt were topics that most were willing to brush under the rug, ignore, or if acknowledged, kick that can down the road. There has been no real consequence to perpetually running budget deficits. When faced with a pandemic, the government responded forcefully and flooded the system with government spending. This was a necessary response in 2020, but observing interest rates that were 0% and with no desire to inflict pain on the economy, significant deficits were run in the following years. In fact, the national debt has increased by nearly $13 trillion since 2019, or approximately 50% of the current GDP.

As we have written about over the past two years, inflation has returned, and the Federal Reserve has embarked on an interest rate hiking cycle. This is now starting to have consequences on the nation’s finances. Interest expense on the debt has nearly tripled since 2021 to almost $900 billion this year. Combined with continued significant fiscal spending, the budget deficits are increasing at a rapid pace - even during an economic expansion. **The persistence of these deficits combined with the already sizable national debt is beginning to cause many to say the quiet part out loud** - this is unsustainable, and we must act now. Below is a chart showing the current projected budget deficits by year, assuming that current tax and spending policies remain in place.



Looking at the previous chart, what comes to mind is the first rule of holes. **In order to get out of a hole, you must first stop digging!** Individuals and families around the country know the only way to get out of debt is to either make more money or spend less money. The path forward on an individual level is oftentimes a combination of the two. Much like family finances, for our government, there is no silver bullet. The table below shows the total deficit reduction over 10-years for a number of proposals that are frequently mentioned as ways to solve the problem. Given the current size of the annual deficit, NONE of these proposals individually would even stop the hole digging!

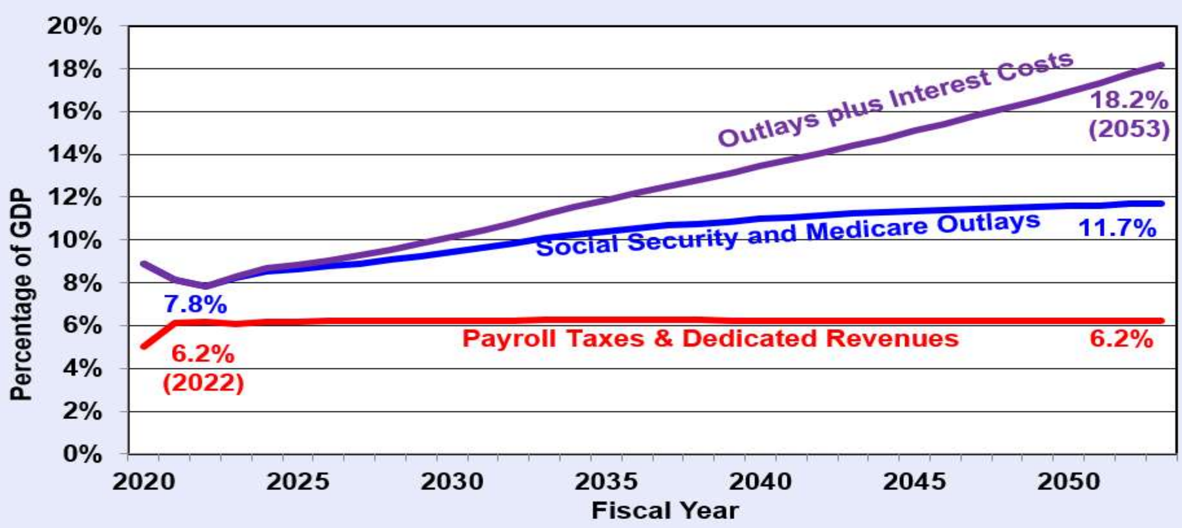
No "Easy" Pay-Fors for Social Security & Medicare: Programs Face Shortfalls of 5.5% of GDP by 2040s

Tax Proposals (static scoring)	10-Yr Savings ($Billions)	Long-Term Savings (%GDP)
Raise Payroll Tax by 10 Percentage Points, no wage limit	$11,357	3.60%
Raise Income Tax Rates Across-the-Board by 10 Percentage Points	$10,813	3.38%
Impose a 20% Value-Added Tax (VAT) – like a national sales tax	$7,800	2.75%
Repeal Tax Exclusion for Employer-Paid Health Premiums	$3,671	1.69%
Double 35% and 37% Tax Brackets to 70% and 74% (plus 15% state/payroll)	$4,583	1.52%
Repeal All Itemized Tax Deductions	$2,507	0.98%
Eliminate FICA Cap – 15.3% Payroll Tax on All Wages (*data from SSA*)	$2,992	0.90%
50% Income Tax Rate Over $200k (single) $400k (married)	$1,910	0.63%
Impose Bernie Sanders' 8% Wealth Tax (*data from TPC*)	$2,326	0.59%
Raise Corporate Tax Rate from 21% to 35%	$1,810	0.57%
Biden Tax Hikes for Multinational Companies (*data from OMB*)	$1,048	0.34%
Carbon Tax of $25/Metric Ton – no rebate for households hit	$865	0.29%
Impose Bernie Sanders' 77% Estate Tax (*data from TPC*)	$483	0.17%
Tax Dividends & Capital Gains as Income over $1M & End Step-Up (*OMB*)	$179	0.17%
Impose a 0.1% Tax on Financial Transactions	$264	0.10%
Impose a 0.15% "Bank Tax" on Large Financial Institutions (*TPC*)	$93	0.02%
Spending Proposals		
Cut Defense Budget to European Target of 2% of GDP (*data from CBO*)	$3,653	0.80%

Source: Dec. 2022 CBO "Budget Options" book unless otherwise noted. These static estimates do not account for revenues lost to the economic impact. Combining policies may also create duplications and interaction effects, so these cannot be summed.

The previous charts do not account for the unfunded Social Security and Medicare liabilities. The chart below shows how these deficits, while small currently, are scheduled to explode, further exacerbating our situation.

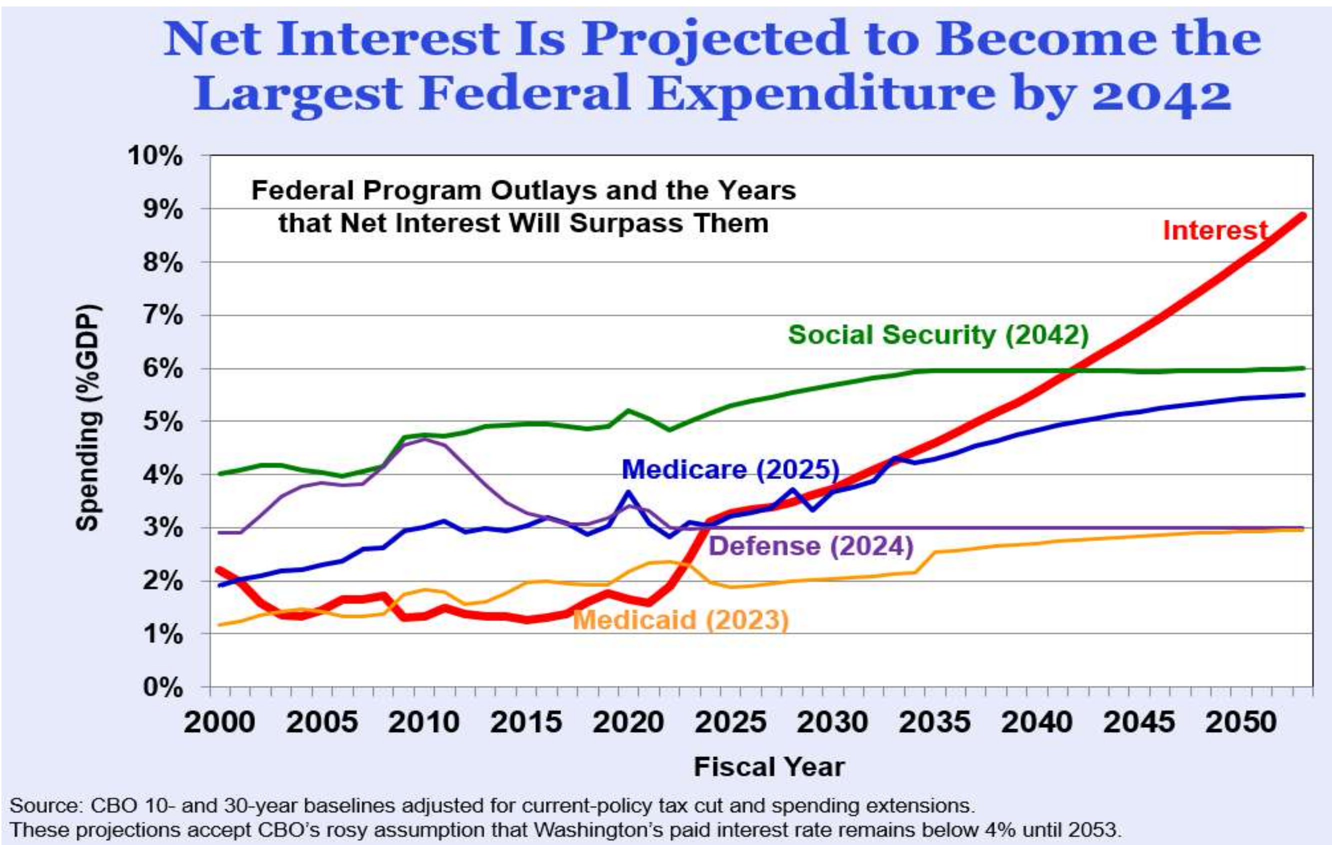
Social Security and Medicare's Cash Shortfalls Will Soar to 5.5% of GDP plus 6.5% in Interest Costs



Source: Calculated using CBO 2023 Long-Term Baseline. Outlays are net of Medicare premiums paid.
Interest costs are those directly attributable to Social Security and Medicare's annual deficits over this period.

While the situation may seem impossible, nothing is impossible. Looking at the previous numbers and charts, it is hard not to summon an inner Vince Lombardi and ask, “What the hell is going on out here?!”

The impending catalyst to do the right thing is a debt ceiling limit expiration on January 1, 2025, which will require finding a solution. Given the divisive nature of our politics and the third rails that must be touched by politicians on both sides of the aisle, we believe **it is likely that a bipartisan commission will be formed in the near future to work towards a solution.** If we continue to kick the can down the road, the problem will only get worse. The easy answers are past us. Without change, interest expense on the outstanding debt will soon overtake every other federal spending category. It is important to note that this projection from the Congressional Budget Office (CBO) assumes that interest rates remain below 4% until 2053. With current 30-year treasury bond yields hovering around 4.30%, this seems like a best-case scenario. The graph below highlights the urgency of the matter.



This will not be an easy problem to fix. The solutions will require acknowledgment of where we are, agreement on an acceptable destination over time, and shared sacrifice along the way. Winston Churchill once famously observed that “Americans will always do the right thing, only after they have tried everything else.” We optimistically agree that the time is upon us, and history is watching.