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Economics Group

Special Commentary

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Raise the Roof: A Perspective on Federal Spending

"Trends that can't continue, won't."
— Herb Stein

The current combination of low interest rates, low inflation and the dollar's foreign exchange value versus other currencies will not be sustained given the existing patterns of federal government spending and expected future budget deficits. The failure to control spending will result in some combination of higher inflation, higher interest rates, a weaker dollar, weaker economic growth and, hence, a lower standard of living in the United States relative to the rest of the world going forward. This is what the debt ceiling debate is all about.

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Increasingly, the public has become concerned about the long-run burden of entitlement spending. For more than 40 years, policymakers in Washington and many state governments, from both political parties, have benefitted from the time inconsistency problem; that is, the promise of future entitlements did not have to be delivered while previous policymakers were in office. Now that those promises are coming due, more money is needed to meet entitlement obligations. Currently, there is not a way to fund these promises without significantly altering the risks and rewards for working, saving and investing in our society.

Moreover, historically, fiscal stimulus has been proposed as a counter-cyclical tool that stimulates economic growth by adding to aggregate demand. In recent years, this view has changed and there may be a change in the structure of expectations that will affect how fiscal policy is seen. The baby boomer generation is now retiring and the younger generation no longer believes it will get the promised entitlements—but the younger generation will get the taxes. To what extent do taxpayers today discount the future tax burdens implied in current spending? This question is increasingly important for two reasons. First, the impending retirement of baby boomers and the duration of quality care they will require suggest a larger drain on the Social Security and Medicare systems than prior generations incurred. Yet, the generation of taxpayers after the baby boomers is smaller and will likely face an increased tax burden to support retiring baby boomers. Second, the extent of the current fiscal deficit is outside of the long-term experience of taxpayers. These deficits represent a possible significant change in traditional economic frameworks, with implications for growth, inflation and interest rates that would be part of any forward-looking business plan. Large, continued fiscal deficits would promote continual Treasury borrowing, which could upset the demand and supply balance of domestic and global capital markets and further alter the economic framework of the U.S. economy. The budget problems are so large and so immediate that the can is too heavy to kick down the road.

Overview of the Problem

The last minute Congressional decision over the fiscal year 2011 budget has left some to wonder about the action that needs to take place to raise the federal debt ceiling. As has been the case in the past, we expect Congress to raise the debt ceiling, but not without some much-needed consideration of the longer-term spending strategy of the federal government. Along with the debate on raising the debt ceiling, the formulation of the fiscal year 2012 budget is the other major fiscal-policy decision that needs to be made.

Both political parties agree that the deficit needs to be reduced.

Regardless of the outcome of these debates, the fact remains that the current pace of federal spending is unsustainable, and, if left unchecked, will lead to further crowding out of private investment, holding back future GDP growth and raising the risk of greater inflation and dollar depreciation over time relative to what is currently discounted in the marketplace. Both political parties agree that the deficit needs to be reduced, but the extent of the cuts and what government programs should be affected are where heavy disagreement lies. We will explore the economic implications of spending cuts and the consequences of delaying the increase in the federal debt ceiling. We also consider the effects of a prolonged delay in action of policymakers to rein in federal spending.

Raising the Debt Ceiling

Currently, the federal debt limit stands at $14.294 trillion. To meet government obligations for the rest of the current fiscal year, however, an additional $783 billion would need to be added to the federal debt limit. This represents about 20 percent of the current fiscal year budget. To stay below the debt ceiling through the end of the fiscal year 2012, the ceiling would likely have to be raised by approximately $2 trillion. As has been the case in the past, we suspect that Congress will raise the debt limit. In fact, an increase in the debt limit is required even if the budget remains in deficit or the deficit spending level is lower then current levels.[1] The questions that now need to be answered are the following: By how much should the debt ceiling be raised and what level of spending reduction needs to be made to remain under the new debt ceiling?

The general timeline for reaching the debt ceiling, according to Secretary of the Treasury Tim Geithner, begins on May 16. On this date, the Treasury Department begins taking “extraordinary” measures to stay under the debt limit. This process includes a “debt issuance suspension period,” which involves redeeming existing Treasury securities that the federal government has invested, suspending the issuance of new Treasury securities held as investments and suspending the daily reinvestment of Treasury securities held as investments by the Federal Employees’ Retirement System Thrift Savings Plan. The consequence of these measures amounts to lost interest returns in federal trust funds and the federal retirement fund. However, current law does require that the lost returns to the trust funds be restored upon enactment of a debt limit increase. These steps would ensure that borrowing is held below the debt ceiling until August 2 of this year. On the Aug. 2 deadline, if Congress has not taken steps to raise the debt ceiling, default does not become imminent, but rather all government expenditures would be prioritized and funded with only existing revenue.

Failure to raise the debt ceiling does not necessarily translate to a shutdown in government operations.

Failure to raise the debt ceiling does not necessarily translate to a shutdown in government operations; federal employees would still show up for work and would still be issued paychecks, but there would be delays in honoring the checks, resulting in a disruption in the flow of government services.[2] In addition, government agencies can continue to obligate funds as long as they have the authority to spend (an appropriation). Other types of payments that would be stopped, limited or delayed, according to the Department of the Treasury, include military salaries, Social Security and Medicare payments, interest on debt, unemployment benefits and tax refunds.[3]

The prolonged partisan politics around the fiscal year 2011 budget debate is a sign that a compromise to raise the debt ceiling is likely a ways off, and we would not be surprised if the debt ceiling debate drags on until the current Aug. 2 deadline. Another complicating factor that is starting to emerge is the need to pass a 2012 budget. The potential exists for both issues to be debated together as the beginning of the 2012 fiscal year approaches in October 2011. The next section will highlight some of the recent 2012 budget proposals that will likely shape the discussion around future federal spending plans.

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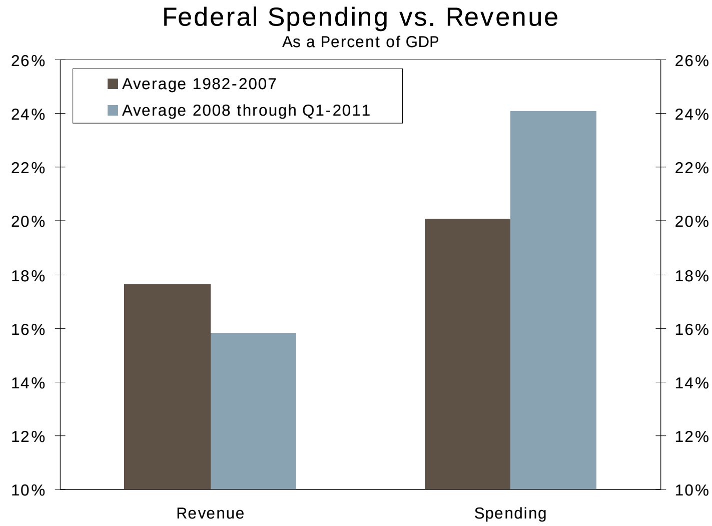
[1]Levit, M. R. et al. (2011). Reaching the Debt Limit: Background and Potential Effects on Government Operations. Congressional Research Service. R41633.
[2] Congressional Budget Office (1995). The Economic and Budget Outlook: An Update. The Economic and Budget Outlook: An Update. p. 49
[3] Letter from Timothy F. Geithner, Secretary of the Treasury, to the Hon. John A. Boehner, Speaker of the House, May 2, 2011.

The 2012 Budget Debate

As noted earlier, policymakers from both sides of the political aisle agree that the current pace of federal spending is unsustainable. Because of this agreement, the debate regarding the fiscal year 2012 budget is centered on providing a framework that reduces the long-term projected federal budget deficit. Unfortunately, while policymakers share the common goal of reining in the long-term projected federal budget deficit, they disagree immensely on what should be done to accomplish that goal.

Figure 1



Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

Policymakers from both sides of the political aisle agree that the current pace of federal spending is unsustainable.

There are two main budget proposals that form the basis for the upcoming debate on the fiscal year 2012 budget: the House Fiscal Year 2012 Budget Resolution (also known as Congressman Paul Ryan's GOP Path to Prosperity) put forth by the House Republicans and the president's Fiscal Year 2012 Budget Proposal put forth by President Obama. Both budget proposals claim to reduce the federal budget deficit substantially over the next decade, with Paul Ryan's proposal reducing the deficit to 2.0 percent of GDP by 2022 and the president's proposal reducing the deficit to around 3.1 percent by 2021.[4] On a very high level, the Ryan proposal achieves deficit reduction primarily through spending cuts, including fundamentally reshaping entitlement programs, such as Medicare and Medicaid, whereas the president's proposal achieves deficit reduction through a mix of spending cuts and tax increases. The difference in the size of spending cuts proposed in each budget plan becomes clear when looking at Congressional Budget Office (CBO) projections. According to the CBO, the Ryan proposal would cut total government outlays to around 20 percent of GDP by 2022, whereas the president's proposal would cut total government outlays to around 24 percent of GDP by 2021; if neither budget proposal is adopted and existing fiscal policy continues indefinitely, according to the CBO's Alternative Fiscal Scenario, total government outlays would climb to nearly 27 percent of GDP by 2022.[5] These alternatives represent a significant choice about the allocation of resources in our society going forward and, therefore, the likely pace of economic growth ahead.[6]

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[4] Ryan, P. (2011). The Path to Prosperity: Restoring America's Promise: Fiscal Year 2012 Budget Resolution.
Executive Office of the President of the United States. (2011). Fiscal Year 2012 Budget of the U.S. Government.
[5] Congressional Budget Office (2011). Long-Term Analysis of a Budget Proposal by Chairman Ryan.
Congressional Budget Office (2011). Preliminary Analysis of the President's Budget for 2012
[6] See also the Commentary from the Concord Coalition, http://www.concordcoalition.org/

The Ryan proposal includes heavy cuts to both discretionary and nondiscretionary spending. In terms of discretionary spending, it would consolidate duplicative government programs across numerous federal departments, including the Department of Transportation, the Department of Defense and the Department of Health and Human Services. Spending on nonsecurity government agencies would be scaled back to 2008 levels and a five-year freeze would be applied on future spending growth for these agencies. With regard to nondiscretionary spending, the Ryan proposal would convert Medicaid into a program that distributes block grants to states, giving states more flexibility in terms of providing health insurance to low-income families. The proposal would also transform Medicare into a premium support model whereby individuals now under the age of 55 would receive a specified premium, which increases over time, to cover the cost of private health insurance upon retirement. With regard to reshaping Medicare, a key element in the Ryan proposal involves repealing the Affordable Care Act that was passed last year.[7]

The Ryan proposal achieves deficit reduction through spending cuts, whereas the president's proposal achieves deficit reduction through a mix of spending cuts and tax increases.

Figure 2

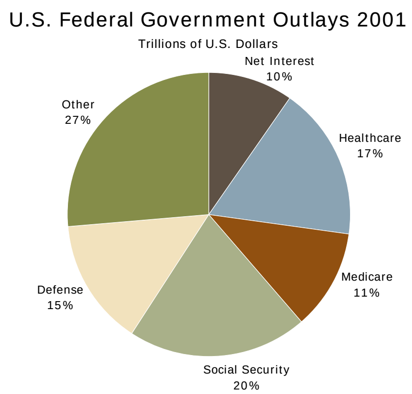
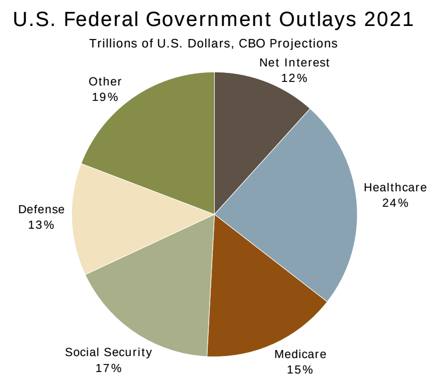


Figure 3



Source: Congressional Budget Office and Wells Fargo Securities, LLC

The president's proposal includes savings that would come from reductions in security and nonsecurity discretionary spending, new healthcare savings and cuts to a number of mandatory spending programs, which, together, account for about half of the proposed deficit reduction. The president's proposal would cut spending across a broad assortment of federal departments, including the Department of Education, where many K-12 duplicative programs would be consolidated, and the Department of Agriculture, where cuts would come from direct payments to high-income farmers, rural home loan programs and wetlands conservation programs. In terms of Medicare and Medicaid, the president's proposal would not fundamentally change the structure of these programs, but rather it would make both programs more efficient by identifying new healthcare savings to offset rising medical-care costs.[8]

The fiscal year 2012 budget proposals from Congressman Paul Ryan and President Obama both identify changes to the federal tax system, which have very important implications for future economic growth.[9] The Ryan proposal calls for a simpler, less burdensome tax code for households, small businesses and corporations. The Ryan proposal would reduce the top individual and corporate tax rates from 35 percent to 25 percent and broaden the tax base, eliminating tax breaks, such as the mortgage interest deduction, to meet revenue targets. Tax changes under the Ryan proposal seek to be revenue neutral over the medium to long term. The president's proposal, on the other hand, relies on both a broadening of the tax base and revenue increases at the federal level. It would allow the 2001-2003 tax cuts to expire for top income earners and the long-term capital gains tax rate would rise to 20 percent from 15 percent. The president's proposal would also eliminate several tax preferences, such as fossil fuel tax

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[7] **Ryan, P. (2011). The Path to Prosperity: Restoring America's Promise: Fiscal Year 2012 Budget Resolution.**
[8] **National Conference of State Legislatures. (2011). Overview of the President's FY12 Budget.**
[9] **See reports on both proposals by the Congressional Budget Office, www.cbo.gov**

preferences for oil companies, and add new business taxes into the current tax code, including fees on certain liabilities at large financial institutions operating in the United States.[10]

While neither of the budget proposals on the table for fiscal year 2012 will likely become law in their present form, they do at least provide a basis for debate among policymakers. Given the agreement on both sides of the political aisle regarding reining in government spending, we expect the fiscal year 2012 budget to encompass substantial cuts to federal outlays when it is all said and done. In addition, some have advocated establishing a debt-to-GDP ratio with tax and spending triggers.[11] It is also reasonable to assume that the fiscal year 2012 budget will encompass some form of tax policy change; however, there will likely be strong opposition from Republicans in the House to any tax policy that seeks to impose higher tax rates and raise revenue. Shortly, we will examine the economic impact that lower government spending and tax policy changes may have on economic growth in the United States.

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Expected Economic Impact of Debt Ceiling Debate

A prolonged debate on raising the federal debt ceiling will likely have a somewhat negligible effect on the current pace of GDP growth. However, a prolonged debate may result in reduced confidence in the ability of U.S. policymakers to make fiscal policy decisions, and, in turn, result in upward pressure on interest rates.

We will first turn to the short-term impact of a prolonged debate around the debt ceiling. The immediate impact of a prolonged debate on the debt ceiling, contrary to popular belief, will not likely have much of an effect on interest rates. The reason is tied to two offsetting effects related to increased default risk and a reduction in the supply of Treasury securities. Treasury rates may begin to rise due to the increased default risk as the debate drags on; however, starting on May 16, the Treasury Department will reduce the issuance of new Treasury Securities, thus the supply of new Treasury securities will be reduced, resulting in downward pressure on interest rates. Our view is that these two factors will offset, resulting in little change in near-term interest rates.

The immediate impact of a prolonged debate on the debt ceiling, contrary to popular belief, will not likely have much of an effect on interest rates.

Finally, if a compromise on the debt ceiling is not reached by the Aug. 2 deadline, there would be a negative economic shock that would result. The slowdown in government operations would lead to increased risk premiums in the bond market, the manufacturing sector would see slowdowns in capital goods orders and shipments and the pace of job growth would slow due to a decreased need for government contractors. These combined effects along with the large decline in federal government expenditures would have a negative effect on GDP growth.

Expected Economic Impact of the Fiscal Year 2012 Budget

As mentioned, we expect next fiscal year's budget to encompass substantial cuts to federal outlays. In terms of the impact to economic growth, cuts in federal outlays per the fiscal year 2012 budget would certainly not be insignificant. Government spending is a key component in the calculation of GDP, and, generally speaking, cuts in government spending have a negative effect on GDP growth. How large of a negative effect cuts in government spending have on GDP growth, in the short run, depends on an assumed government-spending multiplier and offsetting effects.

A prolonged debate with no compromise from either political party would hurt both domestic and foreign investor sentiment and reduce business confidence in the private sector.

Cuts to government spending do not always have a one-for-one dollar impact on GDP growth.[12] How much a one dollar cut in government spending affects gross domestic product is what economists call the government-spending multiplier. The size of the government-spending multiplier depends largely on the macroeconomic environment in which federal spending cuts take place. Some have argued that cuts in government spending have a larger negative impact on GDP growth when the economy is below full employment and interest rates are low, which are certainly characteristics of the current macroeconomic environment. However, cuts in government spending also tend to have offsetting positive effects on economic growth. For one,

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[10] Ryan, P. (2011). The Path to Prosperity: Restoring America's Promise: Fiscal Year 2012 Budget Resolution.
[11] The Concord Coalition. (2011). Understanding the Federal Debt Limit.
[12] The history of fiscal restraint in Canada provides an interesting alternative view to the conventional wisdom.

cuts in government spending, especially following periods of overspending, tend to increase business confidence and tax certainty in the private sector. This occurs, because firms see federal spending cuts as a sign of fiscal prudence, which leads firms to expect a less burdensome tax environment in the future—that is, less burdensome than the tax policy that would have been needed to finance government outlays had spending cuts not taken place.

The other offsetting effect cuts to government spending can have on GDP growth relates to the long-term cost of capital for firms. Chronic federal budget deficits resulting from overspending have the potential to weaken investor confidence, as well as confidence in the U.S. dollar, which increases the cost of borrowing for the government by adding a higher risk premium for government debt. Since the cost of borrowing for the government is a large determinant of the cost of capital for firms operating in the private sector, chronic federal budget deficits tend to increase the cost of capital at firms. So, all other things being equal, cutting government spending and improving fiscal prudence on the part of government can have the offsetting effect of lowering the future cost of capital for firms operating in the private sector, which increases business investment and economic growth.

The longer-term offsetting effects of cutting government spending would make any short-term subtraction from GDP worth the longer-term benefits.

Figure 4

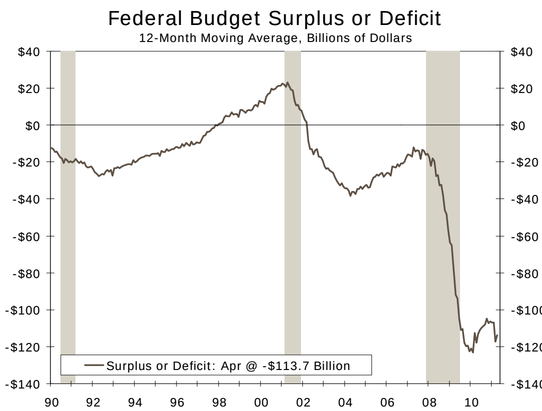
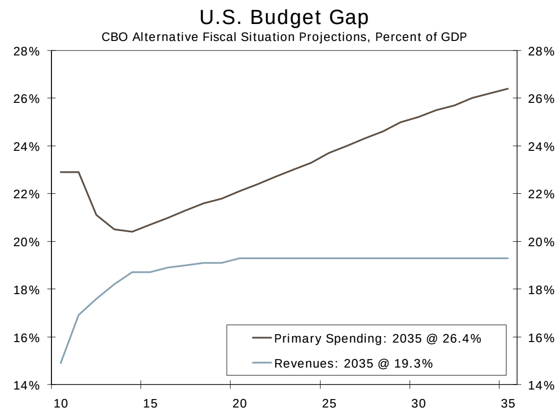


Figure 5



Source: Congressional Budget Office, U.S. Department of Commerce and Wells Fargo Securities, LLC

While it is difficult to estimate what the true economic effect will be from a fiscal year 2012 budget that drastically reduces government outlays and reforms tax policy in some way, one thing is for certain: A prolonged debate with no compromise from either political party would hurt both domestic and foreign investor sentiment and reduce business confidence in the private sector. As a result, further delay among policymakers in terms of addressing unsustainable spending at the federal level increases the risk of longer-term negative economic implications. In addition, higher levels of debt translate into greater federal spending in the form of interest expenses, and, in turn, limit the ability of the federal government to respond to unexpected shocks.[13] So, while a reduction in federal spending will likely subtract from economic growth in the near term due to government-spending multiplier effects, the longer-term offsetting effects of increased confidence and stability in credit markets from anticipated lower federal budget deficits would make the short-term subtraction from GDP worth the longer-term benefits.

[13] **Congressional Budget Office. (2010). Economic Impacts of Waiting to Resolve the Long-Term Budget Imbalance. Economic and Budget Issue Brief.**

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