VIEWPOINT

Montreal Economic Institute
Ideas for a More Prosperous Nation

Viewpoint on US Government Finances

by Germain Belzile and Jean-François Minardi

October 2013

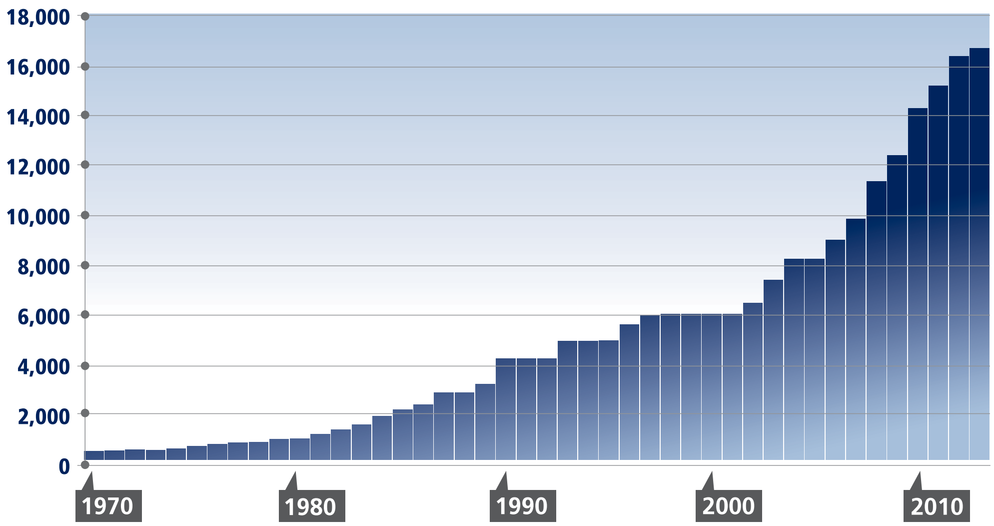
Ever since the adoption of a law to that effect in 1917, the debt of the American federal government is subject to a "ceiling," which is to say a restriction on the amount of bonds that the Treasury Department can issue. A government that wants to borrow above and beyond this threshold because of a deficit must obtain from Congress a law that raises this ceiling (see Figure 1).[1] The current ceiling (US$16.7 trillion) should be reached during the month of October, 2013 due to a deficit of at least US$750 billion for the fiscal year that ended on September 30.[2]

Barring an agreement on the subject in Congress, the US government could be unable to meet its financial obligations. This melodrama, which is a repeat of those that have unfolded numerous times in recent years, is the result of high and recurring budget deficits. These have caused the debt to rise from 49.3% to 72.6% of GDP over the past twenty years.[3]

Unsustainable spending increases

From 1993 to 2012, total federal government spending increased by 63%, which is faster than revenue (43%) or real US GDP (58%). The result: 16 deficits in 20 years. It is therefore not just difficult economic conditions that are weighing down American government finances. Revenue and spending currently represent 15.8% and 22.8% of GDP, respectively. Even if we reduced them to their averages over the past two decades, 17.7% and 20.6%, deficits would persist.

Figure 1 — Debt ceiling of the US federal government (in billions of current dollars)



Source: White House, Office of Management and Budget.

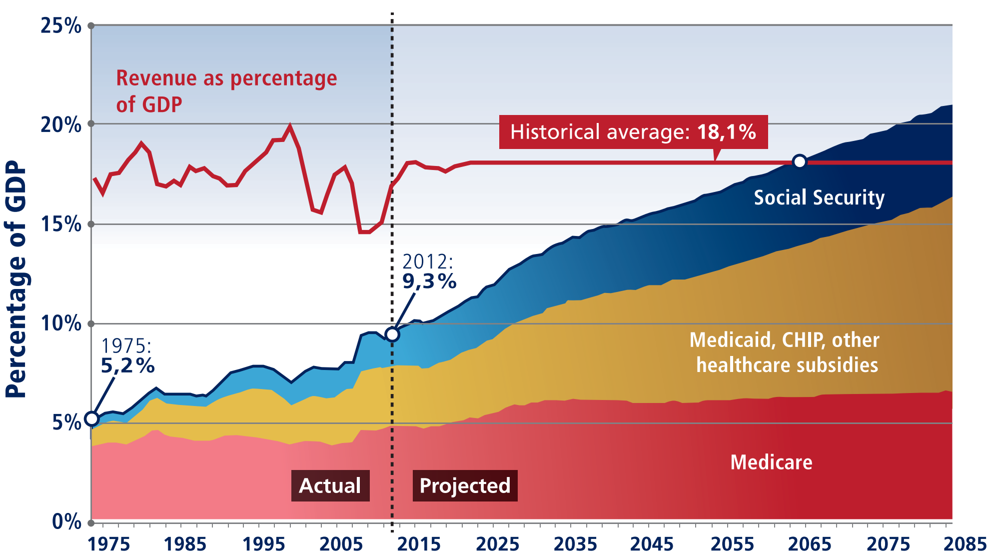
Furthermore, even if we managed to balance revenue and spending, this would only be enough to solve the most pressing problem: budget deficits. It would not allow for a reduction of the debt subject to statutory limit. Nor would it spell the end of the basic imbalance in American government finances, which is due to the ever-growing financial obligations stemming from social programs.

Federal government spending can be divided into two broad categories: mandatory spending and discretionary spending. Mandatory spending is spending that is determined by laws governing social programs, like Medicare and Medicaid (health insurance for the elderly and for the poorest Americans), Health Exchanges (Obamacare) and Social Security (the federal pension), plus interest payments on the debt. Discretionary spending does not have such rigid parameters. It is determined annually by the budget and covers military spending, administration, infrastructure, etc.

For 20 years, discretionary spending has risen at a slower rate than GDP (+45%), while mandatory spending has risen at a much higher rate (+108%). This trend actually dates back to the

1. H. J. Cooke and M. Katzen, "The Public Debt Limit," *The Journal of Finance*, Vol. 9, No. 3, September 1954, p. 298. D. Andrew Austin and Mindy R. Levit, *The Debt Limit: History and Recent Increases*, Congressional Research Service, September 2013, p. 2.
2. A trillion dollars is a thousand billion dollars. Congressional Budget Office, *Monthly Budget Review for August 2013*, September 2013.
3. This refers to the debt held by the public.

Figure 2 — Main mandatory social spending by the US federal government



Source: Congressional Budget Office.

baby boomers combined with increases in longevity, this figure will keep rising. Indeed, these entitlements will eventually surpass, all by themselves, the historical average for federal revenue, 18.1% of GDP, leaving no room for discretionary spending and forcing the government either to live with higher and higher deficits or to continually increase taxes (see Figure 2).[6] This is where the real imbalance in American government finances is to be found.

To solve this problem, some are contemplating a federal sales tax. In Canada, such a sales tax exists: the Goods and Services Tax (GST). We have calculated that the implementation in the U.S. of a GST at a 5% rate would only postpone the problem for

Second World War, which explains why mandatory spending now represents nearly half of the budget.[4] Once again, we can see that this is not a cyclical problem, but rather a structural problem.

According to the forecasts of nonpartisan organizations, this unsustainable increase in mandatory spending will continue, in part because American social programs are not financed by their end users, but instead as needs arise. In other words, no money is set aside to cover future costs. The unfunded liabilities related to these social programs already amount to several tens of trillions of dollars.[5]

If we assume that no new social programs will be created in the meantime, mandatory social spending will increase from 9.3% of GDP today to 14.1% in 2035. And given the retirement of the

a dozen years. The rate of the tax would then have to be continually increased in order to compensate for the growth in mandatory spending and would reach 15% in 2035, three times to current level of the GST.[7] Moreover, such an increase in the tax burden would have a substantial negative effect on economic growth. Such a solution does not resolve the fundamental imbalance in US government finances.

Conclusion

Only one solution is sustainable in the long run: unrealistic increases in government spending must be prevented by undertaking a deep reform of American social programs. In other words, the solution is to be found on the spending side of the federal budget.

4. Pierre Lemieux, *The Public Debt Problem: A Comprehensive Guide*, Palgrave Macmillan, 2013, pp. 55-56.
5. Estimates of the extent of these unfunded liabilities range from $55 trillion according to the Treasury Department to $222 trillion according to the calculations of economist Laurence Kotlikoff based on the long-term projections of the Congressional Budget Office.
6. Congressional Budget Office, *The 2013 Long-Term Budget Outlook*, September 2013.
7. This calculation assumes a tax similar to the GST. The relationship between the tax rate and the revenue generated by the tax would be the same as for the Canadian tax. The dynamic impact of a sales tax on the economy is not taken into consideration, which underestimates its rate.

Germain Belzile and **Jean-François Minardi** are respectively Senior Fellow and Public Policy Analyst at the Montreal Economic Institute.