SIGNATUREFD

WORD OF THE YEAR: "UNSUSTAINABLE"

A SIGNATUREFD WHITEPAPER

abstract

It's no secret that the United States is facing a serious fiscal crisis. The country's current financial situation is unsustainable, and the possibility of reaching a "fiscal cliff" in early 2013 is becoming more real unless our leaders take action soon. But even if we manage to avoid a crisis come January 1, that won't make the larger financial issues the U.S. is facing disappear. The fact is, change is coming, whether we like it or not, particularly to entitlement programs, like Medicare and Social Security. However, there are solutions to the problems we face, and we will be better served by making an effort to work toward those solutions rather than having to cope with change forced on us by a crisis. The question is whether we will have the will to work together and make difficult decisions so that we can preserve the promise of America for our children and grandchildren.

The headline reads, "GAO Warns of Fiscal Crisis," and the story starts out with an ominous warning: "The head of Congress' auditing arm [David Walker] warned Thursday that 'imprudent and unsustainable' federal borrowing is driving the nation toward a fiscal crisis."[1] When was that article published? Friday, January 23, 2004—more than eight years ago. In a globalized world, these imbalances don't happen in a vacuum. In March 2011, China's Premier, Wen Jiabao, said, "It has become more urgent, but also more difficult, to solve institutional and structural problems, and alleviate the problem of unbalanced, uncoordinated and unsustainable development."[2] The Chinese policymakers have been using similar phrases since at least 2007 to inform the markets that the next phase of Chinese growth will be different from the last.

THE QUESTION IS NOT IF CHANGE WILL HAPPEN, BUT RATHER, *CAN IT HAPPEN IN A WAY THAT HAS LIMITED NEGATIVE CONSEQUENCES?*

The international topics are beyond the scope of this paper, but it is important to realize they exist. For the United States, though, the timing of David Walker's warning seems to be drawing nigh. The question is not if change will happen, but rather, *can it happen in a way that has limited negative consequences*? Certainly, this is currently unknown, but we believe the decision points are coming. It is likely to be the issue on the table during the upcoming elections. What is clear is that our political leaders now understand that things are unsustainable. This was not the case when David Walker spoke in 2004, or, we would suggest, even last year before the debt ceiling debate. Why is this a positive change? As the saying goes, "The first step in solving a problem is admitting that you have a problem."

FRAMING THE BROAD ISSUE

The term "fiscal cliff" has been appearing with greater frequency as the media and politicians start to realize that there is a potential crisis looming at the end of this year. "Fiscal cliff" describes what will happen at the end of 2012 if no legislative changes are made. Under current law, several tax and spending changes are set to occur which are expected to decrease GDP by an estimated 3.5%.[3] Many believe a "perfect storm" could be the trigger to push the United States over the edge into a financial disaster. The Congressional Budget Office (CBO), not usually a group to resort to hyperbole, recently projected that without changes before year-end, a recession in 2013 is likely. In a report released last month, the CBO concluded that the so-called "fiscal cliff" would cause, "[a] weakening of the economy [that] will lower taxable incomes and raise unemployment, generating a reduction in tax revenues and an increase in spending," and that, "such a contraction in output in the first half of 2013 would probably be judged to be a recession."[4] Simply put, the CBO is projecting that the expected outcomes on January 1, 2013, are too significant for the economy to handle without triggering a negative reaction.

The CBO paper generally reviewed the long-term impacts of two extreme scenarios—one where all current laws take effect as currently written, and a second where most of the scheduled tax increases and spending cuts are permanently extended. The long-term impact from these two extremes shows how, and why, some type of compromise will have to be reached. Under the former scenario, where all current laws go into effect, the long-term fiscal situation appears sustainable based on the CBO projections, but the pain would likely be politically impossible—a type of financial shock therapy the country has never seen. The country would likely enter a relatively severe recession quickly, and pressure on politicians to take any possible action to end this discomfort

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would cause changes in policy back towards something resembling the current situation. Under the latter scenario, large deficits become permanent and the total government debt moves to 200% of Gross Domestic Product (GDP) by 2037. The market would likely revolt many years before this level were to be reached.[5] Thus, we conclude that the situation is truly unsustainable, and some change is coming, likely within the next year. Later in this white paper series we will detail our hopes for what a true compromise would look like.

Before going further into the details, it is important to understand the true facts about the U.S. fiscal situation. As we mentioned in our first white paper, "Economic Outlook: The Debt Supercycle," the total government debt (federal and state) as of year-end was approximately $25 trillion. This is equal to 164.9% of our total economy, according to Ned Davis Research.[6] However, we need to break this number down further to get a full understanding of the current situation. Total government debt declines to 124.9% after removing the debt of the housing system (mostly Fannie Mae and Freddie Mac). These debts were assumed by the U.S. Treasury during the 2008 financial crisis, and are backed by home mortgages. The long-term losses from these are manageable and likely to be modest compared to the overall size of the liabilities assumed. Finally, after removing the liabilities held by various intra-government accounts (e.g., the Social Security Trust Fund), the amount held by the public (including foreign central banks) is equal to 93.8%. This number is high—nearly double from the total in 1980—and is growing at an unsustainably rapid rate. However, the current problem is solvable. In this observation we find a reason to be optimistic.

Starting with the premise that the existing government debt can be reduced over time from the current starting point is an important concept. The next level then is to study the trends and the rate of change. On this front, things appear more concerning. The 2012 federal budget shows that only 68% of total spending will be covered from revenues and a full third of spending is paid for via borrowing ($1.2 trillion.)[7] These numbers sound incomprehensible to many people, so it is important to understand what they mean. Given the amount of total income the federal government receives, it is not even covering the four largest line items in the budget: Medicare and Medicaid, Social Security, defense, and interest. In other words, every other program and expense of the government, except these four, could be completely wiped away and we would still run an annual budget deficit.

The scale of the current deficit has three primary causes.

- First, the cyclical increase in spending that occurred because of the 2008–09 financial crisis.
- Second, the persistent decline in tax revenues at the federal level.
- Finally, the structural rise in entitlement spending that is based mostly on demographics, particularly as baby boomers retire.

Forecasting the current trends into the future is fraught with danger. However, one of the most comprehensive studies we have seen was done by Boston University Professor Laurence J. Kotlikoff. In his study, Kotlikoff concluded that the net present value (he called it the fiscal gap) of all future expenses minus all future revenues is equal to $211 trillion.[8] Of this amount, future spending on Medicare, Medicaid and Social Security is more than 70% of all future government outlays. Thus, the source of any necessary change becomes rather clear.

THE "ELEPHANT IN THE ROOM"— ENTITLEMENT SPENDING

An IMF study concluded that the biggest factor affecting its projections was related to healthcare costs. These costs essentially rise to 18% of GDP, encompassing the entirety of federal revenues by 2050. Mary Meeker, a well-known analyst, produced what we believe to be the best compilation of data and analysis related to the fiscal challenges in a presentation called "USA, Inc." Her report takes a look at the U.S. government and financials from a business-like perspective. Most of the details in the rest of this section come from her work.[9] In her summary, Meeker concludes that, "more than 35% of the U.S. population receives entitlement dollars or is on the government payroll, up from ~20% in 1966." She further concludes that, "Entitlement expenses amount to $16,000 per household per year, and entitlement spending far outstrips funding, by more than $1 trillion (or $9,000 per household) in 2010."

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The outlook for Social Security is not nearly as dire as that for medical expenditures, but due to demographics, reform will be needed soon. In reality, Social Security was created as a pay-as-you-go funding program. As such, over most of the period since it was started in 1935, revenues have matched or exceeded the actual expenditures. In fact, revenues to date have exceeded expenditures due to the baby boom generation and previous reforms. As a result, approximately $2.5 trillion of assets are held in the Social Security Trust Fund. The Treasury is obligated to pay back these funds, but they were spent on other areas over the years, resulting in a situation where the economic costs of the program are more serious than the legal ones.

However, because Social Security does have significant revenues associated with it, fixing the program is not impossible. The demographic data is clear. In 1935, the average life expectancy was 62 and benefits didn't begin until age 65, thus only 1 in 127 Americans were receiving benefits. Today, life expectancy is 78 years and the retirement age is 67, which has resulted in 1 in 6 Americans receiving benefits. In the 1970s and early 1980s, Social Security became significantly underfunded as a result of high inflation, and major reform was implemented in 1983. These changes delayed a permanent underfunded situation until 2016. Now, it is time to again review reforms. Three basic levers exist for fixing Social Security: adjust the retirement date, the benefits, and/or the tax rates. Each or a combination of these reforms can be made and have relatively slow and modest impact. For example, the combination of increasing the retirement age to 70 and a reduction in annual cost of living of 0.5% would essentially close the gap.

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So now that we have fixed Social Security, let's move on to the really big challenge: Medicare and Medicaid. Unlike Social Security, which has a fairly significant source of funding, Medicare has limited funding through beneficiary copays. Medicaid has almost zero funding. As a result, problems with these programs are much more difficult to address. Further, the costs of healthcare are rising more than 8% annually due not only to the demographic wave, but also because of advances in medicine and significant end-of-life expenses. As a result of these trends, total government spending on healthcare is now 8.2% of our total economy compared to 1.2% in 1960. When Medicare was implemented in 1965, fewer than 20 million Americans were eligible; today that number has grown to 46 million. More concerning, in constant 2005 dollars, the annual spending per Medicare participant has grown from less than $500 to $8,325. Enrollment in Medicaid has exploded even faster. When the program was established in 1966, fewer than 4.5 million Americans qualified; today more than 50 million are eligible. Total per capita spending has been somewhat more restrained for Medicaid, with averages going from about $1,000 to $4,500.

Certainly the potential exists for our healthcare to be the finest in the world. But it is troubling that we produce such poor results for such high expense. Our annual spending is three times the average of other developed countries while our life expectancy is only ranked twenty-fourth. In looking at solutions for these programs, pure economic changes are not going to be possible. Average Medicare benefits would have to be reduced by 53% or Medicare tax rates increased by 75% to balance that program, and Medicaid is nearly impossible to fix without a dedicated revenue source.

In reality, a more comprehensive solution that considers some combination of the following is necessary: reduced litigation and defensive medicine, spending exclusions for non-mandatory procedures/services, reduced benefits for higher-income participants, increased Medicare tax rates on workers, increased efficiencies in delivery of services, and reduced spending during last 12 months of life. These are emotional and politically charged topics, and a more detailed analysis of a combination that is feasible and politically possible is beyond the scope of this paper.

MODERN CLASS WARFARE

The heart of the entitlement issue is likely to result in what we would call a modern-day version of class warfare. In our opinion, however, it is as much about a generational tension as it is about a collision of classes. Niall Ferguson questioned recently, "whether the U.S. can solve its 'clash of generations.' The pressing divide is not the 1% versus the 99%," he argued, "but the baby boomers versus their children and grandchildren."[10]

Optimistically, we feel that Americans always come together when the time calls, and as Thomas Jefferson stated, "An informed citizenry is the only true repository of the public will…The People cannot be safe without information. When the press is free, and every man is able to read, all is safe." Our hope is that all citizens would be eagerly seeking to understand the facts of our situation and make decisions based on their heartfelt desires. As has happened so many times before, we believe an enlightened, self-interested and educated public will make the right decisions.

That said, we do worry about results of recent polling. According to a Pew Research study released last summer, 60% of Americans believe it is more important to keep Social Security and Medicare benefits while 32% felt it was more important to reduce the deficit.[11] That research also showed that support for change is actually declining. In February 2006, "70% of Americans said Medicare needed to be completely rebuilt or undergo major changes; today, 54% say the same."[12] The generational views come out quite clearly in the polling data. For both Social Security and Medicare, approximately 60% of those over age 65 believe the programs do an 'excellent or good' job of serving people they cover. At the same time, 62% of those ages 35-49 view those program as doing 'only a fair/poor' job of serving those they cover.[13]

Depending on the way the figures are calculated, we estimate that the federal government has made 'promises' that equal 1.6 to 2.0 times its likely resources over the next 50 years. It is a mathematical certainty that all the presently promised liabilities of the government cannot be paid.

We can see in this dilemma the genius of the representative form of government. Left to a complete democracy, these solutions are unlikely to be solvable. But with our form of government, our best hope remains that our elected leaders that set aside personal differences to do what is right for the nation as a whole. We all have a voice in this process, and we encourage everyone to exercise it this year, and every year. We find a passage in George Washington's 1796 Farewell Address that seems to almost recognize the state we are in:

> *As a very important source of strength and security, cherish public credit. One method of preserving it is to use it as sparingly as possible, avoiding occasions of expense by cultivating peace, but remembering also that timely disbursements to prepare for danger frequently prevent much greater disbursements to repel it, avoiding likewise the accumulation of debt, not only by shunning occasions of expense, but by vigorous exertion in time of peace to discharge the debts which unavoidable wars may have occasioned, not ungenerously throwing upon posterity the burden which we ourselves ought to bear. The execution of these maxims belongs to your representatives, but it is necessary that public opinion should co-operate.*[14]

A NEW MORNING IN AMERICA

It has become apparent to most observers that the U.S. is on an unsustainable fiscal path. Every person we speak with seems to have an answer to this far-reaching and wide-ranging problem. The difficulty is in bridging the gap between opinions and political rhetoric and the cold hard facts of economics and accounting. In reality, the problem is extraordinarily complex and multi-dimensional. If there were any 'easy' solutions, we fully believe they would have been employed by now. That said, it is clear we are approaching a watershed moment in our country's fiscal management. The combination of expectations for ever-expanding social safety nets along with relatively low levels of taxation (compared to most developed nations) is no longer a possibility as we confront a future with challenging demographics, slower growth and high levels of current debt. In the end, some compromise between these two competing goals will need to be struck.

The longer we wait to address these structural issues, the more daunting and dramatic the solutions required will need to be. Moreover, as we wait, the potential for crisis-forced change will continue to rise. Our goal in writing this paper is not to add to the already nauseating partisan rhetoric. Rather, our hope is to elevate the awareness of our fellow citizens to the severity and urgency of the task at hand. Each generation of Americans has been asked to rise to the occasion and leave this country better than when they were born. We have no doubt this will happen again.

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Although the topics discussed in this paper are difficult, and our commentary may sound bleak, we don't want the reader to "give up hope." The facts are the facts, and they are difficult. Nonetheless, we remain optimistic that solutions will be found. The history of capitalism in America is one of constant creative destruction, yet in the end the system has always come back stronger than it was before. We believe fully in the American dream, our internal strengths, and the flexibility of our political, economic and military systems. Although the current challenges obscure our vision, we are confident that a new day will dawn soon, as it always has before.

Ronald Reagan once said, "Freedom is never more than one generation away from extinction. We didn't pass it to our children in the bloodstream. It must be fought for, protected, and handed on for them to do the same." We would argue that the same can be said about economic strength. For each generation to pass along the opportunities and blessings of our great economic system, it must be handed off with proper investments in education, innovation and without the burden of growth-sapping debt. The time for recognizing the importance of these issues is now.

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