Too Dovish on Debt?

A common refrain among deficit hawks is that the federal government, like prudently run businesses and households, should minimize the use of debt. Bloomberg Opinion columnist Noah Smith recently wrote a smart retort to the PAYGO crowd that explains the unique role of the federal government as a seeder of innovation, the benefits of which are realized downstream (e.g. funding basic research through agencies like DARPA, whose communication protocols led to the internet).

While I agree with the points he raised in principle, I am concerned that the growing chorus of "spend, baby, spend," whose voice was already full-throated prior to the pandemic, is abandoning all pretext of reason. To be clear, I am not arguing against targeted relief for those hit hardest by the pandemic. Indeed, we have a moral obligation to help those facing eviction, foreclosure, and hunger through no fault of their own. However, there are two reasons that cause me to fear that by courting ever-higher levels of debt, we are whistling past the graveyard.

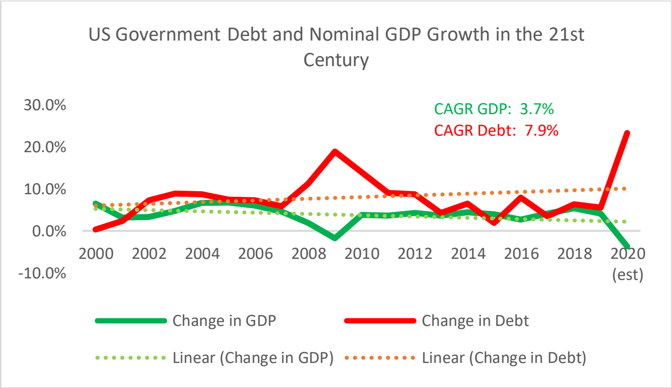
1. The theory that debt can benignly rise in perpetuity requires a relationship between debt and growth we have not seen this century.
2. The nearly $28 trillion of debt is only the tip of the iceberg. Unfunded obligations, shaky state and local finances, and unbudgeted critical needs, understates the true debt level and undercuts the notion that the current high spending level will be temporary.

Growth of government debt vs. GDP growth

Noah argues in his article that:

> In the long term, the government can run deficits forever, as long as the economy grows faster than the debt. In the short term, it can run up debt even faster than that and still be OK, as long as it's a temporary thing — like Covid relief, or the stimulus in the Great Recession.

Theoretically, that is correct. However, as illustrated in the graph at right, for the first 21 years of the 21st century, the economy has grown in nominal terms at less than half the rate as US government debt. Further, as we will discuss, there is no shortage of "temporary" spending imperatives like Covid relief or recession stimulus. Much like companies that ask us to overlook a surprisingly steady stream of "special items" when reporting earnings, there is a constant drumbeat of emergencies and national priorities that require massive capital outlays.



(Sources: Statista, World Bank, Statista, author's calculations[1])

Often referred to in the abstract, it is important to emphasize that it is not enough for the government to simply "spend". The government must do so in a deliberate, thoughtful way that leads to higher economic output that is broadly shared. On this measure, the data suggest a poor record.

In the three years of the Great Recession (2008 – 2010), federal spending jumped in each successive year by 11%, 19%, and 14%. Despite spending on a scale not seen since WWII, average nominal GDP growth in the decade that followed (2010 – 2019), was 23% lower than the average of the first 8 years of the century. Adjusted for inflation, the economy has grown about 2% per year since the Great Recession (excluding 2020, which will be negative). Both the rate of new business formation and labor productivity growth are at or near historic lows.[2] [3]

What has increased is income inequality. Between 2009 and 2019, income for the top 1% of household increased by 20.4%. More than 2.3 times the rate for the bottom 90%.[4] This is largely due to the fact that the trillions of dollars printed by the Fed have not been used to invest in Americans through any number of needed projects or programs. It has instead been hoovered up by the financial system's insatiable

[1] The $28 trillion debt total for calendar year 2020 is based on monthly debt data through October 2020, and assumes a rise at its average monthly increase for the remainder of 2020. Year-end 2020 GDP uses a consensus estimate of -3.7% growth.
[2] Bureau of Economic Analysis
[3] Bureau of Labor Statistics
[4] Economic Policy Institute

need for free cash to inflate asset prices, which, of course, accrues to those with the least need for government support.

The tip of the iceberg

The estimated $28T national debt by year-end 2020 amounts to about $215,000 per household. Think of it as an additional mortgage to be paid off in $900 monthly morsels by each of us over the next 30 years.[5] If that seems like a big ask, it gets worse. The $28 trillion figure does not include state and local debt, and, more crucially, unfunded liabilities. Therefore, the amount of money that the government (you, I, our children) must come up with at some point, is significantly greater.

Federal Unfunded Liabilities

Unlike corporations, government accounting excludes its "implicit" liabilities and obligations. This "voodoo accounting" (h/t George H. W. Bush) results in "unfunded liabilities" that dwarf the headline national debt number. According to the non-profit research institute, Just Facts, at the close of fiscal year 2019, the federal government had accrued the following:

- $10.1 trillion for federal employee retirement benefits and other liabilities
- $35.2 trillion in unfunded obligations for current Social Security participants
- $42.3 trillion in unfunded obligations for current Medicare participants

The $87.5 trillion in unfunded liabilities from these 3 sources is more than 3 times the national debt.[6] These numbers may very well understate the liabilities related to these programs. The Social Security and Medicare numbers are related to *current participants*. That means it excludes young people who have not yet entered the workforce. They will be expected to pay for these liabilities to support their parents and grandparents, naturally, but no provision has been made for actually extending these benefits to them.

Additional required spending

In addition to current debt and unfunded liabilities, there is the need for additional spending for which the government has not accounted.

It is well-reported that the U.S. has significantly underfunded the investment required to maintain the nation's infrastructure. In its most recent "report card", the American Society of Civil Engineers gave America's infrastructure a "D+." The total gap between needed and planned infrastructure investment is $2 trillion through 2025. Left unaddressed, it would result in loss of almost $4 trillion in GDP during the same period.[7]

Also unaccounted for are the massive investments needed to reduce systemic inequalities, specifically:

- remaking our education system so *all* Americans can compete effectively in a global economy; and
- a healthcare system befitting a first-world country.

No doubt there are more needs unaccounted for, and it is certain there will be other "one-off" emergencies that will require additional expenditures. The point here is that while Covid relief may be a "temporary thing," the need for the government to make additional unbudgeted and significant additional cash outlays – for both what we can anticipate and emergencies unforeseen – will not abate.

Trouble at the state and local levels

The federal government can't look to pass some portion of unfunded liabilities related to Social Security and Medicare down to the states through unfunded mandates. State and local budgets are straining under the weight of a combined $3.3 trillion in outstanding debt and hundreds of billions in unanticipated spending and lost revenue related to Covid.[8] Since states cannot print their own money and 36 have rigorous balanced budget requirements, they will be looking to feds for help. Like the federal government, states and municipalities have unfunded liabilities in excess of their debt. Underfunded pension obligations alone are estimated to be between $4 trillion and $6 trillion.[9]

A word about pensions

At approximately $20 trillion, underfunded federal, state, and municipal pension obligations are the largest off-balance sheet obligations, save Social Security and Medicare. The problem may actually be more acute, as these obligations are surely underfunded and the liability is potentially more volatile.

While pension funds have largely lowered their expected rate of return from a historical flat assumption of 8% to 7.3%[10],

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[5] To be clear, this does not mean that if such payments were made, we would be debt-free in 30 years. It means that if our debt increases over the next 30 years at the same rate it increased in the previous 30 years (about 7.5% per year), the national debt will be about $100T rather than $245T in 2050.

[6] Total federal unfunded liabilities are $155 trillion according to the U.S. Debt Clock. The difference may be related to both the inclusion of additional unfunded liabilities and imposition of GAAP accounting treatment.

[7] Council on Foreign Relations – The State of U.S. Infrastructure

[8] U.S. Debut Clock

[9] MunicipalBonds.com

[10] Pew Trusts

the nudge is likely not nearly enough. About 25% of pension assets are allocated to fixed income securities. The current yield (December 2020) on an evenly weighted basket of 10-year Treasuries, AA corporates, and BBB corporates is 1.54%. If interest rates remain at historic lows, the non-fixed income portion of the portfolio must return 9.2% annually to meet the 7.3% hurdle rate. A high bar with equity markets at historic levels. Highs, based not on fundamentals (as of this writing the S&P is trading at almost 37.5 earnings, roughly double its historical average), but on the search for yield. Meaning, if interest rates rise, equity returns will fall.

This is just one shortcoming in current estimates of pension liabilities. Two others worth a brief mention:

- Returns on pension assets are typically modeled assuming using constant returns (e.g. asset values march up in straight line at the assumed rate of return). A more accurate stress test would use stochastic modeling to reflect the volatility in returns. Ignoring that volatility understates the risk.
- The mortality and interest rate assumptions used to calculate pension obligations may be overly optimistic (e.g. discounting using interest rates much higher than current rates). This may understate, potentially significantly, the assets needed to support future benefits.

What happens next

To tame debt to manageable levels, including the phantom debt of unfunded liabilities, there are only 3 options:

1. Reduce spending
2. Increase tax revenue
3. Inflation

How do we figure out the best mix?

What could happen

One option would be for policy makers and politicians to take a holistic view of how government works with all of its interconnected, messy entanglements and reimagine a new approach. They could decide to streamline a sprawling bureaucracy, base spending on a thoughtful prioritization of needs rather than political expediency, and gut the tax system to make it more fair and collection more efficient. In the course that effort, they could figure out how to spread the needed sacrifice over time, so that one generation or constituency does not bear a disproportionate share of the pain.

Unfortunately, there is no modern precedent for such action. Perhaps if money were taken out of politics such that all federal and state elections were publicly funded and reasonable term limits were enacted then the proper conditions would at least be in place. However, it is unlikely that anyone alive today will see that come to pass.

What is more likely

Returning to reality, there is little enthusiasm from any quarter to address these issues. To the extent we emerge from our mass consensual hallucination,[11] two competing approaches will likely emerge.

On the right, there will be calls to simply reduce spending. As a practical point, discretionary spending represents only about 30% of all government spending, over half of which is the defense budget,[12] leaving little to cut. And as discussed above, there will be pressure for more spending, not less.

On the left, the loudest voice on the subject is from proponents of Modern Monetary Theory. MMT'ers argue that the government can simply keep printing money with abandon. To the extent GDP growth outpaced the debt growth, this theory would have more merit, but as illustrated earlier, the rate of debt growth is more than double that of GDP growth. With the growth of debt outpacing the economic growth, inflation will eventually occur. MMT argues that inflation can be kept in check simply by sucking up those extra dollars through higher taxes. That works in theory, but is politically impossible in practice; soaking the rich would not be sufficient, tax increases would have to extend well into the upper middle class.

So, with both reduced spending and higher taxes out, that leaves us with inflation. At some point, with inaction on both spending and taxation, pressure will reach such a point that inflation will return, likely to levels at least as high as what we experienced in the 1970s. The $64,000 question is "When?"

Two months? Two decades?

In 5th grade, I began drum lessons at school. At the end of the year, my teacher offered to give me a "B" if I promised not to take drums the following year.[13] My sense of timing has not improved.

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[11] The term "mass consensual hallucination" was coined by science fiction writer William Gibson in reference to what would become the Internet. I first heard it so artfully used in this context by entrepreneur and NYU Stern School of Business professor Scott Galloway.

[12] Congressional Budget Office

[13] The only other drum student was my friend whose last name was "Drumheller." He really was a hell of a drummer. I took the deal.

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