Government Spending — Running on Empty

The central issues of this presidential election is the scale and the scope of government involvement in the U.S. economy, and how to prevent America from going down the path of a sovereign debt crisis. The questions stem not just from the rapid rise in federal government spending in recent years but also from worries about projected increases in future spending on mandatory government programs such as Social Security, Medicare and Medicaid.

Presently, it appears that both political parties are in agreement the current path of deficits is unsustainable, but this is where agreement ends. Some increases in budget deficits are temporary, caused by the slowdown in economic growth following the Great Recession. Below trend growth has led to increases in spending and decreases in tax revenues. Over the past 40 years, excluding the Depression years and World War II, long-term U.S. federal government spending has been about 20% of gross domestic product (GDP) while tax revenues have averaged 18%\(^1\). But in 2011, federal spending exceeded 24% and tax revenues were a little more than 15%. This has left us with a staggering gap of 9% of GDP. Compare this to the eurozone countries who are struggling to keep their deficits under a mere 3% of GDP while simultaneously battling the wrath of bond markets. If U.S. economic growth improves, tax revenues may rise and some spending may fall. But under current law, budget deficits are going to continue primarily for two reasons — composition of government spending programs and insufficient revenues. This week, we focus on the federal government budget; next week we will explore the tax side of the deficit.

The federal budget is divided into approximately 20 major categories and each year the President’s budget and the Congress’ annual budget resolution propose its plans for these 20 functions. We have used data from the Congressional Budget Office (CBO) to group spending into those functions which are discretionary and those considered mandatory under the current laws\(^2\). Social Security benefits for retirees and the disabled, Medicare, Medicaid and several programs for veterans, food stamps, unemployment benefits, plus the interest expense on federal debt are mandatory expenses totaling about 62% of the total federal spending. Nearly two-thirds of the budget is mandatory spending, i.e. expenses we cannot stop making payments on without changing current laws. In addition, spending 20% of the budget on defense expenditures leaves us with less than 18% in non-defense, discretionary spending. In other words, if we were to shut down every single federal department except defense and continue with current entitlement programs, then based on the current stream of revenues, the U.S. would continue to amass debt at the pace of about 4% of GDP per year.

Budget Breakdown

1) Social Security: At $725 billion, Social Security spending is the single largest item in the federal budget and amounts to a little more than 20% of the budget. There is intense political debate

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about the future of this program and any realistic budget plan must tackle the impact of our aging population on this program. Currently, 51 million people receive Social Security benefits and an additional 3.5 million baby boomers become eligible to receive Social Security every year. The total number of boomers hitting retirement age over the next 19 years is expected to be around 70 million. Meanwhile, the proportion of younger people paying into the Social Security fund is not increasing at nearly the same pace. The coverage ratio of those over 65 years to those in the working age group is expected to go from about 1.5 to 1:3 over the next generation\(^3\). This means that at present, one retiree is supported by five potential workers. In about two decades this ratio will fall to one retiree being supported by a mere three working-age adults. The current Social Security rules need to change whether by increasing the retirement age as has been proposed by the Republicans or by raising taxes via the elimination of the cap on Social Security taxes as suggested by President Obama or a combination of both.

2) Defense: The second largest expenditure in the U.S. budget is defense at $700 billion, about 20% of the budget. According to David Wessel of the Wall Street Journal, the U.S. defense budget is greater than the combined defense budgets of the next 17 largest spenders\(^4\). That is, U.S. spends more than the combined military budgets of China, the U.K., France, Russia, Japan, Saudi Arabia, Germany, India, Italy, Brazil, South Korea, Australia, Canada, Turkey, the United Arab Emirates, Spain and Israel. The Budget Control Act better known as “Sequestration” will likely result in defense spending cuts starting in 2013 but it is far from certain whether last summer’s cuts will hold. Worries of a “fiscal cliff” are likely to result in over-turning of these cuts and of kicking the can down the road for a few more years.

3) Health Care Expenditure on Medicare and Medicaid: Another rapidly increasing segment of the budget is Medicare and Medicaid. Together they account for roughly 21% of the budget but are projected to grow rapidly as the baby boomers age. An additional factor causing the rise in Medicare expenses is the soaring

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cost of health care. Between 1987-2007 intensive inpatient services for diseases such as heart attacks were the fastest growing segment of health care spending; but recently increases in chronic health conditions such as diabetes, hypertension, arthritis, kidney diseases and the associated spending on prescription drugs have been the culprit. Republicans have taken the bold but unpopular step of proposing changes to Medicare benefits with the introduction of a voucher system for those under age 55, essentially capping spending. The President’s plan relies on bringing health care costs down and reducing fraud and waste in the Medicare plan, he has not provided specifics.

4) Interest Expenses: In 2011, the U.S. spent $227 billion (6% of the budget) or 1.5% of GDP on interest paid on the U.S. debt. Interestingly, despite a rise in total debt levels interest expense as a proportion of total budget is projected to fall in 2012, as U.S. government continues to fund itself at increasingly lower interest rates. At some point, this is expected to change and debt servicing is likely to become an additional burden on the economic growth process.

Both the Simpson-Bowles Commission on Fiscal Responsibility and Congressman Paul Ryan’s budget raised the level of national awareness and dialogue on budget deficits. The decisions politicians need to make on cutting spending and raising revenues are difficult. The good news is that the matter is still in the hands of politicians and bond markets are not forcing the issue as is the case in Europe. The Obama plan appears to do little to seriously address the expected increases in spending. The President favors increasing revenues by letting the Bush era tax cuts expire for those considered wealthy, limiting deductions and making changes on tax codes for corporations. Analysis has shown that these measures are unlikely to raise enough revenues. His plan doesn’t go far enough to tackle the deficit crisis. It does not take a position on the relatively large potential sources of revenues such as tax expenditures in the U.S. tax code for example, health care exclusions, home mortgage deductions or defined benefit plans.

The Romney-Ryan plan focuses on reducing spending by tackling entitlement programs. While they are willing to make the most of vastly unpopular decisions on Social Security, Medicare and Medicaid, the Republican candidates are reticent when it comes to cutting defense spending for a party running on a platform of controlling debt. Despite collecting record low revenues at a time of exploding debt, they have

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been unwilling to entertain any budget plans which involve increases in revenue. Clearly, a balanced approach is required. As improbable as it may seem, the best team for reducing the budget deficit would be an “Obama-Ryan” ticket. A Democratic plan to increase revenues combined with a Republican plan to control spending could stem the potential explosion of debt. See the chart on the previous page on spending projections from the Office of Management and Budget (OMB).

The past few years of trillion dollar deficits have helped highlight the escalating budget deficit crisis in the U.S. But scholars have been sounding the alarm over the significant spending expected on Social Security programs for more than two decades now. Disagreements over whether federal spending should be near the long-term average of 20% of GDP for the U.S. or near the 24% level that it sits today are a good starting point of discussion. Unfortunately, programs which have been promised to the American citizens for many years — Social Security, Medicare, Medicaid, and a few smaller programs — plus the distortions in U.S. tax code, are structural challenges which will require even greater focus and action on the part of our politicians if we are to prevent a fate similar to those of the debt laden countries in Europe.
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1 Columbia Management Investment Advisers, LLC, Haver Analytics and Office of Management and Budget.
4 David Wessel, “Everything you ever wanted to know about the Budget, but were afraid to ask.” July 20, 2012.
5 Peter G. Peterson, “Will America grow up before it grows old.” 1996.