Aureus Asset Management
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U.S. Budget Deficit and Debt Problems: Is There a Solution?

Summary

The $1 trillion U.S. Federal Budget deficit has attracted both national and global attention. If the deficit's projected growth continues unchecked, we risk severe consequences, including higher interest rates and a prolonged period of anemic economic growth.

A credible plan to reduce the deficit with consensus political support would change the situation dramatically. Last December, the deficit reduction commission, appointed by President Obama, published "The Moment of Truth", which we believe provides the most complete solution to the deficit challenge to date. The report, authored by co-chairs of the National Commission on Fiscal Responsibility and Reform, Alan Simpson and Erskine Bowles, is a thorough examination of the challenges of balancing the budget for the future.

I.

The budget gap, which is the difference between U.S. tax revenues and expenditures, is wider than at any time since the end of World War II. This year, the Congressional Budget Office (CBO) estimates that revenues will be about 15% of Gross Domestic Product (GDP) while expenditures will be around 24%, for a 9% gap. Historically, the gap has been closer to 2% (revenues have typically averaged about 18% of GDP and expenditures closer to 20%).[i]

Revenues are unlikely to improve much near term. While the Bush era tax cuts are scheduled to lapse at the end of 2012 and the CBO assumes that the Alternative Minimum Tax (AMT) is in full effect, it seems more likely that the tax cuts are retained and the AMT is amended (as has happened virtually every year). In this scenario, Federal tax revenues would rise only back to the long-term average of 18% of GDP, even given relatively full employment assumptions.

Total Federal spending should drop in the short term, because of withdrawal from the Middle Eastern conflicts and a lid on non-defense expenditures. However, by the end of this decade, the aging of the American population and the concomitant increase in people drawing their Social Security benefits and enrolling in Medicare, suggests that Federal spending might rise to 26% of GDP. That would mean eventual return to a budget gap of 8% and deficits nearly identical to current levels.

II.

With Republicans absolutely opposed to any tax increases, and Democrats determined to maintain many entitlements, the budget gap seems intractable. However, the Simpson-Bowles report establishes a clear pathway out of this dilemma, and takes a balanced approach:

- To address the revenue side of the equation, the Simpson-Bowles report recommends a complete overhaul of the U.S. tax code, to restrict the use of special deductions which benefit certain groups. Today, such deductions account for $1.1 trillion of lost revenues. The plan would repeal these selective tax benefits and dramatically simplify the tax code.

- With respect to expenditures, the report suggests strict limits on both defense and non-defense spending, while generating its largest potential savings from entitlements:
  - Social Security must be responsive to the fact that Americans are living longer, and many citizens should defer taking benefits for a few years.
  - Medicare must trim its cost increases by cutting payments to providers and by ensuring more efficient use of health dollars.

If all the report's recommendations are adopted, then Federal revenues are projected to rise to about 21% of GDP while spending should decline to about 22-23%, or very close to balance.

Tackling the budget gap may seem hard, because it demands sacrifices. Yet, this plan is sensible and fair. Two factors are responsible for deferring its consideration today:

- First, many people are concerned about the near-term problems of unemployment and weak consumer demand. However, the best way to improve consumer confidence is to demonstrate that we are serious as a nation about our deficit. In contrast to the last financial crisis, in late 2008, today most consumers have started the process of reducing debt and improving balance sheets, and most corporations demonstrate both record profit margins and record amounts of cash. It will be easier today to deal with our true problem, the long-term deficit, than three years ago.
- Second, most politicians are mainly worried about their own constituency (not the nation as a whole), and neither political party wants to support a potentially unpopular agenda before the Presidential election. Only if the citizens insist on a responsible deficit cutting plan will the politicians listen.

Realistically, we believe that the odds favor a political standoff for the next year. After the election, we hope that posturing might give way to compromise and progress. At present, equity valuations seem cheap while bonds seem expensive. However, until the risks of recession and political stalemate recede, we plan to reduce holdings of cyclicals in favor of a more defensive posture. Cash, high-quality fixed income, and alternative investments such as the Aureus Fund, should offset some of the high volatility of common stocks. When we see progress towards a solution of the deficit, we would plan to increase equity and equity-like holdings, providing that those valuations still appear attractive.

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[i] This paper draws on work by The Congressional Budget Office (CBO), as a basis from which to assess the magnitude of the U.S. budget deficit issue. The CBO is a non-partisan group of fiscal experts in Washington with an excellent reputation for economic analysis.