A HOUSE DIVIDED- AMERICAN BUDGET BATTLES

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Captain Miller declares in the World War II film, “Saving Private Ryan”: “Things have taken a turn for the surreal”. (Steven Spielberg, director; 1998)

CONCLUSION

America’s substantial federal deficit problem, both for the near term and over the looming long run, captures headlines. A long march through a thicket of forecasts and fixes reveals the immensity of the deficit and the complexity of the intertwined factors and policies creating the deep fiscal hole. However, advancing through the repair proposals of leading legislators unveils the substantial disagreements in outlook regarding a solution. Even in Washington, differences in political perspectives on “economic” matters sometimes represent really serious sharp splits.

Called to action by the need to seriously attack the issue, confronted by the imminent August 2 deadline for boosting the deficit ceiling, the President, Democrats, and Republicans squawk, squeak, and squirm. Few budget combatants want a default, or even a reduction in America’s credit rating. Matters of principle and 2012 election politics will interrelate both to avoid debt default and to defer any noteworthy substantive resolution of the fiscal challenge. Since such a temporary compromise is not a genuine solution, the United States fiscal disaster will continue to beleaguer financial marketplaces.

Some observers may raise a couple of flags tied into these budgetary struggles. Everyone knows that to promote an economic recovery, America has enacted stimulus measures. What effect did the huge (around $800 billion) stimulus package of 2009 have on the economy, and what is its likely effect going forward? Will public- especially foreign- owners of US government debt obligations and other dollar denominated assets sit contentedly on the sidelines during these budget battles? Especially when the Federal Reserve fervently insists on keeping short term interest rates pinned down!

WARS: 2011 AND 1861

A NYTimes bulletin shouts: “Behind Battle Over Debt, A War Over Government” “Deal Elusive as 2 Parties Cling to Principles About Washington’s Role” (7/15/11, pA1). President Obama hunts for a way to avoid a default in order to “at least avoid Armageddon.” (Financial Times, 7/16/11, p1). To draft legislation to raise the current $14.3 trillion deficit ceiling in time to meet the August 2 target, the President has picked July 22 as the date by which political parties should conclude a deal.

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Manassas. This is not a misspelling of an ironic description of current Congressional generals and warriors in the budgetary conflict. Bull Run. This is not a metaphorical badge for the location or loquacity of the White House, Senate, and House of Representatives.

This year is the 150th anniversary of the start of the American Civil War. The current 2011 deficit feuds of course are minor in comparison to the major issues and horrific carnage of that real war, fought over slavery and an alleged right to secede. Yet present-day deficit quarrels nevertheless involve important topics and principles.

Anyway, the current calendar period and deficit conflicts perhaps evoke the first major Civil War land battle. It was fought very close to Washington, DC, about 30 miles away in Northern Virginia. The First Battle of Bull Run occurred July 21, 1861. The Confederates labeled that clash First Manassas. Bull Run was a dominant stream in the area, Manassas Junction an important point.

This initial battle, won by the South, did not end the war, which lasted another four years. How long will budget battles and large deficits continue? There was even a Second Battle of Bull Run/ Second Manassas, around one year later, on August 28-30, 1862. The rebels defeated the North in this fray too. However, the Union won the war.

How long can Congressional negotiators evade making difficult unified decisions to solve fearsome deficit challenges? A famed Southern general received his nickname during the First Battle of Bull Run. In his biography of "Stonewall Jackson", James I. Robertson, Jr. writes (p264) that Confederate General Bernard Bee yelled: "Look, men, there is Jackson standing like a stone wall! Let us determine to die here, and we will conquer! Follow me!" In present-day budget wars, how long should a dogged negotiator stonewall its adversary in order to achieve partisan goals?

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With the election of 2012 on the horizon, another American military history anniversary beckons- the 200th anniversary of the War of 1812 against Great Britain. Though some believe America prevailed, many believe the conflict ended in stalemate. The British burned Washington on 8/24/1814.

BUDGET BATTLEFIELD: THEATER OF OPERATIONS

Before he became President, Abraham Lincoln stated in regard to the slavery issue: "A house divided against itself cannot stand." ("A House Divided"; June 16, 1858 speech in Springfield, Illinois).

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Entitlement programs exist as a category within the United States budget. Though these policies do not result from laws of Nature or divine decree, many beneficiaries are in no hurry to surrender or alter their rights. "Entitlement" issues in a more general sense of the word weave through the debates. For example, to what extent is a given clan of taxpayers entitled to lower taxes?

The concept of rights involves ideas of obligations. In general and over time in America's democracy, political rights and obligations, as well as economic ones, should be in approximate balance. When entitlements in this extended view of the word greatly exceed the national (collective) inclination to adequately cover them, shocking sustained fiscal deficits can appear. And current proposals fiercely promoted by most legislative generals and their valiant soldiers do not eliminate a growing deficit over the next ten years (or longer). At best, they only slow its accumulation.

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The complex issues and extensive details of actual and proposed federal budgets can bury readers. Budget models reflect diverse opinions and inputs and therefore produce an assortment of results. Yet let's first highlight some items from the nonpartisan US Congressional Budget Office (CBO budget documents are worth digging into in much further detail).

Look at the "CBO's 2011 Long-Term Budget Outlook" (6/22/11). There's a crucial point lurking in the summary. Both the CBO's baseline and alternative fiscal scenarios unveil substantial deficits looking forward. Most marketplace players and legislators probably would call the baseline situation bad, the alternative one very bad (even terrifying).

The extended-baseline scenario is close to current law. It includes the expiration of tax cuts enacted since 2001 and extended in 2010. Under the baseline approach, government revenues reach 23 percent of GDP by 2035. This percentage of course does not please most fans of modest taxation and smaller government. In any event, "debt would increase slowly from its already high levels relative to GDP…from an estimated 69 percent of GDP this year to 84 percent by 2035". ("Summary", p x). According to "Federal Budget Math: We Can't Repeat the Past" (Presentation at the NY Fed on 6/16/11 by the CBO Director), in the baseline scenario, debt held by the public grows from 2010's 62.1pc to 75.6pc in 2021. This "percent" refers to the percentage of debt held by the public. It does not include debt held by trust funds and other government accounts, which together with debt held by public, makes up gross federal debt. (See "CBO's 2011" Table 1-2, p8; also footnote 13 at p13.). The bottom line is that even with higher revenues, the deficit still grows.

Under the alternative fiscal scenario, federal debt grows much more rapidly. By 2021, debt held by the public exceeds 100pc of GDP. It will surpass its historical peak of 109pc by 2023, and approach 190pc in 2035. ("CBO's 2011 Long-Term Budget Outlook", p x). According to this model, tax cuts enacted since 2001 and extended in 2010 continue further. In this alternative universe, revenues remain near the long run historical average of 18pc of GDP. Yet many current Congressional players want to raise revenues, especially from rather affluent individuals and overly benefited corporations and others.

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President Obama's proposal offers no budgetary improvement relative to the baseline scenario for the period from the present up to 2021. As a matter of fact, it probably worsens the budget situation relative to the baseline.

Start with the CBO's "An Analysis of the President's Budgetary Proposals for Fiscal Year 2012" (April 2012). In its Table 1.5, "CBO's March 2011 Baseline Budget Projections" from 2012 to 2021" the deficit increases by a total of $6.7 trillion. By comparison, it leaped about $1.3tr in 2010, with projected jumps of $1.4tr in 2011 and $1.1tr in 2012. Under the President's budget, the deficit grows by a total of $9.5tr over the 2012-2021 span (Table 1.3). It thus rises over the baseline deficit by about $2.7 trillion. The Administration estimates the deficit growth under its plan will be $7.2tr, or therefore around $500bb over the baseline (p7)

"Federal Budget Math" points out that the 1971-2010 average deficit as a percentage of GDP is 2.8pc. Some may wonder why there's not more effort to establish an average of balanced budgets, or even an occasional surplus. In any event, in 2021 under the CBO's March baseline forecast, the deficit edges up further, to 3.1pc. For 2021, the President's plan results in a 4.9pc deficit relative to GDP. A graph in "Federal Budget Math" indicates that the federal deficit in 2021 is over six percent for a "Continuation of Certain Policies" (this "continuation" probably is the alternative fiscal scenario or one close to it).

The CBO's April 2011 "An Analysis of the President's Budgetary Proposals for Fiscal Year 2012" is consistent with the view that the budget situation deteriorates under the Presidential plan. See Chapter 1, p2, Table 1.1. Debt held by the public as a percentage of GDP in 2010 was

62.1pc. It advances to 75.6pc in fiscal year 2021 in the baseline view, yet runs up to 87.4pc in the President's.

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According to "Federal Budget Math", under the main Republican Budget proposal (Representative Ryan) for 2022, outlays still exceed revenues. Under the key Republican plan, the overall federal debt then increases in absolute terms at a two percent rate (p13; a footnote states the Ryan figures are not "precisely comparable" to the latest baseline projection or the President's budget). But under the Republican Party's own document ("The Path to Prosperity", 4/5/11) there still is a budget deficit in every year from 2012 through 2021, though it claims the 2021 shortfall will be 1.6pc of GDP, with debt held by the public at that time only 67.5pc of GDP (See for example, "Appendix I" Table S.1).

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Some high-powered fiscal talk has focused on potential net budget savings via some mix of spending cuts and revenue additions. Many discussions concentrate on the next 10 years as a time frame for such savings. In these (often behind-the-scenes) debates, the total net sums to be saved over that decade have fluctuated between two and four trillion dollars.

Regardless of any dollar objective, strategies differ regarding how much spending to cut and how much revenue to bring in. Duels continue regarding which spending programs should be slashed and by how much, and which revenue sources are best. Assorted constituencies and their lobbyists influence and join the strife.

Suppose Congressional skirmishers partly overcome their substantial differences in economic visions and are able to agree on savings. The political parties are not themselves entirely unified. Both the Democrat and Republican sides have fractures. Nevertheless, assume divisions between and within America's political parties will not sabotage the agreement.

However, recall that under the baseline scenario ("President's Budgetary Proposals for Fiscal Year 2012"; Table 1.5, "CBO's March 2011 Baseline Budget Projections" from 2012 to 2021") the deficit increases by a total of $6.7 trillion. Suppose there's a remarkable agreement to save four trillion dollars relative to this benchmark. Even if this significantly reduces the percentage of debt held by the public relative to GDP (especially if nominal GDP increases considerably), that four trillion dollar savings would still not halt deficit growth in absolute terms. A reduction in the level of impending growth in the deficit is not the same as actually destroying that upcoming deficit increase. Besides, even a savings of two to four trillion will not solve the large deficit problem for the period after 2021.

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Regarding any cut triumphantly agreed to in Washington, viewers must ask whether the reduction is versus the baseline scenario, the alternative fiscal scenario, or some other benchmark. If versus the alternative script, the four trillion dollars in total savings is much less significant. In any case, onlookers should wonder about other issues. In new legislation, are the revenue gains specific and mandated? Are spending rivers definitely designated and guaranteed to be reduced or eliminated? Won't it probably take at least quite a few months to accomplish a noteworthy overhaul of America's complex tax code? Beware of vague savings via elimination of alleged waste, or due to hypothetical efficiency gains. If solutions depend on newly created bipartisan study groups, that may result in eventual notable agreement- but probably nothing definite in the near term.

In all the efforts to win the future and create paths to prosperity (and to avoid roads to ruin) where is talk of means to achieve budget surpluses (over any time horizon)? Budget deficits are not inevitably or eternally required as part of notions of fiscal prudence, are they?

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If a victory over severe near and long term budget problems is not currently likely, at least the warring camps can leave their foxholes and arrange a truce designed to last for a while. Postpone major budget battles now, renew them later!

Hence the appeal of a measure like Senator McConnell's plan. If enacted (and if constitutional), it enables an increase in the debt ceiling (borrowing limit) and thereby avoids the dangerous default outcome. However, this plan is merely a cosmetic solution to severe deficit problems.

This scheme allows for a debt limit increase between now and the 2012 presidential election. The White House will request from Congress three debt limit increases of $700-900bb each between now and the election. If Congress rejects the requests, the President could veto the denial. Only a two-thirds majority can overturn the veto; so the debt ceiling increase will require only one-third of the lawmakers to agree. In the current Congress, enlisting a two-thirds majority willing to override the veto is unlikely. Under the McConnell plan, the President is supposed to specify spending cuts of the same amount as the debt limit increase. However, Congress does not have to approve proposed spending cuts prior to the debt limit increase.

BOOMING DEFICITS=BLOOMING RECOVERY?

The Congressional Budget Office in May 2011 published a little-noticed study titled "Estimated Impact of the American Recovery and Reinvestment Act ["ARRA"] on Employment and Economic Output from January 2011 Through March 2011". Congress enacted ARRA in February 2009. The CBO analysis details consequences in addition to first quarter 2011.

Initial estimates placed the budget deficit consequences of the ARRA legislation at about $787 billion for the fiscal 2009 through 2019 period. The CBO now concludes that total bill will reach about $830bb. Relative to one year of nominal GDP (2010 GDP), ARRA's overall cost was quite large, equaling about 56.6pc ($830 billion/$14.66 trillion.

The CBO's Table 1 (p3) indicates a range for ARRA's boost to real GDP for various calendar years and quarters. Take the midpoint of the estimated ranges. Half of the bill's impact occurred in fiscal 2010 (which ended September 2010). For calendar year: 2009, GDP growth derived from ARRA was 1.4pc. In 2010, ARRA tacked on 2.9pc to real GDP recovery. The 2011 full year addition will be 1.5pc (1Q11 2.1pc, 2Q 1.8pc, 3Q 1.3pc, 4Q only .7pc). However, the expected 2012 upward push from the Act is a mere .2pc. Thus the economic boost from ARRA, especially after 3Q11, will dwindle.

ARRA reduced unemployment. For example, it slashed the calendar 2011 unemployment rate level by almost one pc.

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Identifying and tracing causes and effects between economic variables involves and engenders waves of theories and a variety of conclusions. The CBO does not engage in some further interesting arithmetic and its implications. In any event, one reasonably can attribute some of America's economic growth to this deficit-creating ARRA legislation.

US real GDP dropped 2.6pc in calendar 2009. It grew 2.9pc in calendar 2010. In first quarter 2011, it increased 1.9pc (annual rate; 4Q10 rose 3.1pc annualized). (Bureau of Economic Analysis, 6/24/11, Table 1). Subtract the corresponding aid from ARRA noted above. Calendar 2009 real GDP declines four percent (-2.6pc less 1.4pc). Calendar 2010 falls to zero (2.9pc less 2.9pc). And first quarter 2011 ebbs from a modest increase to a decline of .2pc (1.9pc less 2.1pc). Thus the ARRA deficit spending campaign played a key role in reducing economic weakness and promoting recovery.

America's 2009, 2010, and 2011 GDP improvement derives partly from a less than secure foundation- a barrage of incremental government borrowing and spending. What happens when that helpful push via deficit spending from ARRA (or other sources) ceases?

Of course deficit spending is only one consideration regarding the substance and likely duration of the current recovery. Let's not omit the Federal Reserve's money printing barrage (two gigantic rounds of quantitative easing) and its sustained low interest rate rampart. Keep in mind that the Federal Reserve has been a key purchaser of Treasuries and thus a crucial financer (via the money printing game) of the budget deficit. It doesn't matter if Fed captains bought previously sold old US debt as the public acquired newly-issued bills, notes, and bonds. That only makes the Fed's deficit financing path an indirect one. The Fed declared a ceasefire for quantitative easing as of end June 2011.

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The ARRA legislation is not the tax act of December 2010, which also sought to heal economic damage and encourage a recovery ("Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010"). This legislation (extension of the 2001 and 2003 income tax cuts, payroll tax reduction, and other measures) also has a multibillion dollar deficit consequence (some estimate it at $850 billion). In any event, this additional stimulus (and sustained enormous deficit spending in general) likewise probably will not produce eternal economic growth. With Treasury interest rates near the ground, how long will lenders keep happily lending to the US government?

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Suppose deficit spending decreases. Or, imagine the US finds it more difficult to finance impending deficits. In either case, the US probably will not generate anything more than mediocre real GDP over the near term. The risk of renewed recession is significant.

A HOUSE DIVIDED

Abraham Lincoln's "house divided" remark has its origin in the Bible. Jesus preached (Mark 3:24-25): "And if a kingdom be divided against itself, that kingdom cannot stand. And if a house be divided against itself, that house cannot stand." Matthew 12:25 warns: "Every kingdom divided against itself is brought to desolation; and every city or house divided against itself shall not stand."

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In the Civil War, so-called neutral nations such as Great Britain and France were quite interested in the war's outcome. America is not divided or cut off from the rest of the world, especially these days. In regard to the US's current budget battles, not only its citizens but also countries around the world closely monitor events and trends. Like sovereign debt problems on the European periphery, America's fiscal issues have global implications. Plus what occurs in debt and interest rate theaters has implications for stocks, currencies, and commodities. For example, if the American deficit crisis worsens significantly, what will the collateral damage be? Will stocks in the US as well as overseas nosedive? Will there be a renewed assault on the dollar?

Pull out binoculars on the budget in regard to overseas holders of US Treasury debt. According to the “Treasury Bulletin”, (June 2011, Table OFS-2 “Estimated Ownership of U.S. Treasury Securities”), America’s total public debt at end 1Q11 was $14.27 trillion. Of this, $8.31tr was privately held. Federal Reserve and intragovernmental holdings thus equaled just under $6.0tr. Some might refer to the Fed and intragovernmental inventory as being in strong hands (not likely to be fearfully sold).

The foreign and international group held $4.48 trillion of the total public debt. This is 31.4 percent of the total public debt, a substantial share. Moreover, these overseas holdings represent nearly fifty-four percent of the privately held debt total. Treasury statistics for April 2011 (TIC reports) show total foreign holdings of $4.49tr. Foreign official holdings were $3.21tr (China $1.16tr, Japan $.91tr, oil exporters $.22tr). Thus foreign official holdings are about 71.5 percent of the overall foreign and international category, and about 38.6pc of the total privately held amount (divide $3.21tr by 1Q11’s $8.31tr).

If the US keeps running huge budget deficits, or if explosive long term deficits look more and more certain, how eager will foreigners (official or otherwise) be to own Treasuries (or at least big stacks of Treasuries)? Why risk being a casualty? The US may not be the European periphery, but look what recently happened to interest rates there. Will many foreigners say enough is enough and decide to retreat at least a little bit? From the overseas vantage point, and even allowing for some merit in “flight to quality” justifications for owning US Treasuries, keep in mind current Treasury yields. Also, imagine if the dollar slumps even further from its recent record lows (broad real trade-weighted dollar; monitor cross rates as well). Will foreign holders of dollar-denominated assets be joyful?

Perhaps foreign official holdings in general represent owners that are rather unwilling to liquidate existing supplies of Treasuries. Yet some circumstances may encourage some net official selling. Anyway, how enthusiastic will they be regarding substantial net additions of Treasuries to their ample stockpiles? In any event, foreign holders outside of official spheres concerned about America’s deficit troubles may elect to be net sellers or reduce their net purchasing rate.